

Chapter 4 : Literature Review

This Chapter provides review of the important characteristic that make the Futures Contracts successful

4.1 Review of the Futures Contracts Success Factor

Financial futures and options, alternatively known as financial derivatives, have emerged in response to price volatility in financial markets (*Keith Redhead 1990*). Since the beginning of futures trading, contracts have been devised for a large number of underlying commodities and financial instruments. Many of these contracts have succeeded, but, also, many have failed. Eurodollar futures are vastly more successful than certificate of deposit futures. It is interesting to ponder why one futures contract success and another fails - why one has an average daily trading volume of 100,000 contracts, for example, while another has less than 500.

The following have been found to be the most important characteristics that make futures contracts successful (*New York Institute of Finance 1989*)

a. The supply of and demand for the product or financial instrument must be large.

Otherwise, too few people will care about the price to generate the broad interest that is needed to sustain active futures trading. Large supply is also an important deterrent

to price manipulation. Consider that both hedgers and speculators would be reluctant to trade contracts that could easily be manipulated by others with greater financial resources.

b. Different units of the underlying item must be interchangeable.

This is a prerequisite for the development of standardised, transferable contracts, which are, in turn, a prerequisite for active, liquid markets. One of the great advantages of futures contracts is that traders need not worry about which particular Treasury bill or bar of gold they are trading. Once the contract specifications are agreed upon, all contracts are equivalent. Certain potentially useful futures contracts (such as real estate futures) have never been developed because of the inability to standardise units.

The items that underlie a successful futures contract need not, and indeed cannot, be strictly uniform, as the live cattle and live hog futures contracts prove. One hog is not identical to another in the same sense that every Swiss franc is identical to every other. What is important is a degree of standardisation that is both narrow enough to be consistent with commercial realities and broad enough to include the required breadth of supply. A contract specifying delivery of “a hog” would never get far. Few buyers would, so to speak, purchase a pig in a poke. On the other hand, a futures contract specifying that the hog must weigh exactly 185 pounds and be 221 days old would be too restrictive to permit liquid trading. Striking the correct balance between

standardisation and breadth of supply is one of the major challenges for designers of futures contracts.

c. Pricing of the underlying item must be determined by free market forces, without monopolistic or governmental control.

No single buyer, seller, or regulator should have such influence on prices. This is one reason why there is no Moscow Futures Exchange. When prices are fixed by the government there is little incentive to hedge because the price will not change except by government decree.

This situation may sound appealing from a planning perspective but problems arise if the price that has been fixed by the planning authorities is too high or too low. Expected future prices not only permit planning -they also influence planning. For example, if a government agency sets the price of soybeans too high, farmers will produce a huge surplus; if it sets the price too low, there will be a shortage. The economic advantage of freely traded futures markets is that they are more likely than are centralised planners to react appropriately to changing market conditions and outlooks and are more likely to help keep supply and demand aligned. Few things highlight the difference between free market economies and planned economies more starkly than the existence of thriving futures markets in the former and their complete absence in the latter.

d. Prices must fluctuate.

If they are stable, or almost so, then there is no incentive for hedgers to hedge and no incentive for speculators to participate in the market. Interest rate futures would not have been a success in the 1950s as they have been in the 1970s and 1980s because the stability of interest rates during the earlier era would have been a disincentive to both hedgers and speculators.

e. The contract should have the support of commercial interests.

Hedgers contribute greatly to the volume of trading in any futures contract. Their activities, including the making and the taking of delivery, also provide an important link to the underlying cash market, without which prices might be subject to disruptive speculative forces. Of particular importance here is participation by dealers. Dealers are those who trade the underlying commodity or financial instrument for short-term profit and are an important lubricant in the machinery of any market. Once they come to use a futures market as a central pricing point, its success is virtually guaranteed.

f. The futures contract must be supported by a well-capitalised group of traders on the exchange floor.

