

CHAPTER 2

TRENDS AND CHALLENGES



Trends and Challenges

The Malaysian capital market is currently at the crossroads of change. Given the rapid evolution of global financial markets, it is vital at this stage for a clear and objective assessment of the domestic issues as well as global trends that affect the capital market and the effectiveness with which it performs its function. This section is therefore intended to provide such an assessment, as well as the key implications of these trends on the future of the Malaysian capital market.

THE PROGRESS THUS FAR

Over the last few decades, the Malaysian capital market has undergone significant change, reflecting: the increasing role of the private sector in catalysing domestic growth; the continued developmental efforts of the government and market authorities; and the increasing globalisation and integration of international financial activity. The process of issuing and trading securities in Malaysia has evolved over the years from informal dealing to the complex organised system that is seen today. Among the several key areas in which the Malaysian capital market has seen substantial development are:

- Growth in fund-raising capacity
- Expansion of capital market products and services
- Application of internationally benchmarked practices
- Establishment of a robust regulatory framework

The combination of these factors, coupled with the country's strong economic fundamentals, comprehensive supporting infrastructure, presence of a pool of educated and talented professionals, and cost-competitive operational resources have all combined to create an attractive investment environment for both domestic as well as international investors. Despite the setbacks in the growth path experienced during the financial crisis of 1997–98, these strengths represent cogent factors in favour of the future development of the capital market.

Growth in Fund-Raising Capacity

Until the late 1980s, capital market development related mainly to serving the growing funding needs of the Malaysian government. During this period, government securities issues accounted for nearly three-quarters of the funds raised in the capital market, which was spent on public-sector investments. With the privatisation programme of the late 1980s and early 1990s providing impetus for the greater shift in responsibility for driving economic growth to the private sector, the capital market has since taken on increasing importance in financing private business expansion. As a result, the capital market has

witnessed a significant amount of change and development, and now assumes a vital role in the raising of funds by the Malaysian private sector (Figure 1).

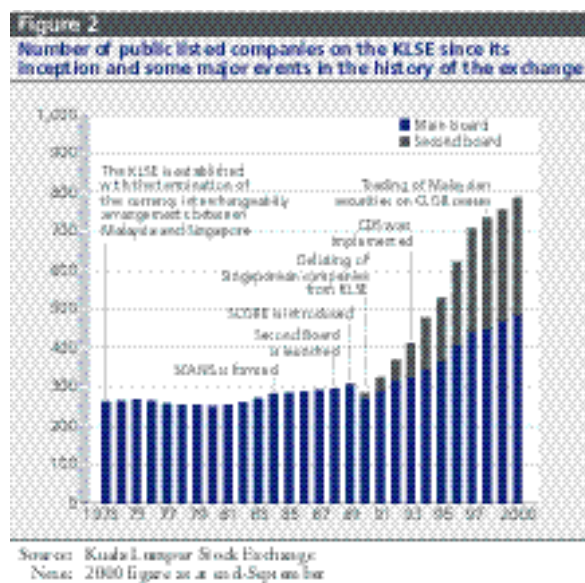
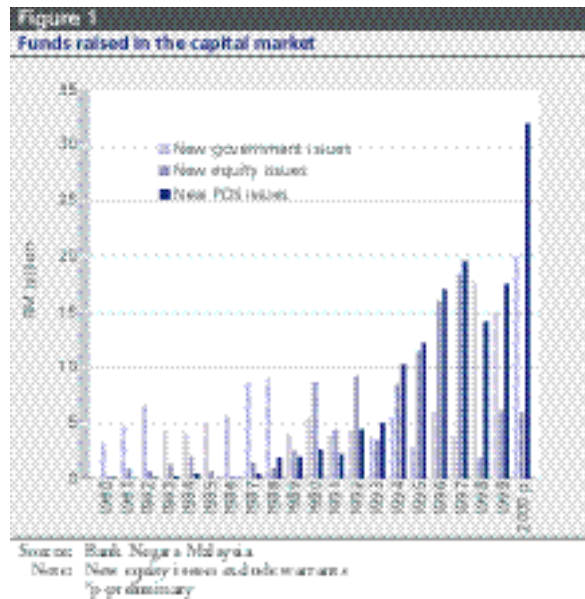
Equity market

The equity market has seen significant development thus far. During the 1980s and early 1990s, significant improvements were made to capital market microstructure. Much of this focused on building the capacity of the equity market, which saw a rapid succession of structural improvements, especially in its trading, and clearing and settlement systems. The Kuala Lumpur Stock Exchange (KLSE) introduced a computerised clearing system in 1984, followed by real-time price and information dissemination in 1987. Trading was soon automated through a screen-based trading system, the System on Computerised Order Routing Execution (SCORE) in 1989. This paved the way for a fixed delivery and settlement system (FDSS) in 1990 and the immobilisation of share scrips in the Central Depository System (CDS) not long after.

The equity market saw its growth accelerate over the 1990s. The Second Board, which was launched in 1988, picked up greater momentum over the subsequent few years, thanks largely to the dramatic increase in liquidity during the “super bull-run” of 1993–94 and the Second Board run-up in 1996. At the same time, the listing of several major privatised companies played a major role in the surge in the overall market capitalisation of the KLSE from RM132 billion in 1990 to RM807 billion in 1996, an increase of over 500% in six years. This made the KLSE the third largest bourse in the Asia-Pacific (ex-Japan) after Hong Kong and Australia at the time.

Following a sharp decline during the East Asian crisis, the size of the stock market recovered to RM489 billion as of end-September 2000. Nevertheless, the number of new issues continued to increase steadily, as reflected in the growth in the number of counters listed on the KLSE (Figure 2), from 262 counters in 1973 to 788 as of the end of September 2000.

In line with the listing activity on the KLSE, the average daily trading volume has also grown over the years from 6.0 million units a day in 1980 to a peak of 432.7 million units in 1993. Even during the financial crisis in 1997 and 1998, the average daily volume of the KLSE remained at 331.5 million and 247.4 million units respectively.



Up to the mid-1990s, fund-raising activity via the capital market required prior approval by a number of authorities. Furthermore, while substantial progress had been made in streamlining the approval process with the formation of the SC as the principal regulator in 1993, companies' fund-raising submissions still had to be assessed by the regulator on a merit basis prior to approval. The merit-based regime that the SC inherited at its inception required that the SC assume a paternalistic role in assessing the merit of investment opportunities and thus interposing itself between the users and suppliers of capital.

However, as the market grew, it was clear that there was a need for a more market-based approach that would be efficient while not compromising investor protection. As such, a three-phased programme towards disclosure-based regulation (DBR) began in 1996, to reduce the involvement of the SC in assessing the merit of investment opportunities, and to enhance the role of issuers and their advisers and investors in capital allocation and decision making.

Under this approach, the onus of assessing the merits of primary investment offerings would increasingly become the investors' responsibility, while companies themselves would be required to adopt higher standards of information disclosure in their interactions with the market. Effectively, DBR places greater emphasis on transparency, due diligence, corporate governance and the promotion of accountability and self-regulation.

Significant measures have already been taken by the SC to effect a more disclosure-based environment and improve disclosure standards during the period 1996–2000. These include, among others, the introduction of major changes to the Securities Commission Act 1993 (SCA), and the introduction of new guidelines for a variety of public offerings incorporating elements of DBR.²

In line with the growing funding needs of the issuers in the Malaysian market, measures were also taken to support and clarify the regulatory treatment of new methods of raising capital. In order to facilitate online securities issues, for instance, the SC issued a policy statement on *Primary Offers of Securities via the Internet* in August 1999 explaining the regulatory treatment for such activities.

The development of the market for risk capital—encompassing informal investment by business angels, venture capital and stock markets specialising in small and medium-sized enterprises (SMEs) and high-growth companies—has also become an increasingly important facet of the country's overall thrust towards becoming a knowledge economy and the creation of a more value-added production base.

To promote the development of high-growth and technology companies in Malaysia, a separate exchange—the Malaysian Exchange of Securities Dealing and Automated Quotation Berhad (MESDAQ)—was approved as a stock exchange in October 1997. Importantly, it was a mechanism to promote and facilitate capital raising for technology-intensive industries with strong growth prospects but which lacked profit track records, and to develop a strong science and technology base through indigenous research and development efforts, including supporting the development of the Multimedia Super Corridor (MSC). Trading on MESDAQ commenced in April 1999, with a total of three companies listed on the exchange as of end-October 2000.

² Some of the SC's guidelines released over recent years in the course of the phasing-in of DBR include *Policies and Guidelines on the Issue/Offer of Securities*, *Guidelines for Public Offerings of Securities of Infrastructure Project Companies* and *Guidelines on the Issue of Call Warrants*.

The raising of funds through venture capital has also been the focus of significant developmental efforts. As at end-1999, there were 30 venture capital companies registered with Bank Negara Malaysia (BNM), with total assets worth RM1.7 billion. This constituted a 32% annual growth rate over the period 1992–99. Of these 30 venture capital companies, the government held stakes in 19, reflecting its prominent role in promoting the local venture capital industry. In addition to this, the government is also an important provider of venture capital financing, such as through the establishment of venture capital funds announced in previous Budgets.

As a result of these developmental efforts, as well as the sound economic environment and the privatisation programme initiated by the government in the 1980s and 1990s, Malaysia's equity market grew substantially in terms of size and liquidity over this period. This was reflected in the fact that the total amount of funds raised in the equity market alone amounted to RM87.7 billion over the period 1990–99, compared to the RM10.6 billion raised over the preceding decade.³

Bond market

Until as recently as two decades ago, substantial proportions of funds raised in the capital market were for public-sector investments through government issues such as Malaysian government securities (MGS). In the early 1980s, increased government development spending and the rising fiscal deficit led to an increase in MGS issuance. However, the secondary trading was highly illiquid because administrative and statutory requirements saw most financial institutions holding MGS until maturity.

In January 1989, reforms to promote the secondary trading of MGS were undertaken. A system of principal dealers for government securities was introduced. These dealers underwrote primary issues and provided two-way secondary market quotations. To further encourage secondary trading of MGS, a computerised scripless trading system, Sistem Pindahan Elektronik untuk Dana dan Sekuriti (SPEEDS) was introduced in January 1990. Trading was supervised by the Trading Practices and Market Development Committee, which was established in the same year. In July 1999, SPEEDS was replaced by the Real Time Electronic Transfer of Funds and Securities (RENTAS) system, which allowed real-time delivery versus payment (DVP) for electronic book-entry settlements. As of the end of 1999, there were 15 principal dealers in MGS.

In conjunction with the growing role of the private sector in economic growth and increasing corporate activity, private debt securities (PDS) issuance in Malaysia began to take off in the late 1980s. A landmark initiative by the authorities to promote the PDS market in Malaysia was the establishment of Cagamas Berhad, the national mortgage corporation, in 1986. In 1987, Cagamas issued its first mortgage-backed bonds worth RM100 million. This was followed by a total of RM5 billion in new issues of Cagamas bonds over the following five years.⁴

In 1988, *Guidelines on the Issue of Private Debt Securities* were issued to clarify the basic legal and administrative framework for bond financing. Under these guidelines, issuers were required to have minimum shareholders funds of RM25 million and a debt-to-equity ratio not exceeding 2:1. Additionally, under section 25 and schedule 1 of the Banking and Financial Institutions Act 1989 (BAFIA), BNM approval was necessary for the issuance of

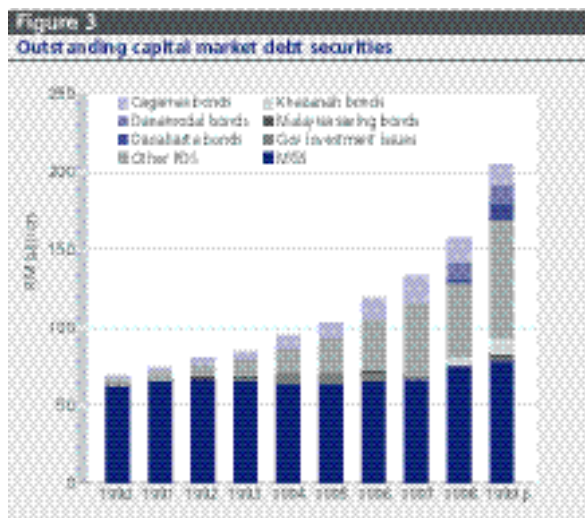
³ Source: Bank Negara Malaysia.

⁴ See footnote 3.

PDS. Following the dissolution of the Capital Issues Committee (CIC) with the establishment of the SC in 1993, all public limited companies (PLCs) also had to seek the SC's approval to issue PDS.

In 1992, the issuance of long-term bonds were required to have a rating of at least BBB and short-term papers a rating of at least P3. In January 1996, all unlisted PDS had to be issued scripless, to promote more efficient trading and settlement, with the central bank acting as the central depository and paying agent for all scripless PDS.

To ensure a co-ordinated approach towards developmental efforts, the National Bond Market Committee (NBMC) was formed in 1999 comprising senior representatives from the MOF and the relevant regulatory agencies to provide policy direction and to rationalise the regulatory framework for the development of the ringgit bond market. As an initial step towards rationalising the regulatory framework, NBMC announced that the SC would be the sole agency for the regulation of the corporate bond market.



Source: Bank Negara Malaysia
 Note: Other PDS refers to financial and semi-financial private bonds other than those issued by Cagamas, Pengeraja Danaharta Nasional Berhad and Dana modal Nasional Berhad
 * p-preliminary

In conjunction with these regulatory initiatives, local credit rating agencies have also played an important role in fostering greater awareness, transparency and public scrutiny of the PDS market. In 1990, the Rating Agency of Malaysia Berhad (RAM) became the first rating agency in Malaysia. The Malaysian Rating Corporation Berhad (MARC) was established five years later.

As a result of the overall expansion in capital market activity and targeted policies for the development of this segment of the market, over the years the size of the bond market has grown steadily (Figure 3). Recent years have also seen a sharper growth in bond issuance for meeting the restructuring needs of Malaysian banks and corporations in recovering from the regional financial crisis.

As of the end of 1999, PDS outstanding stood at RM111.8 billion or 37.2% as a percentage of gross domestic product (GDP).⁵

Expansion of Capital Market Products and Services

In tandem with the growth in the equity and bond markets, there has also been significant development of the services and products that both support and supplement these underlying market segments. The development of these ancillary services and instruments has provided further breadth to the overall capital market, firmly underscoring its growing maturity from a newly emerging market into an increasingly developed one. The following sections outline the progress over the years in some of these key services and products within the Malaysian capital market.

⁵ Total PDS figure includes Danamodal, Danaharta and Cagamas bonds and other PDS.

