CHAPTER 2

TYPES OF PRIVATE DEBT SECURITIES AND HOW THEY ARE RATED

2.1 INTRODUCTION

The types of PDS in issue in Malaysia have been increasing since their inception in the late 1980's. From a few types with shorter maturity profile in the late 1980s, they have increased in both numbers and maturity profiles. We now have PDS with maturities more than 15 years. There are many ways of classifying PDS. It would depend on the perspective of individual/institution making the classification and the objective at hand. Bank Negara Malaysia in its annual reports since 1989 has been classifying PDS into conventional, Cagamas, convertible and Islamic bonds. In their case, the criteria used are the nature of the issuer and principles on which the issue is based. To RAM, such criteria have little usefulness since they are more concerned with the default risk of the issue. Instead, their own criterion is time related i.e. the maturity profiles of issues. Hence they classify PDS as short-term, medium-term or long-term.

2.2 TYPES OF PRIVATE DEBT SECURITIES

This section discusses the types of private debt securities in Malaysia, in accordance with both Bank Negara and RAM classifications. However the two types of classification are not mutually exclusive and do overlap in many instances. Even within the modes, there are no clear cut lines of demarcation and any resulting sub-groups can only be arbitrary. Hence the classification is only for administrative convenience of the Institutions.

2.2.1 CONVENTIONAL BONDS

Conventional bonds refer to those PDS promising to pay the investor certain specified coupon rates and the final repayment of the principal at the maturity date of the bond. The coupon interest rate can be fixed, for example 8% of the bonds face value per annum, or it can be a floating rate. For example, 1% point over and above the KLIBOR (Kuala Lumpur Inter-Bank Offer Rate). The maturities of these bonds, range from one year to twenty to thirty years (Even though some have maturities of less than a year, these are not being referred to as the focus of the study is on the capital market which only concerns securities whose maturities exceed a year).

Among are the sub-groups in the Bank Negara Malaysia classification, this is the most varied. Most of these bonds are copies of issues already in the American and other more developed bond markets, where bond financing is especially popular, particularly in management buy-outs (MBOS) and leveraged buy-outs (LBOs). Not surprisingly, all issues of debt securities by Malaysian firms in foreign bond markets are of this type.

2.2.2 CONVERTIBLE BONDS

Due to the long established tradition of share trading and the relatively recent nature of the PDS market, convertible bonds are becoming increasingly popular. Convertible bonds give the investor an equity-linked option which may be exercised at a price and time determined when the issue is made. Of the 36 new PDS issues in 1994, 28 were linked with equity derivatives, compared with 11 out of 22 new PDS issues in 1993.

Bonds with warrants are popular because of the advantages they offer to both issuers and investors and Asia Money, (June, 1994) quoted an analyst as calling it a "win-win situation". Corporate issuers are able to raise funds at 3% to 4%, half the cost of conventional loans, because of the enhancement provided by warrants. Unlike straight equity issues, there is no immediate impact on earnings per share and the majority shareholders need not put a lot of money up front to maintain their stakes. The warrants also tend to be issued at a premium, usually 5% to 10% in contrast to rights offerings, shares of which are always priced below the market.

Investors are attracted to the warrants gearing (value of the warrant relative to the underlying share price). Although at the outset, the cost of the warrant is effectively subsidizing the issuers borrowing cost, investors find it a reasonable price to pay for an attractive option to buy shares in the company at a predetermined price.

Other equity linked convertibles are not as popular as warrants. Pundits say other convertibles are less popular because the equity element cannot be stripped from the bond, and, also because there is always a moratorium on their convertibility to shares.

2.2.3 ISLAMIC BONDS

A significant innovation in the development of the Malaysian PDS market is the introduction of the first Islamic debt Instruments (IDS) in 1990. What really differentiate IDS from conventional PDS is the principles on which they are based. While conventional bonds can bear fixed or floating interest rates, such principles are totally unacceptable in Islam as it amounts to "riba". IDS can contribute significantly to the development of the PDS in Malaysia because it brings into the market a new group of investors who would never have invested in conventional bonds.