This is particularly important from the perspective of commercial hedgers, who tend to trade in large quantities and expect enough liquidity on the exchange floor to accommodate these quantities. If this liquidity is not present, and exchange will have difficulty attracting the commercial participation necessary for a contract's success.

g. The futures contract must be sufficiently different from other existing contracts to attract speculative participation.

“Me-too” contracts are all but doomed to fail, as we have seen time and again since the mid-19670s when the success of interest rate and stock index futures contracts spawned a multitude of unsuccessful financial contracts. From the perspective of most speculators, one long-term interest rate futures contract is pretty much the same as another. Fixed-income professionals may distinguish between 10-year and 7-year Treasury notes, but few speculators care about the difference. Where a particular type of futures contract (e.g. long-term U.S. government interest rates) is established and active, it is very hard to induce speculators to forego existing liquidity and trade another contract that is simply a slight variation on the established theme.

These characteristics are crucial to the success of a futures contract, but they certainly do not ensure success. Futures contracts are products, like automobiles and tickets to baseball games, and products seldom sell themselves. **Effective promotion is usually necessary, and some futures exchanges are better than others at promoting their contracts. The time of a contract’s introduction is also important.** Futures exchanges must compete with securities exchanges, the real estate market -essentially the entire spectrum of trading and investment possibilities. If opportunities abound elsewhere, a new futures contract may have difficulty attracting attention and participation. Weighing all these factors to develop and maintain a roster of active contracts is one of the key challenges that every exchange must face. Exchanges that adapt existing contracts of that

introduce appropriate new contracts as economic conditions change will thrive; those that are less responsive will languish or even disappear from the futures scene.

4.2 Review of Financial Futures in Malaysia.

An economic environment characterised by growing uncertainties in the world's financial markets, sharp increases in the amount of government debt, and greater financial interdependence among nations have caused exchange and interest rates to become increasingly volatile.

Such Global impetus in the development of financial futures markets is likely to continue with the emergence of other Asian markets within the decade. In particular, Malaysia's introduction of financial futures at this juncture is therefore timely especially with the country's growing development of treasury, capital market, fund management and other financial activities. (*Benjamin Foo,1995*)

Apart from the fundamental risk management benefits of financial futures and its contribution to the country's financial futures and its contribution to the country's financial services capability, Malaysia's introduction of financial futures has other positive economic ramifications. It is not merely the launch of a few new financial products but rather a whole new industry. The accompanying multiplier effect would mean added demand for office space, job creation, new career options, development of new skills and technology, increase use of banking and telecommunication facilities, new business

opportunities for education providers, conference organisers, systems developers and information vendors, and inflow of foreign earnings.

4.2.1 Prospect Of Malaysia's Financial Futures Market

While the economic benefits are apparent and hopes may run high, the key question on the minds of domestic and international participants is ultimately that of the prospect of the Malaysia market. (*Benjamin Foo, 1995*) The criteria for success that may be present in the Malaysian market.

b. Sound Regulatory Framework

A very fundamental existing criterion for success is the sound regulatory framework which has been developed for the Malaysian context after careful evaluation of other regulatory environments. Malaysia, being a former British colony, has broadly adopted the internationally recognised British accounting standards and legal system. These have been in force (with modifications) since independence in 1957, and have served the country well. Malaysia's Companies Act requires proper disclosure to protect the interest of minority shareholders. These include the annual audit and publication of accounts, rules pertaining to directors' conduct, and the disclosure of substantial corporate interests. Aggrieved shareholders have recourse to the Malaysian courts according to the Companies' Act and common law.

The Malaysian market is regulated by the Securities Commission (SC) and the KLSE. The tight regulation of the market ensures that minority interests are protected; for

example, the purchase of an asset through an issue of shares has to be approved by the SC. The SC will determine whether the purchase price and the proposed issue price of the new shares are fair. The need for SC approval means that many transactions by listed companies are often slower to complete than those on other bourses but this is compensated by better protection of minority interests.

