

Chapter 11 – Investment Financing

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Learning Objectives

What you should achieve after completing this chapter:

- Understand the different types of shares and unit trusts;
- Understand how share financing works;
- Understand how unit trusts works; and
- Understand the features and benefits of shares and unit trusts.

1. Share Financing

1.1 Types of shares -- ordinary and preference

Investors who invest in a company are issued shares in the company. A company commonly issues two types of shares, i.e. ordinary shares and preference shares.

(i) Ordinary shares

An investor who is interested in capital gains, income and willing to take the risk of even losing his investments will seek for ordinary shares in a company.

A holder of an ordinary share is a legal owner of the company and is entitled to the following:

- Company profits by way of dividends
- Reserves by way of bonus issues
- Increase his investment in the company by way of acquiring more ordinary shares and/or through rights issues and conversion entitlements, such as convertible loan stocks or warrants

Credit officers must understand the difference between the intrinsic value and the market value of shares. The market value of shares is usually not always reflected by the intrinsic value of shares.

Blue Chip Stocks are stocks that have already been well established and well-positioned in the market. These companies would probably have a good track record of management, earnings as well as dividend payout.

Defensive Stocks are stocks that are operating in a business environment that is the backbone of the economy and will not be badly affected through economic cycles.

It is therefore less risky for financial institutions (FIs) to hold Blue Chips or Defensive Stocks as security for loans. However, it must be realised that in any business there is always the element of risks and that share prices of all shares will invariably be affected by the market sentiments whatever shares are held as security. The difference is that the good shares will eventually recover as they are supported by fundamentals.

Speculative shares are normally perceived to be more expensive and less attractive than Blue Chips or Defensive Stocks because of the speculative element. Their share prices fluctuate over a broader price range and are also more volatile and the prices can suddenly go up or down. FIs take a greater risk holding speculative shares as security because a sudden drop in the price of these shares can result in a short fall in the value of security. FIs should therefore limit the exposure to holding speculative shares as security.

The comparison of companies is normally made, based on the Fundamental Analysis of the individual companies. To compare the value of share of different company's, market indicators like Price Earnings Ratios (PE Ratios) and Dividend Yields can be used as a general guide. But these indicators are basically indicators. To more effectively value each company, one has to make a comprehensive analysis of the business sectors, the management quality, the position of the company in that business environment, its size, its strategies as well as its financial strengths. The PE Ratios give a guide as to the market price in relation to the earning capacity of the company, while the Dividend Yield gives the investors some comfort as to the Income he/she will receive from the company. However, it must be noted that both these indicators are historical in nature unless the credit officer is able to project the prospective indicators.

Another risk attached to holding shares as security is its marketability. The less marketable the shares are, the higher the risks. This is especially so for shares which are very thinly traded – where market prices can be managed by borrowers. The volume of shares held as security in relation to its marketability is crucial too. The general market sentiment is equally important, as prices are very often affected not only by fundamental factors but also emotional factors.

The investment styles of the investors should be considered to determine his risk profile. We must be able to differentiate between investors who are speculative, growth or value-inclined.

(ii) Preference shares

An investor who is interested to invest in a particular company may opt to invest in the preference shares of the company because they are treated in preference to the ordinary share holders in terms of dividend payments. Preference shares allow the investors to enjoy the advantages of owning ordinary shares as well as being given fixed income ahead of the ordinary share holders.

Hence, preference shares maintain their degree of preference over ordinary shares. For example, when a company is liquidated, any funds leftover for shareholders will go towards preference shareholders first before the ordinary shareholders. Other examples of the preference enjoyed by preferred shareholders are mentioned below:

- Preference shares are also a form of equity hybrid, which carry a prior right to a fixed dividend (ordinary shares do not have a right to a fixed dividend). This fixed dividend is usually expressed as a percentage of the share's nominal value, and is paid when sufficient profits are earned.
- Preference shares that also carry the right of any arrears of preference dividends which have not been paid, are known as *cumulative preference shares*. Preference shares that are not entitled to such arrears in dividends are called *non-cumulative preference shares*.