Investment management industry

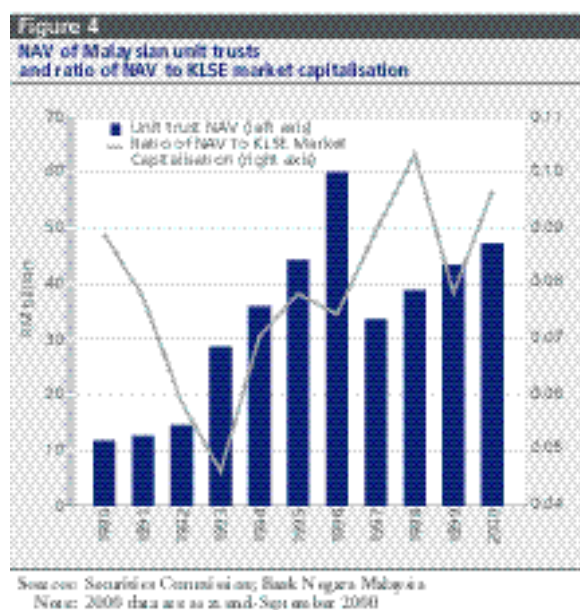
Investment management funds in Malaysia consist of, among others, funds managed by provident and pension funds, unit trust management companies, asset management companies and insurance companies. As at the end of 1999, these institutions collectively deployed around RM280 billion worth of funds, while the banking NAV sector managed about RM560 billion.

Unit trust funds were first introduced in Malaysia relatively early on compared with other markets in the region. The first unit trust fund in Malaysia was established in 1959. However, over the following 20 years, only five new unit trust companies were established, with a total of 18 funds introduced over that period.

At the time, the industry was regulated jointly by the Registrar of Companies (ROC), BNM, the Minister of Domestic Trade and Consumer Affairs and the Public Trustee of Malaysia. 1975 saw the formation of the Informal Committee for Unit Trust Funds to regulate the industry.⁶ This period also witnessed the launching of the Skim Amanah Saham Nasional (ASN) or the National Unit Trust Scheme in 1981 by Amanah Saham Nasional Bhd (ASNB), the unit trust company of Permodalan Nasional Berhad (PNB), with the purpose of promoting savings within the Bumiputera community and to encourage Bumiputera ownership in the corporate sector. Property trusts were added to the list of products available to investors in 1989. In 1990, the Amanah Saham Bumiputera (ASB), or the Bumiputera Trust Fund, was launched to replace ASN as a fund that transacted based on daily pricing of its net asset value (NAV).

The Malaysian unit trust industry experienced its fastest growth in the 1990s in terms of the number of new management companies established and funds under management. The centralisation of regulation of the industry, with the formation of the SC in 1993, and coupled with the coming into force of the *SC (Unit Trust Scheme) Regulations* in 1996, extensive marketing strategies adopted by the ASN and ASB, played key roles in making unit trusts household products in Malaysia during this period. Consequently, the total NAV of unit trusts grew more than five-fold from RM11.7 billion at the end of 1990 to RM60.0 billion at the end of 1996 (Figure 4).⁷

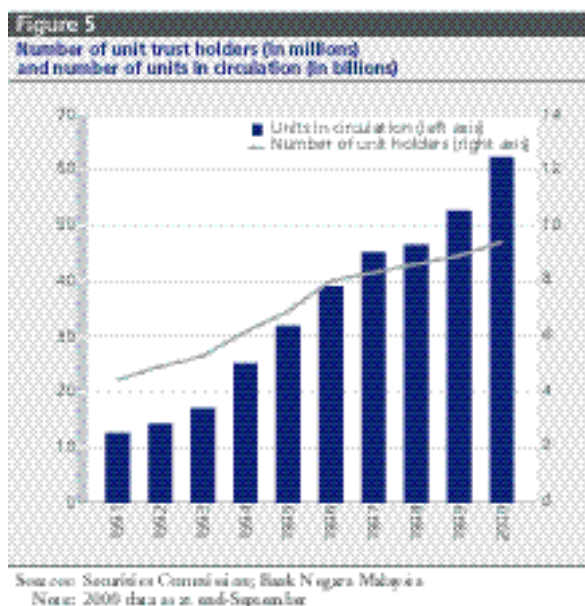
Although the pace of growth of these funds has moderated since the financial crisis of 1997–98, it has nevertheless maintained its upward trend, in terms of the number of units in circulation and unit holders (Figure 5). Registered Institutional Unit Trust Agents (IUTAs) were allowed to market the unit trust products of third parties from February 2000, a move that was positively received by market participants. As of end-September 2000, there was a variety of unit trust funds available including equity funds, long- and short-term fixed-income funds as well as Islamic funds, although at present most (almost 70%) of the funds are equity-based funds.⁸



⁶ The committee was composed of representatives from each of the authorities.

⁷ Source: Bank Negara Malaysia.

⁸ Source: Securities Commission; Lipper Analytical Services.



In line with the growth of the unit trust industry, as at the end of 1999 there were 71 licensed asset management companies with a total of RM40.7 billion of local funds under management. The bulk of local funds managed by asset management companies, approximately RM33.0 billion (or 80.9% of total local funds under management by asset managers) were from local unit trust funds that had chosen to outsource their investment functions to external fund managers.

In addition, the SC introduced *Guidelines on the Establishment of Foreign Fund Management Companies* in August 1995 as part of its efforts to further promote and develop the investment management industry.⁹ As at the end of 1999, there were six

foreign fund management companies (FFMCs) managing a total of RM2.7 billion, or 6.2% of the total funds managed by licensed fund managers.

Stockbroking and corporate advisory services

As the capital market developed, so too did the scope, quality and penetration of intermediation services offered by securities brokers and corporate advisors. Stockbroking companies, which are members of the KLSE and MESDAQ, typically carry out a range of activities. These include trading in KLSE-listed instruments and other securities, offering investment advice, and providing nominee/custodian services. Some qualified stockbroking companies also participate in underwriting new securities issues.

The first domestic exchange, the Malayan Stock Exchange—the predecessor of the KLSE—had only four founding members when it was launched in 1960, but this number grew in tandem with the growth in activity in the stock market. Stockbroking services are now fairly widely dispersed throughout the country, mainly due to the government's distribution policy during the developmental years of the capital market of limiting the concentration of stockbroking companies by their geographic locations. As of the end of September 2000, there were 62 licensed stockbroking companies in Malaysia (Figure 6). Of this number, four companies had foreign equity ownership above 40% (but less than 50%) while seven more had foreign equity ownership above 20%.

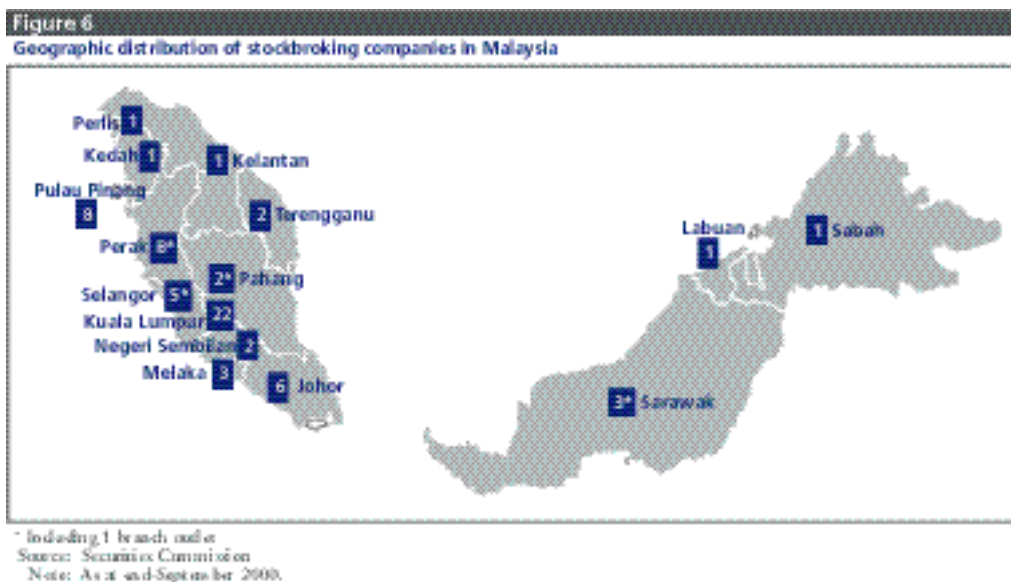
The wide dispersion of stockbroking services throughout the country, supplemented by the remisier network, has played a role in the domestic stock market's high retail investor base, with individuals making up 86.4% of total investors on the KLSE as of the end of 1999. Although they only account for around 18.5% of total equity holdings, they are observed to be more active and generally have a higher turnover rate than institutional investors.¹⁰

The influence of technology was also clearly recognised early on to be a potentially far-reaching catalyst in the direction of the industry's development. Although the application of e-commerce within the Malaysian capital market is not yet at the same scale as in some developed markets, there has been an acceleration in such activity over the past two years,

⁹ The guidelines were subsequently revised in July 2000.

¹⁰ In comparison, domestic institutional investors make up 1.6% of all KLSE investors, but account for 32.8% of total shareholdings, while foreign institutions constitute only 0.1% of total KLSE investors and hold 8% of total equity holdings. The remaining 11.9% of total shareholders are made up of nominees, of which Malaysians account for 82% and non-Malaysians the remaining 18%. They hold 39.5% of total equity shareholdings, of which Malaysians account for 76% and non-Malaysians the remaining 24%.

particularly in areas such as the provision of investment advice and order-routing via electronic media. This is despite the fact that the levels of Internet penetration and information technology (IT) awareness amongst local market participants are still far below the levels seen in developed markets.



In recognition of these developments, the SC has in recent years, released several consultation papers clarifying its regulatory position and inviting feedback on these issues. 1995 saw the release of the *Guidelines on Electronic Client-Ordering System* for KLSE Member Companies for the benefit of stockbroking companies wishing to provide electronic means of routing orders from their clients, whether through proprietary or open systems.

Corporate finance advisers include merchant banks, approved stockbroking companies, public accounting firms and law firms that provide advice to applicant companies in connection with applications submitted to the SC. However, at present only merchant banks and approved stockbroking companies are permitted to submit proposals on behalf of listed companies to the SC for its consideration.¹¹ As there is only one stockbroking company authorised to offer such services as at end-September 2000, merchant banks licensed by BNM are currently the primary providers of corporate finance advisory services in Malaysia.

Derivatives market

Exchange-traded derivatives were introduced in the Malaysian capital market in 1980, with the establishment of the Kuala Lumpur Commodity Exchange Bhd (KLCE) and the launch of its flagship product, the crude palm oil (CPO) futures, that year. In 1989, warrants/transferable subscription rights (TSRs) traded on the KLSE were added to the list of products available to investors, while call warrants were introduced in 1994.

In 1995, the Kuala Lumpur Options and Financial Futures Exchange Bhd (KLOFFE) and the Malaysian Derivatives Clearing House Bhd (MDCH) were established, and stock index

¹¹ As at end-September 2000, the regulation also stipulates that unlisted companies, with the exception of those making an application for flotation on the stock exchange, may do so either through merchant banks, an approved stockbroking company or an approved firm of public accountants. Companies can also submit a proposal through a discount house or a commercial bank but only for issues involving non-equity-linked debt securities.

futures based on the benchmark KLSE Composite Index (KLCI) were introduced. The following year, the government approved the establishment and operation of the Malaysian Monetary Exchange (MME) as a futures and options exchange and the 3-month Kuala Lumpur Interbank Offered Rate (KLIBOR) futures contract was launched in May 1996.

In line with the development of the derivatives industry, efforts were made to foster a conducive environment for the more effective usage of derivatives products. In December 1995, regulations on securities borrowing and lending (SBL) were introduced, while regulated short selling (RSS) was allowed from September 1996 onwards. However, both SBL and RSS were suspended in 1997 during the regional financial crisis.

The later part of the 1990s saw some consolidation occurring within the Malaysian derivatives industry as the existing institutions sought to streamline their operations in order to achieve greater economies of scale. In December 1998, KLCE and MME were merged to establish the Commodity and Monetary Exchange of Malaysia (COMMEX). Shortly after, in January 1999, the KLSE acquired KLOFFE Capital Sdn Bhd, the holding company of KLOFFE, making KLOFFE a subsidiary of the KLSE group of companies.

Overall, these developments aimed at strengthening the derivatives industry reflect the general accord among financial institutions and professionals that the derivatives market is a necessary fixture within the Malaysian capital market. While the number of market participants in this sector has fallen following the decline in liquidity after exchange control measures were introduced in 1998, the representation of futures intermediaries in the capital market is still relatively strong given the current market size.¹² As of the end of September 2000, the number of futures broking companies stood at 32, with a total of 735 licensed futures brokers' representatives.

Islamic capital market

The emergence of the modern Islamic financial market in Malaysia has been a relatively recent development, in comparison with the more established broader conventional financial system. It was only in 1983 that the country's first Islamic bank, Bank Islam Malaysia, was established to provide financial services according to Islamic principles.

Despite its relatively nascent nature, however, the domestic market for Islamic securities has grown slowly but steadily over the last few years. Since Shell MDS Sdn Bhd issued the first private sector Islamic bond of RM125 million in 1990, many of the country's largest corporations such as Petronas, Tenaga Nasional and Telekom Malaysia have sought financing and issued long-term corporate debt using Islamic-based instruments.

In 1993, the first Islamic unit trust fund was launched, and the following year the first full-fledged Islamic stockbroking company, BIMB Securities Sdn Bhd, was established. In 1995, the SC established the Islamic Capital Market Unit, comprising experts in *fiqh muamalat* and capital market practices, to undertake research in product origination and Islamic capital market operations.

In 1996, the SC established its Syariah Advisory Council (SAC), made up of *muftis*, Islamic scholars, academicians and Islamic finance experts, to advise the SC on Syariah compliance matters in Islamic capital market operations. The following year, BNM established its own SAC to provide advice on Islamic banking and *Takaful* matters.

¹² Initial prohibitions on the transfer of funds in and out of the country for trading on the Malaysian futures market were only temporary and were relaxed on 14 September 1998.

Today, various products and services are available for those who seek to transact only in Islamic securities, including an official list of Syariah-approved securities, Islamic debt securities, Islamic unit trusts, warrants/TSRs based on Syariah-approved securities, and CPO futures. As of September 2000, 72% of the total counters traded on the KLSE and MESDAQ were Syariah compliant. There are two Islamic equity indices, the KLSE Syariah Index and the RHB Islamic index, and there are even plans among market participants to establish an Islamic-based venture capital fund.

In terms of services, the Malaysian capital market offers Islamic product structuring, project financing, stockbroking and management services. Malaysia has a number of local market intermediaries that cater specifically to Islamic capital market investors. In addition to BIMB Securities, there are presently other stockbrokers which operate based on Syariah principles or have opened Islamic windows operating side-by-side with their conventional stockbroking services. On the asset management side, there are three specialist Islamic asset management companies. As of end-September 2000, there were 14 Islamic unit trust schemes available on the market, with a total NAV of RM1.7 billion, amounting to 3.6% of the NAV of the unit trust industry.

Application of Internationally Benchmarked Practices

Concerted efforts towards ensuring that the Malaysian capital market is benchmarked against international practices have made Malaysia one of the few East Asian countries to practise the same or higher standards of financial reporting, trading, clearing and settlement, among others, as most developed countries.

The SC, through its own active participation in international forums such as the International Organisation of Securities Commissions (IOSCO), has been very much involved in the formulation process of many of these standards, even at the very early stages of the SC's own development. This has helped not only to ensure that Malaysia is constantly kept abreast of the lessons derived from developments in other capital markets, but also to maintain an effective voice in future international capital market development.

