

## CHAPTER 5

### PROBLEMS AND PROSPECTS OF THE MALAYSIAN BOND MARKET

#### 5.1 INTRODUCTION

The Malaysian bond market has experienced very rapid growth since the late 1980s. By the end of 1994, the PDS market alone is worth about RM6 billion, excluding RM4 billion Cagamas bonds and RM2 billion short term debt securities issued under various types of issuance papers (Yan Lin, 1994). With the economy continuing to grow at its present pace and the vast amount of funds needed to finance this growth, the prospects for the bond market are very bright.

Although the corporate bond market in Malaysia is growing, in terms of absolute size it is still a relatively small market (Wong, 1994). In fact, some of the very huge capital requirements could not be satisfied by the local bond market within a short time and issuers had to seek for foreign funds. There are some problems that inhibit the development of a more sophisticated bond market.

This chapter attempts to discuss these problems and prospects of the local market. Although a very comprehensive treatment of the topic is beyond the scope of this research paper, an attempt will be made to treat it in a manner consistent with the study's scope. The problems will be dealt with in Section 5.2 and prospects in section 5.3.

## **5.2 PROBLEMS OF THE BOND MARKET**

The Malaysian bond market is still relatively young inspite of its recent, rapid growth, and hence there is room to increase efficiency, breadth and depth. A number of factors have been attributed to the inhibition of growth of the PDS market by pundits and critics alike. While this section does not provide an exhaustive treatment of these factors, it does elaborate on the major ones.

### **5.2.1 LEGAL, REGULATORY AND ADMINISTRATIVE**

Like most countries that have experienced very rapid growth and have recently established official bourses to enhance financing and liquidity in the economy (recent refers to bourses established after World War II, as opposed to the more mature markets which achieved considerable development even before the turn of the

century), a number of institutions were set up in Malaysia to ensure free, fair, stable and orderly markets (Ariff and Johnson, 1990). The regulatory framework of the PDS market in Malaysia is spread over numerous legislations, regulations and guidelines (Business Times, 1993). The institutions currently involved in the process and the functions they perform, is given in Table 5.1.

TABLE 5.1

**INSTITUTIONS AND THEIR FUNCTIONS IN PDS ISSUES**

AUTHORITY	MAIN FUNCTION
RAM	Assign credit ratings to the bonds. This process takes between six and twelve weeks
BNM	Evaluates PDS proposal on the basis of guidelines
SC	Evaluates PDS proposals. Fixes pricing of bonds (From December 1995, this responsibility lies with the issuer)
ROC	Checks compliance with prospectus and trust deed requirements in Companies Act
KLSE	Formulates the administrative processes for the listing of PDS on the exchange

Presently it takes about six to nine months to bring a PDS issue to market (The Sun, 1995).

There are also numerous statutes that govern the issue of PDS. A study undertaken by Price Waterhouse Associates, funded by UNDP (United Nations Development Programme) has concluded that the regulatory framework needs to relax certain issuing guidelines to encourage more issues and reduce the approval time. Currently, issues must comply with provisions in the Securities Industries Act 1983 (SIA), Company's Act, Banking and Financial Institutions Act (Bafia), Exchange Control Act, Securities Commission Guidelines on Issue of Debt Securities, and the KLSE Listing Requirements if the issue is to be listed. The study also found some inconsistencies among all the legislations and guidelines governing the PDS market (Business Trends 1992). Even though the establishment of the SC has consolidated some of these functions and bodies, there still exists some amount of duplication of efforts (Mansor, 1995).

As market conditions can move against the interest of the issuer of underwriter if the approval process is unduly long, there is need for a one-stop agency to expedite the approval process. It has been argued that one of the reasons larger Malaysian companies seek to raise money in the developed bond markets is the ease and speed of arrangements compared with the local PDS market (Mansor, 1995).