In the investment market, various hybrids of preference shares have been issued to make them more attractive. Preferential shares have now been padded like in Cumulative, Participating and Convertible Shares. Each has its own benefits and receives a different rate of dividend. The types of preference shares are:

(a) Cumulative preference shares

Most preference shares are cumulative in nature. In the case of cumulative preference shares, unpaid dividends may accumulate as dividends in arrears, but must be paid to the cumulative preference shareholders before any dividends can be paid to ordinary shareholders.

(b) Participating preference shares

In the case of participating preference shares, the holder is also able to participate in some of the rights of the ordinary shareholders when the company performs well. The participative nature is spelt out in the offer document.

(c) Convertible preference shares

Convertible preference shares have the added feature to allow the holder to be able to convert the preference shares into ordinary shares of the company at an agreed conversion rate within a pre-determined time frame.

However, the investor must be aware of some preference shares that are redeemable at the option of the company. Such redeemable preference shares can be redeemed or recalled by the company. When this option is exercised, the investors will receive a pre-determined sum of money, which usually includes any unpaid dividends. The company usually pays a premium to the preferred shareholder for this privilege.

1.2 Types of loan stocks – secured, unsecured, redeemable and irredeemable

Given the development and evolution of products in our capital market, there are now some hybrid investments that are part-equity and part-debt. Most loan stocks that are listed are usually the ones with the convertible nature as non-convertible loan stocks are least attractive and will have to carry a higher coupon rate.

(i) Convertible loan stocks

CULS are convertible unsecured loan stocks. A loan stock is a security issued by a company for a loan made to it by investors. CULS combine certain advantages of bonds (which are loan securities) with the option of converting into ordinary shares, known as the conversion privilege. The bond characteristics of CULS are they pay investors a fixed rate of interest to the holder at specific dates, usually bi-annually, as spelt out in the CULS agreement and the undertaking to repay the principal sum on its maturity in the case of the redeemable loan stocks. The equity part of CULS materialises when they are converted into shares and the investor can enjoy possibilities of capital appreciation.

CULS can be issued in the form of redeemable (RCULS) or irredeemable (ICULS) convertible unsecured loan stocks. If the loan stocks are irredeemable, the holder must convert the ICULS into shares on maturity (normally after four to five years) at a predetermined conversion ratio and conversion price. If redeemable, then on maturity the holder can either convert the RCULS into shares or redeem the RCULS from the issuing company at their par value.

Companies issue CULS because they make the bonds more saleable with the addition of a conversion privilege. CULS also lower the cost of borrowing money by giving the investor the chance of potential capital gain with the convertibility feature. It thus enables the company to raise equity indirectly on more favourable terms than through the issue of new shares. To the investor, CULS give him securities that combine much of the

safety and income certainty of a bond with the option to convert into common shares and benefit from any increase in share prices.

1.3 Derivatives: Warrants or TSR, and Options

The value of warrants and options are derived from the underlying asset of the ordinary shares related to these instruments. As an example, the warrant value of Company A's warrant is derived or dependant on the value of Company A's share.

(i) Warrants or transferable subscription rights (TSRs)

Transferable subscription rights (TSRs) or warrants, as they are commonly called, give the holders the right but not the obligation, to subscribe for new ordinary shares at a pre-determined exercise price within a stipulated validity time frame (exercise period). The warrants become worthless after the expiry of the exercise period. Warrants are, thus, a form of call options.

The theoretical price of the warrant is the difference between the market value of the ordinary shares and the exercise price. However, the market value of the warrant is normally at a premium because of the lower capital outlay as well as the speculative element. The price of the warrant will be determined by the expiry date the warrant.

When you buy a warrant, you pay the market price of the warrant. The warrant then gives you the right to purchase the underlying instrument at an agreed price during the exercise period.