The following discussion reviews two important areas in which the Malaysian capital market has been, and continues to be, benchmarked against best international practices: financial reporting; and trading, clearing and settlement processes.

Financial reporting standards

Financial reporting in Malaysia reached a milestone in March 1997 when a new standard-setting framework was established, consisting of the Malaysian Accounting Standards Board (MASB) and the Financial Reporting Foundation (FRF). The former has statutory responsibility for national accounting standard setting under the Financial Reporting Act 1997 (FRA), while the latter oversees the operations of MASB.

Prior to the establishment of MASB, the Malaysian Institute of Accountants (MIA) and the Malaysian Association of Certified Public Accountants (MACPA) played significant roles in the setting of accounting standards in Malaysia for many years. In this respect, both MIA and MACPA issued their own sets of standards for compliance by their respective members,

which were generally based on International Accounting Standards (IASs) issued by the International Accounting Standards Committee (IASC), with appropriate modifications where necessary.¹³

Under the new framework, standard setting is undertaken by MASB, an independent body, pursuant to an extensive due process involving consultation with all relevant parties including the accounting profession, the business community, users, preparers, auditors and regulators. This arrangement safeguards the impartiality and integrity of the standards set by the board.

With the establishment of the FRF and MASB, Malaysia became the first country in Asia to take the step of setting up an independent and statutorily incorporated accounting standard-setting body. In markets such as the United States (US), the United Kingdom (UK) and Australia, the promulgation of accounting standards has long been the province of independent accounting standard-setting bodies, and in the US, for one, these standards are enforced by the Securities and Exchange Commission (SEC).

MASB standards are formulated with reference to the work of the IASC and other national standard setters, and are as such aligned with international best practices.¹⁴ A framework to ensure compliance and enforcement of the standards set by MASB has also been introduced under the purview of the SC for all PLCs, BNM for all financial institutions, and the ROC for all other companies. Another significant measure taken to improve the quality of financial reporting was the introduction of quarterly financial reporting requirements for PLCs by the KLSE in 1999.

Trading, clearing and settlement

The Malaysian capital market possesses the infrastructure for efficient trading, clearing and settlement. The exchange-traded market in Malaysia has over the years developed a relatively sophisticated and efficient microstructure for the effective execution and settlement of its products.

Since the 1980s and 1990s, exchanges worldwide have been increasingly moving towards screen-based trading systems. This occurred as markets expanded and the ability of traditional trading floors and the open-outcry system to facilitate further expansion without a loss in efficiency waned. However, the KLSE had already initiated electronic trading at a relatively early stage of this trend with the implementation of the SCORE semi-automated trading system in 1989, and fully automated trading by 1992. For MESDAQ, its trading launch in 1999 saw the exchange already operating within a scripless, screen-based trading environment.

While contracts traded on COMMEEX still use the trading floor due to the exchange's longer history in floor trading and relatively low participant demand for moving towards screen-based trading given the size of the volumes traded, KLOFFE was launched as a fully electronic exchange. The latter's members have the option of trading its products via a centralised service bureau that offers standardised trading and back-office facilities, or through their own internal integrated systems using interfaces to access the KLOFFE Automated Trading System (KATS).

¹³ At that time, while the Companies Act 1965 (CA) required that company accounts be properly prepared so as to give a true and fair view of the company's affairs, there were no explicit provisions requiring compliance with the standards set by these professional bodies. However, the KLSE did require its listed companies to comply with the standards and pronouncements of the two bodies.

¹⁴ IASs issued by the IASC have received widespread international support. In May 2000, IOSCO endorsed the use of IASs for cross-border offerings and listings. Subsequently, the European Commission announced in June 2000 that it will be introducing proposals requiring all European Union (EU) companies listed on a regulated market to prepare consolidated financial statements in

In terms of clearing and settlement practices, the Malaysian market benchmarks itself very closely against the Group of Thirty's (G-30) 1989 recommendations for strengthening and harmonising settlement arrangements in securities markets worldwide.¹⁵ The recommendations of this study are international standards that are widely regarded as the benchmarks for settlement practices in securities markets around the world.

The G-30 study recommends, among other things, the centralisation of the securities depository function, DVP for settling all securities transactions and settlement by T+3 to mitigate settlement risk. It also encourages allowing SBL as a method of expediting the settlement of securities transactions, and the adoption of a common technical message standard for securities messages and the International Securities Identification Number (ISIN) numbering system developed by the International Organisation for Standardisation (ISO).

In 1990, steps were taken to bring the stock market's depository system more in line with international best practices. That year, the Malaysian Central Depository Sdn Bhd (MCD) was set up to implement and operate the CDS, in accordance with G-30 recommendations. The Malaysian market also allows for DVP whereby the transfer of securities and funds occur on the same day at the end of the settlement cycle and fixed delivery and settlement.

More broadly, the SC has made continuous efforts to participate in standard-setting processes undertaken by international bodies. For example, the SC is currently a member of an international task force on cross-border securities settlement, a joint initiative of IOSCO and the Bank for International Settlements' (BIS) Committee on Payment and Settlement Systems (CPSS) of the Group of Ten (G10) central bank governors. The IOSCO-CPSS task force has been mandated to promote the implementation, by securities settlement systems, of measures that can enhance international financial stability, reduce risks, increase efficiency and provide adequate safeguards for investors by developing recommendations for the design, operation and oversight of such systems.

Establishment of a Robust Regulatory Framework

Malaysia's capital market regulatory infrastructure has seen some major enhancements in the last decade—including streamlining, deregulation along with appropriate re-regulation, and the building of regulatory and enforcement capacity—with the aim of developing a fairer and more efficient capital market, and facilitating market innovation.

Before 1993, the responsibility for overseeing the Malaysian securities industry fell on the ROC, the CIC, the Panel on Take-overs and Mergers (TOP), the Foreign Investment Committee (FIC), BNM, the Ministry of International Trade and Industry (MITI) and the KLSE.

The need for a more streamlined regulatory framework and, in particular, a single regulatory body with a broad overview of capital markets, had been identified by the Sixth Malaysia Plan for 1991–95. On 1 March 1993, the SC was established under the SCA to act as a single regulatory body to promote the development of the capital market. It was also charged with the responsibility for streamlining the regulations of the securities market, and for speeding up the processing and approval of corporate transactions.¹⁶

¹⁵ Source: *Clearance and Settlement Systems in the World's Securities Markets*, G-30, March 1989.

¹⁶ The SC is responsible to the Minister of Finance, and tables its annual report and accounts to parliament. It is empowered to investigate breaches of securities regulations, enforce rules and regulations, and prosecute securities offences. With the establishment of the SC, both the CIC and TOP were dissolved and their functions assumed by the SC.

Regulatory consolidation since then has meant that responsibility for the oversight of the securities industry now falls largely on the SC but also includes BNM, FIC, the ROC and MITI. The SC has, since its establishment, undertaken a substantial programme of law reform in recognition of the important role that the regulatory framework plays in the growth and development of the capital market. A major part of this programme involved amendments to the legislation governing the securities industry, including the SCA, the Securities Industry Act 1983 (SIA), the Futures Industry Act 1993 (FIA) and the Securities Industry (Central Depositories) Act 1991 (SICDA).

Amendments to the SCA over the period 1995 to 2000 related on the whole to the primary market, corporate issue proposals and take-over and merger submissions. These amendments focused on providing a platform for the gradual move towards a disclosure-based system of regulation for the primary offering of securities, introduced the due diligence concept, and created both criminal and civil liability provisions for contravention of the law. The SC's investigative powers were enhanced so as to strengthen the effectiveness of its enforcement programmes.

Another important aspect of reform was the rationalisation of the regulatory structure with the regulation of offerings of securities centralised in the SC with effect from 1 July 2000. At the same time, the regulatory regime for fund raising was considerably rationalised with the SC assuming the powers to approve prospectuses, and designated as the single regulator of the corporate bond market.

The SC's enforcement options were also expanded, particularly in its ability to institute a range of administrative actions and civil action for contravention of the law. A new *Malaysian Code on Take-overs and Mergers* was introduced in January 1999 with the view to enhance minority shareholder protection and to ensure that take-overs and mergers take place in an efficient and informed market.

Amendments to the FIA addressed conceptual issues relating to the derivatives market and the need for changes in regulations to facilitate the introduction of exchange-traded derivatives on KLOFFE. Amendments were also made to the SIA on areas such as insider trading to further strengthen provisions relating to investor protection, safeguarding market integrity and promoting proper conduct.

Other law reform efforts were related to the SICDA, including the provisions for the full immobilisation of securities and for curbing the abuse of the nominee system of share ownership. A substantial amount of subsidiary legislation in relation to all these laws was also promulgated.

In addition, regulatory changes were made to facilitate better corporate governance, where efforts had begun even before the onset of the regional financial crisis accelerated the impetus for such action. Box 1 outlines the broad regulatory reforms and other measures undertaken over the past few years to enhance the level of corporate governance and enforcement of shareholders' rights in the local corporate sector.

BOX 1

Enhancement of corporate governance standards in Malaysia

Efforts to enhance standards of corporate governance in Malaysia had been on-going even prior to the regional financial crisis of 1997–98 but had been generally piecemeal in nature. The aftermath of the crisis had an adverse impact on confidence among investors in the Malaysian capital market, which accelerated the impetus for more comprehensive and co-ordinated reforms to improve corporate governance.

In 1998, the Minister of Finance announced the formation of a high-level committee to review the framework for corporate governance in Malaysia. The committee, with the SC acting as its secretariat, released its report in March 1999. Since then, an Implementation Project Team has been established to lead and oversee the implementation of the broad-ranging recommendations contained in this report.

The legal amendments recommended by the report are already under way, including comprehensive streamlining of the regulatory structure to rationalise the regulation of fund-raising and bond market activities. Among the work initiated since then are amendments to the relevant regulations encouraging equity participation by non-executive directors, the codification of key duties of directors, and the introduction of provisions to curb abuses of controlling shareholder's voting rights in related-party transactions.

The private sector's participation has also been critical to the corporate governance reforms being undertaken at this juncture. The *Malaysian Code on Corporate Governance* was developed by the Working Group on Best Practices in Corporate Governance, which comprised representatives from the private sector, and was subsequently approved by the high-level Finance Committee on Corporate Governance. Amendments to the KLSE's *Listing Requirements* will bring the Code into effect, requiring companies to report in their annual reports the extent to which they have complied with the principles and best practices set out in the Code.

On its part, the KLSE had also taken substantial measures to improve incentives for good corporate governance and penalties

for breaches of its rules over the past few years. In 1997, the KLSE required all listed companies to establish audit committees and strengthened the rights of minority shareholders. Stringent new requirements were also imposed on related-party transactions, and disclosure requirements were tightened significantly in 1999. The exchange also took the decision to limit the number of directorships held by an individual in PLCs, in order to encourage greater accountability and hands-on involvement by these directors in ensuring that their companies are well-run.

Other steps have also been undertaken to carry out the Finance Committee's recommendations, and support the development of greater shareholder activism and directorship accountability. These include the formation of a minority shareholder watchdog group and the introduction of mandatory director accreditation training programmes. Implementation of the remaining recommendations of the report is still on-going. At the same time, the continued push towards educating investors as to their rights and responsibilities remains a priority of the SC's training arm, the Securities Industry Development Centre (SIDC).

On the international front, the SC has been actively involved in the Asia-Pacific Economic Co-operation (APEC) Collaborative Initiative on Corporate Governance in Malaysia's capacity as the leader of the Core Group for this initiative. The Core Group comprised Australia, the US, the World Bank Group and the Asian Development Bank (ADB), and its report, *Strengthening Corporate Governance in the APEC Region*, was endorsed by the APEC Finance Ministers in May 1999. The report essentially identified leading features or patterns in corporate governance practices in Asian economies, recommended means of addressing the problems and issues identified, and areas in which further co-operative international efforts could accelerate the strengthening of corporate governance in these economies.

CHALLENGES FOR THE CAPITAL MARKET

Despite the significant progress seen in the capital market over the years, the Malaysian capital market is subject to challenges that will substantially influence its ability to effectively meet its constituents' needs in the future. Fundamentally, the future funding and investment needs of the domestic economy alone will require parallel development of the capital market's capacity to continue to serve its constituents effectively. In particular, this will necessitate a close review of where gaps and potential impediments to the developmental process exist, and where there are avenues for greater value enhancement. And as part of the international marketplace, the Malaysian capital market must also continue to be cognisant of and take advantage of changes and opportunities within the global context. The primary issues and trends that Malaysia must address if its capital market is to not only sustain but also augment its role and effectiveness in the longer term are:

- Lingering effects of the regional financial crisis
- Meeting the needs of a growing economy
- Heightened global competition for business and investment
- Changing demands on the regulatory framework and authorities

Lingering Effects of the Regional Financial Crisis

Decline in international competitiveness

Since the onset of the regional financial crisis in 1997, the Malaysian capital market has fallen in terms of its international standing. On a global basis, the market capitalisation of the KLSE has slipped from a ranking of 11 out of 40 international equity markets in 1996 to a ranking of 23 in 1999.¹⁷ From being the third-largest stock market in terms of market capitalisation among the nine major Asia-Pacific markets (ex-Japan) in 1996, Malaysia was ranked sixth in the region in 1999, with a market capitalisation of less than half that of 1996, in US dollar terms (Table 1).

Table 1

Market capitalisation of major bourses within the Asia-Pacific region (ex-Japan)

Market	1996		1999	
	Mkt cap (US\$billion)	Rank	Mkt cap (US\$billion)	Rank
Hong Kong	449.2	1	609.1	1
Australia	311.9	2	427.7	2
Malaysia	306.2	3	139.9	6
Taiwan	273.8	4	376.5	3
Singapore	153.1	5	198.0	5
Korea	139.1	6	306.1	4
Thailand	95.9	7	57.2	8
Indonesia	90.9	8	64.0	7
Philippines	80.5	9	41.5	9

Sources: Federation Internationale des Bourses de Valeurs and Securities Commission

¹⁷ This is based on the information on major stock exchanges in 40 countries as compiled by Federation Internationale des Bourses de Valeurs (FIBV). In 1999, the figure for Germany is based on market capitalisation figure for Deutsche Börse. (Sources: Federation Internationale des Bourses de Valeurs; Securities Commission.)

The liquidity levels on KLOFFE and COMMEEX are also much lower than those of most international derivatives exchanges, with the two exchanges consistently ranked in the 50-55 range since 1997, out of a total of 59 derivatives exchanges worldwide.¹⁸

Lingering perceptions that Malaysia carries a relatively higher risk premium—stemming largely from uncertainty regarding the extent of policy and corporate risk—have also had an adverse impact on the market’s external competitiveness. However, a particularly damaging aspect is that many of these perceptions are far removed from the economic reality of the country at present, and they are partly the result of insufficient or incorrect information. In many cases, even as attested by international financial institutions, the reforms in bank restructuring and corporate restructuring have exceeded earlier expectations and even outpaced the reforms in other crisis-affected jurisdictions.

