Issuers survey debt market landscape

ASEAN bond investors are fast becoming a source of funding not just for those issuers in their own countries, or even those across their borders, but also for issuers from elsewhere in the world. It should come as little surprise, in this context, that the latest event in Asiamoney's annual ASEAN Bond Markets series should feature the head of international funding for a sovereign outside the region, alongside well-known Malaysian issuers, guarantors, and senior bankers. Asiamoney took the opportunity to get a sense from those on the panel exactly how they see the future playing out — and, importantly, how they can use the debt financing markets to make sure that that future is as bright as possible.

PARTICIPANTS
Khoo Boo Hock, vice president, operations, Credit Guarantee and Investment Facility (CGIF)
Alan Greene, vice president, Moody's Investors Services
Nor Masliza Sulaiman, head of capital markets, CIMB
Chu Kok Wei, group head, treasury and markets, CIMB
Azlin Manan, group treasurer, Axiata Group
Zeynep Boga, head of international capital markets, Undersecretariat of Turkish Treasury
Chung Chee Leong, president & chief executive officer, Cagamas
Mohamed Nazri Omar, chief executive officer, Danajamin Nasional
Moderator: Matthew Thomas, contributing editor, Asiamoney

Asiamoney (AM): ***There is a lot of talk at the moment about the chances of a US rate hike later in the year, something that would certainly have an impact on a lot of emerging market borrowers. There is also some uncertainty about the direction of Malaysian interest rates, particularly given the volatility of the price of oil. What are you telling your clients to expect from the rate environment at the moment?***

Chu Kok Wei, CIMB: This year we expect offshore volatility will be higher than 2014. The first half of last year, in particular, had very low volatility and as an institution focused on the intermediation business, that was a pretty bad scenario for us. We expect more healthy volatility in the overall rate environment this year.

Specifically looking at the ringgit market, our view is that the policy rate will remain unchanged this year at 3.25%. The sovereign curve has adjusted to factor that in, and we expect the volatility of the curve to be rather neutered for the rest of the year.

It is more interesting, however, to look at factors outside the capital markets when considering where rates are going this year. The fact that banks are instituting the Basel III liquidity coverage ratio requirement does have implications for the deposit rates we are like to see on offer. Perhaps more importantly, the liquid asset requirement of Basel III will certainly create more demand for high-grade bonds. That is going to a boon for issuers in this market.

Since 1997, most Asian corporations have been rather prudent when it comes to foreign currency exposure. Malaysia's regulatory environment requires corporations to have foreign currency assets before they are allowed to borrow offshore in any significant size. That means the rising interest rate, and the rising value of the US dollar that will follow, is unlikely to have much of an impact on Malaysian borrowers. They have natural hedges in place already.

Khoo Boo Hock, CGIF: We hear of bankers being more aggressive with quality names across the region, so the loan market is probably going to be a natural source of funding this year. But there will be challenges for lower-rated and smaller corporates tapping funds at attractive rates, particularly those looking for longer-term financing. That is where the capital markets can really play a role. The direction of rates is not something to worry about from my point of view. It is the volatility of rates, not so much the direction, that is the real risk.

Alan Greene, Moody's: In some respects, the ASEAN region is the place to be at the moment. Most of the countries in the region are going to post GDP growth of between 3% and 6%, with Singapore and Thailand at the bottom-end and Indonesia and the Philippines at the top. Most countries are pretty strong from a current account point of view, fiscal reforms are happening, and broadly speaking the banking sectors are strong. There have been risks in some countries, such as the risk of property prices rising too quickly, but most countries have put in place successful cooling measures. Banks now have money to lend.

This is not a bad environment for corporates. There are some clouds that we have talked about before, however: currencies, commodities and China. Ringgit weakness has been quite marked. That is very beneficial for the electronics and electrical sector in Malaysia. These companies do not have global ratings, so we do not see much of them, but from a domestic point of view their success is certainly helpful for the economy. The weaker currency will also help tourism, which was down last year. The problem, of course, is servicing dollar debt, especially when there are debt maturities coming up that can be a big issue. This comes back to what Chu was saying about the sophistication of the borrower base here. In most cases, they are ready for these risks.

It is a bit more challenging on the commodity front, because virtually every commodity has suffered a price slide recently. That might help inflation, but there is clearly a top-line impact on countries that sell commodities. There is still money to be made for the palm oil producers, for instance, but they are seeing their margins get squeezed at the moment.

The other major factor to watch is China. The problem there is simple: any major export partner of Malaysia, and the ASEAN region as a whole, is a potential source of risk. The same applies for the US, the EU or Japan. Corporations here need to watch China carefully to see how much a slowing economy there is going to impact their own businesses. It is something everyone should be thinking about over the next few years. Equity markets are quite frothy. Banks are still keen to lend. The bond market is also open at the moment. There is plenty of scope for companies in the region to raise money, but they need to watch that their debt load does not get too high.

