

Chapter 2

Background

2.1 The Malaysian Bond Market

The Malaysian bond market is one of the most advanced in the group of 10 ASEAN nations (BNM, 2009). As of end of year 2009, the Malaysian bond market is the largest among ASEAN countries in terms of size as a percentage of the country's gross domestic product (GDP), with a corresponding size of almost 90% of the year's GDP ⁶.

The setting up of Cagamas Berhad, Malaysia's national mortgage corporation in 1986 was one of the initial steps taken by the Malaysian government in developing a secondary financial market in the country. The government has since taken aggressive steps in promoting and subsequently regulating these alternative financing mechanisms, initially through Bank Negara Malaysia (BNM) and subsequently the Securities Commission (SC). The inception and subsequent improvements of the Fully Automated System for Tendering (FAST), Bond Information and Dissemination System (BIDS) in year 1997 coupled with the improvement to the existing securities and cash transfer system such as Real Time Electronic Transfer of Funds and

⁶ <http://asianbondsonline.adb.org/regional/data> assessed on 22nd October 2010. Asianbonesonline data includes China, Hong Kong China, Korea, Japan and ASEAN countries. Indonesia, Malaysia, the Philippines, Singapore, Thailand and Vietnam are the only ASEAN countries to boost a bond market and hence included in the analysis.

Securities (RENTAS) paved ways for a more systematic and smoother running of the Malaysian bond market⁷.

It was the formulation of the nation's Capital Market Masterplan (CMP) in year 2001⁸ that really set the pathways for the vigorous development of the Malaysian bond market. Spanning ten years, the Masterplan aims to develop, strengthen and ultimately create a fully developed local capital market. Subsequent joint efforts by both BNM and SC in developing guidelines for the issuance of Foreign Currency-denominated bonds have attracted multilateral financial institutions and foreign firms such as the Asian Development Bank to tap into Malaysia's debt securities market. The concentrated steps undertaken by the Malaysian government in promoting and regulating this alternative funding market has certainly spurred the development of the bond market.

The Malaysian bond market generally comprises conventional and Islamic debt instruments. Both the government and corporations issue conventional as well as Islamic papers.

Government bonds include Malaysian Treasury Bills (MTB) which are short-term bills and Malaysian Government Securities (MGS) which are basically long-term bonds. Its Islamic equivalent securities are the Malaysian Islamic Treasury Bills (MITB) and Government Investment Issues (GII). The

⁷ See <http://www.bondinfo.bnm.gov.my/> for the full list of initiatives taken by the Malaysian government and its financial arms in promoting the local bond market.

⁸ <http://www.sc.com.my/eng/html/cmp/executiv.pdf> assessed 22nd October 2010

main objectives for issuance of marketable debt instruments by the Malaysian government are to obtain working capital and to finance the public sector's development expenditure (BNM, 2009).

On the corporate front, prior to the inception of a corporate bond securities market, or private debt securities (PDS) market as it is interchangeably known, Malaysia has always relied on its conventional banking system for its financial and development needs. The Asian Financial Crisis which occurred in year 1997 had highlighted the shortcomings in the existing structure of the banking systems such as funding maturities (BNM, 2009), and many in turn look for alternatives for long-term funding.

The Malaysian corporate bond market has been expanding since its inception, posting an average 7% annual growth since year 2000 (BNM, 2009). The corporate bonds segment has recorded a high 48% of the overall outstanding Malaysian local currency bond market in year 2000 and had maintained an average of 44% of the same throughout the ten years, ending with 83.87 billion USD in value or 45% in year 2009⁹. Malaysia's corporate bond market has ranked the top amongst ASEAN countries in the same year. The PDS is now widely popular among corporates as a source of alternative financing apart from debt financing via bank borrowings or raising equity financing from the stock market.

⁹ <http://asianbondsonline.adb.org/regional/data>, assessed on 22nd October 2010.

The Malaysian PDS market also boasts an Islamic securities or sukuk market which operates in line with the conventional market for both government and corporate instruments. The main difference between Islamic securities and conventional securities is that Islamic securities are basically structured to conform to Shariah principles which disallows interest taking¹⁰.

2.2 Credit Rating Agencies and Bond Rating Processes

In general, corporate bonds are debt instruments issued by corporates or private firms to obtain fundings to suit their business plans. The value of an issued bond generally lies in its credit quality. Credit quality encompasses a wide range of factors related to the bond issuer: whether the scheduled periodical interest payments can be met in a timely manner and for the bond's principle amount to be paid upon maturity. Bond rating serves as one of the most commonly used measure of the credit worthiness of bonds.