- **Role of Security Commission**

Under the Futures Industry Act 1993, the Securities Commission has regulatory jurisdiction over financial futures and Options exchanges and trading activities. As self-regulating exchanges, both MME and KLOFFE also have comprehensive rules to govern member's financial condition, regulate trading activities and protect customer interests. In addition to the high level of management expertise available at both MME and KLOFFE, representatives of broking members are also required to undergo professional training, examinations and licensing. With both exchanges clearing house, the Malaysian Derivatives Clearing House, there is also added security from the combined financial contribution of members of both exchanges.

Securities Commission : Business Plan 1995 - 1997

The Securities Commission (SC) undertook a year long review of the legal and regulatory framework of the securities industry in the country. The purpose of the exercise was to “promote and maintain fair, efficient, secure and transparent securities and futures markets and to facilitate the orderly development of an innovative capital market”

SC produced an outline of the Business Plan for 1995-1997 which lays down the deliverables at which the proposed regulatory reform is targeted as well as the strategies for achieving them is set out over a period of three years. This plan has shown commitment of the Government in developing the Financial Futures market in Malaysia.

- **Bank Negara Malaysia Rules on Derivatives Deals (*BNM Guidelines*)**

Malaysia's new rules, issued by BNM on July on derivatives, seen by many as part of the priorities' plans to develop Kuala Lumpur as a regional financial centre have received a mixed reaction from Banks.

The rules mean dealers no longer have to obtain approval for each derivatives transaction. Banks will be able to transact and trade derivatives with their customers, provided they have adequate systems and controls in place and the business has been approved by the board of directors. End-users no longer have to seek approval on every deal, as long as the transactions are trade-related. However, banks will have to comply with ruling - and some, onerous -of requirements.

BNM is taking the initiative and taking a positive stance on derivatives by issuing these guidelines and amended the rules on the basis of the replies.

Banks that want to be dealers will need :-

- Their board of directors' approval for -and oversight of -derivatives trading;

- Adequate system;
- An integrated risk management process, and
- A comprehensive set of internal controls and audit procedures.

Also, they will only be allowed to offer derivatives for hedging purposes. Speculation and leveraged products are banned. In terms of products, interest rate, foreign exchange and equity derivatives are allowed but commodity derivatives are not.

Banks that want to use derivatives only for their own purposes, e.g., for asset/liability management or for hedging particular exposures, are subject to a less stringent set of guidelines. Another major implication of the new rules is the recommendation that banks develop their own risk management expertise, rather than simply relying on overseas dealers. In a letter accompanying the new guidelines, BNM “strong encourages” Malaysian banks to develop the necessary risk management skills in house rather than intermediating for foreign dealers.

To bring Malaysia’s legal industry up date on the changes, BNM, the Malaysian Bar Council and the Malaysian Institute of Banks organised a conference on derivatives documentation in October. At the conference, BNM assistant governor Rafiah Salim said: “I fear that with the recent deregulation of derivatives business under our guidelines, the banking community may find that the necessary legal expertise and skills are not available in Malaysia. As a last resort, the banks may have to source such legal assistance from abroad.”

c. Unique And Relevant Products

With products that are unique and commercially relevant, the prospect for success should be also enhanced.

- **KLCI Futures Contract**

Kuala Lumpur Composite Index (KLCI) Futures Contract with a contract value calculated by multiplying the KLCI by RM100. It is also be the first South East Asian Stock index instrument and the fifth Asian instrument of its kind after Japan's Nikkei 225, Nikkei 300 and Topix and Hong Kong's Hang Seng. The contract will undoubtedly have a natural appeal to a broader base of customers especially individual investors in view of the widespread familiarity and involvement in the stock market. With the greater volatility of the KLCI futures as compared to KLIBOR futures, higher margin deposits are likely to be required for trading KLCI futures. This may place some capital constraints that could moderate some retail interest. Among institutional users, fund managers, and arbitrageurs are likely to be interested in the KLCI contract. Interest especially from the retail sector, can be expected to be much more subdued for future KLOFFE products like options on the index and on individual stocks.

