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THE PROPOSED ABOLITION OF THE DISCOUNT HOUSES AND ITS POTENTIAL IMPACT ON THE DEVELOPMENT OF THE MALAYSIAN FINANCIAL MARKET

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The Proposed Dissolution of the Discount Houses and its Potential Impact on the Development of the Malaysian Capital Market

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SECTION 1

SECTION 2

SECTION 3

APPENDICES

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Abstract

This paper evaluates the operations of the discount house industry in Malaysia over the period 1987 to 1997. The performance over the 10-year period was analysed to determine the factors affecting their profitability. Next, is to relate these factors to their contributions in the PDS market and their continued relevance to the Malaysian financial market as a whole. The interest rate movements and changes in money supply aggregates over the same 10-year period is studied as well since the discount house business is very much "interest rate related".

It was found that when interest rate falls, the discount houses make money but lose money when interest rate rises. Over time, funding long-term fixed income investments with short-term money had worked well for the discount houses but lately it had been very risky. If interest rates move upwards, income from fixed rate investments could be hurt badly. Furthermore, with investment positions unhedged against "interest rate risk", they are highly vulnerable to potential future losses. Although, they had contributed significantly to the PDS market in terms of their volume in investments, this could be counter productive if the high returns they had hoped for turn into losses. Investing 95.1% of their portfolio in risky-assets is a moral-hazard issue. If this is not checked, the discount house industry could be phased out on account of their own actions.

SECTION 1

1.0 INTRODUCTION

The discount house industry has been in operations for some 35 years now and yet its existence and function in Malaysia is not widely known among the general public. Many had misconstrued the discount houses with the issuance of discount cards and as developers of low costs housing. This misconception is understandable, as the nature of their business is characterised by wholesale activities as opposed to a retailing nature and as such not much of the media marketing was really necessary. Only a very small portion of their funding comes from individual clients. The bulk of their funding comes from interbank borrowings and deposits from large corporations. When the first discount house commenced operations in December 1963, it was met with opposition from the banking community.[1] It was anticipated that with the existence of the discount houses, the banking community would no longer enjoy the interest free money from the current account depositors.

During the period 1994 to 1997, the Central Bank had aggressively pursued the agenda of phasing out the discount house industry, blaming their function for blurring the line with that of the merchant banking operations.

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[1] "Money and Banking in Malaysia", Bank Negara Malaysia 1959-1979, Kuala Lumpur, pg. 294

In various meetings called by the Central Bank, the discount houses were morally persuaded to close shop or merge with their respective parent companies.

However, the sudden resignation of Tan Sri Ahmad Mohd Don saw a complete reversal of policy. The present Governor, Tan Sri Dato' Seri Ali Abul Hassan bin Sulaiman had recently made it officially known that the discount houses had been given another 3 years lease of life. A review would be conducted to ascertain the viability for the continuance of their business (see Appendix 2) after the 3-year period.

The government privatisation programmes had caused the decrease in government debt and hence the reduction of bonds issued by the federal government. Treasury bills (MTBs) and government bonds (MGS) used to be the "bread and butter" for discount houses but the privatisation programmes had clearly changed that. Much of the discount houses future income has now diverted into private debt securities (PDS). The discount houses have since 1991 been participating actively in the private debt securities market. However, with the liquidity structure changing and the mounting competition from other market players, the discount house industry would have to be prepared to have their profit margin squeezed as deposits becomes more expensive or be totally phased out from existence.

2.0 OBJECTIVE AND MOTIVATION

The objective of this paper is to examine and analyse the performance of the discount houses in Malaysia over the past 10-year period from 1987 to 1997. From the 10-year analysis, some basis in determining the factors that affects their profitability would be established. Since 1994, the business of the discount houses had been under constant review by the Central Bank and in early 1996 there had been rumours that the discount houses would dissolve their operations by 1998. At the twelfth conference with financial institutions in September, 1997, the Central Bank's governor touched on the need to have a more dynamic framework of liquidity management and the need to review the role of the discount houses. Although over the years the Central Bank had accorded incentives to facilitate the growth of the industry, the industry had posed problems for the conduct and effectiveness of monetary policy. Since the role of the discount houses had expanded to include among others, lead arrangers and market makers for private debt securities, their traditional role as "keepers of liquidity" had been neglected. As such, the discount houses would have to reposition themselves to be more relevant players in the financial system.[2] The message by the Central Bank's governor would relate to one of the other objectives of this paper, which is to understand the rationale behind the Central Bank's move to dissolve the discount house operations.

