CHAPTER 1

INTRODUCTION

1.1 DEFINITION

"A bond is a debt instrument requiring the issuer (also called the debtor or borrower) to repay the lender/investor the amount borrowed plus interest over some specified period of time" (Fabozzi, 1988). A typical bond has the following features:

1. **Par value**: The par value of a bond is the face value of the bond. This is the amount repaid to lender at the maturity of the bond.

2. **Coupon interest rate.** The bond indenture usually obliges the issuer to make fixed periodic payments of interest to the lender. The interest payments are made annually (or more typically every six months). The coupon interest rate is the fixed periodic interest payment divided by the par value expressed as a percentage. The coupon interest rate

is usually fixed, but few bond offerings also carry floating interest rates e.g. some basis points over and above the bank lending rate. Some bonds covenants, however, do not require any fixed interest payments but are usually issued below par value, like the Bon Simpanan Malaysia issued by Bank Negara Malaysia in 1992. Such bonds are referred to as zero-coup on bonds.

3. **Maturity date**. Bonds usually have a maturity date on which the par value is repaid. The maturity date can also be viewed as the date on which the bond will cease to exist.

Recent years saw a great insurgence in the number of new financial instruments and bonds in particular. Apart from the general features listed above bonds can have either one or more of the following:

4. **Options**. Some bond issues have options embedded in them which give either the issuer or the lender an option to take action before the maturity date of the bond. If the option gives the issuer a right to retire the debt partially or in full before maturity, the option is called a call option. If

the right is vested on the lender, it is called a put option. A put option may be convertible i.e. giving the bondholder an option during a specified period in the life of the bond to convert it into a specified number of ordinary shares.

5. **Warrants.** Alternatively the bond may be issued with a warrant, which gives the holder the right to purchase a designated security at a specified price. Usually warrants are detachable and may be sold independently.

In Malaysia, the private bond or private debt securities market is relatively young and although Malaysian firms had been more cautious in the amount of debt they take, recent studies have indicated that firms are now willling to take more debt and take advantage of the tax deductability of debt interest (Hew, 1993/94).

1.2 BRIEF HISTORY OF MALAYSIAN PRIVATE DEBT SECURITY MARKET

Before the mid 1980s, the only bonds in the Malaysian Capital Market of significant value were the Malaysian Government Securities (MGS). The Government had issued these securities to finance its development expenditures. The market for these bonds has been described as "captive", as the Government, while it wanted to ensure a stable, non-inflationary and cost effective source of funds, made it mandatory for provident funds, financial institutions and insurance companies to commit a certain proportion of their investments in MGS. The effect was that these captive institutions held these MGS until maturity and hence there was no secondary trading in them.

Since the late 1980's, conditions in both the Government and the private sector preempted changes in the bond market. Firstly, the Government embarked on its privatization scheme, reducing its participation in the economy and paving the way for the private sector to be the main engine of economic growth. The efficiency with which the privatization was handled and the robustness of the new institutions set up to oversee the economy led to the elimination of budget deficits. The net additions to the existing supply of MGS is now negligible. Secondly, the fast economic growth and increased demand for Malaysian goods, both at home and abroad, provided new opportunities for businesses. The huge capital requirements of large projects required additional financing from sources distinct from existing ones.

The above two factors paved the way for the development of the private-debt securities (PDS) market in Malaysia. In the former, either existing laws specifying the amount of MGS these captive organizations should hold were modified, or new ones allowing them to invest in other safe assets were put in place. In the latter, the unwillingness of some institutional investors to invest in the risky new ventures also provided an impetus towards PDS financing.

Cagamas Berhad was established in December 1986 with the objective of developing a secondary mortgage market to bridge this gap between the demand for and supply of funds. Incorporated by Bank Negara Malaysia (BNM), commercial banks and finance companies, it issued the first PDS in Malaysia in 1987. In that year, Cagamas issued RM325 million worth of debt securities to investors, consisting of RM100 million in bonds and RM225 million in promissory notes. Since its debt securities qualified as liquid assets as stipulated by BNM, most of the captive institutions turned to it to satisfy their statutory holding requirements. Due to the enthusiasm with which these first issues were received in the market, the amount of

PDS increased almost six fold to RM1,859 in 1988, with Malaysian Industrial Development Finance issuing RM50 million of these and the remaining issued by Cagamas.

As a first step to facilitate the orderly development of the primary and secondary markets for PDS, Bank Negara Malaylsia issued a set of guidelines in December 1988 for the issuance of such securities. The objective of the guidelines was to clarify the basic legal and administrative framework for bond financing. The main criteria included the following:

1. Minimum shareholder funds of the issuer must be RM25 million.
2. Disclosure of proceeds utilization and sources of repayment.
3. Minimum size of an issue was set at RM50 million.
4. Underwriting requirements.
5. Debt-equity ratio of the issuer must not be more than 2:1.

In addition, a one-stop centre was set up in the Banking Department of BNM to process all applications for bond issue. Although some of these requirements have been amended and new ones incorporated, they formed part of the general criteria by which issues were evaluated. A prospectus was also required for an issue if the number of subcribers is not less than ten and if the issue is not placed with the prescribed corporations (defined as licensed financial institutions, insurance companies, provident funds and statutory bodies).

