Guide to The Malaysian Capital Market

INSTITUT BANK- BANK MALAYSIA

CHRIS BUTLER
HARPAL S. DHILLON
LYDIA THIAGARAJAH

Guide to The Malaysian Capital Market

Pelanduk
Publications

Published by
Pelanduk Publications (M) Sdn Bhd,
24 Jalan 20/16A, 46300 Petaling Jaya,
Selangor Darul Ehsan, Malaysia.

jointly with
Institut Bank-Bank Malaysia,
Level 5, The Amoda,
22 Jalan Imbi, 55100 Kuala Lumpur,
Malaysia.

ISBN 967-978-384-7

The views of the authors are not necessarily those of Institut Bank-Bank Malaysia.

Printed by
Eagle Trading Sdn Bhd,
81 Jalan SS25/32, 47301 Petaling Jaya,
Selangor Darul Ehsan.

FOREWORD

Since its inception in 1977, Institut Bank-Bank Malaysia (IBBM) has always been strongly committed to fostering a better understanding of banking and other related financial matters, not only among its members and staff of financial institutions, but also the general public.

In line with this commitment, the Institute is pleased to expand its series on "Guide to Banking Services" with this latest guide on *The Malaysian Capital Market*.

The Malaysian capital market enjoyed a progressive decade in the 1980s, and is set for another period of accelerated growth during the 1990s as more and more instruments and techniques are introduced to cater for different types of users.

It is hoped that this guide will provide readers with a clear overall picture of the Malaysian capital market, as well as the tax implications and key accounting issues involved.

The Institute is extremely grateful to Mr. Chris Butler, Mr. Harpal S. Dhillon and Ms. Lydia Thiagarajah for their time and commitment in writing this useful guide.

Yip Jian Lee
Director
Institut Bank-Bank Malaysia

August 1991

CONTENTS

THE AUTHORS

CHRIS BUTLER graduated from the University of Melbourne with a Bachelor of Commerce and a Bachelor of Laws. He was admitted to the partnership of Arthur Andersen in 1988 and is currently working in Kuala Lumpur. Chris has a detailed knowledge of tax laws affecting both local and international business operations. His experience has covered most industries, in particular the financing and retailing sectors of the economy. He has also written a book entitled *Equipment Leasing* which was published in 1985 by Longman Cheshire Pty. Ltd.

HARPAL S. DHILLON is a tax manager at Arthur Andersen. He is a fellow of the Chartered Association of Certified Accountants (UK) and a member of the Malaysian Institute of Accountants (MIA). He has passed the University of London (External) LLB programme intermediate examination and has a diploma in Commerce from Kolej Tunku Abdul Rahman, Kuala Lumpur. Harpal has had extensive full-time tax experience since early 1977 in most industries. He was the associate editor of the *Malaysian Tax Journal*, a publication of the Inland Revenue Officers Union. He is also the case law editor of the *Annual Tax Review*, a publication of the MIA.

LYDIA THIAGARAJAH studied law at Hull University and qualified as a barrister in London (Gray's Inn). The subjects she specialised in include revenue law, public international law, company law and shipping law.

PREFACE

When Institut Bank-Bank Malaysia approached us to write a book on the capital market scene in Malaysia, we felt both excited and challenged by the idea. The 1980s has been a progressive decade for the Malaysian capital market and we foresee bold innovations to further deepen the market. In this book, we examine the development of the Malaysian capital market and the financial instruments which have and will be introduced to meet the challenges of the 1990s. We also provide an overview of the accounting and tax implications so as to provide the reader with a complete picture.

This book is intended for the business community at large as this topic is of direct significance to them. We hope that their interest in this subject will be further developed by reading this book.

We wish to thank warmly all those who have contributed towards the production of this book.

Chris Butler
Harpal S. Dhillon
Lydia Thiagarajah

August 1991

Chapter 1

INTRODUCTION

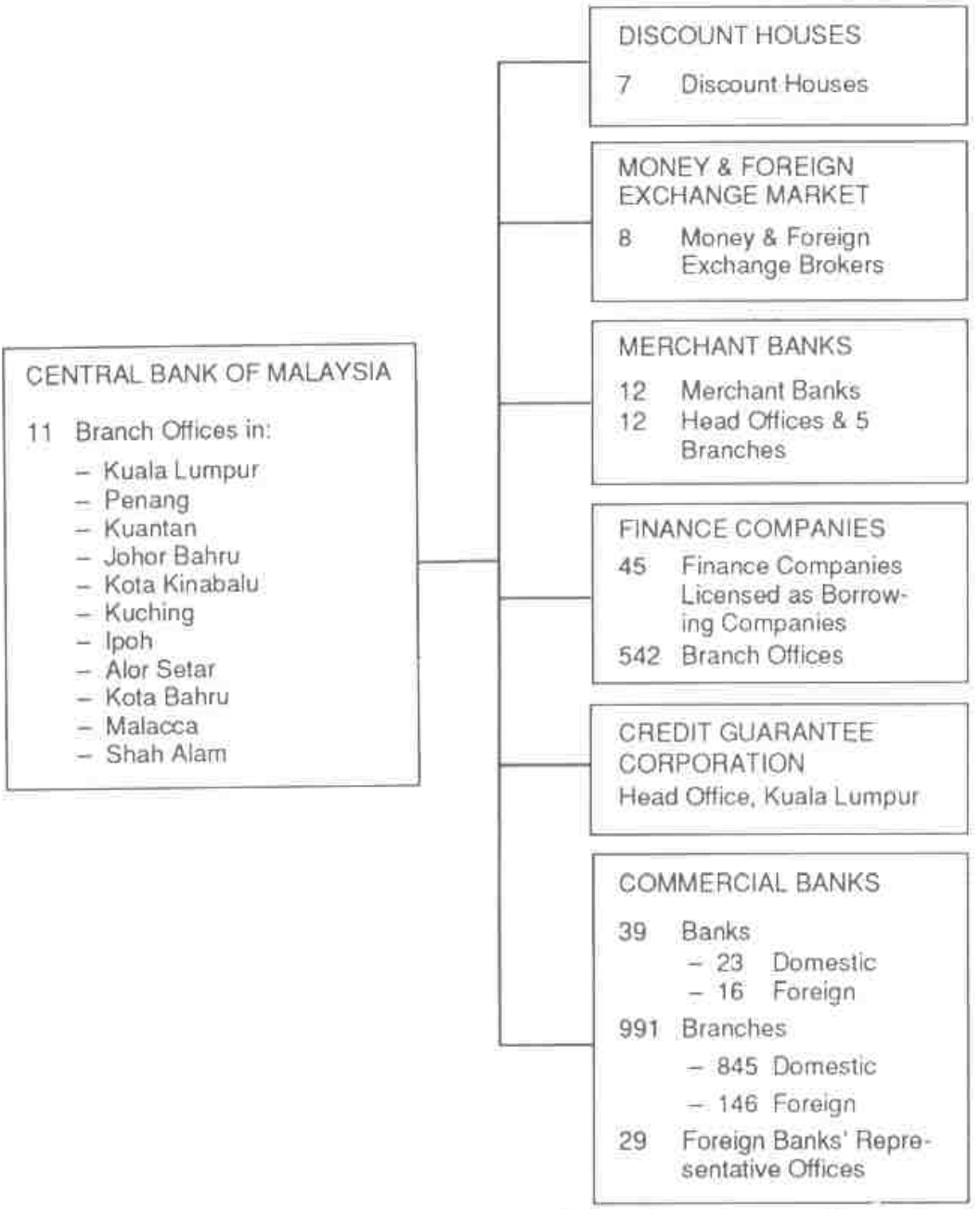
Malaysia offers fairly extensive services in the field of finance. Investors who locate their industrial projects in Malaysia will find a variety of financing instruments easily available. Besides accessibility to such facilities, they are also assured of a modern and efficient banking system which is at par with those in international financial centres.