Nor Masliza Sulaiman, CIMB: There has been a lot of interest from Malaysian issuers recently to tap the offshore market, predominantly the US dollar market. For those who have US dollar revenues, tapping the dollar market is a convenient natural hedge. To be complete and relevant as a holistic debt solutions provider, we also offer other funding currency solutions to our clients especially ASEAN or CNH currencies where some may better fit their objectives. Since the financial crisis, we've seen the ringgit become an attractive source of funding for issuers from South Korea, Turkey, India, Indonesia and the GCC. The Thai baht market is also an attractive destination, although taps are smaller with shorter dated maturities. The Singapore dollar market, which allows unrated bonds, is a clear source of opportunity for issuers who are not keen to pursue ratings but are keen to tap the deep pool of private banking funds.

There are several Asian issuers looking to tap the dollar market at the moment, because of the opportunistic funding levels available at certain rating bands. Given that the potential for a Fed rate hike in the second half 2015 is pretty high, borrowers are advised to tap the dollar market early in the first half of the year ahead of the rate hikes and heavy pipeline.

AM: ***It would be interesting to get a sense from the issuers from our panel on the outlook for their businesses — or, indeed, countries — over the next few years. What are the major areas of growth for Axiata at the moment, and what is the best way for you to finance that growth?***

Azlin Manan, Axiata: Thank you. Briefly, I would just like to introduce Axiata. To date, we have a MR60bn ($16.2bn) market capitalisation, 260m subscribers, and seven licences to operate mobile networks in seven different countries via our subsidiaries and associates. As you can see, we have a regional presence across Asia. We have been experiencing very strong revenue growth consistently, especially in the domestic market for at least the last seven years. But one thing we are also experiencing today is the shift of mobile users from voice to data. Axiata Group is transforming from a traditional mobile operator to a Mobile Data Leadership company, which will be make us data-centric. This is going to be the major area of growth for our group over the coming years.

The optimum cost of funding is, of course, the major objective for us when we tap the market. However, given the market condition today, this is no longer the only consideration. The dollar is certainly the cheapest market for us to fund in, because rates have been at a historic low. But when we look at some countries we operate in, like Bangladesh for instance, there is an absence of hedging mechanisms. Dollar exposure cannot be hedged there, so there is a trade-off between the low interest rate and managing the dollar risk. This gives us the challenge of weighing up the cheapest cost of funding and the management of our currency risk and, from my perspective, given today's market environment and currency volatility, the dollar may no longer be the optimal funding currency.

Chu, CIMB: Emerging market hedging does provide a huge challenge. There are some possible work-around solutions, such as funding a currency that has more stable cross-rates. I'll offer you an example: the dollar strengthened by around 25% against the ringgit in a short space of time. But over that period, the ringgit-Singapore dollar and ringgit-Thai baht cross rates were much more stable, and the cross with the Australian dollar actually went in the opposite direction. It is clear that choosing a currency that is more stable than the US dollar can help borrowers reduce their risk from unhedged positions.

It is interesting to note that among all these Asian currencies that have very stable long-term cross rates, interest rates can vary wildly. There can be a difference of more than 2% between the funding rates you could get in Thai baht, Singapore dollars or Malaysian ringgit, for example. The challenges that Azlin mentioned are something we face as a bank as well. The major consideration is where your payment is taking place, not necessarily what market is the cheapest.

There are various opportunities for ASEAN issuers to tap other markets within the region. The major consideration, though, is the timing. It can sometimes take a lot of time to bring a deal to market very quickly and, even though the currencies are quite stable, the basis swap can move quite quickly during the marketing period.

Sulaiman, CIMB: CIMB Thai issued the first Basel III-compliant subordinated debt by a foreign issuer in the Malaysian ringgit market. The reason the deal made sense at that point was because of the competitive pricing available for sub-debt in the ringgit market as compared to an equivalent US dollar offering and largely because retail Thai investors, the main distribution channel for sub-debt, were recently restricted from buying subordinated bank debt.

The cost saving arising from the synthetic Thai baht deal via an issuance in the ringgit market compared to a US dollar trade was in the quantum of 100bps. To close synthetic transactions, deal execution and timing is very important, since an active monitoring of the basis swap is critical to lock in a favorable all in pricing. There are certainly opportunities for cross-border deals within this region that offer issuers significant cost saving benefits.

