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The triggering events for policy initiatives on securities market reforms and market intervention, and indications of success: the Malaysian experience

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Introduction

Good morning. I should like to begin by thanking the ADB Institute and the Organisation for Economic Co-operation and Development (OECD) and their collaborators, IOSCO, the World Bank, the IMF and the ADB for giving me this opportunity to speak at this roundtable on securities market reforms, and in particular on the causes and impact on securities markets of the Asian financial crisis.

For the next 15 minutes or so, I will present an account of Malaysia's experience of triggering events that prompted certain policy initiatives for the securities market, the nature and current status of those initiatives, and some of the early indications of how those initiatives appear to be affecting the situation concerning Malaysia's securities market and industry.

For the purpose of the presentation this morning, I will keep my comments mainly to securities markets, although where relevant and appropriate I may extend them to the wider economy.

Triggering events for policy initiatives

For Malaysia, as for many crisis-affected countries within the Asia-Pacific region, the triggering events for policy initiatives involved a series of developments that arguably began with a **deterioration of investor confidence, which rapidly grew into an irrational panic.**

In Malaysia's case, this was reflected in a **widening of the benchmark international yield spread**-in this case, the difference between the Petronas 2006 bond yield and equivalent US treasury security yield-from around 66 basis points at the end of May

1997 to 230 basis points five months later to over 1,000 basis points in September 1998.

This was accompanied by **rapid downgrading of Malaysia's sovereign credit rating** by international rating agencies to just above so-called junk bond status in the last quarter of 1998 and a marked rise in sell recommendations by international market analysts.

Panic eventually translated into capital flight which led to a **severe deterioration of Malaysia's reserves position** and **a sharp weakening in the ringgit**. Foreign reserves, which fell from US$18.4 billion in 1996 to US$15.6 billion at the end of 1997. The ringgit dropped by nearly 60% in the year to July 1998.

Eventually, this took its toll on the economy, which contracted by -6.7% in 1998 after having grown at a rate of 7.7% the year before.

These developments had a **significant impact on Malaysia's securities markets, in particular the stockmarket**. The market from its peak of about 1,200 fell very sharply to about 800 and bottomed out at levels of 250 in the second half of 1998. The Kuala Lumpur Stock Exchange's benchmark Composite index declined by over 70% during July 1997-August 1998. The size of the Malaysian stockmarket shrank dramatically as did share trading activity, although it is interesting to note that the market in Composite index futures expanded as the index's daily volatility grew to way beyond historical norms.

The sharp and prolonged decline in asset prices began to realise many **problems among market intermediaries and among the corporate sector**. Falling share prices eroded the value of securities pledged as collateral for margin loans and led to a higher frequency of margin-calls and, in some instances, forced-sales; they also aggravated the maturity-mismatch of their balance sheets.

As a result, a number of market intermediaries, among them several stockbrokers, began to find **difficulty in meeting prudential requirements and in financing their daily operations and short-term obligations.**

Certain listed companies faced similar difficulties, where higher operating and financing costs, as well as bad debts, increased as a result of some of their market exposures. In some cases, **financial problems were aggravated by various links between securities markets, the corporate sector and the wider economy.**

To a certain extent, these developments placed a substantial amount of pressure on the stability of the financial system and arguably **increased the risk of systemic disruption**. Besides intermediaries, systemic stress also rose at the level of market institutions, in particular within the stockmarket's clearance and settlement system. However, I should like to emphasise that at no point was systemic risk ever realised.

Common experiences among many emerging markets: the IOSCO EMC report

The triggering events that I have just outlined were not unique to Malaysia. **Many of these experiences were shared, to a greater or lesser extent, by emerging markets around the world-not just those in Asia-and have been documented in an interim report released last September by the Emerging Markets Committee (EMC) of the International Organisation of Securities Commissions (IOSCO).** The report, entitled "Causes, Effects and Regulatory Implications of Financial and Economic Turbulence in Emerging Markets", was prepared by a working group of the EMC led by Malaysia.

A survey of 17 emerging market jurisdictions [countries included Malaysia, China, Chinese Taipei, Brazil, South Africa and Thailand] conducted for the purpose of the report suggested that **causes of the crisis lay in an interaction of macroeconomic factors, a host of structural issues, and several financial market issues**, which included currency and OTC market activity. The report noted that **major effects on securities markets included a worsening of international perception towards emerging markets regardless of whether or not fundamental weaknesses were apparent at the time in those markets.**

Policy initiatives

I think that it is fair to say that **external factors contributed significantly to the increasing difficulty that authorities had in managing the economy and regulating the financial system.**

Economic deceleration proved difficult to reverse despite various attempts to boost investor and consumer confidence, including the announcement of a stabilisation package for the financial sector and the release of a National Economic Recovery Plan by the National Economic Action Council, a consultative body to the Cabinet that was established to deal with the economic crisis.