The structure of the Malaysian financial system can be subdivided into two systems:

1. The banking system, which is under the supervision of the Central Bank; and
2 The non-banking system, which is supervised by various government departments and agencies.

Figures 1 and 2 give an overall view of the framework.

Within the above-stated financial system, the capital market in Malaysia serves many purposes. First, it helps in the process of economic development. This is done by utilising medium and long-term funds from the population to finance public development programmes and private investments. This process also assists the banking system in securitising its assets. Secondly, it promotes private enterprise by providing intermediary ser-



Note: Figures shown are those updated as at December 31, 1990.

FIGURE 1

NON-BANK FINANCIAL INTERMEDIARIES

DEVELOPMENT FINANCE INSTITUTIONS
- Malaysian Industrial Development Finance
- Agricultural Bank of Malaysia
- Borneo Development Corporation
- Development Bank of Malaysia
- Industrial Bank
- Sabah Credit Co-operation
- Sabah Development Bank

SAVINGS INSTITUTIONS
- National Savings Bank
- Urban Credit Co-operative
  - Co-operative Central Bank
- Rural Credit Co-operative Societies
  - Bank Rakyat

PROVIDENT & PENSION FUNDS
- Employees Provident Fund
- Teachers Provident Funds
- Armed Forces Funds
- Social Security Organisation
- Other Statutory & Private Provident & Pension Funds

INSURANCE COMPANIES

40 General Insurance Companies
3 Life Insurance Companies
15 Composite Life Insurance Companies
1 Reinsurance Company
1 Export Credit Insurance Company
1 Islamic Insurance Company (Takaful)

OTHER FINANCIAL INTERMEDIARIES
- Housing Credit Institutions
  - Malaysia Building Society Bhd
  - Borneo Housing Mortgage Finance
- Cagamas
- Housing Loans Division, Treasury
- Bumiputra Investment Foundation
- Pilgrims Management & Fund Board
- Komplex Kewangan Malaysia

STOCK EXCHANGE
- Kuala Lumpur Stock Exchange
  307 Listed Companies

UNIT TRUSTS
7 Unit Trust Companies

Note: Figures shown are those updated as at December 31, 1990.

FIGURE 2

vices to raise funds for corporate investment and expansion and in changing the ownership structure of companies.

The capital market in Malaysia may be divided into two parts. Firstly, the market in government securities and secondly, the market in stocks and shares, i.e., the corporate securities market. In the primary market, new issues of government and corporate securities are offered directly to investors. Secondary transactions in Malaysian Government Securities (MGS) are conducted mainly through the money market while secondary market trading of corporate securities is carried out in the Kuala Lumpur Stock Exchange (KLSE).

Thus, having briefly provided an overview of the financial institutions and the capital market scene in Malaysia, the first part of this book will proceed to examine the government securities market, the corporate securities market, the private debt securities and the commodity futures market. In the second part of this book, we will examine the new financial instruments which have been introduced to manage the commercial risks arising from the instability of these markets. This book also provides the reader with an awareness of the tax implications as well as the key accounting issues and thus provides a brief overall picture of the Malaysian capital market.

Chapter 2

GOVERNMENT SECURITIES MARKET

Malaysian Government Securities

The 1980s saw the Malaysian securities market coming into maturity. Over the years, the Malaysian Government Securities (MGS) developed mainly as a primary market and based its growth on the social security institutions (mainly, the Employees Provident Fund), the insurance companies and the banking institutions. Over the past three decades, the interest rates payable on the MGS remained fairly low and stable. This led to the MGS being generally unattractive to the private sector investors. However, MGS have been able to find ready markets mainly because of the legal provisions which require most financial institutions to invest a minimum proportion of their funds in MGS. Another consequence of the low and stable rates of interest payable on the MGS is that it hindered the development of an active secondary market. Thus, the 1960s and 1970s were spent mainly in building up the volume of MGS.

It was only in the 1980s that the focus shifted. Promoting an active secondary market in MGS became an important part of the Government's overall objective in developing the capital market. The need to develop the secondary market became glaring when the country's public sector deficit rose to an untenable proportion of 17.9% of GNP (or M$10.7 billion) in 1982. This squeeze on the Government's finances prompted a review of the financial management of its resources and caused the Government to provide regulatory and operational reforms. These reforms were intended to create a more stable short-term money market rate, shorten the maturity period of the papers and change the liquidity requirements of banks so as to enhance their flexibility in financial management. The MGS yield curve also reflected the market rates unlike previously where it lagged behind the market interest rates.

In January 1989, the system of principal dealership was introduced whereby a total of 18 principal dealers were appointed with the responsibility to underwrite the primary issue of MGS and to provide two-way quotations in the secondary market. These principal dealers comprised commercial banks, merchant banks and discount houses and were the only ones to have access to the Central Bank's rediscount windows. The Central Bank's open market operations would also be conducted only through them.

This system of principal dealers means that the Central Bank will now be the lender of last resort in the banking system. This means that its role in the money market will be aimed at maintaining liquidity and providing an environment of money market stability of the system as a whole rather than merely responding to the needs of individual institutions.

There was also a change in the system of issue. Securities with maturity periods of up to 10 years are now issued by way of auction through the principal dealers whilst securities with maturity periods beyond 10 years are issued on the basis of subscriptions to the Employees Provident Fund and the National Savings Bank. With these reforms and growing sophistication of

the capital market in Malaysia, active trading in the secondary market for MGS will continue to develop.

General Accounting Principles

1. Investments in bonds that an investor has no specific intent to sell before maturity and has the ability to hold until maturity should be carried at cost, adjusted for premium or discount amortisation, less any needed provision for permanent impairment in value.
2. Investments in bonds that an investor does not intend to hold to maturity, or will not be able to hold until then, should be carried at the lower of cost or market value.

Purchase of MGS
October 3, 1990 – Purchase MGS – outright, Stock – Loan 1/89. Coupon Rate 6.0% per annum. Maturity March 15, 1994.

a. *Upon purchase of MGS*
   Dr. Government Stock
   Dr. Accrued Interest Received on MGS
   Cr. Bank Negara Malaysia

b. *Monthly Accruals*
   Dr. Accrued Interest Received on MGS
   Cr. Income from Securities– Government Stocks

c. *Amortisation (Premium)*
   Dr. Amortisation of Premium– MGS
   Cr. Government Stocks

General Tax Principles

The tax treatment on income from the sale of securities and returns depends on whether a person is considered to be carrying on a business of trading in securities or whether the securities are considered a passive investment.

A person would normally be considered trading in securities if he habitually and frequently buys and sells securities. In this instance, the gain from the sale of securities will be trading income and subject to tax. Losses (normally arising from interest expense) will be allowed to be set off against income from other sources and also available to be carried forward to be set off against future years' income. The income from sale of securities and dividends are subject to income tax at 35% (for companies) as well as development tax at 3% (the development tax will be subsequently reduced by 1% each year). The investment income of insurance companies, banks and other financial institutions is taxable as business income.

If investment in securities is done more as a passive investment and not as a trade, the gain or loss from sale of securities will be capital in nature for tax purposes and hence not subject to tax. Capital gains are not subject to tax in Malaysia except for gains from the sale of real properties and shares in real property companies. Dividends and interest income from investments are subject only to income tax and not development tax.

Investment income of foreign companies from Malaysia will be taxable as passive investment income unless a permanent establishment is established in Malaysia to trade in securities. It should be borne in mind that a stockbroker who acts as an agent for the foreign company in Malaysia in buying and selling securities could possibly be considered a permanent establishment of the foreign company.