To be competitive against the more mature markets, approval time should be shortened to under three months. To achieve such a target the legal and regulatory framework needs to be overhauled by reducing the regulatory bodies, relaxing guidelines and move towards disclosure based policies.

#### 5.2.2 LACK OF THE DEPTH AND BREADTH TO SATISFY SOPHISTICATED BOND INVESTORS

The success and development of any market depends on how well it satisfies the requirements of market players. This statement is true not only for commodities markets, but financial markets as well. One of the arguments often levelled against the Malaysian PDS market is that it lacks the variety in maturity profile of debt securities to satisfy the requirements of investors. Generally the number of instruments present is small and the majority and most popular ones have equity-linked options, reflecting Malaysian investors preference for equity investment. The features of the existing instruments are small, and the maturities are generally less than twelve years. Some institutional investors, for example, pension funds, may require instruments of longer maturity.

It has often been argued that Malaysian investors are not ready for more complex or intricate debt instruments which are currently used in overseas markets. The geographical distance that traditionally separated financial markets the world over has been eliminated due to the convergence of computing and communication technologies, and, large institutional investors which possess the kinds of funds financial markets require for continued existence, now think in terms of 'global diversification'. The introduction of new instruments, especially those that provide improved features in terms of cost, pricing, liquidity and safety will promote greater competition in the market place. The focus should shift from regional to global competitiveness of Malaysia's bond market.

Another feature currently absent from the Malaysian bond market is the futures market. For the emergence of an active and healthy secondary market in bonds, a bond futures market must be developed. This is necessary to enable investors to hedge their positions in the cash market (if they so choose) as well as provide much needed liquidity (Thillainathan, 1994). The required cash outlay for futures trading is very low (5% or less of the contract value) whereas the required investment for trading in the physical asset is the face value of the contract. It is the marked

difference in the required size of investment funds that makes the futures market a more liquid market than the cash market. This illiquidity of the cash market has discouraged both genuine investors and speculators. The genuine investors are discouraged because of the lack of a futures market makes it impossible to hedge their physical position, while speculators shy away because of the large investments involved.

Besides being an illiquid market, one can only have a long or square position in the cash market but not a short position, unless when the bonds sold are borrowed. If shorting is impossible as it is in Malaysia, market makers only trade in the cash market on the basis of ones views on the direction of change of interest rates. If the dominant view is for a rise or fall in interest rate, players willing to take the other side may be difficult to find. While there can be a concensus on the direction of change of interest rates, there cannot be such an agreement on the shape of the yield curve. One can then trade the yield curve. Trading the yield curve will entail the simultaneously purchase and sale of bonds of different maturities. Such a strategy could be expensive or impossible in the cash market. On the other hand, in the futures market, the contract provides for the purchase or

sale of the underlying instrument for delivery at some future date at a pre-agreed price. Therefore, in the futures market, there is no problem in buying and selling bonds of different maturities simultaneously and hence on trading the yield curve. With the opportunities that a futures market offers for trading the yield curve and shorting, the depth of the market will be enhanced (Thillainathan, 1994).

#### 5.2.3. LOW SUPPLY OF DEBT SECURITIES

In Malaysia, equity financing has always been the popular means of raising corporate capital. Malaysian companies have always been suspicious of debt. Even though the amount of debt financing has grown during the last few years, the gearing ratio in most Malaysian firms is still very low. Table 5.2 shows the financing structure of some selected industrial companies listed on KLSE. If only long-term liabilities are considered, then 88% the operations of the companies is equity finance, leaving on 12% for PDS (Mansor, 1995) Figure 5.1 provides a comparison of financing over the years. The debt ratio of most developed countries is about 60% though as high as 80% in Japan (Brealey and Myers, 1991). According to Mansor (1995), studies have indicated that the pecking order for capital in

TABLE 5.2

CAPITAL STRUCTURE OF A SAMPLE OF KLSE LISTED COMPANIES (1980-93) (N=71)