AM: ***The Turkish government has embarked on a fiscal consolidation program to achieve key targets of raising a primary surplus of 1.3 per cent of GDP by the end of 2016, cutting the general government deficit-to-GDP ratio to below 1 per cent and reducing the public debt-to-GDP ratio to 30 per cent by 2016. Zeynep, can you tell us a little more about this, as well as about your offshore funding plans for the year?***

Zeynep Boga, Turkey: Every year we announce medium-term programmes for the coming three years, in which we set out very clear macroeconomic targets for the near future. We announced a programme that covered the period of 2015-2017 last October, and it is probably worth highlighting some of the key elements of that programme. The central budget government deficit was expected to be 1.4% of GDP last year, although at this point there is some chance of us beating that target. The public sector primary balance is expected to be realised as 0.4% of GDP for 2014, once all of last year's figures are available.

We want to gradually decrease the budget deficit to as low as 0.3% of GDP by the end of 2017, and push up the primary balance to 1.8% over the same period. We are among one of very few countries with such strong fiscal targets, but we know this is important. Turkey has been experiencing very strong growth rates in the last few years, but this came at the cost of a high current account deficit. The government has recently announced some macroprudential measures which have stabilised growth in favour of net external demand. We are expecting growth of 3% for the full year 2014.

In recent years, we have issued around $6bn or $6.5bn of international bonds each year. But this year, because our repayment schedule is much lighter, we are planning to issue only a total of $4.5bn through bond issuance in the capital markets. We have already reopened our 2043 bonds, raising $1.5bn. That leaves us with around $3bn: about half of that will come from euro or dollar bond issuance, and the rest will come from the sukuk market and the Samurai bond market.

Turkey has been issuing in the Samurai market since 2011, using a JBIC guarantee. But this year, we want to try to issue on a stand-alone basis. We think it is time to sell a deal without the guarantee, although that means the deal will probably be smaller than usual. We are expecting around $500m of Samurai issuance this year.

We are also planning to continue our presence in the sukuk market this year. That market is important to us. We issue two sukuk bonds in our local market every year, and one in the international market. We are planning to issue a sukuk in the second half of this year that will be worth around $1bn.

AM: ***It has been reported that Cagamas expects around MYR6bn of asset purchases this year. Mr Chung, can you elaborate on this plan — and perhaps give us a sense of your overall funding approach?***

Chung Chee Leong, Cagamas: As most people in this room know, Cagamas buys housing loans and issues bonds or sukuk to fund those purchases. Unlike other issuers, there is a big element of timing in terms of when we can grow our asset base and issue bonds or sukuks. It is dependent on when the banks will sell us their loans. In 2015 we are forecasting that we will purchase around MYR6bn of housing loan assets. The funding for these purchases could come domestically, or it could come from the international market. That will very much depend on the rates on offer at the time.

We sold a US dollar bond at the end of last year, and when we converted it back into ringgit it represented a cost saving compared to our local funding rate. But we are not automatically going to head to the dollar market when we look at international currency issuance. Our EMTN programme provides options in terms of currencies. When we entered the international market for the first time in September 2014, we actually issued an offshore renminbi bond, contrary to most people's expectation. There was a great opportunity for non-Chinese issuers to tap the market given the size of offshore renminbi funds and get really good value at that time.

We operate on a match-funding policy, meaning that when we buy $1bn of loans we need to issue $1bn of debt matched in amount, tenor and duration. The challenge for a frequent issuer like us is the volatility in the market, because issuers often can get priced based on market volatility rather than underlying credit risk. This is why we want to embark into the international bond market. It allows us to diversify our investor base to benefit from lower offshore rates as well as reduce reliance on a single yield curve. However, our foreign exchange risk will be fully hedged through cross currency swap.

AM: ***How does slowing growth in Malaysia change the outlook for Danajamin's business over the coming year or so?***

Mohamed Nazri Omar, Danajamin: It is obvious to everyone that Malaysia's GDP growth has shown signs of some slowing down. The reality has sunk in now. This is partly because of the huge drop in the oil prices, but when you look at the fourth quarter of last year, growth was still strong despite the lower oil prices. That shows that our economy is quite resilient. It is driven mainly by domestic demand, as well as public sector spending and investments.

When we provide guarantees, it is not for the short-term. It is for the long-term. Those issuers which come to see us are not looking for two or three year funding; they are looking for five years and beyond. Commodity prices will certainly impact some of these issuers, but not in the long-term. Public investments in infrastructure, power and roads need to go on, so the demand for our guarantees is still strong.

We continue to look for issuers who have financial viability in the long-term. That is where we want to help by providing financial assistance — our guarantee — and that is also the type of issuer that is going to contribute to Malaysia's growth in the long-term.

AM: ***Have you looked into the possibility of providing guarantees to the offshore financing of Malaysian companies?***

Nazri, Danajamin: Currently, our mandate is to provide guarantees in the domestic capital market. We are locally rated in order to support that and when issuers want to turn to the offshore market, that is where guarantors like CGIF can come in. But we have had some enquiries over the last few years from issuers that want to raise money in ringgit to fund foreign projects. We would certainly consider that because the main objective of Danajamin is to help Malaysian companies — including those with regional aspirations — and if that growth is coming from overseas, that is not a problem. The main criteria we would look at are the currency mismatch and whether the issuers have a ringgit-generating business that can support ringgit debt repayments in the event that there is some problem repatriating the funds from their overseas project.