Chapter 3

CORPORATE SECURITIES MARKET

Stocks And Shares

The corporate securities market is by far the most active and exciting component of the capital market in Malaysia. However, the primary funds raised in this market represent only a fraction of the amount raised in the Government securities market. Historically, the growth of the new issues market for corporate securities began in earnest in the early 1960s. The instrument which was used to tap this market between 1960s and 1980s has predominantly been ordinary shares. Thus, unlike loans or government securities, returns on investment in corporate equities are not fixed but vary with stock market prices. There are at times huge capital gains to be made but there can also be at times severe capital losses too.

The Kuala Lumpur Stock Exchange (KLSE) provides the facilities for the trading of securities. It, therefore, has the important role of mobilising investible funds among the suppliers and

users of these funds. It also provides liquidity for the investments in the marketplace. The KLSE has, over the last few years, effected various changes and improvements to upgrade and place itself abreast with the other international stock exchanges. In November 1983, the first phase of a computerised clearing system was implemented. By March 1984, the entire clearing system was fully computerised. Through this new clearing system, the delivery of scrips and the settlement of accounts are carried out more speedily and efficiently. In May 1985, the Research Institute of Investment Analysts Malaysia (RIIAM) was formed to help the industry raise its level of security analysis and research. Conferences, workshops and seminars are organised from time to time to educate investors and to raise the level of professionalism in security analysis. New analysis and research materials are also published from time to time for investors. In 1986, the KLSE's new composite index (KLSECI) was launched. Prior to this, investors could only gauge the market based on the existing five sectoral indices. In 1987, the installation of the real-time share price reporting and corporate announcements system (MASA) was installed for brokers and subscribers. Through MASA, brokers and investors are able to have the latest information on the market without any frustrating delay. Learning from the experience of the Pan-Electric crisis, the advance warning and surveillance unit (AWAS) was formed in 1988 to alert the KLSE of stockbroking houses and listed companies facing problems.

In line with the growing sophisticated development of the market, the KLSE introduced its new listing manual in 1987 with an entirely new section on corporate disclosure policies and penalties on errant companies. Through this new listing requirement, investors' confidence is enhanced in that investors are ensured that all trading of securities are conducted on a fair and open basis, allowing the public access wherever appropriate. Investors are also treated with proper consideration at all times through the timely disclosure of material information affecting the development of the company and its subsidiaries. In order

to cater for the listing of smaller and younger companies, the KLSE launched the second board in 1988 to enable smaller companies which are profitable and which have good growth potential, to tap additional capital from the market through a listing on the exchange. Second board companies shares, therefore, add to the variety of financial instruments available for trading in the market. The second board also assists in the development of the economy in that smaller companies can now tap funds through the stock market for their development and expansion programmes. The secondary market in shares has also expanded significantly over the years. The growing size of the secondary market is reflected in the higher turnover. The KLSE's turnover continues to be dominated by trading in industrial shares. Meanwhile, finance shares remain the second most actively traded group of stocks followed by commodity shares. Trading of property and hotel shares account for the balance.

General Accounting Principles

Investment in corporate equities may be either temporary (current) or long-term (non-current) investments.

Temporary Investments in Corporate Eqities

Temporary investments generally consist of marketable equity securities (preferred and ordinary stocks) which must be readily tradeable and easily convertible to cash whenever necessary.

Marketable securities are classified as current assets in the financial statements. Investments in such securities are recorded at cost when acquired. The cost includes the purchase price and incidental acquisition costs such as brokerage fees and taxes (e.g. stamp duties).

Accounting Entries – Acquisition of Marketable Securities

Dr.	Marketable securities	xx	
Cr.	Cash		xx
	(Acquisition of marketable securities)		

Accounting for Changes in Market Value of Marketable Securities

The carrying amount of a marketable securities portfolio is reported at the lower of its aggregate cost or market value determined at the balance sheet date. Where the aggregate cost exceeds the market value of the portfolio, the difference is accounted for as a valuation allowance on the balance sheet and the unrealised loss reported in the profit and loss account. The valuation allowance applies to the total portfolio and not to individual securities.

Accounting Entries – Excess of Cost over Market Value

Dr.	Unrealised loss on valuation of marketable securities	xx	
Cr.	Valuation allowance for excess of cost over market value of marketable securities		xx
	(Recognition of a loss equal to the excess of cost over market value of marketable securities)		

The recovery of unrealised loss on valuation is only recognised to the extent that the unrealised losses were previously recognised and the resulting carrying amount of the portfolio does not exceed the original cost.

Dr.	Valuation allowance for excess of cost over market value of marketable securities	xx	
Cr.	Recovery of unrealised loss on valuation of marketable securities (Adjustment of valuation allowance due to increase in market value of marketable securities)		xx

Disposition of Marketable Securities

When marketable securities are disposed of, the disposer would incur brokerage fees and stamp duties, receiving only the net proceeds from the sale. The difference between the net proceeds from the sale of a marketable security and its cost represents the realised gain or loss. No regard is given to any unrealised losses or recoveries or the accumulated amount in the valuation allowance account at the date of sale, as the valuation allowance relates to the total portfolio and not to specific securities.

Accounting Entries – Disposition of Marketable Securities

Dr.	Cash	xx	
	Realised loss on sale of marketable securities	xx	
Cr.	Marketable securities (Sale of marketable securities held as a temporary investment)		xx

Long-term Investments in Corporate Equities

Long-term investments generally consist of investment in the securities (preferred and/or ordinary stocks) of another corporation (i.e. investment in a subsidiary or an associated company).

Long-term investments are classified in the balance sheet as "long-term investments", "investments and funds" or merely,

"investment". Such investments are held to enhance income through the receipt of dividends or interest or through appreciation in the market value of the securities. They are also held for the purpose of improving intercompany income performance. Long-term investments are usually investments which are held for more than a year.

Shares of stocks may be acquired in the market from stockholders, issuing corporations or stockbrokers. When stock is acquired in exchange for non-cash consideration (e.g. property), the stock should be recorded at the lower of its cost or the fair market value of the consideration given (or the fair market value of the stock received, whichever is determinable).

Long-term investments by one corporation (investor) in the stocks of another (investee) can be classified according to the percentage of the voting stock of the investee. The classification is as follows:

1. Holdings of more than 50% (consolidated statements) – where the investor has controlling interest.
2. Holdings between 20% and 50% (equity method) – where the investor has significant influence.
3. Holdings of less than 20% (lower of cost or market method or cost method) – where investor has passive interest.

The above classification is accounted for as outlined below.

Holdings of 20% or More

The equity method of accounting is used where consolidated financial statements are prepared. Under this method, the investment is originally recorded at the cost of acquisition. Subsequently, adjustment is made each period to account for changes in the net assets of the investee. In short, the investment's carrying amount is periodically increased (decreased) by the investor's proportionate share of the earnings (losses) of the investee and decreased by all dividends received by the investor from the investee. This method recognises that

the investee's earnings increase the investee's net assets underlying the investment and vice versa.

Accounting Entries

At acquisition

Dr.	Investment in ABC Ltd.	xx	
Cr.	Cash		xx
	(To record the acquisition of ABC Ltd's stock)		

Increase in the investment's carrying amount

Dr.	Investment in ABC Ltd.	xx	
Cr.	Revenue from investment		xx
	(To record share of ABC Ltd's income)		

Dividend received from ABC Ltd.

Dr.	Dividend received	xx	
Cr.	Investment in ABC Ltd.		xx
	(To record dividend received from ABC Ltd.)		

Holdings of Less Than 20%

Investments of less than 20% interest are accounted for using either:

a. the cost method; or
b. the lower of cost or market value method

a. Cost method

Under this method, a long-term investment is originally recorded at cost and it continues to be carried and reported at cost in the accounts until it is either disposed of or when the original cost can no longer be justified.

The cost is written down when the dividends received represent a distribution of retained earnings prior to the acquisition of the stock (i.e. liquidating dividend) by the investor. Only ordinary cash dividends received from the investee are recorded as investment revenue. The cost method does not account for the investor's share of the investee's net income/loss unlike the equity method.