YEAR	SHORT TERM LIABILITIES %	LONG TERM LIABILITIES %	COMMON STOCK %	PREFERRED STOCK %	RETAINED EARNINGS %
1980	38.11	6.78	34.22	0.13	20.76
1981	34.42	6.84	35.53	0.09	23.12
1982	33.95	6.69	36.84	0.08	22.44
1983	26.13	6.74	31.54	0.05	35.54
1984	28.83	8.00	30.71	0.04	32.64
1985	29.46	7.79	30.20	0.04	32.51
1986	28.63	8.89	30.98	0	31.50
1987	26.80	8.98	33.88	0	30.34
1988	26.57	6.59	31.47	0	35.37
1989	27.24	7.08	29.38	0	36.30
1990	28.28	8.83	28.47	0	33.92
1991	35.62	10.80	30.36	0.14	23.08
1992	29.98	10.25	26.10	0.11	33.56
1993	28.96	10.23	24.99	0.09	35.73
AVERAGE	30.25	8.18	31.05	0.06	30.48

Source: Mansor Md. Isa

Malaysia is internal funds, followed by equity via rights issues, and lastly debt. Figure 5.1 shows the capital structure of a sample of 71 companies listed on KLSE from 1980 to 1993.

**FIGURE 5.1: CAPITAL STRUCTURE OF 71 COMPANIES LISTED ON KLSE**



The low debt ratio of Malaysian firms can be attributed to a number of factors. Until very recently, a large part of companies in Malaysia, and that of South East Asia, were family businesses. Naturally, these conservative managers would want minimal external intervention or participation in their businesses. Therefore, they finance all operations from internally generated sources or from personal sources rather than from issuing debt. The second reason is the shortage of financial management talent in the companies. Debt finance is a much more cheaper source of raising funds and less risky than equity financing, since debt interest payments are tax deductible and debtors by law to be settled first before any payment can be made to equity investors in a liquidation. The encouragement debt

financing will not only bolster the bond market, it will also increase value in the share market.

Another reason for the predominance of equity financing in Malaysia is the vast number of profitable opportunities existing in a very dynamic economy. The Far East has now become the centre of economic activity and profitable investment projects are rife. In fact, even adopting a more expensive mode of financing has left projects to be very profitable. This situation cannot continue to eternity and later, most opportunities would have been utilized and the financing issue will have to be put in its right perspective for continued survival.

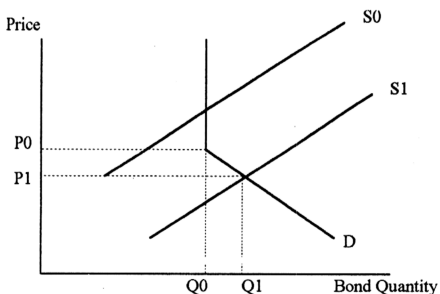
#### 5.2.4 LACK OF BENCHMARKS FOR PRICING PURPOSES

The successful development of the PDS market depends on a well developed secondary market. Unfortunately, the secondary market for PDS is very thin. A common explanation for this thinness of trading is that there are no efficient benchmarks in the price and yield discovery process. Riskless MGS, which is suppose to provide such a frame of reference, is captive and cannot play rightful role in the yield and price discovery process. MGS is thinly traded, not regularly issued and lacks

liquidity required to play such a role. Even where MGS can provide a yield structure, Thillainathan (1994) argues that such a yield is artificial and cannot be used as a benchmark.

Figure 5.1 explains Thillainathan's contention. By statute, certain financial institutions, the insurance companies, provident and social security funds, including

FIGURE 5.1:  
PRICE DETERMINATION OF MGS SECURITIES



Source: Thilainathan



the EPF and SOCSO, are required to hold MGS by statutory requirements. With a captive market for MGS the demand curve for PDS will be kinked. The supply curve on the other hand will be normal. This is shown in the diagram.