Khoo, CGIF: There are only six real local currency bond markets out of the ten ASEAN member countries and, out of these six, foreign issuers are really only present in Malaysia, Singapore and Thailand. For issuers without any operations in these countries but looking to diversify their funding sources, while there are windows of opportunity to tap these markets to achieve significant cost savings, depending on the cross currency swap rates, these windows can close pretty quickly. It is relatively easier to issue in Singapore's debt market, but in Thailand there is an approval process that is fixed only three times a year. Because of this situation, not all the ASEAN markets are really open for Malaysian issuers. The opposite is not necessarily true, however. Malaysia is quite open to foreign issuers.

The ASEAN+3 Asian Bond Markets Initiative (ABMI) is working on a common issuance framework, called AMBIF [the ASEAN+3 Multi-Currency Bond Issuance Framework]. That would allow a corporate to tap multiple currencies, and to be in the position to do so quite easily. Many of the region's regulators are working towards this. There is a pilot issuance being worked on, and we expect the first deal to come this year. That is the first but important step towards a common approval framework where an issuer approved in one market can automatically issue in other markets. There is however, still quite a long way to go as there are many related issues that need to be resolved.

AUDIENCE MEMBER: ***There has been so much discussion about the move towards an integrated ASEAN debt market, and there is a lot of hope there. But when we will see it actually happen?***

Sulaiman, CIMB: It is not going to be an immediate process. A common issuance framework is going to be very useful, but there are still major hurdles. ASEAN countries need to work together to overcome withholding tax issues. It is not going to be easy, but to encourage more investors to move across borders, we need to ensure that they are not paying additional tax every time they do so. Local rating requirement is also an impediment. Settlement is another one. It will take some time, but we are at least moving in the right direction.

THE PARTICIPANTS: (left to right) Khoo Boo Hock, vice president, operations, Credit Guarantee and Investment Facility (CGIF); Alan Greene, vice president, Moody's Investors Services; Nor Masliza Sulaiman, head of capital markets, CIMB; Chu Kok Wei, group head, treasury & markets, CIMB; Matthew Thomas, Asiamoney; Zeynep Boga, head of international capital markets, Undersecretariat of Turkish Treasury; Chung Chee Leong, president & chief executive officer, Cagamas; Azlin Manan, group treasurer, Axiata Group; Mohamed Nazri Omar, chief executive officer, Danajamin Nasional.

Khoo, CGIF: There are issues that appear simple but are highly complex such as language. What language will used in the documentation? This is certainly a hurdle, yes, but it is not insurmountable. There are a lot of languages spoken in the European Union, but they have managed to overcome these issues. We can also find a solution here.The rating requirement is another fundamental hurdle at the moment. There has been talk in ABMI about ratings harmonisation or the move to create a common rating agency across the region. But progress for this now appears to have slowed considerably. So, it looks like issuers who want to sell bonds in multiple currencies and markets will probably, like us, need to rated by five different agencies. This is highly inefficient, costly and will certainly be a hurdle to getting many issuers to tap multiple markets across the region.

Chu, CIMB: In this room, we have the representatives from the issuer community, the investor community, and intermediaries such as guarantors and rating agencies. We can all play a part to push integration forward. Most ASEAN countries have a domestic bond market, at various stages of development. The next step for many issuers in these countries is tapping the G3 currencies. The ASEAN region is so savings rich at the moment that we are channelling money to the US at rates of Libor minus 10bp; they are then lending money back to us at Libor plus 150bp. There is something not right there.

Manan, Axiata: From our point of view, we have done both domestic and cross-border issues. We want more cross-border opportunities to arise, because that really helps us expand across the region without taking on undue currency risk.

We had previously worked with CIMB and other banks on bringing issuers from other countries to tap the Malaysian ringgit sukuk market. At the time, we were considering bringing our Indonesian or Sri Lankan subsidiaries to the market. There are a lot of boxes to tick in terms of structuring the deal and getting the rating. There would also be a slight premium to pay in the Malaysian market, because even though investors here know the parent company well there may not be so familiar with the subsidiaries. In the end, we decided not to go ahead but from my experience of working on these transactions, there is a lot of hope for this market to grow.

I absolutely agree with Chu that the reference for ASEAN borrowers should not always revert to the dollar market. The ASEAN region needs to progress and ensure that we are providing enough cross-border financing between ourselves. It would be great to have a direct reference rate in this region, although that is going to be a long way off.

AM: ***Turkey is chair of the G20 this year. What should economists from the government during this period?***

Boga, Turkey: We are planning to focus our G20 efforts this year mainly to ensure inclusive growth and prosperity towards collective actions. We have formulated our G20 objectives through 'the three Is': inclusiveness, implementation and investment for growth.