Accounting Entries

At acquisition

Dr.	Investment in ABC Ltd.	xx	
Cr.	Cash		xx
	(To record the acquisition of ABC Ltd's stock)		

Liquidating dividends declared by ABC Ltd.

Dr.	Dividend receivable	xx	
Cr.	Investment in ABC Ltd.		xx
	(To record liquidating dividend declared by ABC Ltd.)		

Cash dividend received from ABC Ltd.

Dr.	Cash	xx	
Cr.	Revenue from investment in ABC Ltd.		xx
	(To record cash dividend received from ABC Ltd.)		

b. Lower of cost or market value method

As the case for temporary investment in marketable securities, under this method, all non-current marketable securities (long-term investment) are grouped in a non-current portfolio for purposes of comparing the aggregate cost

and the aggregate market value to determine the carrying amount at the balance sheet date. Differences between the aggregate cost and the aggregate market value are accounted for in a valuation allowance account.

However, changes in the valuation allowance for marketable securities (current assets) are included in the determination of income. Accumulated changes in the valuation allowance for non-current marketable securities (long-term investment) are included in the equity section of the balance sheet and shown separately.

Accounting Entries

Accounting for the excess of cost over market value of long-term equity securities

Dr.	Unrealised loss on non-current marketable equity securities	xx	
Cr.	Valuation allowance for excess of cost over market value		xx
	(To record the excess of cost over market value of long-term marketable equity securities portfolio)		

General Tax Principles

"Shares" in relation to a company as defined in the Malaysian Income Tax Act (MITA), 1967 include stocks other than debenture stocks. Shares as mentioned previously are by far the most commonly traded instruments in the capital market. Companies listed on the KLSE are entitled to issue several types of shares such as ordinary, preference, bonus issues, etc. so as to raise their equity base. Profits or gains made on sale of shares and stocks are not ordinarily taxable because of their capital nature where the seller is an ordinary investor. However, a share trader, i.e.

one who carries on the business of or deals in the buying and selling of shares, is liable for tax on profits and gains resulting from the trade. The rationale is that the profits or gains are of a revenue nature. Hence, in the case of individuals, stock exchange transactions are not normally taxable unless they are carried out regularly and systematically. Clear evidence of a trading activity is required before any tax liability can attach to the profits made.

Some of the factors which the Director General of Inland Revenue takes into consideration in determining the existence of a trade are:

a. the normal occupation of the individual – whether he is an employee, a trader or a professional trader;
b. whether he is a true speculator in the stock market;
c. what his connections with the stock market are;
d. whether his share operations are organised, i.e. he has an office and staff to deal with his share transfer;
e. whether he holds himself out to the public as a share or stock dealer; and
f. whether he possesses special skills in connection with the stock market.

It should be noted however that none of the factors are conclusive on their own. Each case should be decided on its merits. As far as the individual is concerned, the purpose for acquisition is immaterial.

In the case of companies, the usual line of trade engaged in plays an important role in distinguishing the capital and income dichotomy. The realisation of shares by finance concerns such as banks is considered a normal business activity. Any ensuing loss or gain is therefore accountable in computing the assessable income. On the other hand, profits arising from the sale of securities by investment holding companies are not taxable as they are considered to be capital in nature. Gains from shares held in property companies are however liable for real property gains tax upon disposal.

Dividends are the other source of "gain" resulting from the holding of stocks and shares. Dividends represent sums distributed to shareholders by a company. All dividends are income by virtue of Section 4(c) of the MITA and dividends overseas are assessable only if received in Malaysia. Thus, dividends flowing revenue or paid out of reserves (comprising accumulated untaxed capital profits) are considered "income" regardless of its source. Under the franking system, distributed dividends are taxed at the company level at 35% and could subsequently be claimed as tax credits by the individual shareholders depending on their respective tax brackets.

Chapter 4

PRIVATE DEBT SECURITIES

The development of an active private debt securities market has also been given due consideration as an alternative source of financing in addition to the traditional means of share issuance and bank borrowings. In the 1980s, the first step in securitisation was taken with the introduction of the Cagamas bonds.

What Is A Bond?

A bond is a certificate that represents a loan from the institutions or individuals buying the bonds (the investors or bondholders) to the entities selling the bonds (the issuers). As bondholders have in effect made loans to the issuer, they are legally the issuer's "creditors" and not "owners" as stock investors are.

Cagamas Bonds

Cagamas Berhad, the National Mortgage Corporation, was established with the objective of developing a secondary mortgage market in Malaysia. Its shareholders are the major financial

institutions including Bank Negara Malaysia which has the largest single holding of 20% of the paid-up capital. The other major shareholders are the commercial banks as a group (45%), the finance companies (25%) and the merchant banks (10%). In essence, Cagamas acts as an intermediary between investors looking for fixed income investments (through a fixed rate medium-term instrument) and the originators of housing loans. The primary lenders are now able to obtain liquidity for their housing loans by selling these loans to Cagamas at a lower rate of interest than that charged to the borrowers thereby making a spread in the process. Cagamas in turn raises the funds for its purchases of housing loans by issuing bonds to the public, bridging the timing of purchases and bond issues through borrowing in the inter-bank market.

Cagamas bonds are "straight" bearer bonds with a fixed coupon rate and semi-annual payment of interest. These bonds are redeemed in full at their nominal value on the maturity date. They have been approved by the Central Bank to be regarded as financial instruments for purposes of dealing by commercial banks, merchant banks, finance companies and discount houses. Each issue of bonds is constituted pursuant to a Trust Deed executed between Cagamas and an approved trustee company in Malaysia. The Trust Deed sets out the rights and obligations of Cagamas and the rights of the bondholders. In the main, the Trust Deed is aimed at protecting the bondholders by requiring Cagamas to enter into covenants with regard to the payment of principal and interest, prudent conduct of its business and provision of information and reports to the Trustee and the Registrar of Companies.

Besides the primary market, a secondary market for Cagamas bonds has been established through a network of principal dealers comprising a selected group of financial institutions. At present, a total of nine commercial banks, seven merchant banks and all the seven discount houses have been appointed as principal dealers. Their main function is to make an active market for the bonds by undertaking to quote con-

tinuous two-way prices at all times and in all market conditions. The principal dealers have been given an exclusive right to tender for all primary issues of Cagamas bonds although the discount houses cannot hold or trade bonds with a remaining maturity of longer than five years. The attractive features of Cagamas bonds are attractive yields, shorter maturity (up to 5 years), the bearer form of the certificates, their eligibility as a secondary liquid asset and the exemption of transactions in these bonds from stamp duties.

Cagamas' experience as the first institution to issue fixed rate securities at a price determined by supply and demand will pave the way for other private sector corporations to tap the market for capital funds outside the equity and bank loan markets. The holders of Cagamas bonds form a broad spectrum of financial institutions, non-financial corporations and government agencies. Nevertheless, the holder base remains relatively narrow. So far there is no individual holder of Cagamas bonds which reflects a lack of "bond consciousness" among the public. This will change with the Scripless Securities Trading System (SSTS). The SSTS, which is a new system for the issues, lodgement, custody, recording and transfer of Cagamas bonds, holds exciting prospects for the future of the secondary mortgage bond market. The bondholders will in effect hold and trade bonds in a scripless form and basically the SSTS will increase significantly the ease and speed of trading and transfer of Cagamas bonds.