For example, when you buy a warrant for a share of a company, you pay the price of the warrant (say, RM0.60 per unit). The warrant gives you the right, during the exercise period, to subscribe to the share at a fixed price of, say, RM2 each share. If the prevailing price of the share rises to more than RM2.60, you might decide to exercise your right and buy the share at the agreed price of RM2. In practice however, the market price of the warrant will rise in momentum with the price of the ordinary shares within the exercisable period. In which case, you will probably be able to sell the warrant above RM0.60.

If the ordinary share price falls below RM2.00, then the warrant is 'Out of Money' because it is better to buy the ordinary share at RM2.00 than to exercise the warrant. On the other hand, if the share price rises above RM2.60, then the investor is 'In the Money' because the price of the warrant would have probably risen above RM0.60.

Should the situation be reversed, whereby the price of the underlying instrument or share as in the example above do not appreciate above RM2.60 during its lifespan you will lose the RM 0.60 per unit that you have paid for the warrant. Remember that the warrant becomes worthless after the exercise period has expired.

Why do companies issue warrants? Warrants are often issued to investors as a sweetener together with debt securities (particularly bonds) in a package. The warrants are detached from the bonds and traded separately. Companies embarking on capital projects with long gestation periods normally opt to issue such packages so that they can raise cheaper money from the shareholders. The debt securities raised is timed to coincide with exercising of the warrant by the ultimate holders to raise equity fund to repay the maturity value of the bond.

(ii) Options

Options give the buyer/holder of the option the right, but not the obligation, to buy or sell a specified asset at a specified price (strike price), at or before a specified date from the seller, for which the buyer pays a premium (this limits the buyer's potential loss in the options market to the amount of his premium). Options that give the buyer the right to buy are known as calls. The right to buy ordinary shares of the company gives the investor the potential to make capital gains at the cost of the premium paid when the market price of the ordinary shares goes above the total of the strike price and the premium paid to write the option. Options that give the buyer the right to sell are known as puts. The seller of the option has a contingent liability or an obligation, which is activated if the buyer exercises his right. The FIs will not consider the selling aspect of the option as it carries an unquantifiable risk unless they are holding the ordinary shares as security. In this case, the investor is protected if the share price falls below the strike price, and he would have already obtained the premium for writing the option.

1.4 Types of share financing

The purpose is to finance/part finance/subscribe for new shares in the company under an initial public offer issued or to be issued to the eligible employees of the company.

(i) Initial public offer (IPO)

Forms as specified by the companies issuing the shares. The colour of the forms generally follows a guide as follows:

- White forms** White forms are issued to the public
- Blue forms** Blue forms are for rights issues and additional shares
- Pink forms** Pink forms are for employees of the company issuing the IPO
- Green forms** Green forms are for allocations by the Ministry of Trade and Industry.

The stringent procedures imposed by the Securities Commission gives some comfort to finance based on new shares in a company to investors. However FIs must value the IPO based on the prospectus and are comfortable that the market price of the shares when listed will be above the value attached to it for the loan. FIs must be able to differentiate the financial impact depending on the types of IPO – the Issue of new shares, Offer for Sale by existing shareholders, Introduction, Tender System and Private Placement especially in the area of dilution of equity and the probable market price of the shares on its listing. The FIs must know whether any new funds are to be injected into the company or the existing shareholders are selling off their stake in the IPO. In the latter case, the financial situation of the company does not change. Only the shareholders will change.

The risk associated with financing based on an IPO scheme is the difficulty in assessing the potential market price although the FIs may have access to the Prospectus and make comparative evaluation of similar companies currently listed on the Stock Exchange.

(ii) ESOS (Employee share option scheme)

The principles of Share option schemes have been adopted by the Securities Commission in considering share option schemes for employees. Share option schemes cannot exceed 5% of the share capital. The price of the share shall be based on the average of the mean market quotation of shares of the company as shown in the daily list issued by the stock exchange for five preceding market days prior to the date when the written invitation to participate in the scheme is made to the grantee plus 10%.