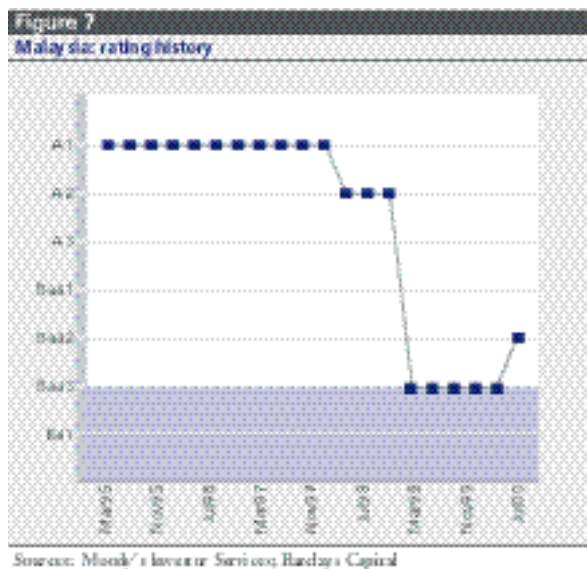
Nevertheless, there are issues inherent in these perceptions that must be considered seriously, and changes must be undertaken if such perceptions are to be effectively addressed. If not, the positive factors that have supported the Malaysian capital market’s growth in the past will become increasingly overshadowed by these other issues. As a result, other jurisdictions that were once given lesser or equal weighting as Malaysia in international portfolios will be progressively viewed with a greater sense of certainty than Malaysia.

The competitiveness of the financial services industry also relies on the pillars of efficiency and cost. Where globalisation influences these two factors, there will be significant implications for the future competitiveness and attractiveness of doing business in the Malaysian capital market.

To date, there has been a slow recovery in Malaysia’s credit ratings—resulting in Malaysian debt issuers continuing to incur high funding costs—despite its significant economic

improvement since the onset of the regional crisis. Up to 1997–98, Malaysia had maintained a good debt rating record where, for most of 1995 through to November 1997, Malaysia recorded high investment-grade debt ratings of around A1. However, these ratings fell during the crisis—although they consistently remained above investment grade throughout the crisis years—and to date still have not recovered to the levels attained previously (Figure 7).¹⁹

It is worth noting as well that portfolio funds are increasingly being allocated not only according to geographical destination, but also according to sectors. In recent years the



¹⁸ Source: Futures Industry Association.

¹⁹ As at end-September 2000, Malaysia's long-term sovereign debt rating stands at Baa2 with Moody's and BBB with Standard & Poor's (S&P). S&P raised the outlook for Malaysia's paper from Stable to Positive on 1 September 2000.

growth in the market for high-risk capital, in particular, has been a prominent measure of where a large amount of investable funds were headed. Table 2 provides an indication of the size of the Malaysian venture capital industry in relation to selected regional jurisdictions. It can be seen that the Malaysian venture capital industry is relatively small in terms of the size of the venture capital under management, amount of funds raised, investments made, and divestments.²⁰

Table 2

Asia-Pacific venture capital industry profile (US\$ million)

Capital under management				New funds raised			
Country	1997	1998	% change	Country	1997	1998	% change
Australia	2,721	3,062	12.5%	Australia	390	400	2.6%
Hong Kong	10,670	15,442	44.7%	Hong Kong	1,940	3,218	65.9%
India	1,016	1,053	3.6%	India	263	60	- 77.2%
Japan	7,722	12,513	62.0%	Japan	1,010	1,242	23.0%
Korea	1,857	2,995	61.3%	Korea	291	551	89.3%
Malaysia	406	460	13.3%	Malaysia	20	55	175.0%
Philippines	169	224	32.5%	Philippines	25	52	108.0%
Singapore	4,468	5,258	17.7%	Singapore	1,167	620	- 46.9%
Taiwan	1,913	3,598	88.1%	Taiwan	570	1,096	92.3%
Thailand	177	242	36.7%	Thailand	47	15	- 68.1%

Investments				Divestments/exits			
Country	1997	1998	% change	Country	1997	1998	% change
Australia	322	313	- 2.8%	Australia	128	169	32%
Hong Kong	988	1,378	39.5%	Hong Kong	165	154	- 7%
India	112	92	- 17.9%	India	1	2	100%
Japan	992	927	- 6.6%	Japan	924	1,488	61%
Korea	920	609	- 33.8%	Korea	150	433	189%
Malaysia	49	53	8.2%	Malaysia	1	2	100%
Philippines	12	54	350.0%	Philippines	2	3	50%
Singapore	388	424	9.3%	Singapore	113	59	- 48%
Taiwan	643	881	37.0%	Taiwan	123	117	- 5%
Thailand	76	44	- 42.1%	Thailand	6	12	100%

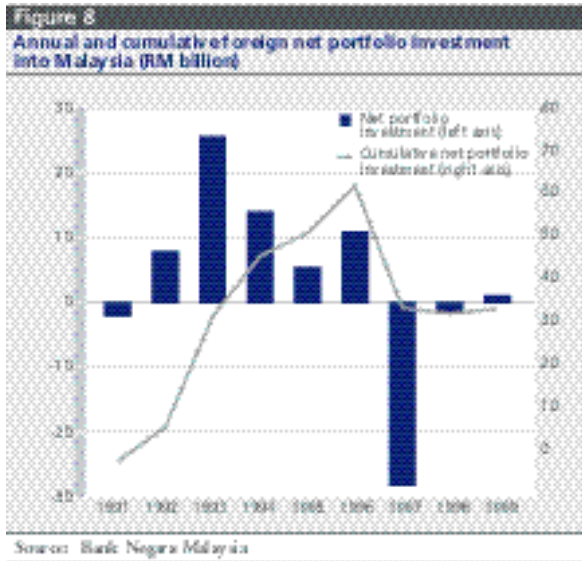
Source: *The 2000 Guide to Venture Capital in Asia (Eleventh Edition)* by Asian Venture Capital Journal

Slow recovery in capital market activity

The capital market's ability to attract investment flows has been an important factor in its successful development over the years. In the case of the equity market, this has hinged upon a combination of features, including sufficient scale and liquidity, and attractive valuations. However, for a variety of reasons, maintaining many of these aspects has become an increasing challenge for Malaysia's markets as well as for many other relatively established capital markets.

Within the domestic stock market, liquidity increased sharply during the 1990s as the value of trading soared with increasing international interest. The annual total value of trading reached over 230% of nominal GDP in 1993 towards the peak of the "super bull-run", but

²⁰ Based on data from *The 2000 Guide to Venture Capital in Asia (Eleventh Edition)* by Asian Venture Capital Journal

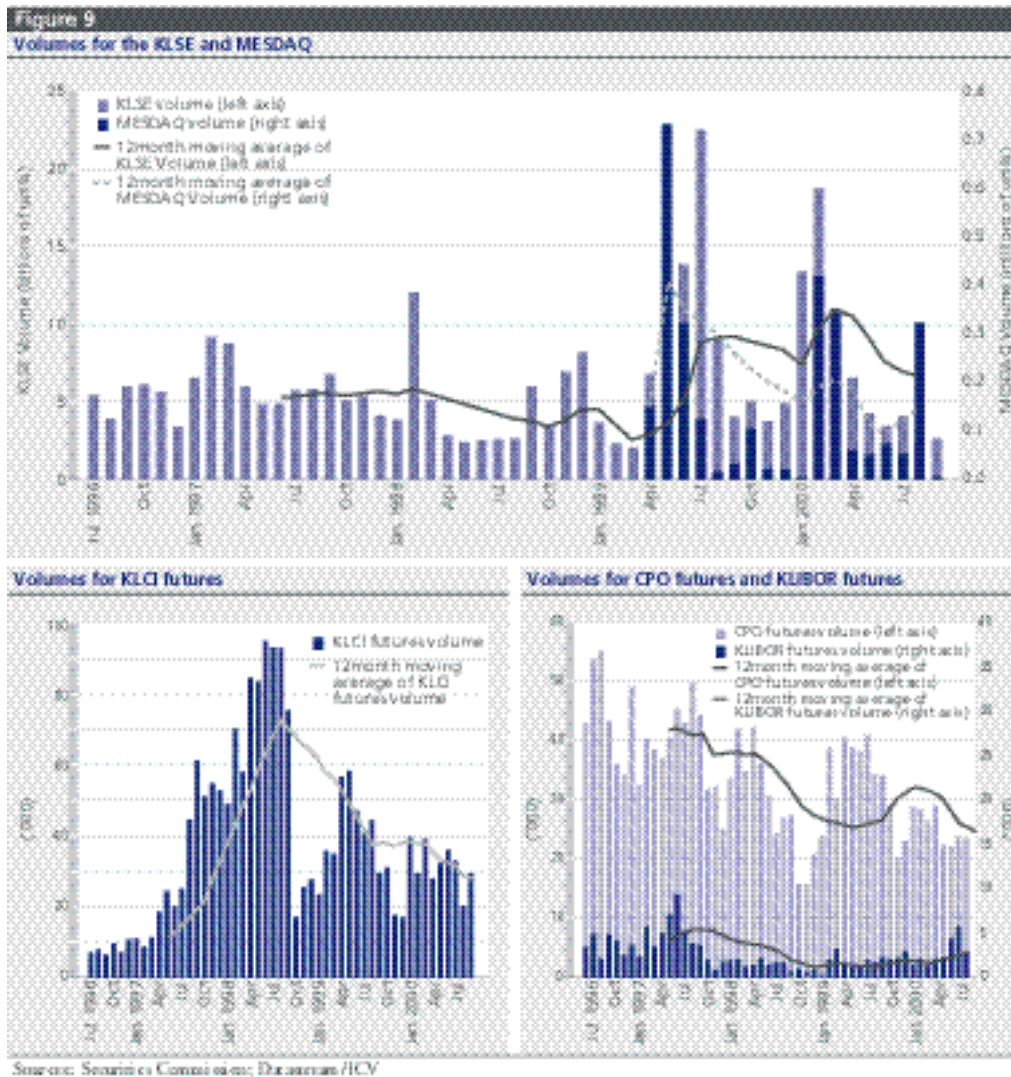


swung sharply after that, falling to around 40% of GDP in 1998 in the aftermath of the Asian crisis. For 1999, this figure had only recovered slightly to over 60% of GDP, still far below 1993–97 levels.

Although the degree of integration between the domestic capital market with the global marketplace has increased over the years, foreign activity in the Malaysian capital market has declined since the regional financial crisis. Annual foreign net portfolio investment in Malaysian securities has to date not reclaimed its 1993 peak, even declining to negative levels in 1997–98 (Figure 8).

The marked and consistent lack of liquidity in the more nascent markets within the domestic capital market is also an issue. For instance, trading activity on KLOFFE has not recovered to the levels seen prior to September 1998, while liquidity on COMEX has remained beneath its peak levels despite concerted efforts to stimulate further interest in these markets. In addition, the relative lack of investor familiarity with derivatives products, lack of an active hedging culture, and specific regulatory limitations related to participation in the derivatives market have also contributed to some extent to the slow recovery of the derivatives markets, despite the broad-based economic recovery from the crisis.

At the same time, the establishment of MESDAQ in October 1997 during the crisis and the related problems encountered at that time also impeded its ability to garner critical mass as quickly as initially hoped for. To date, liquidity and the number of listings on the high-growth exchange remain at comparatively lower levels than many other new high-growth exchanges in the region (Figure 9).



Meeting the Needs of a Growing Economy

Economic development is a central focus of Malaysia's national aspirations. This involves more than merely economic growth, but also a host of broad objectives, ranging from specific macro- and microeconomic targets to those that concern social dimensions.

In going forward, these imperatives will become more critical as the Malaysian economy achieves an increasing level of sophistication and complexity, driven by new technology amid the growing integration of the global economy in which it will continue to participate actively. Moreover, the country will also need to consider value-added initiatives if it is to remain relevant and competitive within this increasingly dynamic environment.

In particular, where technological advances are transforming the shape and role of financial services, there are significant implications for the development of the Malaysian capital market and economy. This is particularly pertinent where dramatic leaps in information and communications technology and the Internet have increased the potential

for growth in knowledge-based and service-oriented economies that focus on the quality of skills, knowledge and innovation to generate further efficiency gains and create added value.

A major thrust in developing the Malaysian economy must therefore be not only to preserve and strengthen the significant achievements of the last 30 years but also to complement these “old economy” strengths with value-added investments in the “new” or knowledge-based economy. And in order for Malaysia’s corporate sector to grow beyond the domestic market, the capital market must likewise be sufficiently global in outlook, and be adequately developed to meet the demands of an increasingly sophisticated economy.

While the capital market has been an important facilitator of economic development in the past, significant challenges remain in relation to the demands on the capital market from anticipated domestic economic development, and in relation to the trends that are affecting the global financial system, which are discussed in greater detail later in this chapter. Box 2 discusses the anticipated financing requirements of the Malaysian economy in further detail.

BOX 2

Projections of financing requirements going forward

In the years ahead, it is likely that the country will have to spend significantly more on investment compared to the previous decade in order to achieve a strong and sustainable rate of economic growth. Broad economic development objectives, as outlined in *Vision 2020*, include increasing GDP by eight times between 1990 and 2020, or around RM920 billion in real (1990) terms. Projections based on the rate of growth necessary to achieve this doubling of GDP every 10 years, and on assumptions about the productivity of capital that would serve to drive the economy towards this goal provide some indication of how large this investment would have to be.

If the size of Malaysia’s economy as of the end of 1999 is taken as a base, it is believed that real GDP will need to grow by around 7.3% a year in order to achieve the development target above in 20 years’ time. Given this, and assuming that the productivity of capital (as measured by the incremental capital-output ratio (ICOR)), is and continues to remain at 1987 levels (2.74), an initial projection suggests that the country will have to spend just under RM930 billion (in nominal terms) during 2001–10 for the economy

to maintain the growth path needed to achieve the *Vision 2020* target. This is 23% more than total (nominal) investment spending achieved during 1990-99 (RM758 billion).

However, it is widely believed that the productivity of capital has declined—possibly by over a half—over the course of the last 13 years as the economy has grown rapidly and moved closer to full capacity. Official estimates suggest that ICOR had risen to 5.5 in 1994 and then to 6.5 in 1998. Assuming that capital productivity going forward follows that of an historical average of around 4.9, and again taking into consideration a target real growth rate of 7.3% a year, then total nominal investment expenditure up to the year 2010 required to achieve the *Vision 2020* growth target will be even higher than that suggested by the initial projection above—possibly around RM1.5 trillion (around 30% of GDP a year).

Since 1994, the capital market has accounted for around 30% of investment funds raised in Malaysia. Assuming this trend is maintained and that investment spending projected above is realised, the Malaysian capital market would have to mobilise nearly RM500 billion over the next 10 years. This is over two-and-a-half times more than the total value of funds raised through the capital market during 1990-99 (RM185 billion).

Regardless of the actual quantum of figures being projected, the analysis above clearly highlights the significance of the financial system in supporting Malaysia's national aspirations going forward, and provides an indication of the greater role it will have to play in mobilising funds. So far, banks have played an important role in financing the needs of the country's rapidly growing economy. But the experience of the recent crisis points to a real danger of over-burdening the banking system with the task of financing production in the economy. A more diversified financial system—one in which the capital market plays a much bigger role than it does currently—can minimise this danger and would result in a more efficient and robust mechanism for mobilising and allocating financial resources in the economy.