A Cagamas bond does not pose a greater price risk than any other fixed rate bond of equivalent quality and remaining maturity. The risks of non-payment of interest or principal are virtually zero. The liquidity risks are also small given the market liquidity provided by the principal dealers. On the other hand, the return is fairly attractive compared with the traditional bank deposit. At present, the yield to maturity on a five-year Cagamas bond held to maturity is about 6% per annum compared with about 5% per annum on bank deposit and 3.72% for a composite of all shares listed on the KLSE. In a country like Malaysia with a generally low inflation record, there is little danger of a per-

manent substantial decline in bond prices. However, like all fixed rate medium-term instruments, Cagamas bonds do pose a price risk to the short-term holder if there is a need to liquidate, i.e. the secondary market price may be different from the purchase price. Thus, a short-term holder may be unable to realise its purchase price or the nominal value of the bonds if there is a need to liquidate its holdings. But a long-term holder investing in the bonds until maturity will not face a price risk, since the bonds are redeemed at par.

Cagamas bonds have paved the way for other private sector corporations to tap the market for capital funds outside the equity and bank loan markets since investors now have a benchmark with which to assess the other borrowers. In creating the secondary mortgage market, Cagamas has helped to develop the market for fixed rate securities in Malaysia.

General Accounting Principles

1. **Purchase of Cagamas bonds**
   November 23, 1990 – Purchase Cagamas outright. Stock loan 1/89 Cr. 6.1% p.a. Maturity February 28, 1994.

   Upon purchase of Cagamas bonds

   Dr. Notes/Instruments Purchase – Cagamas Bonds

   Dr. Accrued Interest Receivable (Notes/Instruments) – Cagamas Bonds

   Cr. Bank Negara Malaysia

   Monthly accruals

   Dr. Accrued Interest Receivable (Notes/Instruments) – Cagamas Bonds

Cr. Interest Income – Notes/Instruments Purchased – Cagamas Bonds

Amortisation (Premium)

Dr. Amortisation of Premium– Cagamas Bonds

Cr. Notes/Instruments Purchased– Cagamas Bonds

2. Sales of Cagamas Bonds

November 30, 1990 – Sale of Cagamas. Stock loan 1/89 Cr. 6.1% p.a. Maturity February 28, 1994.

Upon sales of Cagamas Bonds

Dr. Bank Negara Malaysia

Cr. Notes/Instruments Purchased– Cagamas Bonds

Cr. Profit/(Loss) on Sale of Securities – Cagamas Bonds

Cr. Accrued Interest Receivable (Notes/ Instruments) – Cagamas Bonds

Cr. Interest Income – Notes/Instruments Purchased– Cagamas Bonds

General Tax Principles

The taxability of this income would depend on the following:

a. Resident status of the bondholders;
b. Whether the bondholders are individuals or companies (other than banks or financial institutions); and
c. Whether the bondholders are banks/financial institutions.

The coupon interest received by resident companies (other than banks/financial institutions) would be subject to tax under Section 4(c) of the MITA at the corporate rate of 35%. However, no development tax is imposed on the coupon interest received as it does not constitute a business income of the company. Under Section 109C of the MITA, approved financial institutions are required to deduct tax at 5% from interest payments (other than interest exempt from tax) made to resident individuals. As Cagamas Berhad is an approved institution under Section 109C(4) of the MITA, the coupon interest on the bonds would be subject to the 5% tax. This 5% represents the final tax on the coupon interest of the resident individuals regardless of their respective personal graduated tax rate which may be higher. This serves as an incentive to the individuals to invest in Cagamas bonds.

The coupon interest received by banks and/or financial institutions would be assessed to tax as gains or profits from a business under Section 4(a) of the MITA. The reason for this is because the primary business of a bank and/or a financial institution is to employ money which is its stock-in-trade in the best possible way to earn a profit which includes interest. Therefore, investment in bonds constitutes an integral part of the banking business and the interest thereon would be taxed as a business income under Section 4(a). Thus, the coupon interest would be subject to income tax at 35% and development tax at 3% (development tax will be subsequently reduced by 1% each year).

Interests derived from Malaysia and received by non-residents (whether individuals or companies) are subject to withholding tax of 20% if the interest is not attributable to a business carried on by the non-resident in Malaysia. However, the tax withheld may be reduced if the coupon interest is paid to residents of countries which have treaty arrangements with Malaysia.

For banks and/or financial institutions, the interest expense relating to the loans taken to purchase the bonds would be

wholly deductible against all the business income of the bank or financial institutions. The deduction of the interest expense of a loan taken by a company (other than bank/financial institution) or individual to finance the purchase of the Cagamas bonds would be restricted to the coupon interest received in the respective years. Any excess of the interest expense that cannot be absorbed by the coupon interest would be lost to the company/individual.

Chapter 5

COMMODITY FUTURES MARKET

Kuala Lumpur Commodity Exchange

The development of a commodity market in Malaysia arose out of the country's pre-eminent position in the production of primary commodities. The Kuala Lumpur Commodity Exchange (KLCE) was established on October 23, 1980 to trade commodity futures contracts within Malaysia and to provide domestic palm oil producers with an opportunity to hedge their activities locally. The KLCE operates under the Commodity Trading Act 1980 and is supervised by the Commodities Trading Council. Contracts are offered in palm oil, cocoa, rubber and tin and they are handled by the Kuala Lumpur Commodity Clearing House Berhad which is jointly owned by the London-based International Commodities Clearing House and seven commercial banks.

A futures contract may be described as an agreement to buy or sell a standardised quantity of particular goods on some specified future date but at a price determined now by competitive

bidding on the floor of an exchange. Thus, all futures contracts enable participants in financial markets to fix in advance the price that will apply to their transactions at specified times in the future.

The two organisations which make up a futures market are the exchange and the clearing house. The exchange comprises the marketplace where trades are executed on an "open outcry" basis. The clearing house is the organisation which processes all trades executed on the floor of the exchange. They ensure that commodities match the contracts and that buy contracts match sell contracts. The obligation of a party to fulfil its commitment under a futures contract is secured by a margin (good faith) deposit. Margins comprise cash and securities or guarantees deposited with the clearing house. The clearing house also has a "common bond" system established by member brokers so that defaulting brokers' clients can be covered. The sharing of risk in the common bond system also encourages clearing members to co-operate and bring about a self-policing system so that the credit risks in the system are constantly monitored.

Futures are primarily used for hedging and speculating. Hedging can be described as a transaction in the futures market to reduce the risk of loss through adverse price movements. For example, a rubber dealer with a commitment to deliver rubber three months from today will buy a futures contract so as to protect himself against price increases for rubber by the time delivery date arrives. The participants for hedgers could be individuals or institutions whose activities involve commodities or financial instruments. The speculators provide the liquidity to the market which enables the hedgers to buy or sell in volume without difficulty. Futures enable the speculator to profit from movements in the financial markets without actually having to purchase the underlying financial instrument. The participants for speculators are local traders involved full time, managers of commodity funds or individuals who are looking for a flutter. The basic forces of demand and supply gear futures markets. They are also affected by political, economic and social factors.

General Accounting Principles

Cash	Futures (KLCE)
November 1:	
sells for Feb shipment processed palm oil equivalent to 1,000 tonnes CPO at M$600/tonne	buys 40 Feb CPO Contracts @ 25 tonnes at M$596/tonne
January 1:	
buys 1,000 tonnes CPO at M$700/tonne	sells 40 Feb CPO Contracts at M$694/tonne
Result:	
loss M$100/tonne x 1,000 tonnes = M$100,000	gain M$98/tonne x 1,000 tonnes = M$98,000

The refiner achieved his CPO price objective through an almost equal gain by his long hedge. Notice that in this example, the "basis" has changed from M$4/tonne (M$600 – M$596) to M$6 (M$700 – M$694) and the difference is expressed in the loss of M$2/tonne or M$2,000 (M$100,000 – M$98,000).

