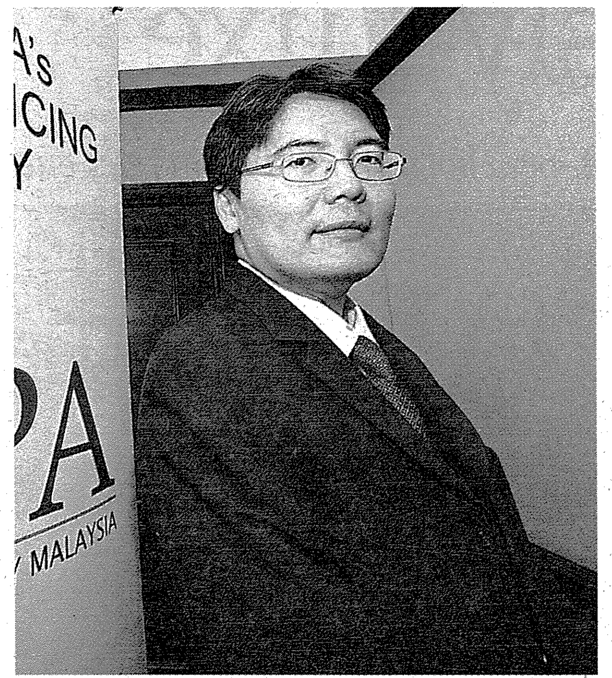
Interesting times for bonds in 2017

Non-mandatory credit rating ruling on bonds will see local credit rating firms competing with foreign players, putting industry talents to the test

by ISHUN P AHMAD



TMR pic

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Foo says in advanced markets, RAM Ratings anticipates investors to continue to use independent 3rd-party credit rating

THE local bond market, one of the largest in South-East Asia, is primed for interesting times in 2017, when the non-mandatory credit rating for bonds comes into effect.

The ruling will see foreign credit rating houses coming on stream in 2017. It will certainly put to the test the talents at the local outfits.

"The local boys will now have to compete with them," Sunway University Business School Professor of Economics Dr Yeah Kim Leng tells *The Malaysian Reserve (TMR)*.

Industry observers believe the move will also result in a rising pool of talents, especially from foreign firms, and competition in the bonds industry. The competition will also force existing players to restrategise and reinvent their business model. This could likely see the creation of new skills and talents in the industry.

"The existence of foreign houses will provide a better rating coverage for Malaysian bonds as well as help to attract foreign investors to buy local bonds. This will allow for greater international investor confidence," said Yeah, who is also an external member of Bank Negara Malaysia's Monetary Policy Committee

Yeah should know. He was a former chief economist at RAM Holdings Bhd, formerly known as Rating Agency Malaysia Bhd, which provides independent credit research and advisory services.

The ruling will drive credit rating demand and provide flexibility to issuers a choice whether or not to opt for credit rating.

Analysts said the move is timely and a natural progression, adding that on the whole it would be good for the local bond market. Generally, they said, investors and industry players are ready for the move.

All said and done, the move will have some teething problems. Investors may take some time to digest and get used to the non-mandatory credit rating.

Local investors, who are so used to having bonds rated, will now have to change their mindset. It will naturally take time.

Competition

The move, part of the liberalisation of the industry, will see big players like Standard & Poors, Moody's Investors Service and Fitch Ratings competing with local players like RAM Rating Services Bhd (RAM Ratings) and Malaysian Rating Corp Bhd.

Less established players like China's Dagong Rating might also want a piece of the pie. This will definitely put pressure on the local players who already have to contend with a drop in business due to the move.

Industry observers said local players will now have to step up their game and improve their efficiency in order to survive.

In the end, they said it will all come up to quality and pricing of their products. It may also push them to find new revenue sources.

In an email interview, RAM Ratings CEO Foo Su Yin said in advanced markets, RAM Ratings anticipates investors to continue to use independent third-party credit rating as a complementary tool in their decision-making process.

In advanced bond markets, where ratings are not mandatory, investors view ratings as being essential to their investment decisions and the continuity of price benchmarking.

As the Malaysian bond market advances, RAM Ratings said the removal of mandatory credit rating for bonds and sukuk in 2017, and other liberalisation measures for the Malaysian capital markets represent the next step in market development.

"An issuer obtaining a credit rating signals the company's commitment to transparency and corporate governance, which investors are increasingly emphasising.

"Further to that, it would be a positive step for the development of the Malaysian bond market if investors are able to utilise the complete range of the rating scale for their investment decision process, if not, at least from 'AAA' to 'A'," said RAM Ratings.

It said running a business entails managing many different types of risks. There are trade-offs between risks and returns.

For RAM Ratings, it said companies that it assigns "A" rating to are relatively well-run companies with business models that are viable, but come with inherent general business risks, such as supply and demand risks, costs and general economic climate and so on and so forth.

Based on its default studies, RAM Ratings said the long-term average cumulative default rate for a five-year A-rated bond is 5.5%. If investors are able and willing to invest in unrated bonds, perhaps they can also consider investing in A-rated bond.

Sole Pricing Agency

Bond Pricing Agency Malaysia Sdn Bhd (BPAM) CEO Meor Amri Meor Ayob said in support of the new bond market development, BPAM has been providing daily evaluated prices for unrated ringgit bonds and sukuk since Jan 2, 2015.

He said BPAM's evaluated prices provide Malaysian bond market players with the relevant data for reporting and decision-making purposes in relation to unrated bonds.

"From our regular interactions with market players, we understand that some asset and investment managers have already started referring to our evaluated prices and utilising the information to decide if they should amend their existing investment mandates or to formulate new mandates," Meor Amri tells *TMR*.

On the industry as a whole, Meor Amri said the move should not be seen as making bond issuance relatively cheaper with the elimination of credit rating agency fees. The initiative, he said, is aimed at encouraging more bond issuers to enter the market and also deepen the secondary market liquidity.

From the issuers' perspective, he said corporations that are known to have good credit standing in the market may choose to take this route going forward.

"That said, they will have to first evaluate the credit rating fees saved against the extra premium that they may have to pay in the market if investors demand additional premium to compensate for the absence of a credit rating. On the other hand, issuers that normally command a lower credit rating may come to the market via this route as well when the timing is right, hoping to capture lower cost of funds," added Meor Amri.

Then again, he said, investors will have to conduct their own internal credit analysis and due diligence when it comes to investing in unrated bonds or sukuk. The comprehensiveness of the credit analysis performed by each investor will depend on the information that each investor possesses, and the timeliness and completeness of these information for their investment management purposes.

Long-term Benefit

Industry players and analysts said the move will benefit the industry in the medium to long term, and broaden the scope and depth of the industry.

They argue apart from improving the maturity of the industry, the move could also likely spur regional bond issues in Malaysia on the back of emergence of foreign credit rating houses. Industry players said the issues would generally come from Asia.

Overall, they said the move will provide further impetus for good growth in the coming years, as well as to deepen and give breath to Asean's largest bond market.