The international ratings industry is generally monopolised by two main agencies, both headquartered in the United States, namely Standard & Poor's Rating Services (S&P) and Moody's Investors Service (Moody's), with Fitch Ratings (Fitch), dually headquartered in the United States and the UK¹¹, coming in a distant third. There are a multitude of other agencies which focuses on certain countries, industries or specialises in a specific field. Other

¹⁰ For more information on Islamic securities and the sukuk market, refer BNM (2009) and <http://bondinfo.bnm.gov.my/>

¹¹ <http://www.fitchratings.com> assessed on 22nd October 2010.

countries utilise their own homeland rating agencies such as Xinhua-Far East China Ratings of China (Poon and Chan, 2008) alongside the major U.S. agencies.

In the Malaysian context, the mandatory requirement imposed by the government in year 1992 for all issuance of domestic debt securities to be rated propels the development of local rating agencies. Currently, most of the local credit rating assignments are conducted by Rating Agency Malaysia Berhad (RAM) which was incorporated in November 1990 and Malaysian Rating Corporation Berhad (MARC), incorporated in October 1995. A majority of the local debt issuances are rated by at least one of them although some may further go for ratings by international credit rating agencies such as S&P, Moody's or Fitch.

So how does a bond rating work? The process is generally initiated when a firm planning to issue bonds approaches an independent credit rating agency or agencies to request for a rating. Upon formalisation of an agreement between the two parties, a team of credit analysts is assigned the task of assessing the firm's creditworthiness. Apart from qualitative and quantitative information available from publicly available sources, rating agencies generally also claim to have access to private information provided by the firm in its assessment. More stringent procedures are applied in handling such confidential information such as more secure storage and filings.

A rating will be assigned upon consideration of such public and private information. The process continues as the assigned rating is continuously being monitored based on the availability of other information, both public and private, as claimed by the credit rating agency/ agencies. The credit rating agency may then reaffirm their initial rating or announce a rating change if the firm's credit quality is perceived to have undergone a significant change. Alternatively the credit rating agency may announce the placement of the issue under a credit/ rating watch list which generally indicates possible (not a surety) future rating changes. All credit ratings generally include a standard disclaimer description which suggests the rating as an opinion of the rating agency and not an indicator to buy, sell or retain the bond (BNM, 2009).

The ratings issued are separated into different classes. However, debt issues within the same class may not be interpreted as being homogeneous in terms of payment capability. Most of the credit rating agencies including RAM and MARC had further refined their ranking system by introducing subscripts to their existing ratings to account for different positions within the same generic class. For example, RAM adds subscripts of 1, 2 and 3 to their rating while MARC adapts the plus (+) or minus (-) signs to indicate the different relative standing amongst securities within the same rating category. Table 2.1 summarises the types and descriptions of corporate credit long term ratings.

**Table 2.1
Corporate Credit Long Term Ratings and Definitions**

RAM Rating	MARC Rating	Description
Investment grade		
AAA	AAA	The highest rating assignable by RAM/ MARC; issues with this rating reflects superior safety for payment obligations
AA1 AA2 AA3	AA+ AA-	High safety for payment obligations
A1 A2 A3	A+ A-	Adequate safety for payment obligations
BBB1 BBB2 BBB3	BBB+ BBB-	The lowest investment grade category; moderate safety for payment obligations
Speculative grade		
BB1 BB2 BB3	BB+ BB-	The highest speculative grade category; low safety for payment obligations
B1 B2 B3	B+ B-	Very low safety for payment obligations
C1 C2 C3	C	High likelihood of default
D	D	Financial obligation is currently in or face imminent default, whether or not declared formally

Source : Rating Agency Malaysia <http://www.ram.com.my> and Malaysian Rating Corporation Berhad <http://www.marc.com.my>¹²

¹² Both assessed on 22nd October 2010

Short term debts are generally securities with maturity period of not exceeding twelve months. The most common types of short-term debt instruments in Malaysia include commercial papers, revolving underwritten facilities or notes issuance facilities. Rating assignments for short term debts are also being undertaken by both RAM and MARC. Table 2.2 summarises the types and descriptions of corporate credit short term ratings.

Table 2.2
Corporate Credit Short Term Ratings and Definitions

RAM Rating	MARC Rating	Description
Investment grade		
P1	MARC-1	The highest rating assignable by RAM/ MARC; issues with this rating reflects strong capacity for payment obligations
P2	MARC-2	Adequate capacity for payment obligations
P3	MARC-3	Moderate capacity for payment obligations
Speculative grade		
NP	MARC-4	Doubtful capacity for payment obligations
D	D	All or substantial portion of financial obligations is in default, whether or not declared formally

Source : Rating Agency Malaysia <http://www.ram.com.my> and Malaysian Rating Corporation Berhad <http://www.marc.com.my>¹³

¹³ Both assessed on 22nd October 2010