- **KLBOR Futures**

Thus far, many interest rate futures contracts of various tenors and currencies have been launched. However, KLBOR futures marks the first Ringgit interest rate futures contract in the world. It will be the first South East Asian short-term interest rate instrument and the third Asian instrument of its kind after Euroyen in both Japan and Singapore and

HIBOR in Hong Kong. With KLBOR futures, banks, corporations and fund managers are now able to manage their Ringgit exposures more effectively. With any financial institutions trading large amounts of money market products in the Kuala Lumpur Wholesale Money Market including banks which are members of MME and possible interest among Singapore financial institutions, there should be reasonable demand for the product to achieve a good start-up.

Money market instruments in Malaysia comprise mainly negotiable Certificates of Deposits (NCDs), Bankers' Acceptances (Bas), Malaysian Treasury bills (MTBs), KLIBOR Deposits, Bank Negara bill (BNB), Malaysian Government Securities (MGS) and Cagamas bonds (CAG). The annual volume of these money market instruments have been on a rising trend for the last three years (Appendix I). The healthy growth clearly reflects the interest of international investors in these instruments and the growing importance of Malaysia as a regional financial centre. During these years, KLIBOR has been one of the most actively traded money market instrument. The total money market volume of RM912,346 million (Appendix J) making it the most traded instrument.

The volatility of market rates as shown in (Appendix J) raises concern among treasury managers with exposures in Ringgit-denominated money market instruments, including loans and deposits. With the introduction of KLBOR futures, it could lead to the growth of short term OTC (over-the -counter) interest rate products such as FRA's (forward Rate Agreements) and IRSs (Interest Rate Swaps). This is because the FRAs and IRSs can easily be priced off the KLIBOR futures. Thus, the KLIBOR futures not only address

their need for an appropriate hedging vehicle to cover their interest rate risk but will also provide a catalyst for further growth and competitiveness in the Malaysian financial and capital markets. This, in turn, will support the industrialisation of the Malaysian economy and meet the demands of international finance.

While participation from individual investors is expected to be minimal for short term interest rate products, interest from such investors can be expected to grow when MME ventures into currency futures at a later stage.

d. Market Liquidity

Next to the soundness of a market and the relevance of its products, one of the most critical ingredient for success is the initial build-up of market liquidity. Customers, especially international institutions, will always want to be certain that they can get in and out of the market instantly at anytime. No matter what such overseas customers may say, they can mostly be expected, with rare exception, to wait and see. The ones in building initial liquidity is therefore squarely on corporate members, individual members (locals) and domestic institutions to give active support by market-making, trading and hedging from day one. **Locals could be expected to contribute up to 20% to 30% of the market volume, usually trading proportionally more in stock index rather than interest rate products.** If members and domestic institutions hesitate in supporting the markets, it may lead to a long uphill task for the markets to develop liquidity and attract overseas customers. Given the large pool of broking members who have direct business

interest in the underlying spot markets, they are certainly in the position to use and make markets in such related derivatives products and to promote them to other users.

e. Wide Broking Network

Another very positive factor which can be expected to contribute to market success is the large base of corporate broking members. MME has 22 corporate members comprising banks, finance -related companies, stockbrokers, money brokers and commodity futures brokers. KLOFFE has 40 corporate members comprising companies in stock-broking, financial services, capital markets and others. With such a large number of broking members both in Kuala Lumpur and other cities, the wide broking network should definitely be quite effective in marketing and servicing a large pool of customers in Malaysia.

f. Profitability and Financial Strength

In addition to a large broking network, it is also essential to the overall financial soundness and success of the marketplace that prevailing conditions are conducive to broking members' growth in financial strength by their capability to run profitable operations. Given the limited availability of experienced staff and brevity of the preparatory period for members, some may find it tough even to be operationally ready on time. It is not unlikely that certain members may be remain dormant while others may find it slow to break-even if their business flow does not commensurate with premium paid for experienced or expatriate staff. In view of the natural appeal of KLOFFE products to individual investors, however, its members may have some edge over MME members in developing

profitable operations in a shorter period. More common memberships permitted between both exchanges would certainly help lower operating cost while possibly increasing turnover from added products. Profitability levels may be raised if members are permitted to increase their turnover by cross marketing other international financial futures products to serve the trading interests of a wider customer base.