Example of a short hedge (cocoa beans producer)

Cash	Futures (KLCE)
November 1:	
expects 200 tonnes of unsold cocoa beans which could fetch US$1,100/tonne	sells 20 Mar Cocoa Contracts @ 10 tonnes at US$1,080/tonne
February 1:	
sells 200 tonnes cocoa beans at US$1,000/tonne	buys 20 Mar Cocoa Contracts at US$978/tonne

Result:

loss US$100/tonne x 200 tonnes = US$20,000	gain US$102/tonne x 200 tonnes = US$20,400

The producer, therefore, achieved his price objective through an almost equal hedge gain. Notice that the difference between cash and futures prices or the "basis" has changed from US$20/ tonne (US$1,100 – US$1,080) to US$22/tonne (US$1,000 – US$978) and the difference is expressed in US$2/tonne earned on this hedge or US$400 (US$20,400 – US$20,000).

Accounting Treatment

a. Unrealised gains/losses in the value of outstanding contracts are settled daily.
b. Unrealised losses, called "variation margin", have to be paid to the clearing house at the end of the day.
c. Unrealised profits will be paid.

General Tax Principles

The Malaysian tax system differentiates in its treatment of the users based on the type of taxable activities they perform. For example, it is obvious that banks, finance companies, insurance companies and merchant banks will be taxed under Section 4(a) of the MITA i.e. as gains or profits arising from a trade or business. Individuals would be given a capital gains treatment and would thus not be subject to tax. However, an individual may well be caught under the all comprehensive Section 4(f) if he has regular swipes at financial futures. For companies, the first presumption where it involves financial futures is that any ensuing profit or loss is accountable for tax as it arises from a trade. Institutions such as investment trusts, unit trusts, pension funds and charities are normally given "capital gains" treatment on their portfolio transactions. Consequently, any gains or losses made in future dealings will be disregarded for tax purposes.

Under the Malaysian legislation, non-residents who participate in future transactions are tax exempt. The exemption is subject to the important proviso that the non-resident transactor does not operate in the Malaysian futures market through a permanent establishment. This should greatly encourage non-residents to venture into our futures market.

The tax treatment may also differ in accordance with the motive for entering into these futures contracts. As mentioned earlier, the basic motives for entering into a futures contract are hedging and speculating. For example, the presumption that companies engaging in futures transactions are accountable for tax is rebutted where the taxpayer company proves that the transaction was a hedge. Individual speculators may still be taxable where the propensity and frequency of trading are sufficiently high.

Chapter 6

FINANCIAL FUTURES

The Product

A financial futures contract is an agreement to buy or sell a standard quantity of a financial instrument of foreign currency at a future date at a price decided at the time the contract is made on the floor of an exchange. Its main purpose is to transfer the risk of price movement from one party to another.

The uses of financial futures are basically divided into three categories:

a. **Hedging** – to reduce risk or loss through adverse price movements in currency rates, interest rates or share prices, by taking a position that is equal and opposite to an existing or anticipated position in the cash market. For example, if the value of an underlying instrument declines in response to a particular market phenomenon, and the futures contract rises in respect to the same phenomenon, the futures contract would be of little use as a hedging strategy for that underlying instrument.

b. **Speculating** – speculators assume the risk transferred to them by the hedgers and provide liquidity to the market which enables the hedgers to buy or sell without difficulty.
c. **Arbitraging** – the use of futures contracts to profit at minimal risk from any irregularities in the pricing of futures contracts. This may involve the use of multiple combinations of futures and financial instruments in order to maximise the risk/return ratio. The advantage of the futures contracts is that its standardisation (i.e. quantity, type and delivery points) and the manner in which they are traded (i.e. through recognised exchanges) allows commercial and financial institutions to manage their business risks by flexible and efficient hedging techniques.

General Accounting Principles

Please refer to this section in Chapter 5 as similar principles apply.

General Tax Principles

Please refer to this section in Chapter 5 as similar principles apply.

Chapter 7

FORWARD RATE AGREEMENT

The Product

A forward (future) rate agreement is a contract whereby two parties agree on a fixed interest rate that is to be paid on a notional deposit of specified maturity commencing at a specific future time. Typically, the buyer of a Forward Rate Agreement (FRA) wishes to minimise exposure to rising interest rates whilst maintaining its liquidity profiles, and the seller is seeking to limit exposure to falling interest rates. Briefly, the major points to note about FRAs are:

a. No principal amount changes hands;
b. No premium is payable on the outset of the agreement; and
c. The compensatory payment is made on the settlement date of the FRA.

Advantages

The major advantages of FRAs as compared with financial futures are:

a. FRAs are non-standard contracts and may be tailored to the needs of specific users; and
b. No margin is required.

Disadvantages

a. FRAs are not transferable and may only be cancelled by reversal with another equal and opposite FRA; and
b. The credit risk of FRAs is confined to the compensatory payment whilst the credit risk on futures is uniform and said to be small because the clearing house assumes the contractual relationship between the buyer and the seller, and acts as the counterparty to both.

General Accounting Principles

1. Notional principle – not an asset or liability
2. Interest differential
   a. Hedge – amortised over period
   b. Speculation – mark-to-market
3. Accounting entries – anticipatory hedge with FRA
   a. *Upon receipt of deposit*
      Dr. Cash
      Cr. Deposits
   b. *Upon receipt from the counterparty of the FRA held in a deferral account until fully amortised*
      Dr. Cash
      Cr. Deferred gain on FRA
   c. *Accrued interest payable*
      Dr. Interest expense
      Cr. Interest payable

d. *Amortisation of deferred interest expense*
   Dr. Deferred gain on FRA
   Cr. Interest expense – FRA

4. Accounting entries for speculation FRA – the marked-to-market requirements may result in unrealised loss which should be reflected in the profit and loss account.
   Dr. Loss on FRAs – Profit and Loss Account
   Cr. Unrealised loss on FRAs – Balance Sheet

General Tax Principles

With regard to a bank, the tax aspects should present few problems. This is because the bank can demonstrate that the using of FRAs was in respect of its normal trading activities and thus the interest income will fail to be taxed under Section 4(a) of the MITA as business sourced income. For non-bank taxpayers, the tax treatment may differ. For a trading entity where it can be shown that the borrowing/finance relates to trading matters, Section 4(a) treatment applies. For other taxpayers, the interest income will probably be caught under the comprehensive provision of Section 4(f).

Interest which has a Malaysian source is taxable in Malaysia. In order to ensure that recipients who are non-residents or do not have a place of business in Malaysia, pay the appropriate tax on it, the provisions of Section 109 are enforced. This Section requires the payer of the interest to withhold tax at the appropriate rate (presently 20%) from the Malaysian source interest, paid or payable to any person not known to him to be in Malaysia. The tax so withheld is to be remitted to the Director General within one month from the date of payment.

Chapter 8

SWAPS

The Product

A swap is an agreement between two counterparties to exchange streams of payments over time. In an interest rate swap, there is no exchange of principal either at inception or on maturity but a periodic exchange of streams of interest payments arising on an underlying notional principal amount. In theory, the interest rate swap is a form of credit arbitrage in which no party loses as it exploits the differences in perception of a borrower's creditworthiness for fixed as opposed to floating rate funds or vice versa.

In a currency swap transaction, the two counterparties agree to exchange specific amounts of two different currencies and make periodic repayments over time which reflect differences in interest rates between the two currencies.

Uses

The end user engages in the swap market in order to obtain low-cost financing, to obtain high-yield assets, to hedge interest and currency exposure and to speculate. On the other hand, the intermediary engages in the swap market to generate fees, or

exceptionally, to earn trading profits from establishing an open position in the swap.

Swaps may be preferred to other hedging devices such as futures or options because futures and options with the necessary characteristics may not be available in the market and even to the extent that they are, will involve fairly substantial dealing costs in terms of commission and the market makers' spread. Swaps, on the other hand, have the advantage that the peripheral costs are minimised and the interest flow will complement the capital value of the portfolio.