The drive towards inclusiveness is quite unusual for a G20 President, but it is something we think is very important. We want to focus our efforts on SMEs, gender inequality and youth unemployment. These are the major areas where a lot of countries could use greater inclusiveness to grow aggregate demand in their economies. There is also an international dimension to inclusiveness: we want to put focus on low-income developing countries. Making sure that these countries benefit from global growth should be a major target of the G20 in the future.

It is easy, of course, to discuss solutions to problems. It is common for meetings like the G20 to lead to many discussions of solutions. But what is too often missing is the implementation of those solutions. We want to introduce a robust monitoring mechanism, so commitments given by G20 countries are definitely going to be implemented.

Investments are not only important for developing countries, but also for the more developed countries. We want to utilise private capital to help finance our infrastructure projects going forward, so public-private partnerships are another major focus for us over the coming years.

AM: ***How important is the growth of a local asset-backed securities (ABS) market in providing an alternate funding source for Malaysian banks and corporations?***

Nazri, Danajamin: The product serves a significant purpose in the development of the local capital market. It not only makes financing options cheaper for borrowers, but it adds diversity for investors in the market. The problem, of course, is that ABS got a bad name in the last few years because of excessiveness. We need to bring back confidence in ABS structures, and that means going back to the basics. We think the next deals in the Malaysian ABS market should be based on sound principles for example, founded on assets with a strong cashflow, so people have confidence that it is going to work. We can help add that value by making investors confident in the credit risk.

We helped on a deal a few years ago that was based on securitisation; essentially it was a securitisation of rental cashflows from office buildings and other properties. We anchored the subordinated tranche, knowing that an anchor guarantor was important there to give confidence to investors. We are happy to do that again, because we know that this market can offer a lot of value to investors and issuers in the future. But it is important that the market always sticks to sound structuring principles.

Chung, Cagamas: We issued RMBS structures between 2004 and 2007. Since the global financial crisis, we have concentrated our funding on the senior unsecured market. It is interesting to note that currently in the secondary market our senior unsecured debt is priced lower than the MBS structure. There is a bit of a disconnect there, for whatever reason. We will certainly consider returning to the MBS market when the opportunity arises but for as long as our senior unsecured funding is cheaper it is not something we can really justify.

Greene, Moody's: One of the issues with ABS is the quality of the data. Until that changes, you are not really going to get much tightening in the market. It is a nice situation for investors when ABS deals are actually paying them more than senior unsecured bonds with the same rating, but until the information flow improves, they will not see the rationale for accepting lower prices. ■

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An Asian Bond Markets Initiative

Investors mull changes in the rating environment

Global and domestic investors taking a close look at the ASEAN bond markets have to face a number of issues, including how best to hedge unwanted rate risk, how to navigate a choppy swap market, and how to ensure that they get the best value from issuers that often have plenty of financing options elsewhere. But when Asiamoney gathered an esteemed panel of investors and market experts at its latest ASEAN Bond Markets event in Kuala Lumpur, only one topic dominated discussion: ratings. We took the opportunity to get the view from market participants inside and outside the country on just how important ratings are, how big the unrated market can get, and how end-investors can be convinced to trust funds' own credit work.

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Dr Yeah Kim Leng, dean of business school, Malaysia University of Science and Technology (MUST)
Moderator: Matthew Thomas, contributing editor, Asiamoney

Asiamoney (AM): ***Malaysia is an interesting case in the credit rating world since Moody's, Standard & Poor's and Fitch all have different views on the future direction of ratings. What is driving this discrepancy?***

Christian de Guzman, Moody's: It is a source of some consternation in the market how much variety there is in terms of the outlook for Malaysia's rating, but that's what makes a market work. We have a positive outlook for our A3 rating, one of competitors has a stable outlook and the other has a negative outlook. It is probably the only country in the world where there is that much difference in the outlook. It should go without saying that we are not all the same: we have different methodologies, and we tend to emphasise different aspects of a particular country's credit profile.

We are inherently comparing Malaysia to other countries, not just to how it was a few years ago. But having said that, we put the country on a positive outlook in 2013, and 2014 was a relatively good year. We saw GDP growth accelerate, the current account surplus widen, and fiscal consolidation gain traction. We saw fiscal reforms accelerating. In a sense, we have already been proven right in terms of our outlook. In 2015, the fall in the oil price is obviously damaging for the economy, but how many people could have predicted that?

The major focus for us is fiscal consolidation. There has been major progress in this area: for those who have been watching Malaysia for a long time, or indeed for those who live here, it is obvious that the removal of fuel subsidies was a pretty historic decision. We are looking to see how the government responds to external challenges. The oil price is clearly one of those major challenges, but there are others such as the imminent normalisation of US monetary policy. There are political challenges. The depreciation of the ringgit has impacted sentiment on the ground. There is also a widespread acceptance that growth will be slower this year. But Malaysia will continue to grow faster than other A-rated economies, despite these risks.