The impact on the profitability of broking operations may also be affected by the degree to which the marketplace is dependent on overseas business. A membership base with greater international partnership could serve to secure a higher level of additional commitment in supporting, promoting and using the market. However, this appears not to be so and a tinge of uncertainty exist among international participants concerning membership distribution. With comparatively minimal foreign participation in exchange memberships, the linkage to overseas participants does not appear to be strong. Trading contribution by overseas institutions to the market as a whole, as such, may be initially subdued, and profitability could also be affected if domestic demand is insufficient to support the large base of brokers. Nevertheless, some members may be assured of benefiting proportionally more than others from overseas business as a result of their futures experience and connections. While the initial membership may be fairly large, at the end of the day, those with the most efficient mix of shareholders, capital, expertise and business will make their mark as major players in the Malaysian market. Others, in any case, are likely to find appropriate niches as competitive market forces shape the industry. Overall, the potential and prospect of the Malaysian financial futures market is certainly very good. In addition to ascertaining the market's prospect qualitatively, perhaps we can

venture further to qualify two possible indicators of market success watched by potential international participants: average daily volume and open interest.

Average Daily Volume

Any futures contract averaging a volume of 10,000 lots traded a day can be considered a liquid and mature contract by most standards although many contracts far exceed such levels. International participants tend to prefer a liquidity of at least 5,000 lots a day but are likely to trade in a market with less liquidity if the product is highly relevant to them or offers a cost-effective alternative. In the Malaysian market, it is likely that the demand for KLCI futures would exceed that for KLIBOR futures as there are more participants in the stock market than the money market. With the KLCI's higher intraday volatility, more trades can also be expected from KLOFFE locals (individual members) as compared to MME locals. However, as open auction trading better facilitates locals activity, trading by KLOFFE locals may be slightly moderated by their use of an electronic trading system.. On the other hand, though, financial institutions in the money market have the means to trade sizeable KLIBOR futures positions. With these favours in mind, the initial liquidity of the MME market may range between 50 to 1,250 lots a day in the first month. At KLOFFE, initial liquidity may range between 1,500 to 2,500 lots a day in the first month. Such numbers, especially the upper range, would be indicative of a very good start.

(Benjamin Foo 1995)

While, given its relative infancy and growth potential, no one is writing the market off, murmurs of discontent among local players are beginning to be heard. “ The authorities

decided to about a slow and steady approach to the launch of the market rather than the Big Bang debut that many were hoping for. Progress has been slow today. (*John Duggan 1996*)

Open Interest

Open interest is the number of outstanding contracts that are not closed out at the end of a trading day but are held to overnight by market participants. It is indicative of the level of commercial hedging activity and also the level of customer confidence in the financial soundness of the marketplace. Open interest tends to build up beyond the daily volume over time. Unless users of KLCI futures are hedging or position trading, they are unlikely to want open positions in view of its high volatility. As such, open interest in KLIBOR futures could potentially be greater initially if banks are willing to hedge or take positions in the contract which may not be very volatile. Initial open interest of 500 to 3,000 lots for each of the market in the first month be quite good.

As at 12 September, open interest in the futures stood at 1507 contracts. The period between 16 August to 12 September recorded an average daily volume of 325.3 futures contracts. The reason for the slight drop in open interest and average daily volume is mainly attributable to uncertainty in market direction. The month ahead should be far more positive for the futures market. If the Federal Reserve raise the Federal Funds rate by 25 basis points, bringing it to 5.5%, such an action is likely to produce a gut reaction in the futures but any selling is likely to be short-lived for the following reasons :

(*Christopher A Podbury*)

- i) Malaysia is likely to experience over the last quarter of this year capital inflows emanating from foreign fund managers reducing US equity exposures, and rising their South-East Asian equity exposure
- ii) Countries such as Malaysia, are likely to be far better in attracting foreign funds than other South-East Asian neighbours (for example, Thailand), whose stock market had not performed nearly as well as Malaysia's over the last nine months;
- iii) Malaysia's GDP growth continues to be encouraging. The 1996 second quarter year-on-year GDP of 8.4% was commendable.
- iv) Malaysian companies continue to show higher corporate earnings.