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[2] "Bank Negara Malaysia – Quarterly Bulletin", Third Quarter 1997, Vol. 12, No.3, pg. 113

The subject of developing the Malaysian bond market has been much talked about and is one of the important criteria in developing Kuala Lumpur as a financial center. However, with the proposed dissolution of the discount houses, it would no doubt have an impact on the development of the bond market. Thus, this paper would also attempt to determine the extent to which the development of the bond market is affected, should the discount houses be dissolved.

It should be noted here that, not much literature exists on the business of the discount houses in Malaysia besides those from Bank Negara's publications such as their quarterly bulletins, annual reports and the anniversary books (published every four years). The focus of these publications is on statistical data and the changes of regulations affecting the discount house operations. The writer would like to put it on record that the motivation for pursuing this research paper is due to this lack of literature on the discount houses. It is the writer's aspiration to have this research personally documented as a way of contribution to the industry after having served 20 years in a discount house.

3.0 LITERATURE REVIEW

As mentioned above, there is not much literature about the business of the discount houses. However, since they are market players in private debt securities (PDS) market, it would be appropriate to look into some write-ups about the PDS and bond market in Malaysia and the Asian region.

Thillainathan, (1996) analysed the current development and future directions of the PDS market. It has been observed that the discount houses were less active as principal dealers and market makers for MGS since they are exempted from holding statutory reserves with the Central Bank against their net deposit liabilities or interbank borrowings. The principal dealers are not prepared to make a secondary market in bonds because of the high cost of carrying inventory. The discount houses are few in numbers and are under-capitalised relative to the size of the domestic bond market. This is further constrained by the lack of a bond futures market. The secondary market for MGS is underdeveloped because of the following reasons:-

- Captive demand for and shortage of MGS papers;
- Illiquid cash market makes it less attractive for primary dealers to make a secondary market in bonds;
- The market does not allow for borrowings and short-selling of securities; and,
- The lack of an interest rate futures market.

As a result of the lack of a well-functioning MGS market, the development of the PDS market has been hampered. The problem is with determining the risk-free interest rates. Thillainathan (1998) explained that since the risk-free rate cannot be easily determined because of the lack of a well-functioning secondary market for MGS, this has in turn curbed the level of issuing and trading activity in private debt securities.

The said paper suggests the following ways in which the secondary MGS market could be activated although nothing has been mentioned about the role discount houses could play in this regards:-

- Reduce or eliminate reserve and liquidity cost and interest rate premium as the high incidence of negative carry which discourages secondary market trading in MGS;
- Develop an interest rate futures market both in short-term and long-term contracts to improve liquidity and to facilitate the yield discovery process;
- To create an institutional framework in facilitating the borrowing of securities through "reverse repo" transactions (for both MGS and PDS) in order to have a more liquid cash market in bonds; and,
- To develop a bond futures market so that investors and speculators can hedge their positions or take positions with ease and at the least cost.

It is noted that the bond market in Malaysia continues to be overshadowed by the equity market. In seeking to boost the ringgit bond market, Munir Abdul Majid (1996) suggests the following:-

- Issuing benchmark securities to facilitate pricing of bonds in both the primary and secondary market;
- Activating the "repo" market so that institutional investors could take short positions in bonds, reduce funding costs for long bond positions and earn incremental income by lending bonds that are in demand;
- Streamlining the issuing process in order to shorten the approval times taken by the regulatory authorities;
- Providing risk management facilities such as the interest rate futures and bond futures and options; and,
- Improving the market infrastructure for trading of bonds in Malaysia.