The net amount of funds raised through the issue of PDS in the capital market rose to RM1,903 million in 1989 as compared to RM1,859 million in 1988. Of this amount, Cagamas issued unsecured bearer bonds worth RM1,250 million.

The year 1990 represent a milestone in the history of the PDS market. A wider variety of new financial instruments were introduced and Rating Agency Malaysia (RAM) was incorporated in November 1990, the first credit rating agency in Malaysia. The first Islamic debt instruments were also issued during that year based on the Al-Musharakah principles. Altogether net issues amounted to RM2,278 million. In 1991, the amount of funds raised through PDS in the capital market amounted to RM1,841 million (net). This was due to the fact that a large number of firms anticipated a cut in interest rates and issue commercial papers in the money market (instruments with maturity period of one year or less) to save on financing cost.

In 1992, PDS net issues amounted to RM3,132 million, marking yet another year of rapid growth in the market. There were large issues in all major types of securities of conventional bonds, convertible bonds, Islamic bonds and Cagamas bonds, with Cagamas issues hitting an unprecendented level of RM2,115 million. In the same year, Bank Negara Malaysia made it mandatory for new issues of PDS for its consideration to be rated by RAM and score an investment grade of BBB for long term papers and P_3 for short term papers.

The Securities Commission (SC) was set up in early 1993 to absorb the powers of the Capital Issues Committee (CIC) and Panel on Takeovers and Mergers (TOP). It put an end to the fragmented system of regulation. SC's functions were defined in the Securities Industries Act of 1983 (amended 1993) and include the orderly development of the Capital Market and the promotion of Kuala Lumpur as a regional financial centre. Net issues fell to RM1,975 million, with Cagamas issuing the largest amount. There were no issues of Islamic Securities that year. In general 1993 was not a very impressive year for PDS.

In 1994, the situation reversed as net issues in PDS soared to RM7,160 million as issuers expected a rise in interest rates and "locked in" longer term funds with lower interest. Another possible explanation for the upsurge is the greater increase in the number of large infrastructural projects and increased securitization by financial institutions. Table 1.1 shows the amount of funds raised in the capital market from 1985 - 1994.

As 1995 moves on, there has been an increasing relaxion of the rules governing the capital market and an announcement of a second rating agency to complement the efforts RAM. Initiatives have been taken to both strengthen and expand the PDS market in Malaysia.

TABLE 1.1

FUNDS RAISED IN THE CAPITAL MARKET, 1985 - 94

	TOTAL FUNDS	PUBLIC SECTOR	PRIVATE SECTOR	SHARES	DEBT SECURITIES
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: Mansor Md Isa (1994)

1.3 JUSTIFICATION

As mentioned earlier, Malaysian firms are now willing to take on more debt to finance operations and long term capital requirements than previously. This could be partly due to the realization that financing through debt is a cheaper source of funds than equity financing and hence would lead to an increase in the value of the company, at least up to a certain point before the cost of debt outweigh its benefit as advocated in capital structure theory. During the last seven years the amount of PDS in issue increase by more than ten fold (refer to Table 1.1). The increase is noted not only in absolute terms but also relative to other forms of financing such as equity and bank lending. By 1987, the amount issued constituted 22.19% of private capital raised. In 1994, it increased to 46.74%. Despite this formidable increase in the amount of debt issued, and hence its increasing role as a mode of financing in the Malaysian economy, no study has yet been made at the MBA level to study the subject.

The justification for the study is therefore two fold: First, it is an attempt to look at this fast growing and exciting area of finance in the Malaysian context.

Second, it is hoped that the study will act as a source of encouragement to other finance students to look at this subject, especially in areas where the study is not able to sufficiently explain due to the constraints of time, space, data etc.

1.4 OBJECTIVES

The objectives of the study are as follows:

1. To conduct an analysis of both the amount of PDS and the percentage of issued capital they constitute.
2. To study the yields on Malaysian PDS over time and compare them to the return on ordinary shares and long-term government bonds
3. To analyse returns on PDS and KLSE Composite Index to see if superior investment performance can be achieved by combining the two types of securities
4. To study the regulatory framework of PDS to identify possible factors that inhibit its development to its full potential.

1.5 SCOPE

The study will cover the period from 1987 to 1994. It cannot cover earlier periods because the first PDS were issued only during this period (as reported by Bank Negara). Where data for some part of 1995 is available, it will be incorporated in the study.

The study will only cover PDS and hence issues of government securities will be completely left out, except in instances where it is felt that a comparison helps to further clarify a point under discussion.

1.6 ORGANIZATION OF STUDY

Chapter 1 gives a brief history of the Malaysian bond market, the reasons for the first Cagamas bonds and how the market develop into its current status. The Chapter also includes justification of the study, its objectives and scope.

Chapter 2 looks at the various type of bonds available and includes a brief discussion of how they are rated.

Chapter 3 is concerned with the methodology of the study. Basically it attempts to answer three questions. What are the sources of the data used in the study? What types of data from the sources are used? How are the data analysed to obtain results useful for reporting purposes?

Chapter 4 presents the findings of the study and puts forward investment strategies for increasing eturn while reducing risk or leaving it unchanged, or, reducing risk while return remains the same.

Chapter 6 concludes the report and discusses the major findings of the research paper, its contributions, limitations and also put forward suggestions as to how future researchers can improve on the study.