Furthermore, there is no doubt that, in hindsight, not all policy measures were appropriate and that some mistakes were made,. For instance, the curb on credit growth when liquidity was in fact needed, the increase in interest rates which further exarcebated the credit crunch, tightening of prudential requirements [NPLs from six- to three-months] when financial institutions were already finding it difficult to meet existing requirements, a cut in government expenditure when aggregate demand was already falling. These measures proved to be wrong principally because of the timing of their introduction. However, these mistakes were recognised and quickly rectified.

As the crisis dragged on, consumer confidence continued to worsen and extremely higher offshore ringgit interest rates hindered the effectiveness in some of the policy changes without an unacceptable increase in the risk of further outflow of capital funds.

A necessary first step towards recovery: exchange controls

Given these circumstances and the policy constraints faced by economic and financial authorities at the time, the government felt that longer-term recovery required a more drastic approach in the short-term.

On September 1st 1998, **Malaysia imposed exchange controls to regain a degree of financial independence**. Among other things, the measures aimed at preventing manipulation and excessive speculation on the ringgit. As a result, trading in ringgit could no longer be conducted outside of Malaysia and the exchange rate was fixed RM3.80 to the dollar. A twelve-month holding period was also imposed on portfolio capital.

However, it should be noted that these measures were followed by a rapid succession of recovery measures that sought to improve the efficacy of monetary policy, provide the economy with a significant amount of fiscal and monetary stimulus and to stabilise and rehabilitate the financial system, including the securities markets. I will elaborate further on what these latter measures were and what prompted their establishment briefly.

Admittedly, imposing exchange controls did have severe consequences on the market at first. Price volatility, already high by historical standards, leapt to levels previously unseen on heavy buying activity emerged-reportedly on short-covering by foreign investors. However, turnover soon fell as **foreign participation diminished on account of several factors, including the removal of Malaysian equity from several major benchmark indices and a change in perception by the foreign investment community in Malaysia.**

Nevertheless, the measures allowed authorities to regain some control over the economy and financial system, and provided some "breathing space" to pursue recovery measures which I shall outline in a moment. And it is important to realise that **the government has maintained a pro-active approach to the implementation of the controls**.

For example, in view of increasing concerns raised by foreign investors over the 12-month holding period requirement as well as to facilitate portfolio investment from abroad, **the government revised the exchange controls by replacing that particular rule with a graduated levy** on the repatriation of portfolio capital.

Measures towards the recovery of Malaysia's securities industry

I should like now to turn towards the **measures that have been taken to promote the recovery and improvement of Malaysia's securities industry**. With the onset of the financial crisis, the Securities Commission, and, where relevant, market institutions, have re-doubled efforts to

- maintain systemic stability
- restore market confidence
- improve market transparency and corporate governance
- facilitate the raising of funds
- rehabilitate the securities industry

I would like to emphasise that the measures I will be describing shortly refers only to those aimed primarily at the recovery of the securities industry. There are a **host of other measures targeting the recovery of the wider economy** that I will not be touching on.

- **Raising corporate governance standards**. In recognition of the role that enhanced standards of corporate governance can play in boosting investor confidence, several measures have been taken to raise standards of corporate governance in Malaysia. The most comprehensive corporate governance review exercise in Malaysia saw the establishment of a high level Finance Committee to review the framework for corporate governance in Malaysia and to set best practices for the industry.

  The Finance Committee submitted its recommendations to the government on 30th June 1998 and a major report containing these recommendations was circulated for consultation among relevant private and public sector organisations. The report was finalised and made public on March 25th this year. The recommendations of the Finance Committee essentially seek to

  - Strengthen the statutory and regulatory framework for corporate governance
  - Enhance the self regulatory mechanisms that promote good governance
  - Identify training and education programmes to ensure that the framework for corporate governance proposed by the Finance Committee is supported by the necessary human and institutional capital

  Significant efforts have been directed at training and education with an aim to developing and strengthening the philosophy and culture of corporate governance in Malaysian boards and corporate participants generally. The Securities Industry Training Centre, the training arm of the SC, has developed and conducted investor education programmes as well as programmes directed at directors of public listed companies on key areas of corporate governance and director's responsibilities.

In connection with the APEC Collaborative Initiative on Corporate Governance, Malaysia is currently leading the APEC Finance Ministers initiative on corporate governance that is being carried out in collaboration with the Asian Development Bank and the World Bank.