In the case of non-listed companies, the quoted price should not be lower than the par value. The time limit to take up the offer ranges from 5 years to 10 years. The purpose is to finance/part

finance/subscribe to new shares in the company under an ESOS issued or to be issued to the eligible employees of the company. Only staff and the executive directors of the company are eligible to participate in the scheme.

The risk associated with financing of an ESOS scheme is the difficulty in assessing the potential market price although the FIs may have access to the Prospectus and make comparative evaluation of similar companies currently listed on the Stock Exchange.

(iii) Margin financing

Margin financing allows one to buy shares with the security of cash or shares.

Banks as well as share brokers do the financing. One can be offered financing, frequently up to thrice the value of the collateral depending on the strategy of the FIs as well as the market condition. For example, if you place an amount of RM100,000, you would be able to purchase a lot more shares worth up to the margin approved by the FIs. In other words, you would be buying shares using borrowed money, which is also known as margin financing or share margin trading.

Brokers will also allow you to use shares you already own as collateral to finance the purchase of more shares. However, some conditions apply, such as, most institutions require that the shares you place as collateral be first board and selected second board shares. Warrants and especially short-dated warrants with less than one year left before expiry and some technology shares are not acceptable as collateral by most brokers.

Margin financing or share margin trading is a loan granted sometimes up to 70% the total outstanding collateral value to trade in shares listed on the Kuala Lumpur Stock Exchange (KLSE) without having to produce the entire cost upfront. With the loan secured, they can start trading on the KLSE by giving orders to the panel of appointed stockbrokers.

(iv) Facility against shares

Overdrafts and term loans are also granted purely on the security of shares. The facility is granted against 50% or 60% of the value of security. This facility is monitored by the value of the shares against the current outstanding.

1.5 Features and benefits

Share financing features and benefits vary according to how it is packaged at individual financial institutions. Generally, they are:

- (i) Loans with a tenor up to 12 months subject to periodic review.
- (ii) There is availability of funds for drawdown as and when required for immediate cash flow requirements.
- (iii) There is flexibility to make full repayment as and when available during the loan tenor or on the maturity date.
- (iv) The interest is charged only on the amount utilised.
- (v) Flexibility is allowed to service only the interest during the tenor of the loan.
- (vi) Some shares are stable in value and are less volatile due to their strong fundamentals, as such are less risky for the financier.
- (vii) The formalities to complete a Pledge of the Shares are simple as compared to a legal mortgage due to the latter's high legal costs as well as the rigidity of a charge.
- (viii) For borrowers who are constantly changing their investment portfolios, this is a better form of security as the deposits and withdrawals of shares are achieved with minimum formality.
- (ix) Hassle-free trading as the bank will settle on behalf of the customers for all purchases and sales of shares.

1.6 Credit Considerations In of share financing

Where the shares are placed in the financial institution's (FI) nominees' name, the FI should be careful in the take-over correspondence and offers of rights issues. Delays can cause possible claims of negligence although the FI may have taken a memorandum which allows it to act as it deems fit.

In the hands of an inexperienced investor, margin financing could mean only one thing: going bust! This is especially true in a declining market.

Over holding of shares of a particular customer or counter will expose the FI to high risks. Therefore, diversification of share holding should be considered.

The stock market acts as a barometer of the economy of the country. Painful lessons have shown bankers the effect of the value of shares and non-performing loans during an economic downturn. Here, force selling of shares must be easy and swift.

The FIs should address the potential Yield Gap – difference between the dividends received and the interest cost of maintaining the loan. Basically, the FIs be comfortable with this key risk or credit considerations and must be able to identify clear alternatives source of cash such as the investor's surplus monthly expenses or the potential appreciation of the investment values of the shares to enable the investor to service the interest payable.

1.7 General terms and conditions

Financing of shares stipulate the following terms and conditions:

- The borrower is required to comply with the loan margin for loans against shares and the maintenance margin for loans against margin trading.
- The borrower is given 2 days to reduce the loan margin from the date of breach.