AM: ***One of the things that comes up a lot when people talk about ASEAN bond markets is the need for an ASEAN rating agency. Christian, I would imagine that you would argue that a pan-ASEAN rating agency is not really needed, since we already have global ratings agencies such as Moody's. But at the same time, there are a lot of companies that have not ventured outside***

of their domestic markets and as a result have not got global ratings. Do you think global rating agencies need to work more closely with smaller rating agencies in different markets?

De Guzman, Moody's: We do have certain arrangements allowing us to cooperate with rating agencies in different markets. We completed our acquisition of an Indian ratings agency last year. We have also previously invested in an Indonesian rating agency. But generally speaking, the need to provide a local perspective is very important. We do provide some local flavour already. We are continuously on the ground to visit issuers and to get the lay of the land, and we have people with years of experience working in markets across the region. These are some ways that global ratings can overcome the challenges of not maintaining an actual physical presence onshore.

Dr Yeah Kim Leng, MUST: The domestic rating agencies in this region have gotten together and created a forum to try to harmonise ratings across the region. It remains to be seen how successful that will be.

There have been a lot of studies on mis-ratings, showing that there is some developed market bias. These are not studies by the smaller agencies; they are written by academics. There are quite a number of issues relating to the rating agencies. We need to move to much more of a cardinal approach to ratings, rather than the ordinal approach we have at the moment. The approach at the moment means that downgrades of one country are likely to impact those of others, as well as those of corporations. There needs to be a new way of doing things.

There are some interesting studies showing that the information and predictive value of ratings have declined, but rating agencies' market power has increased at the same time. There is a disconnect somewhere. Many investors have ratings guidelines hard-wired into their investment decisions. We need to move away from this as much as possible and, of course, rating agencies need to work to improve their approach.

AM: ***We are very used to looking at the ratings of a country or a corporation and seeing everything summed up with a few letters. One country is rated double-A; another is single-A. Is there a better way of understanding credit quality?***

Dr Yeah, MUST: There are a lot of advanced techniques used in the research area to judge the credit quality of a country, but the rating agencies have apparently not caught up with these advances. This is why we see a very large unexplained portion when we feed ratings into our models. This is partly to be expected, of course. There is a degree of opinion to all of this.

It is more important, however, to reduce the dependence of the market on ratings than it is to reform the rating approach of the various agencies. Investors are so dependent on ratings at the moment that downgrades can have a massive impact.

AM: ***Boo Hock, you talked in the previous panel about the headache of getting ratings from five different agencies. It is natural that agencies should have a range of opinions but, in your experience, how different was the process that these agencies actually undertook to come to their view?***

Khoo Boo Hock, CGIF: It has been quite varied in terms of engagement. But fundamentally, the biggest challenge for us is that the rating methodologies used to rate us are very different, which can be quite tricky to handle. Their views of the underlying guaranteed obligors' credit strength in our portfolio can be materially different, too. There is also a clear difference between international scale and national scales.

For example, we guaranteed a bond from Masan Consumer Holdings last year that was denominated in Vietnamese Dong (VND). Depending on perspectives, one may conclude that that this consumer goods giant's ability to repay their VND obligations is superior as it is one of the stellar corporate entities in Vietnam. As such, we are guaranteeing a very low risk obligation. But from an international scale perspective, the corporate's credit quality has to be constrained by the fact that it is based in and operates only in Vietnam; a country that has an international scale sovereign rating that is not yet investment grade. To those running risk and capital models, these differences of rating opinions, perspectives and methodologies mean that the default rate assumptions can vary wildly, from less than 1% to over 10%.

To be cautious, we adopt a conservative approach for now. That might be to our detriment sometimes, but our job over time is to prove that the risk for local currency bonds may be lower, notwithstanding the low sovereign ratings accorded to many countries in the region we cover. How corporate ratings are influenced by sovereign ratings really needs more detailed analysis. Simply adopting the capping or anchoring approach is a convenient assumption, and people often use convenient assumptions because of a lack of alternatives. Because rating agencies all use the same rating scale for all asset classes including sovereigns, corporates, banks, insurance, asset backed securities, and so on, it is also convenient to assume that they are all directly comparable. But looking at the default rate tables published, this is certainly not the case.

AM: ***It would be interesting to get a view from the investors on the panel on this point. How do you navigate the diversity of ratings opinions — and how important are ratings to your end investors?***

Adam McCabe, Aberdeen Asset Management: Investors give money to us to invest on their behalf. They are very much conditioned by their past experiences. It is no surprise that they want a lot of the mandates hardwired to look at a combination of ratings from two or three of the major rating agencies. For us to overcome the difference in standards and start to use more local market ratings, there are an awful lot of changes that need to take place. A lot of institutions will need to rewrite their investment mandates. I don't think there is any chance of that happening anytime soon. There's just very little bandwidth for that to happen on the demand-side right now.