- **Strengthening of rules on related-party and interested-party transactions**. In response to previous episodes where related-party and interested-party transactions were undertaken without due regard for the interests of minority shareholders, the SC reviewed rules on related-party and interested-party transactions. After consultations with the Kuala Lumpur Stock Exchange (KLSE) and the Association of Merchant banks, the SC announced that it would be strengthening these rules and directed the KLSE to incorporate several changes into its Listing Requirements. Changes related to a widening in the scope of rules, enhancing disclosure, voting rights, the appointment of corporate advisors and directors' responsibilities.

  In addition KLSE has been asked to make revisions to rule 118 of the KLSE Listing Rules to stop possible abuses by large/controlling shareholders in connection with related party transactions. Among other things, the rule now requires a company to appoint an independent corporate adviser to advise minority shareholders of the company, and prevents directors, substantial shareholders or interested parties from voting on the transaction.

- **Measures to resolve weaknesses in insider-trading laws**. The Securities Industry Act 1983 was amended this year to resolve weaknesses in insider trading rules in Malaysia. Steps have also been taken to achieve transparency of ownership. Amendments to the Securities Industry (Central Depositories) Act 1991 in October 1998 now prohibit persons from hiding behind their nominees by requiring securities accounts to be opened in the name of beneficial owners or authorised nominees.
- **Strengthening of enforcement capabilities**. The powers of exchanges have been enhanced by recent amendments to the Securities Industry Act (1983). These amendments strengthen the ability of exchanges to take action against directors and anybody to whom the listing rules of the exchange are directed. In addition, the introduction of civil enforcement provisions in insider trading legislation now allow an investor or regulator to claim compensation for losses suffered, while the introduction of civil penalties allow the Securities Commission to recover three times the insider's gain or the loss avoided.
- **Establishment of best sales practice and compliance provisions**. These have been put in place in the business rules of KLSE and MESDAQ, the forthcoming Malaysian Exchange of Securities Dealing and Automated Quotation,

to ensure that clients' interests are always maintained over and above that of stockbroking companies. Among other things, members must

    - ensure that they maintain appropriate checks and balances
    - practise proper corporate governance
    - establish "Chinese Wall" procedures
    - establish compliance officers, whose responsibility will be to secure effective internal controls and an active segregation of duties between trading and operational functions within their respective stockbroking firms.

- **Restructuring of the stockbroking industry**. The SC is implementing a scheme aimed at resolving the problems faced by the stockbroking industry and at redressing the exposure of the banking sector to these brokerages simultaneously. A special task force comprising the SC, KLSE and Danaharta, the national asset management company, will be responsible for overseeing the implementation of the scheme. The main aim of the scheme is to facilitate an expedient and effective regularisation and recapitalisation of the stockbroking industry.
- **Improvement in capital adequacy regulation**. The SC has driven the establishment of a risk-based system of capital adequacy requirements to replace the current system of minimum liquid-fund requirements. The new framework, which is being implemented by the KLSE in phases, aims to bring domestic prudential requirements more closely with international standards. The SC approved the KLSE business rules governing the new requirements on December 31st.
- **Establishment of a client asset protection framework**. The current regulatory structure addresses the issue of client asset protection through both statutory requirements in the Securities Industry Act 1983 and member circulars issued by KLSE to its stockbroking companies. However, the SC believes that the existing requirements can and should be continually strengthened in line with international best practice. Recent events have certainly reaffirmed the need to review and, where possible, enhance existing client asset protection arrangements. Therefore, the SC has made the introduction of a comprehensive client asset protection framework a major programme and envisages the framework to be operational this year.
- **Boosting of KLSE compensation fund**. In order to protect investors and to ensure systemic stability, the SC and KLSE on April 30th agreed to boost the exchange's RM14 million compensation fund with contributions of RM100 million and RM200 million respectively. In addition, member companies of KLSE are required to increase their annual contributions into the fund from RM10,000 to RM50,000 in 1999, and from RM50,000 to RM100,000 thereafter. The fund was expanded to ensure that investors' assets were protected in light of the financial difficulties faced by the stockbroking industry and hence minimise systemic risks arising from a potential "run" on a stockbroking company.