Three types of IDS can be identified in Malaysia at the moment. The first is the IDS based on the **deferred payment sale facility under the concept of** Bai' Bithaman Ajil. Under this arrangement, the lead manager in an underwriting syndicate arrange for a group of financiers to purchase certain assets from the issuer. These assets are resold to the issuer at a mark-up price, representing the cost and a predetermined profit margin. The issuer then issues two types of notes. The primary notes represent the financiers purchase price of the assets from the issuer while the secondary notes represent the stream of instalments for the profit margin accruing to the financiers. The notes may be traded in the secondary market under the concept of debt trading or Bai' Al Dayn.

The second concept on which some IDS in Malaysia are based is profit-and-loss sharing or Al-Musyarakah. This is structured along the lines of a joint participation financing arrangement, whereby the financier will participate in the financing of the operations of the issuer for a limited duration.

The final category of IDS is based on the concept of benevolent loan or Al-Dardhul Hasan. This facility enables the issuer to restructure the settlement of advances extended by the investor by way of issuance of new ordinary shares and IDS which are to be settled at the maturity of the loan. In effect, such loans have transferable subscription rights attached to them. The IDS represent evidence of the debt which is still outstanding. In 1995, RM125 million of IDS is based on Bai' Bithaman Ajil, RM600 million on Al-Musyarakah and RM300 million on Al-Qardhul Hasan.

Even though the first IDS were well received in the market, the following reasons prevent its development to its full potential:-

(I) Lack of knowledge among corporate investors as to the existence of IDS.

(II) Most investors think that IDS have only been created to cater for the investment needs of Muslims.

(III) IDS carries fixed profit margins whereas conventional bonds can carry, in addition, floating rate margins.

(IV) Lower marketability and lack of marketing support.

2.2.4 CAGAMAS BONDS

As mentioned in the introduction of this report, Cagamas Berhad, the National Mortgage Corporation was floated by Bank Negara Malaysia, Commercial Banks, Merchant Banks and Finance Companies to develop a secondary mortgage market in Malaysia. Cagamas provides a facility for primary lenders, that is, the Government of Malaysia, financial institutions or corporations that originate housing loans, to obtain liquidity for their previously illiquid portfolio of housing loans. At the same time, it helps to develop a market for fixed income securities by providing high quality debt instruments in the form of Cagamas Bonds which have a status comparable to Malaysian Government Securities. In efffect, Cagamas purchases housing loans from the originators of such loans and finances the transactions through the issue of debt securities. The establishment of Cagamas Berhad is the single most important step taken by the Government in the development of the PDS market.

Most of the bonds issued by Cagamas carried fixed interest rates. Since the debt instruments issued by Cagamas pass as liquid assets like those of the Government, the spread between instruments of the two institutions having equal maturities is very thin. Usually it is only 10 basis points.[1]

Cagamas has also been issuing floating rate instruments especially during periods of uncertain interest rate movements. The floating rate is usually quoted at several basis points above KLIBOR.

[1] 100 basis points equals 1%

Recently, Cagamas has introduced a scheme known as the Islamic Housing Debt Securitization Scheme. This is the first time that housing loans are securitized on an Islamic basis. Under the scheme, Cagamas may purchase the existing Islamic housing debts of Bank Islam Malaysia and banks offering interest-free banking facilities, and in turn, the former will issue bonds, known as Bon Mudharabah Cagamas to fund its operations. The bonds are based on the Al-Mudharabah or porfit sharing scheme whereby bond holders and Cagamas share the profits in accordance to an agreed ratio.

Having discussed bond types in accordance with Bank Negara classifications, we will now discuss RAM's classification. This will be incorporated into the discussion of rating in Malaysia, the subject of the next section.

2.3 **RATING PRIVATE DEBT SECURITIES IN MALAYSIA**

The history of credit rating in Malaysia is very recent and dates back to the commencement of operations of Rating Agency Malaysia (RAM) in late 1991. Even though RAM was well received in some quarters, the majority of issuers could not appreciate the rating of debts. In America, Moody's introduced the first system for rating fixed income securities in 1909 and it was not until in 1970 with the default of Penn Central, the world's largest transportation company at the time, on its short-term commercial papers which were consistently rated below investment grade by rating institutions, that ratings became appreciated. To avoid such an occurrence, Bank Negara has made it mandatory with effect from May 1992 for all PDS issues to be rated. Furthermore, under current guidelines the issues must secure investment grade ratings.