Funding needs of issuers

Having a broad base of issuers within the capital market requires a sufficiently diverse range of financial products and services in order to meet their different needs and corporate structure profiles. Within Malaysia's context, this points to the need to broaden and deepen the various fund-raising avenues within the capital market that have to date not developed as significantly as the equity market.

The Malaysian private sector has principally relied on the banking system as a major source of funding and, within the capital market, primarily equity financing. Although efforts to develop the corporate bond market have led to the increasing expansion of this market segment, the extent to which the corporate bond market is utilised as a source of funding is still relatively low vis-à-vis the banking sector. In 1999, the outstanding value of bond issues amounted to under 67% of GDP, compared to outstanding bank loans which made up 157%.²¹

In view of the economy's present reliance on the banking sector for debt financing, the further development of the corporate bond market must be quickly and cohesively addressed going forward. For companies whose ventures have a relatively lengthy gestation period (for example, infrastructure projects), the lack of a viable source of long-term debt will hamper their ability to better match their asset-liability maturity profiles, as well as their capacity to adopt value-maximising capital structures. One consequence is that such companies can become over-exposed to rollover risk as they attempt to extend short-term credit for the duration of their projects. This risk is compounded if insufficient hedging measures are taken.

For some companies, one alternative has been to tap the international capital market for long-term funds. International debt issuance proved popular with a number of larger companies during 1995–96, reflecting in part the relatively attractive cost of funds abroad arising from rising domestic interest rates and strong foreign demand.²² However, external funds remain beyond the reach of most companies without the requisite capacity and credit rating to access the international debt markets. Moreover, the ability to tap the global market is clearly subject to the vagaries of international investor sentiment and the external economic environment, as the experience of the East Asian crisis showed only too clearly.

For domestic institutional investors whose portfolios call for the availability of suitable long-dated investment instruments such as pension funds and insurance companies, the absence of a deep and liquid secondary market in corporate bonds further restricts their asset allocation decisions, resulting in greater difficulties than they would otherwise face in meeting their risk-return objectives. In addition, without a sufficiently active market for corporate bonds, corporate risk premia become difficult to estimate, thus reducing the scope for market-based assessments of credit risks.

Risk capital is also another important means of financing within the overall capital market that is as yet relatively underdeveloped. As has long been recognised in the US and more recently in Europe, the capital market plays a crucial role in the mobilisation of risk capital, by providing a basis for valuations, an exit opportunity for venture capitalists, and by facilitating the raising of high-yield debt capital.²³ Similarly, as Malaysia's economic profile moves up the value-added chain, there will also be a need for capital markets to address the financing requirements of a wider spectrum of corporate risk profiles.

Clearly, some efforts have already been made to address this issue. The establishment of MESDAQ was meant to address the need for competitive forms of financing for small- and medium-scale enterprises, as well as the need for a viable exit mechanism for initial investors in technology-based start-ups and growth companies. The apportioning of

²¹ Source: Bank Negara Malaysia.

²² In 1995, Petronas, Telekom Malaysia, Malayan Banking and Tenaga Nasional collectively raised nearly US\$1.7 billion (RM4.3 billion). The following year almost US\$4.1 billion in total (RM10.3 billion) was raised by Malaysian corporations amid the continued availability of cheaper credit facilitated by improved international credit ratings. Only US\$2.1 billion (RM8.0 billion) was raised abroad in 1997—through 17 issues—while RM3.4 billion was raised in 1998. This was partly due to a spate of credit-rating downgrades across emerging market issuers and a significant increase in the credit risk premium demanded of their issues by global investors, both of which led to a significant increase in the international cost of funds for Malaysian companies.

²³ Source: "Risk Capital: A key to job creation—Implementation of the Action Plan", Directorate-General for

significant amounts of government funds for assisting in venture capital investment in start-ups also accentuate the government's firm commitment to seeing through the development of this sector of financing.

However, further efforts are required to ensure that there are effective mechanisms to provide early-stage financing for higher-risk ventures. Research and industry feedback indicate that the lack of a liquid IPO and secondary market for young companies, and a relatively small pool of expertise able to commercialise new ideas—particularly at seed and start-up levels—are among the most significant issues faced by the Malaysian venture capital industry today.

In view of heightened global competition for high-growth listings, such liquidity, value-recognition and expertise are vital in order to take advantage of the commercial opportunities available and preserve innovation within Malaysia. Although the government is a major source of funds in the Malaysian venture capital industry today, in the longer term the private sector is expected to be the primary—and perhaps even the only—source meeting the funding needs of such small high-growth enterprises, as befitting their risk appetites.

Investment and intermediation needs of consumers

In moving forward, it is expected that there will be increased pressure on the capital market from the consumer side to meet their changing investment needs and preferences. Within a growing economy such as Malaysia, in the longer term there will also be increasing challenges for the capital market to provide efficient returns on capital invested. At the same time, the lowering of transaction costs and increasing disintegration of barriers to cross-border investment are likely to prompt investors to become increasingly open to investing in different markets and products, particularly those that offer superior value for their investments.

This means that the services and products available in the Malaysian capital market must be prepared to meet these changing needs and adapt to the added competitive pressures from external markets. This is no small challenge because while Malaysia continues to enjoy one of the highest savings rates in the world, the manner in which national savings are managed—in terms of their mobilisation and allocation—remains relatively centralised. Partly as a result of this, funds under management are also concentrated within a narrow range of financial assets.

As of end-1999, the investment management funds in Malaysia totalled around RM280 billion of which the Employees Provident Fund (EPF) held RM157 billion. By comparison, the amount of funds channelled through the banking sector was RM560 billion. Asset management and unit trust companies managed about RM49 billion, while insurance companies accounted for a little over RM46 billion and other pension funds managed about RM28 billion.²⁴ By comparison, mutual and pension funds in 1995 accounted for over 41% of US financial assets, equal to that held by banking institutions. As at end-1999 investment companies in the US managed a total of US\$7.6 trillion in assets, more than double the US\$3 trillion deposited with US commercial banks, and nearly 90 million shareholders from approximately half of the nation's households had investments in mutual funds.²⁵

²⁴ Local funds managed by asset management companies excludes funds outsourced from the EPF, local insurance funds, local private pension funds and local unit trust funds.

²⁵ The data on US mutual and pension funds in 1995 are obtained from Arthur Andersen. The data on assets managed by investment companies in the US, deposits with US commercial banks and number of investors in mutual funds as at end-1999, are obtained from SEC.

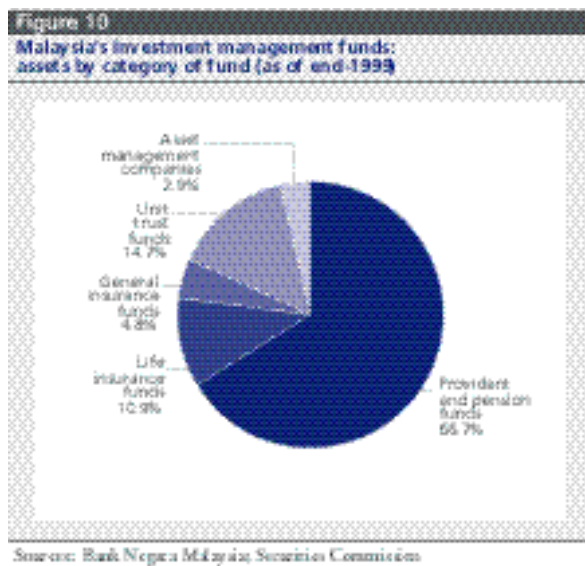


Figure 10 illustrates the breakdown of funds under management in Malaysia as at the end of 1999. EPF, as the largest single participant in the domestic investment management industry, had accumulated contributions amounting to RM 156.9 billion as at end-1999. Of this amount, EPF had only RM1.1 billion—under 1% of its total accumulated contributions—outsourced to external fund managers based in Malaysia.²⁶

Insurance companies comprising general and life insurance companies, together with Takaful, also play a major role in managing private funds. At the end of 1999, local insurance funds had a total of RM46.5 billion worth of assets under management.²⁷

While unit trust funds account for nearly 15% of total funds under management, the unit trust industry is currently dominated by funds under PNB, which manages nearly 70% of the Malaysian unit trust industry's NAV. Various factors, including the investment policies of some of these institutional investors and the relatively limited scope for asset allocation offered by the domestic financial system, have meant that these funds are also heavily concentrated within the domestic banking system and in government bonds.

This situation has limited the development of the investment management industry in several ways. The "capture" of funds by PNB and EPF has effectively reduced competition for investment management services, and this has to some extent limited the broadening and overall development of the investment management industry.

It is anticipated that the eventual decentralisation of managed funds from the hands of a small number of institutions will inevitably occur over time, as the market moves towards a more diversified and competitive investment management industry that will facilitate the more effective management of private funds. In the longer term, this shift will also minimise overall concentration of risk within the financial system and ensure that excess funds can be directed to a broader range of investment choices.

In tandem with the anticipated increased demands on the investment management industry, the market for broking services in Malaysia will likewise face increasing pressure to become more competitive and cost-efficient as well, given the important role it plays in the intermediation of consumers' investment transactions. To date, the development of services and products offered by the stockbroking industry has not grown significantly due to, among other things, limited competition as a result of barriers to entry and guaranteed revenue structures in the form of fixed brokerage commission rates.²⁸ At the same time, however, these same barriers to entry and fixed fee structures have made the stockbroking industry a lucrative one in the past, particularly during periods of bull-runs.

The stockbroking industry as a whole has been closely regulated, including a number of limitations on the scope of capital market activities that the stockbroking companies are allowed to undertake. However, while they are allowed to offer certain services other than

²⁶ Excluding withdrawals through the EPF Members Investment Scheme.

²⁷ Source: Bank Negara Malaysia.

²⁸ Entry into the stockbroking industry, for instance, has been restricted by geographical location.

securities broking, such as investment research and advisory services, it is noted that a high percentage of stockbroking companies' income is derived from brokerage commissions and interest income.²⁹ What this implies is that their primary source of revenue, which is highly correlated with market cycles, makes stockbroking companies highly susceptible to market risk, as was clearly observed during the East Asian crisis of 1997–98.

This narrow revenue base, coupled with a fixed commission structure and a policy that limits competition geographically, has meant that stockbroking companies have arguably had little incentive to devote the resources needed to move beyond their role as pure broker-dealers. Given these issues, the stockbroking industry as a whole faces challenges in building up the ability to develop sufficient capacity—both financially and in terms of breadth of services—to continue to serve their customers effectively and remain competitive amid further deregulation and liberalisation.

Employment and knowledge development needs

The capital market contributes directly to national economic growth in terms of employment and tax revenues. Given the information-intensive nature of capital markets and the demand for a highly skilled workforce within the industry, the continuous upgrading of human capital and supporting infrastructure to create an internationally competitive capital market is critical for the development of both the capital market and a knowledge-based economy.

Malaysia requires a sufficiently large pool of highly skilled human resources to tap onto, particularly in terms of technical financial skills that are needed to take on jobs with high added value. In order to attract these skills and generate incentives for commercially oriented innovation, there must be a sufficiently vibrant and developed capital market.

More generally, it is anticipated that highly skilled personnel will gravitate to those markets and institutions that offer them greater opportunities, rewards and standard of living. A market that wishes to attract skilled manpower does not only need to offer the necessary vacancies and fiscal incentives, but also the sufficient presence of international-class employers that can offer them the opportunities for development that they seek. Where Malaysia lacks the necessary expertise to develop through its own residents, there is also a need to attain sufficient critical mass in these professions in the capital market.

With regard to knowledge development, the promotion of the market for risk capital and a facilitative environment for high-growth companies will help preserve the location of a strong innovation base within Malaysia. In countries where there is a relatively mature market for venture capital, for example, venture capital companies typically not only provide funding to their investee companies, but also advise on strategic planning, business management and sourcing of knowledge workers. This is an added gain to the investee company that should eventually filter down to benefit the broader sector and economy as a whole. At the same time, the levels of professional expertise in the capital market need to be continuously upgraded and redeveloped to support overall capital market growth.

The implication arising from these developments is that any failure to develop the human and knowledge capital within the Malaysian market translates into a real loss of technical capacity and developmental opportunities for not only the capital market, but also its entire spectrum of users.

Heightened Global Competition for Business and Investment

The internationalisation of markets has been seen in the growing tendency for markets to have more multilateral linkages with other countries. This has been particularly the case as individual national markets seek to expand their internal capacity and external reach, while at the same time deriving other auxiliary benefits of greater interaction with the global community. Globalisation, which, in its broadest sense, refers to the increasing integration of global society and economies, has resulted in intensified levels of interaction across traditional geographical, cultural and jurisdictional boundaries. This growth in cross-border economic activity has taken on various forms, including the areas of:

- International trade: the exchange of goods and services between countries
- Foreign direct investment: investments by residents of one country in another country made for the purposes of establishing and running business operations in that other country
- Cross-border portfolio flows: investments by residents of one country in investments or financial assets in another country

While the passage of integration has not been smooth, as exemplified by the cross-border network effects seen in recent financial crises, it has nevertheless become a pervasive feature within the global marketplace. As such, it is impossible for any economy to ignore the effects of globalisation, or their implications for national financial systems.