- **Establishment of a standby facility for the stock exchange clearing system**. A standby facility of RM500m has been established to be used in the event that KLSE member companies are unable to meet their obligations in the course of trading. The facility fulfills obligations arising from trades executed through the exchange's automated trading system. It should be noted that the facility is not to provide assistance, whether financial or otherwise, to stockbroking companies. Rather it is to preserve systemic stability: with the facility, problems are confined to the stockbroking company concerned without affecting the rest of the stockbroking companies who might be parties to the transaction.
- **Revision of primary market regulation**. Most restrictions on submissions for new listings, capital-raising exercises and restructuring schemes that were introduced at the height of the crisis have been removed. In addition, requirements under the Securities Commission's (SC) Policies and Guidelines on Issue/Offer of Securities (Issues Guidelines) were revised to facilitate the raising of funds by listed companies.
- **New Malaysian Code on Take-Overs and Mergers**. The new code is aimed at resolving various deficiencies of the old code and to enhance transparency and to protect the interests of minority shareholders. It seeks to ensure that minority shareholders are given a fair opportunity to consider the merits and demerits of an offer and to enable them to decide whether they should retain or dispose of their shares. The new code also requires offer documents, board of directors circulars and independent advice circulars to include all relevant information required by shareholders and their professional advisers to make informed assessments of the merits and risks of accepting or rejecting a take-over offer.
- **Regulatory measures to restore confidence through ensuring an orderly and fair market, and improving market transparency**. Several measures were initiated through changes in rules, regulations and procedures of the Kuala Lumpur Stock Exchange (KLSE), the clearing house and the central depository. One effect of the measures was to hinder the trading of Malaysian shares on Singapore Stock Exchange's (SES) Central Limit Order Book (CLOB) system, which the SES consequently discontinued on 16 September. Trading on CLOB, beyond the regulatory reach of Malaysian authorities, meant that various abuses of national policies and securities laws could not be stamped out.

  Other measures came about through amendments to five securities laws and regulations effective November 1st, namely in the

  - Securities Industry (Central Depositories) Act 1991
  - Securities Industry Act 1983
  - Securities Commission Act 1993
  - Futures Industry Act 1993

- Securities Industry (Substantial Shareholders' Reporting) Regulations 1998

Indications of success

The measures I have just outlined, as well as other measures taken by the government and through other agencies, appear to be having a positive effect, even at this stage of their implementation.

In terms of the broader economy, growth prospects for Malaysia appear to have improved. Consensus estimates put real GDP growth at around 1-2% in 1999 and 2.7% in 2000, while private consumption is expected to rise by around 2% in 1999-2000. Car sales, for example, have seen substantial growth in recent months. The outlook for inflation remains subdued and an average forecast suggests annual growth in consumer prices of no more than 4.3% over the next two years. The current account balance should register a surplus and recent estimates suggest a US$10.9b surplus by end-1999 declining to around US$9.7b at the end of the millennium. Foreign reserves have increased to their highest level since 1993 and currently stand at over US$26b.

An important development is that domestic confidence in economic prospects appears to have stabilised. At least one global survey has suggested that confidence in the domestic economy for 1999 may be among the strongest in the region although third-quarter indicators still point to depressed consumer sentiment. As Japan's experience has shown, positive expectations have an important bearing on the success of expansionary policies and, if maintained and encouraged, can facilitate economic recovery.

Domestic confidence has been reflected in the performance of the stockmarket, which has shown marked improvement since September 1998 compared to the previous five quarters on active retail and institutional participation. Stock prices on the KLSE stabilised from the sharp declines registered since the onset of the financial crisis and the Composite index has gained over 100% since September 1st, registering among the best performance of any major index in the world.

Importantly, there are also signs that foreign investor sentiment has improved. A string of positive recommendations have emerged over the last quarter. Many have noted and strongly approved of Malaysia's corporate restructuring efforts and point to the relative undervaluation of the equity market. There has also been broad approval of Malaysia's current economic policy mix for encouraging demand expansion.

Policy and economic developments have also spurred a review of Malaysia's credit standing. Markets have begun pricing the country's sovereign risk more favourably. The benchmark yield spread of Malaysian international debt continues to decline substantially, from 547 basis points over US 30-year treasuries at end 1998 to just under

280 basis points currently. Recently, **Standard & Poor's upgraded Malaysia credit rating outlook**, citing

- The government's pro-active policy response in a difficult domestic and external environment
- The halt in capital flight following the government's introduction of selective exchange controls
- Diminished risk that capital controls would be followed by imprudent credit policies and the government's success in managing inflation expectations, suggesting that there is room for a further easing of interest rates, which in turn could reduce pressures on banking institutions' asset quality
- The government's recapitalisation and asset management agencies are appropriately centralised and prudently focused on up-front costs

Indications are that other rating agencies will follow suit.

Finally, there are strong indications that Malaysian equity will soon be reinstated into certain major global and regional benchmark stockmarket indices. The International Finance Corporation announced recently that it intends to count Malaysia in the calculation of its key indices later this year and market expectations suggest that Malaysian equity will return to other benchmark indices in the near future.

Ladies and gentlemen, thank you.