There has been a lag between the style of investments and the wording of investment guidelines. There has been a lot more money moving into Asia, including local currency bond markets, over the last few years. But nothing has changed in terms of the rating requirements. That makes it very difficult when it comes to dealing with a local investment in Indonesia, for instance. Do we need to continue to rely on the big three, or can we use ratings from one of the local agencies? And if we do use a local rating, how can we rank the different agencies in each local market?

There has been a push by regulators around the world to ensure that managers do not solely rely on a third-party rating. Managers have to do the credit work themselves.

That is going to be the best way to solve the ratings issue. We will still also want to use the insights of others, but it is fundamental that we show our clients that we can do a lot of the work ourselves.

We saw three or four years ago that many funds relied on the third-party model, but more and more they are building their own in-house research teams. At Aberdeen, we have a very large team and we have long had a bias to do the in-house work ourselves. But the competition for talent on the research side is definitely heating up. That is symptomatic of the increasing focus on building in-house research teams.

Goh Wee Peng, AmInvestment Management: Ratings are very important for many of our institutional clients. Malaysian clients, in particular, are quite conservative. They tend to not want us to invest in anything rated less than single-A, or in some cases even double-A in case there are any downgrades. Some investors seem to forget that investment grade is actually triple-B; we don't see much demand for triple-B deals in this market.

There was an interesting case recently. The Abu Dhabi National Energy Company (TAQA) decided to remove its rating from RAM, because it wanted to cut costs. That created quite a panic among local investors. But they are still rated by S&P and Moody's, which have given them ratings of A-/A3, on par with Malayisa. The local rating assigned by RAM was AA1. This brought confusion to investors in Malaysia. Should they price TAQA at triple-A, because it is the same rating as the sovereign? Or should they continue to price TAQA as a AA1 credit?

It is interesting for us to ponder how we can map back from international ratings to local ratings. A lot of mandates here are based only on MARC and RAM, but when the international agencies rate a deal, there should be an easy way for investors to become comfortable.

Wong Loke Chin, CIMB Principal Asset Management: All of our clients are very ratings-focused. Most of our mandates require us to invest in single-A or above and, as Wee Peng said, some even want us to focus on double-A or above.

Most of the bonds in our portfolio are rated locally. The global issuers tend to have at least two ratings. But in Malaysia, there is usually only one rating given to individual issuers. It would probably be wise to move towards most local issuers having two ratings at this point because it will reduce ratings shopping among issuers.

De Guzman, Moody's: The value added by our ratings has always been the qualitative aspect of it. It is indeed relatively simple for anybody to put together a spreadsheet and spit out a rating. But it is our on-the-ground knowledge, experience, and our relationships with issuers and governments that bring value to the market. The qualitative aspect of our ratings — although seemingly subjective — is important for investors to understand. But at the same time, it is the key area where we try to demonstrate our value.

We don't particularly like ratings to be a required aspect of issuance. We would welcome a lot more competition, but we also recognise that there is a market for unrated deals too. This is where it becomes particularly important for investors to do their own credit work.

AM: ***Malaysia is transitioning to a point where within two years all unrated bonds will become freely-tradeable. It seems from the discussion already that there is a pretty rigid ratings focus from end-investors in Malaysia. Given that fact, how difficult is it going to be to ensure liquidity for these unrated bonds and, as a result, encourage unrated issuance to really grow?***

Chu Kok Wei, CIMB: The major investors for unrated bonds at the moment are predominantly banks, as well as some corporate loan investors. The tradeability of unrated bonds will certainly increase the opportunities for

THE PARTICIPANTS: (left to right) Khoo Boo Hock, vice president, operations, Credit Guarantee and Investment Facility (CGIF); Christian de Guzman, senior analyst, sovereign risk group, Moody's Investors Service; Nor Masliza Sulaiman, head of capital markets, CIMB; Chu Kok Wei, group head, treasury & markets, CIMB; Matthew Thomas, Asiamoney; Dr. Yeah Kim Leng, dean of business school, Malaysia University of Science & Technology (MUST); Goh Wee Peng, chief investment officer - fixed income, AmInvestment Management; Adam McCabe, head of Asian fixed income, Aberdeen Asset Management Asia; Wong Loke Chin, head of fixed income – regional, CIMB Principal Asset Management.

funds in this market, but whether their end investors allow them to start buying unrated bonds remains to be seen. Fund investors often impose a rating requirement here, but for banks it comes down almost entirely to the internal credit approval model. Funds are likely to move closer to the situation at banks at the moment.