Based on these reasons, we foresee that prospects for the futures market. In addition, the announcement of a reduction in margin levels required by the Malaysian Derivatives Clearing house (MDCH) for trading futures contracts on the KLOFFE from RM7,500 to RM6,000 per contract, effective 10 September 1996, should be successful in promoting further retail investment in the futures market for the rest of the year. (*Christopher A Pobury 1996*).

g. Government Support

The Malaysian government is actively promoting the financial services industry, of which the KLSE is an integral part. Its emphasis on competition and the private sector as growth stimulators has boosted the KLSE through the listing of privatised companies.

The authorities are also encouraging greater sophistication of the market through KLOFFE and MME. The private debt security (PDS) market has also been growing rapidly. The issuance of convertible loan stocks allows investors to participate in instruments with both debt and equity features.

In order to establish Kuala Lumpur as a major financial services centre, the government has relaxed restrictions on foreign fund managers operating in Malaysia. This, together with ability of the Employee Provident Fund (EPF) to invest a larger percentage of their funds in the market, has created greater interest in the local bourse.

4.3 Malaysian Economy Review

Malaysia's real gross domestic product (GDP) growth in the second quarter of 1996 was sustained at an annual rate of 8.4% compared to 8.3% in the previous quarter. For the half-year period, the economy register a deficit of RM798.4m, down markedly from 1995's first-half of RM5.6bn. Positive indicators include the strengthening of the Ringgit against the Japanese yen and slower imports partly due to the curb on consumption spending. RAM expects the current account of Malaysia's balance of payments (BOP) to improve from -7.8% of the Gross National Product (GNP) in 1995 to -7% this year and -6.7% in 1997. Import growth is anticipated to decelerate even more sharply from last year's 24.7% to 16.6% this year. This means that Malaysia's trade deficit will decline to RM7.1bn this year from RM9.19bn in 1995.

Compare to 1995's GDP growth rate of 9.6%, the 8.4% growth rate is a welcome change, easing fears of an overheated economy after eight years of consistently strong economic growth. The impressive performance of the Malaysian economy, growing at about 8 to 9 percent per annum in the past eight years, the longest period of sustained high growth experienced ever since independence. This is attributable to the adjustment measures undertaken to bring the economy into even keel after a serious recession in 1985 and a dismal growth in 1986. During the recession both per capita income and government revenue contracted while unemployment escalated to pre 1980 numbers. The economy then could be summarise as commodity-driven, uncompetitive, over regulated and less liberal. On reflection the 1985 recession forced Malaysians to undertake a major soul-searching exercise i.e. the need for speedy structural adjustments and to manage the economy on the basis of its fundamentals.

Among others, the following measures were undertaken during the period of 1987 -1990:-

- A tax reform resulting in a reduction of corporate taxes from about 45-48 percent to about 30 percent now.
- Allowing the Malaysian Ringgit to be determined by market forces resulting in some depreciation.
- Permission for foreign equity to reach 100 percent if exports exceed 50 percent.
- Waiving of licensing requirements for small and medium scale industries.
- Fiscal policy bent on strong controls on government expenditures and debt, privatisation and focusing expenditures on infrastructure, skill training and R&D and encouraging savings. (*Dr Sulaiman Mahbob, 1995*)

Consequent upon these measures, the economy rebounded by leaps and bounds. In particular foreign investments accelerated to unprecedented levels. Overall per capita income doubled between 1986 and 1994 rising from US\$1595 to US\$3406.