A key implication of globalisation for the capital market is that of heightened international competition for business as market participants respond to this increased cross-border integration. Some of the major global trends identified as driving this competition are:

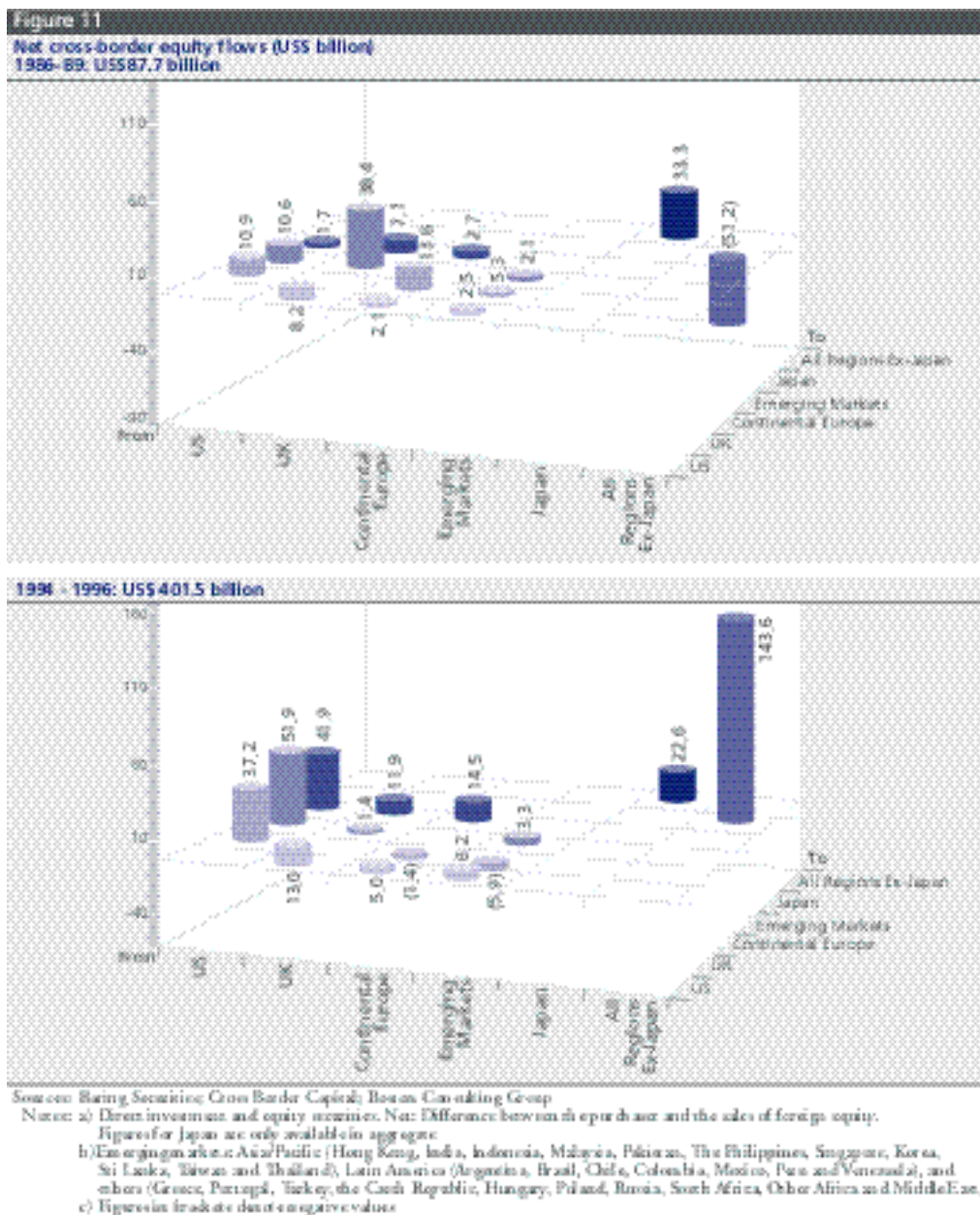
- Growing pools of investable funds worldwide
- Consolidation and alliances between financial institutions, and between exchanges
- Increasing usage of technology and innovation to obtain greater efficiency and competitive gains
- Focus on specialised areas of the capital market to diversify, differentiate and add value to the market
- Liberalisation of capital markets

These issues, both in isolation as well as in combination, have had a profound influence on the landscape of the global financial market and financial services industry, and are discussed in further detail as follows.

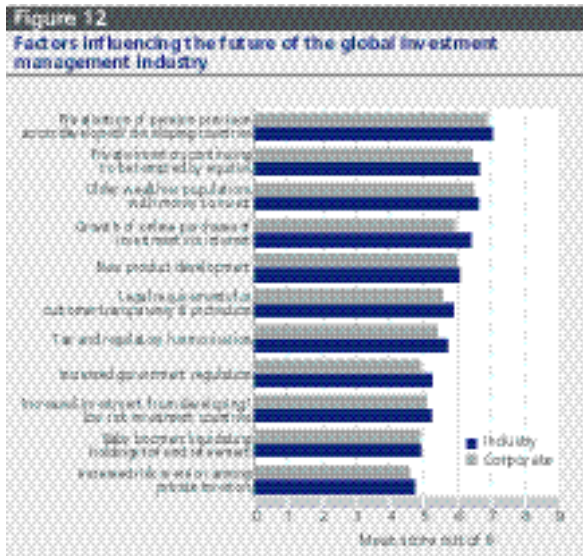
Growing pools of investable funds

The environment in which capital market activity takes place has become increasingly dynamic, competitive and globalised, driven by a combination of factors, including advances in financial techniques and computing technology; the deregulation of financial activity in many jurisdictions; and the changing patterns of fund raising and investment.

As global economies and their output grow, the pools of investable funds are also expanding significantly.³⁰ Cross-border transactions are growing as investors increasingly view international investment opportunities as part of their investment universe. Direct and portfolio investments from the US, in particular, have seen rapid growth since the 1980s, while Asian economies, including Japan, witnessed a tremendous increase in net capital flows from the mid-1980s to mid-1990s (Figure 11).



³⁰ Combined with the increased level of interaction and interdependence among participants, long-term estimates suggest that given current trends in the early 21st century: total worldwide pension assets could top US\$15 trillion; international investments by pension funds might rise to US\$2 trillion; global mutual funds may reach US\$16 trillion; and listed financial assets of global securities markets are projected to reach US\$90 trillion. (Source: Arthur Andersen.)



Source: "Asset management: strategic perceptions of investors' markets", *Global Financial Services Research Paper Issue No. 1*, Arthur Andersen, June 1999
 Note: Survey participants were asked to rank factors that might influence the future growth of the asset management industry, either positively or negatively.

Pension and mutual fund reform in many markets is also a key factor that potentially signals the continued increase in available funds looking for viable investments (Figure 12). Regulatory reforms and incentives, for example, have greatly facilitated the boom in the mutual and pension fund industries in the US and Latin America. As pension systems in other markets grow larger and as global wealth increases, there will need to be more efficient channels through which this wealth can be invested, resulting in rising demand for more competitively managed investments.

Commensurate with the expected increase in liquidity pools, the intermediation of funds in emerging economies is expected to become increasingly capital market-based as they compete with more developed markets for global funds. Improvements in communications technology and greater

consumer awareness of the availability of alternative investment destinations other than the domestic market are also likely to accelerate the growing mobility of funds.

Competition among market institutions

Increasing globalisation is leading to more inter-linkages between national financial systems, with markets across different geographical locations and in different asset classes becoming interconnected through a higher level of cross-border activity. Technology has been—and continues to be—a key driving force of this, prompting heightened competition for mobile capital flows while at the same time redefining the roles of traditional market institutions.

One way in which many international exchanges are responding to these challenges is through consolidation and strategic alliances, often across different asset markets and countries. This is largely a reflection of the increasingly borderless nature of financial markets, and the wide recognition that investors and issuers are essentially faced with viable options not only within their own national boundaries but also beyond them.

As large issuers seek greater liquidity and ease of access to new capital, exchanges are increasingly competing amongst each other to increase their market share, achieve economies of scale, and offer alternate delivery channels and more flexible trading practices such as online, after-hours and cross-border trading.

Because exchanges' primary sources of business come from where there are existing pools of liquidity and high-quality investments, many are responding to these competitive pressures through a variety of measures. These include aggressively moving towards demutualisation

and more commercially oriented business strategies, merging among themselves, and establishing alliances in order to position themselves most effectively in the global marketplace.

Examples of both proposed and existing mergers and alliances between exchanges include Euronext, Euronext, the National Association of Securities Dealers Automated Quotation (Nasdaq) alliances, and the proposed Global Equity Market; bilateral alliances such as those between Sydney Futures Exchange Ltd (SFE) and New Zealand Futures and Options Exchange; and domestic mergers such as those between the Stock Exchange of Singapore (SES) and the Singapore International Monetary Exchange Limited (SIMEX). Figure 13 and Figure 14 illustrate some of the major trading linkages between international exchanges that have been proposed or are already in existence today.

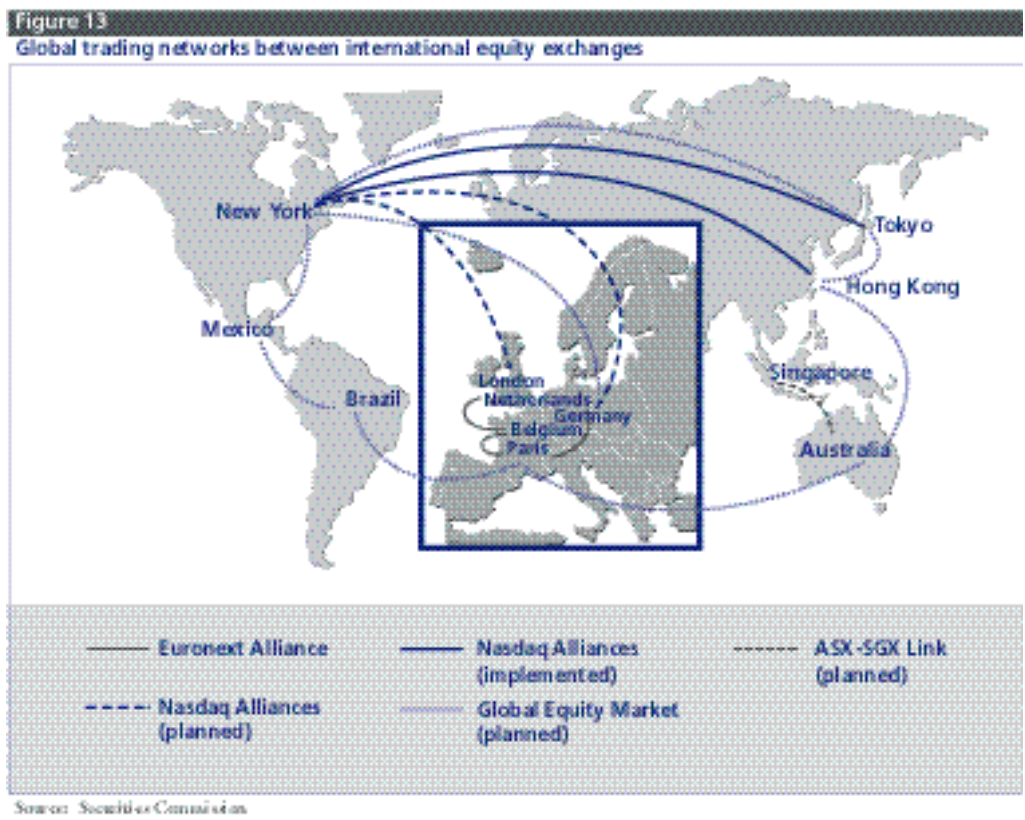
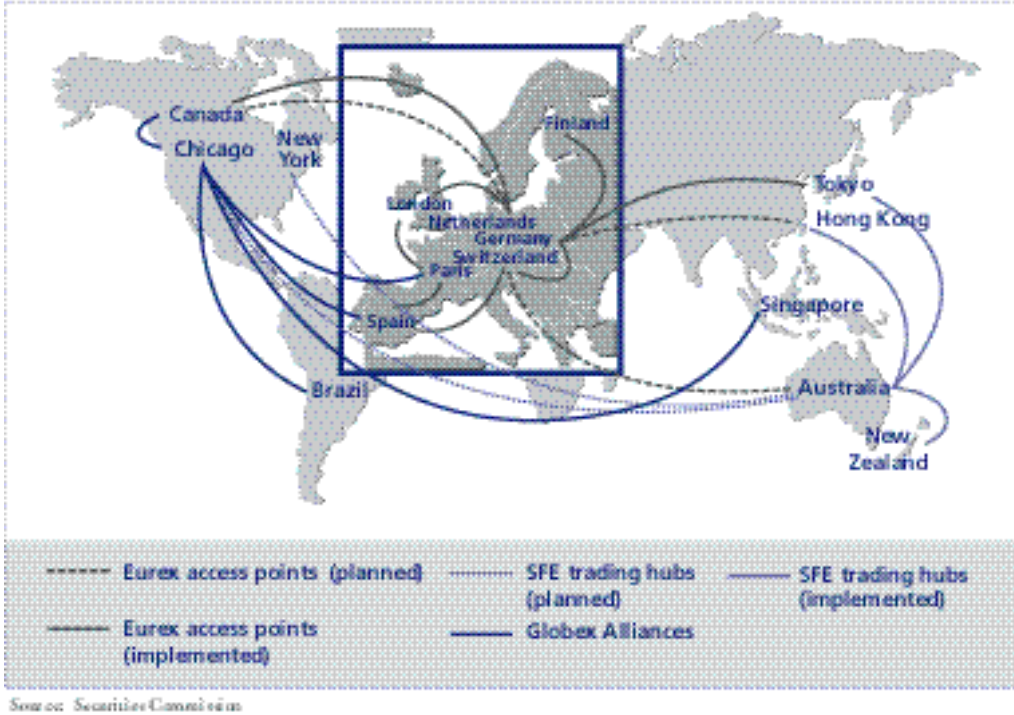


Figure 14
Global trading networks between international derivatives exchanges



This trend towards mergers and strategic alliances augurs the faster development of a wider variety of integrated products. Exchanges that successfully capitalise on the expertise and market share of their partners will be able to offer their collective constituents access to a wider range of markets, and will in turn be able to derive additional business through their access to their alliance partners' markets.

This trend poses a challenge for Malaysian market institutions' role as the exchanges of choice for issuers and investors in the future. The current existence of several market institutions as separate entities results in a fragmentation of liquidity and disperses the overall capacity, efficiency and marketing position of Malaysian market institutions in responding to these increasing challenges (see Box 3 for an overview of the present structure of market institutions in Malaysia).

While some extent of industry consolidation has already taken place, there is still scope for greater efficiency gains and alignment of their individual strategic interests. This would also solve some of the funding and market access problems currently faced by some of the smaller exchanges, which could then leverage on the broader membership base and financial resources of the larger institutions.

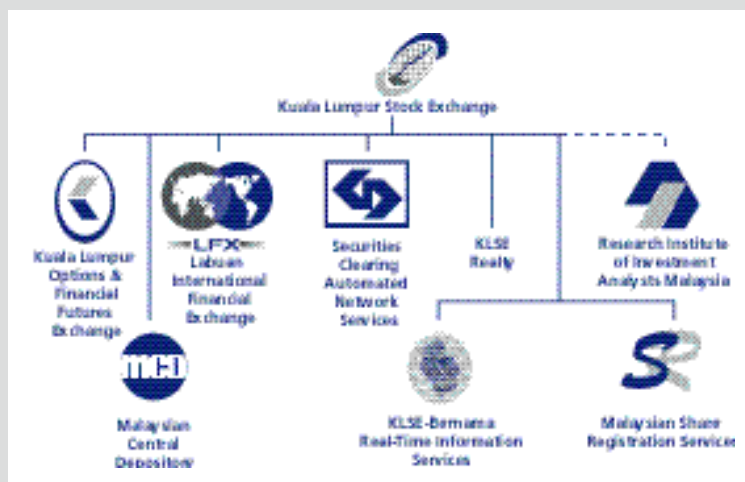
BOX 3

Present structure of market institutions in the Malaysian capital market

The KLSE operates as a group of companies that collectively service the securities industry. Both KLOFFE and the Labuan International Financial Exchange Inc. (LFX) are wholly owned subsidiaries of KLSE. Securities Clearing Automated Network Services Sdn Bhd (SCANS), another wholly owned subsidiary of KLSE, is the central clearing house, while the MCD is a 55%-owned subsidiary of the KLSE and operates the CDS, the central depository system.

KLSE-Bernama Real-Time Information Services Sdn Bhd (KULBER), also a subsidiary of the KLSE, compiles and disseminates real-time share price and other relevant financial and economic information to information vendors and other subscribers. Research Institute of Investment Analysts Malaysia (RIIAM) is an affiliate company of the KLSE. Its main objectives are to upgrade the standard of investment research in Malaysia and to enhance investor education through courses, seminars and workshops. Malaysian Share Registration Services, another subsidiary of KLSE, provides computerised registration services to listed companies and to existing company registrars.