Credit rating is an objective and impartial third-party opinion on the ability and willingness of an issuer of a debt instrument to make full and timely payments of principal and interest over the life of that instrument. It is therefore an objective process of trying to assess the default risk of an issue.

2.3.1 RATING AGENCY MALAYSIA (RAM)

RAM was incorporated in 1989 to provide a professional opinion on the quality of debt instruments issued in the capital market. It was an attempt to promote the smooth development the emergent bond market. To prevent any particular shareholder from influencing its rating decisions, no particular shareholder is allowed to own more than 5% of the equity.

RAM's RATING PROCESS

Because ratings attempt to predict the future abililty of an issuer to make timely payments of its obligations, it is necessarily subjective. Therefore any attempt to set down fine formulas or precise methodology can be misleading and quickly outdated. However RAM has developed an analytical framework for assessing the quality of issues.

All rating analysis begin by an analysis of the characteristics of the industry of the issuers core business. Business cycles, economic scenarios, trends in international trade and monetary policy and the sensitivity of the issuer to these are assessed.

A second evaluation criteria is financial. Here the RAM analyst forms an opinion not only on profit trends, but also on the ability of the issuer to generate cash, its other commitments and capital requirements.

A third perspective in the RAM framework is the business assessment of the firm. The focus here is on the strategic position of the issuer, its opportunities and threats, cost structure and how it stands in relation to the competitive factors in the industry.

Lastly, a very critical assessment of management quality is made. Management flexibility and its ability to both anticipate and implement changes as required by market forces are assessed.

After such an in-depth analysis ranging between one and two months, a grading is finally reached which is communicated to the potential issuer. The grading system for long-term debt used by RAM is AAA for highest grade issues while lower grades are assigned AA, A, BBB. Issues rated below BBB are not investment grade issues.

Since it started operations in 1991, RAM has rated a total of 230 issues of PDS with a total value of

RM29.63 billion (as at July 1995). It classifies issues as short-term (issues with matury of less than one year), medium-term (issues with maturities between one and three years) and long term (issues with maturities of greater than one year). The issues rated by RAM and their classification is shown is shown in Table 2.1

Table 2.1:
DEBT ISSUES RATED BY RAM CLASSIFIED BY MATURITY PROFILE
AS AT JULY 1995

INSTRUMENT	NOS	RM MILLION
Long-Term	124	20,151.37
Covertible Bonds	109	12,832.20
Fx/F1 Rates Notes	5	444.17
Fx Rate Bond	1	1,500.00
Islamic Debt Securities	2	1,100.00
Mortgage Bond	1	100.00
Preferred Stock	1	1,000.00
Medium Term:	5	380.00
Medium Term Note	5	380.00
Short Term:	101	9,098.50
Commercial Paper	9	317.00
FI Rate Note	5	1,002.00
Notes Issuance Facility (NIF)	14	1,215.00
Revolving Underwritten Facility (RUF)	58	5,208.00
Revolving Underwritten NIF	15	1,356.50
GRAND TOTAL	230	299,629.87

Source: RAM

2.4 BENEFITS OF BOND RATINGS

Since rating indicates the issuers ability to make timely payments of both principal and interest, it provides an indication of the investment quality of the issue. Moreover RAM's ongoing surveillance of issues and subsequent reporting of any changes in the issuers ability fo honour its commitments helps to restore and strengthen investor confidence in the entire process. Most investors have neither the time nor the ability to translate the massive data on issuers into grades of investment quality. By indicating creditworthiness, the reliance of investors on the past name and glory of issuers is eliminated, replacing it with a more objective measure based on willingness and ability to pay. Resource allocation is greatlly enhanced as credit worthy firms can raise huge amounts of funds faster and at lower cost than less credit-worthy firms.

Ratings also provide an objective basis by which issues can be priced. A basic principle in the study of finance is that investors require higher returns to compensate them for assuming higher risks. Ratings provide relative measures of risk inherent in issues and therefore lower grade ratings should be priced lower than higher grade issues. Investors can therefore choose among alternative rated issues to reflect their risk/return preferences.