For the past several years Malaysian had been successful in attaining rapid economic growth with reasonable price stability despite a tight labour market. This has been made possible through a tight monetary policy and a fiscal policy addressing the issue of supply bottlenecks as well as through more liberal imports such as of labour, investment goods and food.

The facilitation of further economic growth with price stability require that we address issues related to the efficiency level of our distribution system, services and public transport so that we are able not only to attain sustained growth of 8-9 percent in the next few years but do so with reasonable price stability, a pride that we as Malaysian like to keep. Towards this end, the financial liberalisation implemented by the Government is a right move to encourage savings and strengthen our capital market. So far the policy makers have been remarkably successful. The Malaysian Stock market has outperformed those of Singapore and Thailand marvellously. This year, performance of the Malaysian bourse increased by 10% against a 15% decline in Thailand and 8% fall in Singapore.

(Source : Economic Report, Ministry of Finance Malaysia)

4.3.1 Foreign Exchange Policy

In an article Co-published by Peregrine Fixed Income Ltd in *The Finance Asia volume 1 Issue 2 October 1996* entitled “*Thailand and Malaysia : a tale of two deficits*” illustrate that Malaysia is capable of implementing Exchange Policy that is beneficial to the development of its country.

Malaysia manage to turn its current account woes around so fast is attributed to its more flexible exchange rate policy. Recognising the difficulty -if not impossibility -of controlling both interest rates and the exchange rate at a time when international capital flows are much freer than they were, **Malaysia appears to have opted for a strategy of “flexible switch” between the two, depending on prevailing liquidity conditions.**

When foreign capital is flooding the economy Bank Negara lets market forces strengthen the Ringgit, while it concentrates on keeping domestic interest rates high. But, when capital begins to flow out, the central bank steps in to prop up the currency, allowing the resultant tighter liquidity to push interest rates up. **The outcome : a strong Ringgit coupled with high interest rates in Malaysia.** This strategy worked so far. A strong currency might not help Malaysia’s exporters in the long run but, in the short term, it does have a favourable effect on the trade balance expressed in Ringgit. It also helps to offset the impact of capital inflows on local liquidity, which is just what an overheated economy needs. Similarly, higher interest rates mean less spending, which in turn lowers imports and reduces the trade deficit. All of this adds up to a rosier picture for the current account. The policy package looks rational and credible- at least credible enough to calm the nerves of foreign investors. As a result, Malaysia has been spared the sudden, massive

capital flights to which other Asean countries now appears vulnerable and making the development of Futures market crucial in achieving its aim to become the Asian financial hub.

4.4 Conclusion

With all the positive characteristics the financial futures in Malaysia possessed in terms of government support, strong economic growth, competent government policy and unique products, why is the financial futures not taking-off in Malaysia ? The biggest problem confronting the exchange is the absence so far of committed local players. (*John Duggan 1996*) . A number of factors behind this are cited.

- The general lack of familiarity with the concept of derivatives in general and futures in particular had been underestimated by the authorities, and both acceptance and understanding will take some time to cultivate.
- The impact of the Barings fiasco is felt here. Many have been frightened off from derivatives because of the perception that they can bring about the fall of entire institutions.
- KLSE's settlement arrangements require payment for shares only seven days after the initiation of a transaction ($T+7$). "Cash market players in Malaysia get a large amount of natural gearing as a result of $T+7$ which effectively means that they can trade for seven days in a particular stock and achieve a gearing of ten times on the index for as

little as RM50. This has naturally taken away much of the appeal of the futures market.

A survey on Financial Institutions was done by MME to determine the factors that holds the FI back from participating in the Financial Futures. The survey results showed that commercial banks are most active in the KLIBOR futures market and the financial institutions showed positive views towards entering the futures market. **Results of the survey depicted that the main factors holding back the FI were compliance with the new BNM guidelines and to find the appropriate risk management system.** The MME survey covered only the FI in the 3-month KLIBOR futures market.

As pointed in the literature review, the local institutions is lack in making up the liquidity in the market, this project paper hence, hope to cover also the NFI to understand better the factors holding them back from participating the financial futures.