The diagram below illustrates the structure of the group:



Source: Kuala Lumpur Stock Exchange

MESDAQ was intended to bring together growth companies and investors. MESDAQ was established as an exchange in October 1997. It is a company limited by guarantee and wholly-owned by its members. It is a non-profit organisation but intended to be self-funding, and generates income from sources including membership and listing fees. It has a nine-member Board of Directors comprising four representatives selected by the Minister of Finance and five representatives selected from MESDAQ's market participants.

COMMEX is a member-owned exchange. Incorporated in July 1980, it is established as a company limited by guarantee. Funding comes mainly from membership fees, annual subscriptions and contract levy. The Management Board comprises three Minister-appointed directors (of which one serves as Executive Chairman) and six others elected by the affiliates of the exchange. On 24 March 2000, the KLSE, which owns KLOFFE, and COMMEX signed an Memorandum of Understanding (MOU) in a move to consolidate the two exchanges.

The futures clearing house is the MDCH, which is jointly owned by both KLOFFE and COMMEX, and is a company limited by shares. It is a legal entity separate from the two derivatives exchanges with which it has contracted to act as the clearing house.

Greater competition faced by capital market intermediaries

Increased competition in the financial services industry, coupled with the deregulation of key restrictions on the scope of activity in many jurisdictions over the past couple of decades, has resulted in greater emphasis on lowering the costs of intermediation and greater customer-orientation through the quality and diversity of services rendered. Importantly, it has also prompted the rise of financial conglomerates that undertake a wider range of financial market services.

The distinctions between traditional forms of financial intermediation such as commercial banking, investment banking, insurance, securities broking, investment management and other services are being further challenged as a result of innovation and heightened competition for business. The emergence of financial supermarkets has been particularly marked in recent years, with the mergers of a number of well-established multinational financial institutions resulting in the establishment of even larger international, integrated financial groups.

The global presence of these intermediaries means that it is easier for them to cater to their clients' needs across different countries, making them the preferred one-stop intermediaries for multinational companies and mobile clientele. In addition, they would also be well placed to participate in the lucrative area of advising clients on raising finance and on mergers and acquisitions given their international reach.

The creation of large financial conglomerates through consolidations, alliances and expansion plans poses significant pressures for Malaysian capital market intermediaries. While not competing directly for global market share with more established multinational financial services providers, they will nevertheless have to prepare themselves adequately to face the implications of potential new entrants into the domestic playing field. In terms of sheer size and influence alone, domestic intermediaries will need to significantly strengthen and diversify their services in preparing for heightened competition with their international counterparts. Smaller intermediaries will find it increasingly difficult to compete in an environment where competition is forcing profit margins lower and costs to the intermediary itself are rising as a result of the increasing need to invest in new technology.

The international experience has been that intermediaries that are responsive to these trends, and which either focus on building integrated services or differentiating themselves through niche markets, continue to be in demand by consumers. For instance, competition for business in many other jurisdictions has seen a number of foreign securities houses getting involved in various value-added fee-based activities. These include brokerage services for non-equity capital market products, corporate finance activities such as primary market issues and private placements, and cash management services including flexible central asset accounts for securities transactions with functions such as money market fund sweeps, debit cards and other financial management services.

Usage of technology and innovation

Existing market structures and institutions are being challenged in many ways by advances in technology and innovation. New entrants are increasingly exploiting technology to achieve cost efficiencies and to create new distribution and transaction channels, as well as to take advantage of inefficiencies and supply gaps in the market. Consumers of financial services increasingly have more options to bypass traditional market intermediation. At the same time, market intermediaries are introducing newer and more innovative ways of producing, distributing and accessing financial products in order to retain their client base, as well as to gain the edge on potential market entrants.

Greater use of the Internet within the capital market has led to a drastic change in the investing landscape in many markets. The rapid growth of online trading in the US, Germany, Korea and Taiwan, for example, attest to investors' growing use of this medium and play a more direct role in managing their financial portfolios.^{31, 32}

A major reason for this growth has been the ability of online brokerages to exploit the cost-savings afforded by Internet technology and thus offer lower commission rates than what traditional full-service brokerages and discount brokers charge on average.³³ The disparity between the cost of physically distributing financial services and the cost of doing so "virtually" is significant in favour of electronic media, and this is expected to increase over time.

This poses a challenge for those performing stockbroking services all over the world, where certain traditional broking functions, such as manual order-taking and entry, are facing the increasing pressures of disintermediation. In spite of these developments, however, market intermediaries are not in immediate danger of becoming obsolete. There is still a demand at present for them to act as a buffer between the general investing public within the more

³¹ For instance, online trades in the US are estimated at 35% of total trades done in early-2000, and may even reach 75% of total trades by the year 2005. (Source: Arthur Andersen.)

³² Online trading accounted for 63% in August 2000 (with trading value amounting to US\$150 billion for that month) of Korea's total stock trading volume. (Source: "Korea Online Trading Hits 63 Percent of Total" by Michael Kim, internet.com Corp., 11 October 2000.)

³³ Some estimates indicate that US online brokers charge commission rates of about 10% to 25% of what traditional full-service brokerages and discount brokers charge on average. (Sources: Ameritrade Inc.; PC World, February 1999.)

traditional exchange-traded market structure. Rather, the implication is that market intermediaries must be cognisant of where such technological solutions and opportunities exist, and take advantage of them to broaden their scope of activity and add further value to their core services.

Developments capitalising on technological efficiencies augur increasing competitive pressures for exchanges as well. Alternative trading systems (ATs) in the form of electronic communication networks (ECNs), for one, have gained substantial attention in recent years, due to the potential implications they pose to future market structures. Although ATs have been in existence even from the 1970s, more recent entrants in this field might be viewed as part of the wider phenomenon involving the growth of business-to-business (B2B) e-commerce, which capitalise on network technology to establish direct links between business participants. Indeed, the growth in activity handled by ECNs in the US has seen them handling approximately 28% of all Nasdaq trades in 1998.³⁴

However, while the disintermediation of traditional exchange structures by ECNs seem to provide certain immediate benefits to investors, it is not clear at this stage whether they offer uniform benefits to other markets operating under different systems and circumstances. Questions also remain as to whether multiple markets can feasibly co-exist where there are smaller liquidity pools, which would possibly lead to less efficient and fragmented market structures.

Nevertheless, to stay ahead of the curve many jurisdictions are already rapidly closing the digital gap through the judicious use of technology and innovation. In some cases, the development of technologically advanced market infrastructure itself has been used as a source of competitive advantage. This is reflected, for instance, in the proposed development of an integrated market “eInfrastructure” in Hong Kong. These developments signal clearly the need for market participants to not only be continually aware of the challenges posed by technological facilitation, but to be highly proactive in exploiting strategic opportunities where technology offers them a potential competitive advantage.

Development of specific value-added areas of the capital market

As markets move higher up the value chain, they increasingly focus on specific areas that offer potentially greater value for the market as a whole, and those in which they can gain a competitive advantage. As exchanges are increasingly shifting from non-profit to profit-oriented concerns, they are seeking to reduce costs and find new business opportunities through differentiating themselves.

One avenue through which some markets are positioning themselves is in the form of strategic alliances with other markets, which in some cases has also helped more expansionary-minded markets to strengthen their role and influence within their own regions.

Another notable trend has been the rapid progression made by many countries to develop their venture capital industries. India, for one, has been particularly active in this regard. Exchanges are also competing aggressively to retain and enhance liquidity by attracting the best-quality listings, particularly those in high-growth sectors such as technology and biopharmaceutical sectors. These include the Neuer Markt in Germany, the Alternative Investment Market (AIM) in London and the Growth Enterprise Market (GEM) of Hong Kong.

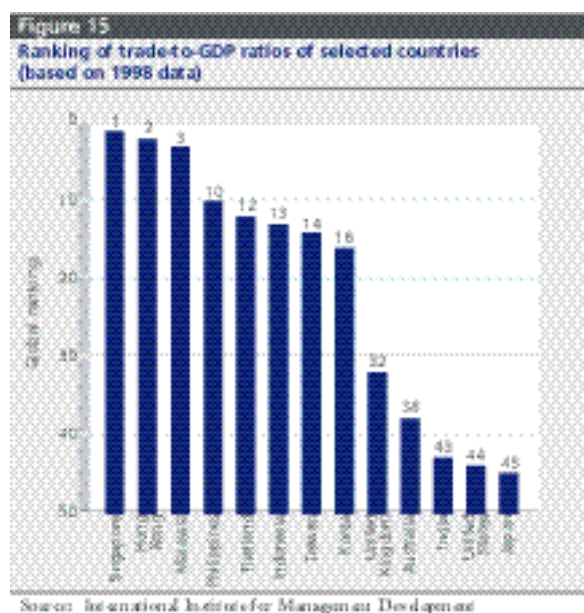
³⁴ Source: Forbes, 11 June 1999. In the US, the emergence of ECNs was prompted by changes to regulation in January 1997 aimed at introducing greater competition for market making on Nasdaq. Their success in providing an alternative market for Nasdaq-listed stocks has primarily been due to their relative efficiency and lower transaction costs compared to Nasdaq market makers. Moreover, ECNs also provide innovative services such as access to cross-border investors and markets, and after-hours trading.

However, other less ubiquitous niche markets are being explored by many jurisdictions as well. In most cases, the area of specialisation is one where the market of origin already possesses the basic building blocks and natural advantage to be a competitive player in the global marketplace. This is why the push to be an international Islamic financial centre is not only seen in Middle Eastern markets such as Bahrain, but now also in other emerging Islamic nations such as Brunei Darussalam. The Toronto Stock Exchange is capitalising on Canada's existing position in the natural resources sector by marketing itself as a preferred international hub for the listing of resource stocks. And Singapore is also focusing on its strengths in the financial services sector by building on its own domestic fund management industry while enacting liberalisation policies to attract more foreign institutions and professionals in this sector.

Liberalisation of capital markets

Since the 1960s, the liberalisation of regulatory restrictions has resulted in significant increases in the proportion of world output traded internationally. The nominal value of exports globally rose from US\$200 billion in 1967 to over US\$5.5 trillion in 1999. As countries and their economies have become more open and more intertwined through international trade, so too have their financial systems.

At present, Malaysia is one of the most trade-dependent economies in the world (Figure 15).³⁵ As Malaysia's own trade barriers are gradually being relaxed further given its various multilateral trade liberalisation commitments, the country's reliance on the economic and financial health of its economic partners will consequently increase over time. As such, Malaysian businesses will increasingly need to have access to the appropriate instruments and services that allow for effective capital formation and risk management, commensurate with the country's current and future involvement in the global real sector.



Malaysia's involvement in various global multilateral negotiations to liberalise access to its financial services sector reflects its recognition of the importance of the liberalisation process in furthering Malaysian economic interests. In the 1994 Uruguay Round of Multilateral Trade Negotiations of the General Agreement on Trade in Services (GATS), Malaysia's commitments included measures to increase foreign equity ownership limits in stockbroking companies and measures relating to the entry of managers, specialists, experts and professionals, and the commercial presence of foreign capital market service providers. In December 1995, Malaysia also entered into the ASEAN Framework Agreement on Services (AFAS), one aspect of which was to develop its commitments on financial services liberalisation.

However, recent years have seen an acceleration in the rate of financial services liberalisation in many other developing and neighbouring markets, in order to tap the benefits of greater foreign participation in their markets. A number of these markets now

³⁵ The country's combined exports and imports stood at around 190% of GDP in 1999.

even allow up to full foreign ownership of PLCs and market intermediaries, with no restrictions on the number of foreign professionals employed.

As such an environment encourages the entry of high-calibre finance professionals and skilled manpower from all over the world, such liberalisation has been used as an approach towards building a critical mass of players and activity in these markets. Even as capital and financial institutions are becoming more internationally mobile, so too are the people who manage this capital and who work for these institutions.

More generally, the competition for skilled human capital among global markets means that national economies must address the issue of mitigating the “brain drain” to other markets, while at the same time attracting highly skilled citizens working in other countries back to the domestic market. Some, such as London, Singapore and Hong Kong, have also chosen to substantially liberalise their financial markets with emphasis on building the depth and quality of financial services offered in their markets through the accumulation of expertise from all over the world.

These issues are reflective of global trends that will have to be taken into account within the context of the Malaysian capital market. Inaction may result in increasing cause for issuers and investors to shift to other markets that offer more attractive value proposition. Under such circumstances, the risk that the domestic market will become the main funding base for only those issuers that are not able to raise funds elsewhere will increase.

Changing Demands on the Regulatory Framework and Authorities

Financial activity at both the national and international level has become increasingly complex and dynamic. In addition, the East Asian crisis that erupted in mid-1997 has provided further evidence that national financial systems are more interdependent and that links between markets trading in different assets have strengthened significantly. This evolving landscape has resulted in a blurring of historical distinctions between institutional arrangements and financial activities. As a consequence, the scope and nature of financial activity is increasingly being seen to have developed well beyond that of traditional regulatory structures and jurisdictions.

Market participants are increasingly branching out and diversifying to offer a broader range of products and services, in order to compete and grow. As product lines blur, a greater convergence of functions is expected to emerge in the financial landscape, which will result in expanding the influence of financial conglomerates or financial supermarkets.

Consequently, regulators who oversee sectors of the financial market where they have the authority and specialised expertise are being challenged amid the growing integration of financial intermediaries’ functions. Regulators in a number of markets have attempted to effect changes to better address these challenges, of which the regulation of financial institutions by the functions they perform has been widely seen as the direction to take in optimising and streamlining existing regulatory resources to ensure seamless regulation.³⁶

³⁶ In Australia, for instance, the regulatory framework was restructured in recent years based on the separation of prudential and product regulation. The former now falls under the purview of the Australian Prudential Regulation Authority (APRA) and the latter under the Australian Securities and Investments Commission (ASIC). The UK, on the other hand, consolidated all regulatory agencies in the financial services industry into one single Financial Services Authority (FSA). Hong Kong uses the functional regulation approach, as the US does, whereby the Hong Kong Monetary Authority (HKMA) oversees the banking system and the Securities and Futures Commission (SFC) oversees the capital market and licenses all entities—including banks—operating as capital market

In Malaysia, the shift towards functional regulation of the financial markets has, to some extent, been initiated with the establishment of the SC in 1993 as the regulator of the capital market, with BNM retaining regulatory oversight of the banking system and responsibility for monetary policy. However, given the changing role of intermediaries and professionals in the securities, banking, and insurance industries and the increasing offering of integrated services and products in these markets, a closer review of where gaps and overlaps exist should be addressed to ensure that full functional regulation of the financial markets is achieved (see Box 4).

The increasing internationalisation of financial operations has also accentuated the international dimension of regulation. Regulators at the national level no longer concern themselves only with issues within national boundaries but are forced to consider issues relating to the growing international nature of their constituents. As a result, regulators are increasingly moving away from prescriptive rules to a market-based approach, in order to be able to react swiftly and respond adequately to changes in the marketplace.

Greater international regulatory co-ordination and harmonisation are also needed. Increasing pressure will be placed on regulators to co-operate and develop information sharing networks as well as mechanisms to meet the regulatory demands of globalisation and technology. Regulators must keep pace with the increases in cross-border activity such as market participation, trading volumes and exchange linkages. In many cases, international groupings of securities regulators and financial authorities have drawn up relevant international standards in order to establish readily recognisable and acceptable benchmarks on key areas affecting the development of capital markets.