Winston Koh, (1997) outlined the importance in developing the bond market in Asia as follows:-

- It facilitates the financing of massive investment needs in the region, especially for long-term private fixed investments required to sustain the high rate of economic growth forecast over the decade.
- Allow regional policy makers and market participants to manage their risks better, improve liquidity, and reduce intermediation costs relative to comparable instruments such as equities and bank deposits.

- Encourage new risk management products such as interest rate futures and options.
- Enable Central Banks in the region to carry out indirect monetary policy through open market operations.

Dato' Rajandram (1997), suggests that four key institutional infrastructures that are critical to the deepening of the Asian bond markets. With the government bond markets already relatively large, the challenge is to develop the corporate bond market to expand to private sector financing needs.

- The need to create specialised bond issuing corporations such as the Cagamas Bhd (The national mortgage corporation);
- The need to strengthen the role of credit rating agencies to boost the bond market. Rating agencies help popularise bonds among potential issuers and investors with the dissemination of the use of its credit rating system. The mandatory rating requirement and minimum investment grade ruling helped instill investor confidence in the bond market. Rating agencies also provides leverage in gaining access to more comprehensive as well as confidential information of issuing companies.
- The need to establish bond market clearing houses in order to facilitate secondary market trading.
- The need to create market-based benchmark yield curve in order to increase pricing efficiency of corporate bonds.

4.0 HISTORY AND THE ROLE OF DISCOUNT HOUSES

The first discount house was established in December 1963 and there are now seven discount houses operating in the Malaysian financial market. The operation of the discount houses has expanded over the years since its inception in 1963. Total deposits grew from RM3.347 billion in 1987 to RM17.963 in 1997. Total assets expanded from RM3.559 billion in 1987 to RM18.798 billion in 1997 (see Appendix 8). The following are the seven discount houses currently operating in Malaysia:

Table 1

DISCOUNT HOUSES OPERATING IN MALAYSIA

Original Name	New Name	Year of Establishment
Short Deposits (Malaysia) Sdn Bhd	Amanah Short Deposits Bhd	December, 1963
Malaysia Discounts Bhd	No change	August, 1971
KAF Discounts Bhd	No change	October, 1974
Asiavest Discount House Bhd	BBMB Discount House Bhd	November, 1975
Kota Discount Bhd	Mayban Discount Bhd	November, 1978
Jati Discounts Bhd	Abrar Discounts Bhd	April, 1984
Antara Discount Bhd	Affin Discount Bhd	December, 1984

Source: from the senior staff of the various discount houses

The table below shows the discount house ranking in terms of asset value size:-

Table 2

RELATIVE SIZE IN TERMS OF ASSET VALUE AS OF 1997 / 1998

Company's Name	**Asset Size (in RM Millions)**	**Ranking**
ASHORTD	RM4.054 billion	1
BBMBD	RM3.456 billion	2
MAYDIS	RM2.821 billion	3
MALDIS	RM2.329 billion	4
KAF	RM2.269 billion	5
AFFIN	RM1.897 billion	6
ABRAR	RM1.771 billion	7

Source: Annual Reports of Discount Houses for 1997 / 1998

The discount houses were established to specialise in short-term money market operations. In the early years, all deposits accepted by them had to be invested in treasury bills and government securities with maturity of not more than three years.[3] The establishment of the discount houses saw the interest-free money from current account deposits being channelled to them from commercial banks. The opposition to establishing the discount houses by the banking community was understandable.

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[3] "Money and Banking in Malaysia", Bank Negara Malaysia 1959-1979, Kuala Lumpur, pg. 294

The fact that they had been enjoying interest-free money from current account deposits for years was seen as an obvious reason for their opposition. Deposits placed with discount houses would earn interest eventhough placed for a short-term period or on call basis. On the contrary, deposits in current accounts with the commercial banks do not earn interest eventhough placed for long-term.

Over time, the banks have come to realise and accept the role of the discount houses as a convenient and reliable channel for short-term deposits placement and as dealers for money market instruments such as the Malaysian government treasury bills and government securities. The corporate sectors have also become more conscious in maximising income on their temporary idle funds and the discount houses have become an avenue where these temporary funds could be "parked".

