ASIA TIMES

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Banks hold the key to future of Malaysian derivatives

In the concluding part of our series on the Malaysian derivatives market, RALPH YIEHMIN LIU, *founder and managing director of Advanced Risk Management Solutions, a Singapore-based consultancy, argues that the market will only reach the critical mass necessary for takeoff when the banks begin to use it to manage their interest rate exposure.*

There is more going on in the Malaysian derivatives market than in almost any other market in the region today. There are many reasons to be excited about what is happening – not least of which are the opening of the Malaysian Monetary Exchange and the Kuala Lumpur Options and Financial Futures Exchange over the past year.

The development of the new exchanges has been the biggest factor promoting banks and other corporate entities to set up futures broking subsidiaries. Not only do these companies have the infrastructure in place to conduct such activity, but there are also plenty of brokers qualified to trade in the futures market.

But efforts by the exchanges alone are not enough to build the domestic derivatives industry. Moving at its current pace, the market will take a long time to accumulate the critical mass it needs for takeoff. The change which has taken place over the past several months does not allow the many market participants to be rewarded for being in the business – daily volumes on exchanges are not satisfactory.

There are plenty of futures brokers to do the selling, but nobody has the resources to become intelligent consumers of the products. Given the investment put into setting up broking subsidiaries, there is only a remote chance of generating enough in commissions to cover all costs.

That does not mean the market for new instruments is doomed in Malaysia. But it must change.

Right now, decision-making on matching assets and liabilities is too inefficient

The solution lies with the banks. It is clear that many money market dealers are currently merely ticket-fillers covering banks' liquidity requirements. There is rarely any proper analysis of the market which would result in the appropriate matching of aggregate bank assets and liabilities.

Right now, decision-making on matching assets and liabilities is too inefficient and too far removed from the traders who understand and can quickly act on opportunity. Most banks generate a gap analysis report for asset-liability committee meetings, but these reports are often inaccurate and few at the top do anything about them anyway.

One of the problems is senior management in some cases may not be proficient in interpreting the reports. But in some cases they are not concerned about interest rate exposure because they claim they do not see interest rates fluctuating in the way share prices do in their personal portfolios.

So who is managing the interest rate exposure of Malaysian banks? The answer is nobody. And this is where the opportunity for the development of the Malaysian derivatives market really lies.

The way things work now, money market dealers primarily source liquidity while investment managers and bond traders make decisions on where to place the bank's funds solely based on the yield levels. Faced with an inverted yield curve, a situation where interest rates are falling as maturities lengthen, most stay short, thus taking on more credit risks by adding bankers acceptances or short-term time drafts, to their liquid asset portfolios.

Futures traders on the money market desks may end up putting on a small lot punting position, but hedging transactions involving big volumes have yet to be understood or tried in Malaysian banking.

The other area where banks can develop the derivatives market is the over-the-counter market, where the instruments are not traded or quoted on an exchange. By trading three-month KLIBOR (Kuala Lumpur Interbank Offered Rate) strip a series of KLIBOR futures contracts consecutive maturities, Malaysian dealers could quote forward rate ag ments (FRA) and interest rate swaps their corporate customers.

There are currently fairly liquid dollar/Malaysian ringgit swaps quote the offshore market, but the market pa ipants are limited to a handful of for banks. There is no participation domestic Malaysian banks.

Meanwhile, for the offshore ma makers there is no access or link to be mark Malaysian government securitie futures strips, such as a dollar interest swap dealers would have in the Ur States.

Hedging the book depends primaril the liquidity offered by other market r ers. The rest depends on the nerve of ticular dealers. By having access to domestic three-month KLIBOR fu contract for the first time through the exchange, domestic banks can partici and develop the local FRA and int rate swap market. The opportunic build an options market will follow.

Indeed, with all these possibilities new products the Malaysian mark among the most exciting in the w today. What is even more thrilling is local banks could be the leaders in buil one of the most sophisticated fina centers in the region.

If that time comes, Malaysians will much more to be proud of than Petr Towers – currently regarded as the wo tallest structure.