Withdrawal of shares: The borrower is allowed to withdraw his shares provided that there is available credit in the account. The withdrawal amount shall not exceed about 50% of the market value of the capped price.

Events of default:

- Failure to service the interest
- Declared bankrupt
- Death or mental incapacity
- Ceased employment or termination
- A breach of maintenance margin (share financing)

1.8 Application of credit considerations (Combined with 1.6)

1.9 Monitoring of credit limit / margin of finance based on movement of share prices

For quoted shares, it is a simple matter to establish the current market value. Most FIs have online access to the KLSE.

1.10 Price capping

Quoted shares pledged as collateral are taken in at capped prices for purposes of determining the facility limit. The factors that determine the value are: industry outlook, management team, price volatility, fundamentals of the company and liquidity of the counter.

1.11 Margin call

When the loan ratio (calculations are based on market value) rises above the permitted margin, the account is subject to a margin call. The borrower is given 2 trading days from the date of the breach to reduce the loan margin.

1.12 Sale of shares

Failure of the customer to rectify the breach will result in the shares being force sold.

The borrower can reduce the margin by the following:

- Depositing additional cash
- Selling out a portion of the shares in the portfolio
- Pledging additional collateral

Any further shortfall after forced sale will result in recovery by sale of the shares held under margin.

1.13 Payment of bonus shares / dividends

Nominees and custodian services handle the customer's entitlement of dividends, bonus issues, etc. Dividends and bonus issues are credited to the CDS accounts of the borrower with the nominee company. Rights issues allotted are advised to the borrower for his disposal. The borrower is kept informed of any rights and bonus issues.

The nominee company has the right to take up the rights issue if the borrower is not interested in taking it up.

1.14 What are bonus issues?

There are also two other types of share issues an investor will come across in trading shares. They are bonus and rights issues. A bonus issue is the issue of new ordinary shares at no cost to existing shareholders but out of the company's reserves and given in direct proportion to the number of shares owned. Bonus issues are used to enlarge the capital base of the company and may also be used as a means of rewarding its existing shareholders. What the bonus exercise does is to make the share more marketable in trading as more shares will be in issue. Theoretically, the share price will be adjusted downwards in proportion to the new bonus shares that are issued. Therefore, credit officers must realise that the whole exercise of a bonus issue does not change the attractiveness of the company nor increase the total value of investments held by the investors. It just increases the shares currently being held by the investors after the bonus issue exercise although in practice there could be a slight increase

in total values of the investment held partly because the company is perceived to must have performed sufficiently well to be able to accumulate and distribute the reserve as bonus shares.

The period from the day of announcement of the entitlement of bonus or rights issue or dividend to the day before the Ex-Date is commonly referred to as the *cum-period*. Normally, cum is a prefix meaning “with”. A share that is cum-dividend means the buyer is entitled to the dividend currently attached to it. The same is true for cum-rights and cum-bonus.

1.15 What are rights issues?

A *rights issue* gives the existing shareholders the right to subscribe to new ordinary shares at an issue price lower than the prevailing market price and at a ratio equivalent to their existing shareholdings. Companies carry out a rights issue when they want to raise additional funds to finance their cash requirements or to reduce its level of gearing.

In offering a rights issue, the company sends out a provisional allotment letter (PAL) to all existing shareholders informing them of the rights issue entitlement. Shareholders are required to follow all the instructions given in the PAL in subscribing their rights for the new shares. If one chooses not to exercise the right, the PAL can be sold to the open market (if quoted) or the entitlement can be renounced to someone else.

Just as in the case of the bonus issue, the market price of the shares will be adjusted after the whole rights issue exercise. However, in the case of a rights issue, the investor has the right to take up the rights entitlement or to sell their rights to the shares in the open market or to just ignore the issue depending on his perception of the purpose of the right issue and the prospective impact of the shares after the exercise. Alternatively, the investor can sell his shares cum the rights entitlement before the ex-date.