General Accounting Principles

1. Accounting for interest rate swaps:
   a. There is no specific authoritative pronouncement within the generally accepted accounting principles (GAAP) that applies directly to swaps.
   b. However, the overall accounting framework is generally consistent with other products:
      - For swaps used in hedging, deferral or accrual accounting should be applied.
      - Swaps used in trading or by dealers should be marked to market.
2. Hedge accounting for interest rate swaps:
   a. For a swap used to hedge debt, the net interest payment to be received or paid should be accrued over the current period it covers as an adjustment to interest expense on the debt that it is intended to hedge.
      Dr. Accounts Receivable
      Cr. Interest Expense
   b. The floating interest rate for each period is usually set about two days prior to commencement of the period. Settlement will occur at the end of the pe-

riod. Therefore, it is possible to accrue the payment over the period to which it applies.

Dr. Cash
Cr. Accounts Receivable

3. Market value accounting
   a. In revalueing swaps, the journal entries are relatively simple although the calculations may become involved.

   Revaluation

   Dr. Other Assets – Swap revaluation
   Cr. Trading Income
   Dr. Trading Losses
   Cr. Other Assets – Swap revaluation

   b. Swap profit and loss actually include two components:

   - Accrual of the interest differential (fixed versus floating rates) for the period that has just expired.
   - Revaluation for the remaining term of the swap.

   Settlement

   Dr. Cash
   Cr. Other Assets – Swap revaluation

General Tax Principles

Where a bank acts as an agent of an intermediary principal, it will normally charge a fee (based on a percentage of the capital sums involved) for arranging the transaction. Such an income would be taxable as part of the bank's normal trading profits and an allowable deduction where the bank is called upon to pay such fees. However, payment of arrangement fees by non-bank or financial institutions will not qualify as a deduction as it does not satisfy the test of being "wholly and exclusively" incurred for the purposes of its trade (Section 33(1) of the MITA).

Under a currency swap, the contracting parties have basically exchanged one currency for another with an understanding to re-exchange at a later date. Consequently, the payments made such as swap fees between the parties cannot be considered as interest payments for purposes of tax law. Although these payments are computed by reference to interest rates, they are considered as annual payment of fees. Consequently, there ought not to be any withholding tax implications where cross-border transactions are concerned. Interest swaps are also given the same tax treatment as currency swaps. In interest swaps, there are also no funds that are swapped or which interest is paid. The parties only swap interest rates. Where withholding tax is imposed on the grounds that the payment is in the nature of interest, it may be preferable to run the transaction through an intermediary bank as payments made to a bank are more easily identified as deductible.

Chapter 9

CURRENCY AND INTEREST RATE OPTIONS

The Product

An option is the right obtained by a fee to purchase or sell property, especially shares or commodities, at a specified time in the future at a fixed price. With regard to an option contract, the two parties are the option buyer and the option writer. The option buyer may for a cash consideration, called the premium, purchase from the option writer a commitment that the option writer will sell (or purchase) a specified amount of, say, foreign currency upon demand at an agreed exercise price.

An interest rate option involves an agreement whereby, in return for the receipt of an upfront fee, the writer of the agreement, which is generally a financial institution, agrees to make a number of payments in the event that interest rates rise above a determined level. The main groups of option users are the speculators and the hedgers.

a. **Speculators** – The advantage of buying an option for speculative purposes is that the return is highly geared in relation to the cost of the underlying financial instrument, and the amount of loss is limited to the premium paid. This is in contrast to the speculator who writes an option, since the profit is limited to the premium received but the loss is potentially unlimited.
b. **Hedgers** – Options are used by hedgers for the purpose of transferring a rise in price, and foreign exchange or interest rates to the speculators. The advantage to hedgers of using this market is that for a comparatively low cost, exposures can be controlled whilst maintaining the ability to profit from favourable changes in price, foreign exchange and interest rates.

General Accounting Principles

1. Accounting for options
   a. Overall accounting for exchange traded options on interest rate futures.
      - There are no specific authoritative pronouncements within generally accepted accounting principles that apply directly to options.
      - Therefore, accounting for options is derived by analogy to other instruments.
      - For the buyer, the premium paid is recorded as:
        – an asset for purchased options; and
        – a liability for written options.
      - The seller must record any margin deposit as an asset.
      - Daily changes in market value should be recognised in income immediately (marked-to-market

accounting) unless the option qualifies as a hedge.

b. Hedge accounting

- For assets, liabilities or firm commitments

Purchased options criteria:

– Item to be hedged exposes the company to price or interest rate risk.

– Option position reduces the exposure-high correlation.

– Option position is designated as a hedge.

Written options criteria:

– Must meet same three criteria specified for purchased options (above).

– Option is so deep in-the-money that it is reasonably assured that the option will remain in-the-money throughout the term; alternatively, losses should only be deferred to the extent of premium received.

2. Accounting treatment for interest rate options

For a purchased option that hedges interest-bearing assets or liabilities carried on the balance at cost:

a. Split the time and intrinsic value and amortise time value over the life of the option.

b. Defer gains and losses and adjust the carrying amount of the hedged item at each reporting date.

c. Amortise gains or losses to interest income or expense over the remaining life of the hedged item.

d. For assets or liabilities carried at market value on the balance sheet, the option that hedges these items should also be marked-to-market (symmetry). No separate amortisation of time value is necessary.

- For hedges of firm commitments or anticipated transactions in which an interest-bearing asset or liability is acquired:

- The time value may be amortised over the life of the option or deferred and included as part of the purchase price of the transaction when it occurs (to be amortised over the life of the item acquired).
- Defer gains and losses and include in the measurement of the transaction when it occurs (to be amortised over the life of the item acquired).

• For hedges of firm commitments or anticipated transactions in which an interest-bearing asset is to be sold:
- The time value may be amortised over the option term or deferred and included as part of the gain or loss on sale.
- Gains or losses should be deferred and included as part of the gain or loss on sale.

3. Accounting entries

At inception, the total option premium is recorded as an asset:

Option premium	xx	
Cash		xx

The time value is amortised over the life of the option as a reduction of interest on the bonds:

Interest income	xx	
Option premium		xx

As the value of the option increases, gains are deferred (amount assumed):

Options held	xx	
Discount on government securities		xx

Amortising the deferred gains protects the spread:

Discount on government securities	xx	
Interest income		xx

When an option is sold, the original intrinsic value of $x plus gains of $x are received:

Cash	xx	
Option held		xx

General Tax Principles

In many respects, the use of currency options and consideration of their tax consequences can be seen as a return of the same issues as arising from currency swaps. Malaysian tax statutes have not provided specifically for the taxation of options transactions. Nevertheless, by utilising the general tax rules it is possible to predict the tax treatment of such transactions. The key determinant of whether a transaction is taxable or not is governed by the capital revenue dichotomy. "Revenue" or trading transactions are taxable while "capital" transactions are not. Capital losses and expenditure are however non-deductible but are deductible if classified as revenue items.

The tax treatment of an option transaction will vary with respect to the different classes of participants. Firstly, financial institutions and individuals trading on their own account are considered to be in the trade of buying and selling options. Consequently, option income (such as option writing premiums and commission income) will be taxable on them and corresponding losses and expenses are deductible against this income.

Secondly, commercial users of financial options may or may not qualify for capital treatment. Commercial users utilise options to hedge foreign exchange or interest rate risks associated with related commercial transactions. The nature of these underlying commercial transactions will determine the tax effect of the

options. Options used to hedge trading items will receive revenue treatment. Alternatively, options used to protect against exchange rate fluctuations on contracts relating to capital assets or liabilities will attract the capital treatment.

Lastly, as regards to speculators, speculative gains and losses are not trading in nature. Thus, speculative gains are not taxable and the associated losses and expenses are not deductible. The factors which the Director General takes into account in determining whether the level of speculation amounts to "trading" are:

a. The normal occupation of the individual – whether he is an employee, trader or a professional trader;
b. Whether he is a true speculator in the options market;
c. What his connections with the options market are;
d. Whether his options transactions are organised, i.e. he has an office and staff to deal with his options transactions;
e. Whether he holds himself out to the public as an options dealer; and
f. Whether he possesses special skills in connection with the options market.