4.1 HOW THE DISCOUNT HOUSE OPERATES

Since the establishment of the first discount house in 1963, discount houses were allowed to borrow or accept deposits up to 35 times of their shareholder's funds. Additionally, they were allowed to accept deposits up to 40 times of their shareholder's funds that must be inclusive of whatever contingent liabilities accruing at any point in time.[4]

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[4] "Contingent liabilities" refer to the sale of banker's acceptances (more often with recourse to seller) which has not matured.

Apart from taking deposits, discount houses were also allowed to engage in "repo" transaction with their depositors.[5] Discount houses must invest <u>not less than 85%</u> of their borrowed funds in the Malaysian government treasury bills and government bonds as a requirement specified by the Central Bank's guidelines. At the same time, the permissible holdings of banker's acceptances, Cagamas bonds, negotiable certificate of deposits (NCDs) and loans to other discount houses <u>should not exceed 15%</u> of their borrowed funds (see Appendix 4 – Money Market Instruments). As the return on government treasury bills and bonds were lower, it is quite logical for discount houses to hold more of the high yielding securities such as the banker's acceptances (BAs), negotiable certificate of deposits and cagamas bonds. An illustration of the above mechanism is shown below: -

<u>Example 1</u>

<u>ABC Discount Bhd</u>

Paid up capital	-	RM5, 000,000
Reserves	-	<u>RM5, 000,000</u>
Shareholder's funds	-	**RM10, 000,000**
Maximum borrowings	-	RM350, 000,000 (35 x RM10 Million)
TBills and Bonds	-	RM298, 000,000 (85.14% x RM350 Million)
BAs, NCDs and Cagamas	-	RM52, 000,000 (14.86% x RM350 Million)

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[5] "Repo" refers to the sale of securities (eg. usually MTBs, MGS, BAs and NCDs) for the same value date at the current market price or interest rate with a promise to buy back the same securities at another agreed price or interest rate on a specified future date.

The fact that returns on bankers acceptances, NCDs and cagamas bonds is usually higher than the return on treasury bills and government bonds makes it more attractive for discount houses to hold them. More often discount houses hold these securities over and above the minimum limits allowed. However, by the close of each trading day, their holdings of these securities would be reduced below the given limit of 15% of total borrowings. This is achieved through the "repo" transactions. Whatever the securities pledged with the "repo" transactions must be deducted from their portfolio holdings. An illustration of the above is shown below:-

Example 2

Maximum borrowings	-	RM350, 000,000 (35 x RM10 Million)
TBills and Bonds	-	RM298, 000,000 (85.14% x RM350 Million)
BA's, NCDs and Cagamas	-	RM100, 000,000 (28.57% x RM350 Million)
Less: Repo transaction	-	RM48, 000,000
BA's, NCDS and Cagamas	-	RM52, 000,000 (14.86% of RM350 Million)

The "repo" transaction allows the discount houses to pay their depositors a slightly higher interest rate or price than the normal deposits. This is possible because "repo" funds are usually backed by higher yielding securities such as the banker's acceptances and NCDs.

Sometimes treasury bills and government bonds are also used in "repo" transaction. The higher price or interest paid for "repo" transaction is often necessary in order to secure the needed funds to cover the daily short cashflow position and to reduce the investment holding of securities in line with the limits allowed by the authorities. One of the main problems with allowing the discount houses to do the "repo" transaction is that they tend to over indulge themselves in higher risk investments. Securities such as the banker's acceptances and the NCDs although gives a higher return and the comfort of a banking institution behind the securities, are assumed as of a slightly higher risks than treasury bills and government bonds.

Sometimes their investment holdings in these securities go beyond their ability to fund the shortfall in their daily cashflow. This is especially so in a rising interest rate scenario and during times when contraction of the money supply in the financial system takes effect. Often, the discount houses are faced with a mismatched cash flow position due to the fact that short-term deposits are used to invest in longer-term securities. In other words, the discount houses are perpetual borrowers of short-term money. To a discount house, a negative (short) cash flow position at the start of each day's trading is a normal affair.