Normally for a right issue to be successful, the rights price should be at a discount to the theoretical ex-market price of the shares to attract the current investors of the shares to take up their rights entitlement.

As far as the FIs position is concerned, the ultimate market price of the shares will be the secured market value held by them.

2. Unit Trusts

The first unit trust fund in Malaysia was launched in 1959. Who then would have imagined that years later there would be billions of ringgit in funds under management?

Currently, about 22% of the market capitalisation of the KLSE is from unit trust funds. The idea behind a unit trust is that it pools the resources of many people and from this open-ended pool, the trustees place the funds in a wide range on investments. Depending on the level of his/her contribution, the investor will be given a registered certificate, which shows the stated number of units in the trust.

2.1 What is a unit trust?

A unit trust fund is an investment scheme that pools money from many investors who share the same financial objectives. In exchange for the money, the fund issues units to the investors who are known as unit holders. Unit holders can sell (known as redeeming) their units back to the fund, or buy (and sell) further units.

Unit trusts have grown in popularity in recent years. It's not hard to figure out why. Unit trusts are the small investor's answer to achieving wide investment diversification without having to come out with prohibitive sums of money. And the benefits do not end at that.

Each fund will be governed by the Prospectus and Trustee Agreement which will spell out in detail the objectives of the Fund as well as the rules governing the running of the Fund. The investors must understand the purpose of the Fund that they are investing in by carefully reading such documents.

Credit Officers must understand the rules of the Funds to be able to assess the risk level of financing the respective Funds. Items like what shares the Funds are allowed to invest in as well as charges and distribution policy made by the Funds should be understood to safeguard their valuation.

2.2 Managing the fund

The fund is managed by a group of professional managers (known as the unit trust company) who will invest the pooled money in a portfolio of securities such as shares, bonds and money market instruments or other authorised securities to achieve the objectives of the fund. Because of the large sums collected, the fund manager is able to diversify among various investments in such range and diversity that the risks of investing are minimised.

2.3 Income earned

The net assets of the fund determine the value of the fund and the price paid by unit holders or the amount received when they redeem their units. The Net Asset Value (NAV) being determined by the formula = (Asset Value + Cash + Accrued Income) – (Liabilities + Expenses).

The unit trust fund earns income from its varied investments in the form of dividends, interest income and capital gains. This Fund may distribute dividends or issue bonus units in accordance with the Trustee Agreement from time to time. However this exercise will only result in an equivalent adjustment in its unit value.

2.4 Protection for unit holder

As a unit holder, your protection within a unit trust is ensured in the way unit trusts are structured. Unit trusts are actually trusts. The protection is enshrined within the unit trust deed, which spells out the respective duties, responsibilities and expectations of the three parties in the unit trust, namely:

- i. The unit holders who provide the funds for investing;
- ii. The unit trust company providing investment, administrative and marketing services; and
- iii. The trustee company, which holds the assets of the trust on behalf of the unit holders.

2.5 Types of unit trusts

Unit trusts are considered good instruments for medium- to long-term financial plans. However, it is important that you choose the appropriate fund depending on the risk profile and investment objectives. Listed here are the types of unit trusts currently available in the market:

- (a) **Income funds:** are fixed income securities and huge dividend-yielding shares with the view to pay out most of the returns. Suitable for investors seeking income and some level of growth at low risks.
- (b) **Equity funds or capital growth funds:** are primarily shares with the view to maximise capital growth over the long-term (i.e. through a higher unit price). Appeals to high-risk investors keen on capital accumulation.
- (c) **Aggressive growth funds:** Similar to capital growth funds but with investments in aggressive, fast track shares that promise high returns – with higher risk. Generally suitable for high-risk investors.
- (d) **Balanced funds:** Have three objectives: income, moderate capital appreciation and capital preservation. Investment is across a broad spread of asset categories including shares, fixed income securities and cash. Well-diversified and suitable for investors looking for reasonably safe investments where the risks are lower and which produce average returns.
- (e) **Index funds:** are investments in a basket of shares that track a selected stock market index.