It should be noted however that none of these factors are conclusive on their own. Each case will be decided on its merits.

With regard to interest rate options, the availability of a deduction for the payment of the upfront fee will depend on how the transaction is characterised, i.e. whether it is regarded as being of capital or revenue account or as a trading item or not.

In general, the exercise of an interest rate option will not lead to the delivery of the underlying commodity (i.e. a deposit) but the payment will generally constitute something other than interest. The withholding tax regime applying to interest is thus unlikely to apply to payments made on interest rate options.

Chapter 10

INTEREST RATE CAPS, COLLARS AND FLOORS

The Product

Caps, collars and floors may be seen as another set of tools for transferring rise in interest rates away from the corporate sector to the financial sector. These instruments are a form of interest rate volatility protection that enable a corporate manager to fund his medium-term projects with short-term money in the confidence that substantial increases in interest rates will have no ill effects on his company's profit and loss account.

An interest rate cap is an agreement between a bank and a corporate borrower with floating rate debt whereby the bank, in return for a premium, undertakes to cap the cost of this debt over an agreed rate for an agreed period of time. The bank will pay any interest costs arising as a result of an increase in the cost of the debt above the agreed cap rate.

The cap is thus designed to protect borrowers of floating rate funds against excessive upward movements in interest rates.

Interest Rate Floor

A floor is an agreement between a bank and a corporate lender with floating rate loans whereby the bank, in return for a premium, agrees to set a floor on the interest income that the corporate lender will derive from its loans. The bank will pay any lost interest income arising as a result of a fall in the interest rates below the agreed floor rate.

An interest rate floor protects investors in floating rate instruments against excessive downward movement in interest rates, whilst being able to take credit for upward movements in rates.

Interest Rate Collar

A collar is a combination of a cap and a floor which enables a party with a floating rate stream of funds to lock into a predetermined interest rate band. This means that the buyer has capped the cost of floating rate borrowings but limited the potential gain from reductions in interest rates, to the floor rate.

Uses

The cap users are generally risk-averse corporations seeking protection against large adverse movements in their floating rate loan. These instruments are also useful to companies involved in medium-return projects such as construction and leasing, and those funding themselves for leveraged buyouts.

There are a number of factors that limit the use of these instruments:

a. The payment of a substantial upfront premium is at best incompatible with a company's cashflow, and at worst, may put a severe strain on the company's liquidity.
b. Any hedging policy is always viewed in hindsight as being sub-optional, i.e. if retrospectively, the cap was found to be unnecessary, the company frequently sees itself as having paid a premium for nothing.

c. There is a credit risk associated with a cap in so far as, if the interest rate exceeds the strike level of the cap, the writer of the cap is liable to make a compensating payment to the company.

General Accounting Principles

1. Accounting
   a. Caps are basically options.
   b. There is no specific authoritative pronouncement within generally accepted accounting principles that applies directly to caps or options.
   c. However, the overall accounting framework is clear.
      - For caps used in hedging, deferral or accrual accounting should be applied.
      - Caps used for speculative purposes or caps sold by dealers should be marked to market.
   d. Hedge accounting
      The initial cap premium is amortised over the one year term of the deal. When a cap payment is determined, it should be accrued and recognised over the settlement period (six months, in this example). At the end of the six months, the payment is collected.

      Inception
      Dr. Cap Premium
      Cr. Cash

      Amortisation
      Dr. Interest Expense
      Cr. Cap Premium

      Rate reset
      Dr. Cap Premium
      Cr. Deferred Credit

Amortisation
Dr. Deferred Credit
Cr. Interest Expense

Settlement
Dr. Cash
Cr. Cap Premium

e. Marked value accounting

- Caps bought or sold for trading purposes, including those offered to customers and held in portfolios of dealers or market makers, are accounted for at market value, with changes in value reflected in the income statement.
- In this example, a cap was sold and the premium is set up as a liability. Changes in value are recorded as income or loss as they occur and payments are made at settlement dates.

Inception
Dr. Cash
Cr. Cap Premium Liability

Revaluation
Dr. Trading Losses
Cr. Cap Premium Liability
Dr. Cap Premium Liability
Cr. Trading Income

Settlement
Dr. Cap Premium
Cr. Cash

General Tax Principles

For a bank or financial institution, the incurring of an interest rate caps, collars and floors premium would be allowed as a deduction for the same reasons as stated under a forward rate

agreement although the event of payment differs. For a non-bank trading company, although the premium will not usually be paid to the lender, it is understood (in the United Kingdom) that where this is connected with an underlying borrowing, the Revenue will normally accept a deduction.

The tax treatment here is basically the same as that mentioned under interest rate options and interest rate caps as they are in essence an interest rate option which has been tailored to meet the specific requirements of the purchaser.

GLOSSARY OF TERMS

Arbitrage – Trading strategies designed to profit from price differences for the same or similar goods in different markets. Historically, the term implied little or no risk in the trade, but more recently it has come to suggest some risk of loss or uncertainty about total profits.

Currency Swap – A transaction in which two counterparties exchange specific amounts of two different currencies at the outset and repay over time according to a predetermined rule which reflects interest payments and possibly amortisation of principal.

Forward Rate Agreement (FRA) – An agreement between two parties wishing to protect themselves against a future movement in interest rates. The two parties agree on an interest rate for a specified period from a specified future settlement date based on an agreed principal amount. No commitment is made by either party to lend or borrow the principal amount. Their exposure is only the interest difference between the agreed and actual rates at settlement.

Futures Contract – An exchange-traded contract generally calling for delivery of a specified amount of a particular grade of commodity or financial instrument at a fixed date in the future. Contracts are highly standardised and traders need only agree on the price and number of contracts traded.

Hedge – To reduce risk by taking a position which offsets existing or anticipating exposure to a change in market rates.

Interest Rate Cap – An option-like feature for which the buyer pays a fee or premium to obtain protection against a rise in a particular interest rate above a certain level.

Interest Rate Swap – A transaction in which two counterparties exchange interest payment streams of differing character based on an underlying notional principal amount.

Intermediary (Swap Market) – A counterparty who enters into a swap in order to earn fees or trading profits.

Margin – Funds or collateral posted as a good faith performance guarantee. Futures and options exchanges often require traders to post initial margin when they enter into new contracts.

Market Liquidity Risk – The possibility that a financial instrument cannot be sold quickly and at full market value.

Notional Principal – A hypothetical amount on which swap payments are based. The notional principal in an interest rate swap is never paid or received.

Option – The contractual right but not the obligation to buy or sell a specified amount of a given financial instrument at a fixed price before or at a designated future date. A "call option" confers on the holder the right to buy the financial

instrument. A "put option" involves the rights to sell the financial instrument.

Premium – The price paid for an option by an option holder to the option writer.

Securitisation – The term is most often used narrowly to mean the process by which the assets, mainly loans or mortgages of traditional banks or thrift institutions, are converted into negotiable securities which may be purchased either by depository institutions or by non-bank investors.

Swap – A financial transaction in which two counterparties agree to exchange streams of payment over time according to a predetermined rule. A swap is normally used to transform the market exposure associated with a loan or bond borrowing from one interest rate base (fixed term or floating rate) or currency of denomination to another.

Underlying – The designated financial instruments which must be delivered in completion of an option contract or a futures contract. For example, the underlying may be fixed income securities, foreign exchange, equities or futures contracts (in the case of an option on a futures contract).

Voluntary Termination (Swap Market) – The cancellation of a swap contract which is agreed to by both counterparties. A voluntary termination usually involves a lump sum payment from one party to another.

Writer – The party that sells an option. The writer is required to carry out the terms of the option at the choice of the holder.