Nor Masliza Sulaiman, CIMB: In the past two years, between 8.3% and 9.5% of all the Malaysian ringgit bonds issued were unrated. You can see an increasing trend towards unrated bonds and this trend is expected to gain momentum when unrated bonds become fully tradable in 2017. Currently, there is a premium priced in the unrated bond deals given that it is non-tradable and non-transferable and therefore appeals to a limited investor base. Although banks still dominate the unrated bond market, we have seen increased participation from other investors, typically those with deep pockets and those who do not require active trading on their portfolios.

Investors should not look at ratings as the sole basis for their investment decisions although they can be complementary to help provide investors with an independent view on the credit.

McCabe, Aberdeen: There is one consideration here. Those who currently hold the unrated bonds may be waiting for the day to come that they can start trading them, and then perhaps there will be some massive selling pressure in the market, as those holders wish to clean up their portfolios. The initial period might not be as smooth as one would like. But if you think pragmatically about it, for those investors who can buy these bonds there is going to a big opportunity because of the inefficiencies in the unrated market.

There is a chance that this move could actually encourage more issuers to get credit ratings. Because of the way mandates are focused on single-A credits and above here, at present, there is no incentive for issuers to get a triple-B rating. But when trading in the unrated market becomes more significant, some issuers will see the logic in getting a triple-B rating because it is likely to improve their pricing. Either way you look at it, this is a positive development.

Wong Loke Chin, CIMB Principal Asset Management: We have a team of credit analysts that can look at unrated bonds. But we need to consider: will information be forthcoming to all investors, including those who are not already invested in a bond yet? Wee Peng mentioned the TAQA decision before. We held some of those bonds after they made the decision to drop the rating. But after the RAM rating was removed, we asked the trustee for information on the company and the first question they asked us was: are you a bond holder? It is important that there is still information that is freely-available to those who do not hold the bonds now, but who may consider buying them in the future.

Pension funds and insurance companies may have the balance sheets to start buying unrated bonds in large size, but asset managers will be limited. We still need to get the clients to agree to go into unrated bonds, and that process is going to take a lot of time.

Goh, AmInvestment Management: It is important we educate our clients on the opportunities in the unrated market. We need to show that we can do a lot of the work inhouse and that our own valuations are worthwhile and can be used not just alongside credit ratings but, in some cases, in the place of credit ratings.

A major reason why asset managers did not invest in unrated bonds before was that these deals were not tradeable. We stand the risk of investors pulling out their money and us not being able to sell our holdings. That is going to change, and that greater flexibility is going to be a boon for asset managers.

The big corporations do not want to pay ratings fees. These household names are likely to be the first issuers to sell unrated bonds in any significant size and because they are so well known, they are likely to get strong demand. It is a good situation for investors, because some of the money that these issuers save by not paying their ratings fees can be returned to investors.

Dr Yeah, MUST: The bond market is too segmented at the moment. There have been many efforts to increase awareness of lower-rated credits. They have largely been unsuccessful. But this announcement could have a major impact. It is certainly a good step for the market.

AM: *Barclays has announced that it will add Malaysian shariah-compliant government bonds to its Global Aggregate Index on March 31, only days after this event. How much impact is this likely to have on demand for government bonds?*

Chu, CIMB: It is definitely a positive step. It is part of this increasing global acceptance of sukuk, which you can also see from a lot of countries deciding to issue sukuk in the international market. It is only natural that as sukuk supply increases, indices need to be updated to reflect that. The market has come a long way in that regard.

Particular credit must go to the government of Malaysia, which has persisted issuing sukuk for so many years despite the fact that the spreads can be 25bp higher than their conventional bonds. That is not rational for a normal issuer, but the government knows there are bigger issues at play here. This is fundamental in ensuring that the sukuk market here has developed strongly.

McCabe, Aberdeen: We are very happy to build our sukuk exposure in our portfolios. Malaysia is certainly leading the charge, as Chu rightly said. That is why it really helps funds like us to have a footprint in Malaysia. It helps us to participate in the growth of this market, and benefit from decisions on the ground as soon as they happen.

There is a sense, though, that you should be careful what you wish for. Many foreign investors will now be able to invest in government sukuk here, but these investors are often transitory. When something goes bump in the night, they can leave the market very quickly and, as a result, they can significantly increase volatility. We caution a lot of investors around the world in relying too much on indices because they are sitting alongside so many other investors that are there for exactly the same reason. There is a big risk to that sort of crowded market participation.

Wong Loke Chin, CIMB Principal Asset Management: A lot of investors will not be happy with the move because they have long enjoyed the yield pick-up compared to the MGS market. That spread differential is definitely going to tighten a lot, and we have already seen that start to happen. There is no spread difference at all in the short-end of the curve, and the spread in the 10 year part of the curve has tightened from 25bp to 20bp since the announcement. We expect spreads to continue to tighten further and further. ■