- (f) **Bond funds:** Investments are only in fixed income securities such as bonds and short-term money-market instruments. All bond funds are subject to interest rate risk and most to credit or default risk by the issuers.
- (g) **Money market funds:** Investments are only in short-term money market instruments such as treasury bills, negotiable certificates of deposit and bankers acceptances, with a maturity of less than 90 days. Since the funds invest in money market instruments, the returns, while small, are generally more attractive compared to saving deposits. Good for investors looking for liquidity, and perhaps a temporary place to park their funds before they commit to other funds.
- (h) **Islamic funds:** Managed according to Syariah principles, investments are in shares and fixed income securities, which exclude non-halal shares and interest-bearing money market instruments.
- (i) **State funds:** Managed by the state development corporations for investors from the respective states.

2.6 Types of unit trust financing

(a) Margin financing

Margin financing allows one to buy units with the security of cash, shares or units. One can be offered financing up to 67% of the selling price for the units

(b) Facility against unit trusts

Overdrafts and term loans are also granted purely on the security of unit trusts. The facility is granted against 60% of the value of unit trusts. This facility is monitored by the value of the unit trusts against the current outstanding.

2.7 Features

- (i) There is leveraged gain. It allows the investors to acquire more units with a smaller capital outlay.
- (ii) There are long-term benefits as the funds can provide consistent returns.

2.8 Benefits

There is a better spread of risks due to diversification of the investments.

2.9 Risks of unit trust financing

- (i) Wide price fluctuations can have an adverse effect on the repayment of the loan.
- (ii) Dividend risks – the management companies do not guarantee dividends
- (iii) Investments in funds denominated in non-local currency carry the risk of exchange rate fluctuations that may cause a loss of principal.
- (iv) Fluctuations in interest rates can affect the borrower's ability to pay.

2.10 General terms and conditions

The margin of finance for loans in the sales of units should not exceed 67% of the selling price for the units. Where an investor takes a loan financing, the management company of the unit trust should obtain a unit trust loan financing risk disclosure statement signed by the investor acknowledging that he has understood its content.

The risk disclosure statement brings to the attention of the investor the following risks of loan financing:

- Margin of financing;
- The servicing of interest payment;
- The margin calls or top up loans; and
- Unit trusts returns are not guaranteed

2.11 Application of credit considerations

Income from unit trusts is not guaranteed. Non-income from the units bought can reflect on the repayment of the loans.

It is important for the FI to monitor the unit's exposure portfolio:

- Over-holding of units of a particular customer or counter will expose the FI to high risks.
- Diversification of unit holdings should be considered.
- Force selling of units must be easy and swift.

2.12 Monitoring of unit prices against margin of finance

For quoted units, having online access to the KLSE monitors the price.

2.13 Margin call

When the loan ratio (calculations are based on market value) rises above the permitted margin of 67%, the account is subject to a margin call. The borrower is given 2 trading days from the date of the breach to reduce the loan margin.

2.14 Sale of unit trusts

Failure of the borrower to meet the margin call will result in the units being force sold.

The borrower can reduce the margin by the following ways:

- Depositing additional cash
- Pledging additional collaterals

2.15 Payment of bonus / dividends

Dividends and bonus units are credited to the unit trust account held with the trustee.

Practice Questions

1. Why do some customers prefer to invest in preference shares?
2. What are loan stocks?
3. What are transferable subscription rights?
4. What is margin financing?
5. Name some features and benefits of share financing.
6. What are the risks of share financing?
7. How does a financial institution monitor share prices?
8. What is force selling of shares?
9. What does a nominee do when bonus issues, rights issues and dividends are received on behalf of the borrower?
10. What are the features and benefits of unit trust financing?
11. What are the risks of unit trust financing?
12. What is a margin call?