BOX 4

Functional regulation of the capital market

The financial system in Malaysia is divided into three sectors: the banking system, the non-bank system and the capital market. The reasons for this sectoral division are in part historical, with the growth of commercial banks in the 1950s as the origins of the financial system, to the growth of a myriad of intermediaries in the 1970s together with other non-banking institutions, followed by the active development of the capital markets in the 1980s and more recently, the futures markets.

The regulatory framework has developed on an incremental basis as new institutions emerged on the basis of the existing legislative framework of the time. Legislative activity has by and large taken place to address perceived or potential failures in the system or to address the need to protect investors. Consequently, the regulatory approach is one that is based on the specific purview of the

regulatory agency, such as BNM over the banking system and its intermediaries and insurance industry, and the SC over the regulation of the securities and futures markets and non-bank intermediaries in the capital market. In addition, the ROC also exercises regulatory authority over financial market participants in its administration and enforcement of duties, rights and obligations pertaining to public companies, their directors and officers as well as investors as shareholders.

The underlying objectives for such an approach to regulation remain sound, namely, to enable investors to assess the risks involved in financial markets, and as well as to maintain the safety and soundness of the system. However, because of the manner of its growth, overlaps in the jurisdictions of the various agencies as well as inconsistencies within the regulatory framework now exist. These overlaps and inconsistencies result in:

- **Inefficiencies** . Regulation based on an institutional structure may impact on the effectiveness of regulation and supervision because of the expertise, experience and culture that develop within each respective regulatory agency. Closely related to effectiveness is the question of clarity of responsibilities for particular aspects or objectives of regulation. An example is the duplicative regulation in relation to corporations that occurs in some cases. This often leads to considerable difficulties, particularly in the area of enforcement
- **Differing standards of investor protection for similar risks.** Seldom is there a single objective of regulation. When multiple objectives are set and because of the institutional structure of regulation, they can lead to conflicts and differing standards of investor protection for similar products. Similar forms of protection should apply where similar risks are involved. However, under the present regulation, similar investments provide differing standards of disclosure and different regulatory regimes in respect of agents and other persons marketing such products
- **Unequal treatment of participants** . Some inconsistencies in the application of regulation that have arisen over time have also resulted in the unequal treatment of participants. For example, banking institutions which carry out asset management services are not licensed under the SIA, unlike other asset managers licensed under the SIA.

As financial modernisation increases within the domestic market and financial products become increasingly less open to easy

classification and interpretation, whereby a wide variety of institutions engage in substantially equivalent activities, it is vital that the regulatory framework for the Malaysian capital market embodies the concept of regulatory parity.

The idea of functional regulation emphasises the principle of regulatory parity. The need for a functional perspective is reinforced by the increasing scope for hybrid and complex transactions; the trend to the unbundling of financial products and services into their constituent economic, risk and value components; and the blurring of boundaries between once separate institutions, products and market sectors. The notion is that if a market participant is engaged in a particular activity, the participant should be regulated in the same manner as other market participants who engage in substantially equivalent activity. This level playing field promotes confidence and consistency in the overall regulation of the market place.

GOING FORWARD

Capital market growth is premised on two inter-related areas: the extent of competition; and the nature of the environment in which businesses operate. As the economy develops, what were strengths in traditional ways of competing may become weaknesses at more advanced levels of development. Moving on to more sophisticated ways of competing depends on parallel changes in the capital market environment. Successful economic development is a process of successive upgrading, in which the market microstructure and regulatory environment evolves to support increasingly sophisticated and productive ways of generating wealth.

In addition, the process of globalisation, while not new in itself, has become an integral issue in the development of financial markets worldwide. Extensive technological advances have made it possible for information dissemination and transaction execution to be done on an increasingly faster and more efficient basis. Capital and labour mobility means that markets are becoming increasingly integrated and it is becoming more and more necessary for individual markets and institutions to remain efficient, liquid and offer superior value to their stakeholders, to ensure they remain the market of choice for their constituents.

In Malaysia, the situation is clearly not yet as dynamic or intense. This relative calm, however, is not necessarily fortuitous if it connotes the potential diminution of the domestic capital market's role and competitiveness both at home and abroad. If this is the case and the status quo is maintained, greater effort will be needed at a later stage to catch up with more progressive markets. The following outlines some of the major areas for attention in responding to these challenges facing the Malaysian capital market and its participants.

Enhancing the Value Proposition for Malaysian Issuers

Companies ultimately set the level of national productivity, and their ability to compete is inextricably linked with the quality of the national business environment and capital market development. More sophisticated strategies by companies require an adequately integrated capital market infrastructure, responsive and efficient market institutions, skilled human capital, and a culture of innovation and entrepreneurialism within the market's community of participants that takes full advantage of the opportunities available for developing these traits.

To ensure that the needs of the growing economy are met, there must be sufficient avenues for capital mobilisation to sustain and augment economic activity. This requires the development of liquid and efficient markets across the spectrum of fund-raising instruments, from bonds and equities to hybrid securities, as well as related risk management products. The process of raising funds through each of these markets must be efficient and competitive in terms of the time and costs involved.

Secondary market liquidity is also an important consideration for potential issuers, as it lowers the cost of raising funds. Any potential marginalisation from global liquidity flows will mean that issuers in Malaysian market institutions will need to rely primarily on domestic funds, which in turn will limit their fund-raising capacity to the amount of capital available through domestic means.

In moving forward, it is envisaged that global competition to offer the best value for international issuers will require the domestic capital market to be able to respond quickly and effectively to these pressures. Inaction may result in increasing cause for the most highly rated Malaysian issuers to look overseas for the best fund-raising valuations available to them. For many issuers, among the benefits cited for listing on more established exchanges are greater liquidity, global profile, efficiency of the fund-raising and securities valuation processes, availability of a wide range of services, internationally recognised standards and the reputational value of the exchange's name.³⁷

As it is, Malaysian corporations already have considerable funding dependency on the international markets. For instance, since the mid-1990s large Malaysian corporations such as Petronas, Tenaga Nasional and Telekom Malaysia have looked to bond markets overseas for long-term funding. In addition, a number of Malaysian companies have also successfully listed securities on foreign stock exchanges.³⁸ Also, the restructuring of Malaysian banks and corporations post-crisis will still require some amount of external funding, while the early financing needs of emerging high-growth companies will require further development of the market for risk capital.

As enterprises with good prospects, sound reputation and high growth potential are typically those that have the capacity for easy entry into international markets for raising funds, efforts need to be taken to ensure that such withdrawals do not represent an opportunity loss to Malaysia. More importantly, these efforts must ensure that issuers within the Malaysian capital market continually derive value recognition, low cost of raising capital and efficient secondary market trading of their issued securities. At the same time, the breadth of markets and funding instruments must be further developed on par with the growing diversity and depth of the private sector's funding requirements.

³⁷ For example, as of the end of 1998 there were 379 non-US companies listed on the New York Stock Exchange (NYSE), and in the third quarter of 1999 alone, Asian companies raised US\$7.2 billion in capital by means of depository receipts on the NYSE. (Source: "From Stock Exchange to Financial Portal", Lehman Brothers, October 1999.)

³⁸ The foreign securities listings include equities, bonds and other exchange-traded instruments.

Improving the Role of the Capital Market in Meeting Investors' Preferences

Given their fundamental importance to the overall growth of the capital market, the services and products offered in markets are typically designed and marketed to cater to investors' different needs. For Malaysia, increasing individual wealth given the expected economic growth as the country progresses towards its vision of becoming a developed nation by 2020 means that the capital market must have the continuous capacity to meet the evolving needs of investors. Increased educational levels and general awareness will bring with them increased financial sophistication and familiarity with more diverse methods of investing.

In line with this, shareholders will want to assess whether the firms they invest in are using their assets efficiently, and in their best interests. In this respect, the availability of timely, relevant and accurate data is crucial. However, corporate accountability by Malaysian companies has clearly been lacking in some instances, and corporate governance concerns are still cited as a pertinent factor in many investors' minds in making their investment decisions. More active participation by major institutional investors in this respect is also desirable as institutional shareholders are typically those with greater influence on corporate decisions.

More generally, however, investors at large are demanding greater shareholder value recognition by companies in which they have taken a stake. This tendency—underscoring a return to the basic rationale for investing in a company—is expected to become a central issue in investing decisions as the competition for capital among companies and markets heightens further in the future.

At the same time, not only will the Malaysian capital market need to ensure that high standards of corporate governance and appropriate shareholder value recognition are practised, it must also enhance the range and quality of investment services and product options available to investors. The investment management industry, in particular, needs to be further built up to a sufficient level where it is competitive enough to facilitate the provision of the best value to its consumers. Accumulating such critical mass means that there must be broader and deeper markets for such services, which in turn means that market share within the industry should not remain concentrated for too long within a small number of institutions.

In addition, the range of products available to investors should not just be limited to plain-vanilla types, but progressively developed and supplemented to also meet a more diverse range of investor preferences. This is particularly pertinent for the derivatives industry, which plays a crucial role within the overall capital market by facilitating the management of risk, providing investors with an alternative means of exposure to the underlying markets, and generally allowing for improved pricing efficiency.

Developing Internationally Competitive Market Institutions and Intermediaries

The changing financial landscape, coupled with the implications of globalisation mean that there is a need to develop more competitive market institutions and intermediaries who possess the capacity to offer wide-ranging, integrated and cost-efficient products and services.

Heightened competition for business among global exchanges, coupled with the relative ease of replication of similar contracts in the derivatives market in particular, mean that having sufficient critical mass and competitive transaction costs play a key role in attracting further liquidity and ultimately the continued competitiveness of the exchanges.

Coupled with the need to revitalise the competitiveness of the Malaysian capital market in the aftermath of the regional financial crisis, these factors point to the urgent need for Malaysia to develop stronger market institutions to compete effectively with other international exchanges for listings and order-flows. Efforts towards this goal must take into account the need for a holistic approach towards the appropriate business strategy for positioning the exchange within the international community, from external promotional efforts to comprehensive efforts to ensure that these various institutions are focused on the interests of their constituents.

These issues are also pertinent in the area of capital market intermediation. There is a need to push towards more competitive intermediation—whether in broking, corporate finance advice, investment advice or other such services—where greater financial strength, management capacity, integration of services and access to international portfolio flows can lead to increased investment efficiency and greater resilience of these intermediaries.

Thus, the current nature of the stockbroking industry, for example—while having served its purpose well in the past—requires a thorough reassessment in moving forward to a more competitive environment. Also, the market for corporate finance advisory services will need to continue to be highly responsive to the needs of the corporate sector going forward, particularly in light of the changing environment for these services, such as with the on-going implementation of the DBR framework. These issues point to the need for industry participants to ensure they can—and do—adapt and upgrade their services, in order to continue to meet the needs of their clients effectively and at reasonable cost.

On a broader level, the proliferation of market economies, the removal of trade barriers, advances in telecommunications and the impact of applied technology are all increasing the degree of integration of financial markets and competition therein. Malaysian capital market institutions and intermediaries must not only recognise the challenges of globalisation they will have to face, but also prepare themselves accordingly to take advantage of it in order to remain internationally competitive and to continue to fulfil their respective roles within the domestic economy effectively.

Ensuring the Effectiveness of Regulation within the Changing Market Environment

Sustainable and equitable growth requires sufficient regulatory flexibility to adapt to changing market dynamics and needs. The transitions in goals, operating practices and strategies required for successful development necessitate a regulatory framework that is responsive to changing market needs. At the same time, such a framework should not unduly add to the regulatory burden of operating within the Malaysian capital market while ensuring that high standards of investor protection and market integrity are maintained.

There is a need therefore for the regulatory framework to be flexible and effective in adapting to the fast-changing market environment. To have the capacity to accommodate change and the evolution of market structures, regulation must not lag behind or act as an impediment to market development and innovation. However, the challenge ahead lies in the ability of regulators to balance flexible regulatory structures with uncompromisingly robust provisions with regard to the fundamental principles and objectives on which it is based: the protection of investors; ensuring that markets are fair, efficient and transparent; and reducing systemic risk.³⁹

In going forward, the regulatory framework must also recognise the increasing integration of the various segments of the financial market, resulting in a network of economic, commercial and legal relationships. Proper functional regulation has thus become more important due to the increasing trend towards the “commoditisation” of transactions; unbundling of financial products and services into their constituent economic, risk and value components; and the blurring of boundaries between once-separate institutions, products and market sectors.

In cognisance of these issues, there have recently been a number of efforts in various other jurisdictions—such as the UK and Hong Kong—towards reforming their legal and regulatory framework with regards to the capital market or even the financial sector as a whole. In most cases, the structure of regulatory agencies was a legacy of the financial system present at the time these agencies were established. However, structural changes and financial innovation have rendered the continued maintenance of these structures sub-optimal, hence a revamp of the existing regulatory system was needed.

In Malaysia, given the changing role of intermediaries and professionals in the securities, banking, and insurance industries and the increasing offering of integrated services and products in these markets, a closer review of where gaps and overlaps exist needs to be conducted. As financial markets become more and more complex, the enforcement function will need to be further developed correspondingly to ensure the effectiveness of regulation. In addition, the maintenance of market-wide systemic stability is becoming an increasingly important issue for capital market regulators given that financial systems are becoming increasingly market-based and inter-linked.

Promoting Value-added Areas Aligned with Malaysia's Comparative and Competitive Advantage

National markets are increasingly focusing on niche and value-added market segments in order to diversify their market base, differentiate themselves to their constituents, and generally enhance the combined value of their pools of products and services by promoting areas in which they have comparative and competitive advantage.

For Malaysia, one key market, amongst others, that is a potentially important niche market with significant potential for growth is the Islamic capital market. In Malaysia itself, some RM24.7 billion worth of Islamic banking deposits was mobilised in 1999 alone. And while there are no definitive data on total size of global Islamic funds due to the paucity of comprehensive monitoring systems, an estimated US\$800 billion of "latent" capital belonging to Muslim individuals and institutions is invested in conventional banks globally.⁴⁰

However, a major challenge facing not only the local, but also the global Islamic capital market, is for it to reach its full potential and to be fully recognised as a viable parallel market for financing and investment. The current range of available and liquid Islamic-based products is small in comparison with the broader conventional capital market. While this is largely a function of the nascent demand for Islamic investments, there is scope for significant further development given the steady growth of traded Islamic securities in recent years, the increasing awareness of the existence of such products, and the potential latent capital both within the country and abroad that may be invested in such products.

In the absence of a viable Islamic capital market, issuers and consumers who wish to transact in securities in accordance with Islamic principles will eventually seek avenues in other markets beyond their national borders. This is not only in relation to markets that have already developed their capacity for handling Islamic funds, but also amongst other international markets where there is now greater awareness as to the potentially significant benefits of tapping and meeting the needs of the global market for Islamic investments. There is therefore substantial scope for widening the opportunities available to local industry players to establish their niche in the business, as well as to participate in a large global market with relatively few major players.

⁴⁰ Source: Labuan Offshore Financial Services Authority's Annual Report 1999.

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