Since certain financial institutions are required to hold  $Q_0$  amount of bonds, the demand curve for bonds will be a vertical line at bond prices of  $P_0$  and above and normally sloped at prices below  $P_0$ . If supply is  $S_0$ , then equilibrium will occur in the inelastic segment of the demand curve. If the supply is  $S_1$ , then equilibrium price and quantity will be given by the intersection of supply and demand curves along the normally sloped segment of the demand curve. In the 1980s because of the heavy government borrowings, the MGS price and quantity were determined in the normally sloped segment of the demand curve because supply was abundant. Recently the government has been posting near balanced budgets and supply is stationary. Because of the large number of financial institutions the linked demand curve, has moved rightward. It is believed that demand - Supply dynamics have led to intersections in the captive segment thus causing rising prices and declining yields. The prices and yields provided by such benchmarks

are therefore artificial and should not be allowed to provide a lead in bond price determination.

### **5.3 PROSPECTS OF THE MALAYSIAN BOND MARKET**

The debt market in Malaysia is the most developed in the ASEAN (Association of South East Asian Nations) region both in terms of size and maturity profile (Thillainathan, 1994). The growth has been dramatic from an average of less than 10 listed issues in 1988 with an average monthly trading volume of 2.5 million units and an average value of RM3 million, the average of listed issues have grown to over 40 with an average monthly volume of 56 million units and an average monthly value of RM72 million in the first three quarters of 1995. Such growth can be expected to continue considering the general economic climate and initiative undertaken by the government to propel its growth.

Malaysia's plans to build large infrastructure projects over the next five years could help kickstart its bond market. According to estimates, at least RM35 billion would be needed to fund highways, power plants, the first phase of an international airport and a light rail transit. The huge capital requirements and the long term duration of such projects require funding from capital markets (Asiamoney,

June 1994). The PDS market should be accordingly organized to meet such challenges.

The general nature of bond financing has inherent advantages over bank financing. Through financial disintermediation, PDS have proven to be a more cost-effective and efficient source of financing for borrowers. Corporations needing funds can, by issuing debt securities, obtain these funds direct from the investing public. By eliminating the financial intermediaries, borrowers are spared the cost that banks incur in meeting statutory and liquidity requirements. The borrowing process becomes more efficient and firms can save 0.5% to 5% margin depending on market liquidity and perception of risk (RAM 1995). Conventional bank borrowing also involves restrictions by single customer limit and capital adequacy ratios in meeting the financing needs of their customers.

The imminent transfer of Hong Kong to Chinese rule has preempted many fund managers previously stationed in Hong Kong to relocate their corporates within this region. Huge sums of money are involved and a decision to come to Malaysia would boost the bond market.

The following are some suggestions as to what measure government can take, in addition to those already taken to further develop the PDS market:

1. Enhance market liquidity by reducing the amount of funds captive institutions should hold in MGS, allow short selling and introduce a bond futures markets.
2. Relax the legal and administrative framework governing the issue of PDS by establishing a one stop centre to process issues and reduce the statutes need to be satisfied. Approval times will be shortened and issuers and underwriters risks reduced.
3. Regularly issue various MGS of different maturities, yields etc. in large amounts to be used as benchmarks for pricing purposes. Alternatively AAA rated corporate bonds such as Cagamas issues can be used as bench-marks.
4. Reduce transaction costs for issuers who must comply with prospectus and issuing guidelines. Commissions in trading can also be reduced at the level of the mature markets.
5. Educate the market in evaluating project risk and encourage information motivated market makers by encouraging information vendors to provide analytics.
6. Promote market awareness and greater transparency in a general move towards disclosure base reporting.

7. Facilitate electronic fund transfer in addition to the up-to-date clearance system in place.
8. Encourage local portfolio managers to seek more advance training in bond portfolio management to be able to compete with foreign fund managers on equal footing.
9. Co-recognition of both local and international ratings. This will encourage local agencies (a new rating agency is about to be set up to complement the efforts of RAM) to attain international standards of performance.