The Finance in the Capital Market and Credit Rating in Malaysia

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[Malaysia]

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1. Financial/ Capital Market in Malaysia

(1) General feature of the capital markets in Malaysia

The financial system in Malaysia before the Asian currency crisis strongly depended on the banking sector. Banking sector consist of commercial bank, merchant bank and discount house, and commercial bank account almost 80% of total asset of banking sector. On the other hand, market size of the equity market was relatively larger than that of other ASEAN countries. 707 companies were listed and market capitalization was 375.8 billion ringgit as at 1997. Regarding the corporate bond (Private Debt Securities: PDS) market, market size enlarged from the early 1990s through 1996 due to the expansion of the investment for the capital-intensive industry and infrastructure project. Under this situation, the first Malaysian credit rating agency Rating Agency Malaysia (RAM) was established in 1990. Then in order to deal with market expansion and promote sound market competition, second Malaysian credit rating agency Malaysian Rating Corporation Berhad (MARC) was established in 1995. Moreover, market infrastructure was also developed by the central bank (Bank Negara Malaysia; BNM). Namely the Bond Information and Dissemination System (BIDS) which is the database on ringgit debt securities were established in 1997.

After the crisis, finance sector reform was carried out under the strong initiative of the government. Commercial banks were reorganized including other financial institutions into 11 groups. In addition, banks became sensitive to a credit concentration risk which reflected prudential regulations such as the strict single customer limit. Moreover, driver of the economic growth turned into the consumption from investment and in accordance with this change, the presence of the service sector rose. As a result, the production structure of the banking sector shifted to working capital and the retail sector service namely housing loan, car loan and credit card business etc.

In the bond market, issuance of government bond increased due to expansion of government expenditure. On the other hand, regarding the PDS market, although many corporate bonds with bank guarantee was issued before the crisis, the ratio was decreased greatly after the crisis. As a result, the PDS market became the financial source of the long term capital for the firms which had high creditworthiness. Today, the market size of the Malaysian bond market is the third place next to Japan and Korea. In addition, the market size of the equity market also continues expanding, and as of 2009, 960 companies were listed and the market capitalization was 999.45 billion ringgit.

Meanwhile, the existence of the Islamic finance is very important feature of the Malaysian financial sector. Especially after the crisis, the government has made effort to develop the market, and today, Islamic debt securities (sukuk) count more than 60% of the outstanding amount of corporate bonds.

(2) Financial markets and corporate finance

Until 2008, the equity market was composed by the Main Board, 2nd Board and MESDAQ market which were high-growth and technology companies markets. From 2009, Main Board and 2nd Board are consolidated into Main Market, the MESDAK market extended the target company, and the name was changed to the ACE market. The number of listed companies and the market size are shown in Table 1 and Table 2. Main Market plays a role as the financing source for the big companies, and the ACE market plays a role as the financing source for the other high-growth and technology companies. The main sector which is issuing equities includes service and commercial sector, finance sector, consumer goods sector and plantation sector.

Table 1: Total Number of Listed Companies (as at 4 April 2011)

Year	Main Market *		ACE Market	Total
2011	840		114	954
2010	844		113	957
2009	844		116	960
	Main Board	Second Board	MESDAQ Market	
2008	634	221	122	977
2007	636	227	124	987
2006	649	250	128	1027
2005	646	268	107	1021
2004	622	278	63	963
2003	598	276	32	906
2002	562	294	12	868
2001	520	292	–	812
2000	498	297	–	795
1999	474	283	–	757
1998	454	282	–	736
1997	444	264	–	708
1996	413	208	–	621
1995	369	160	–	529
1994	347	131	–	478
1993	329	84	–	413
1992	317	52	–	369
1991	292	32	–	324
1990	271	14	–	285

Note*: Excludes ETFs and REITs

Source: Bursa Malaysia

Table 2: Market size of the equity market

	Turnover (million units)					Turnover (RM million)					No. of Listed Companies	Market Capitalisation (RM billion)
	Main Board	2nd Board	Main Market	ACE Market	Total	Main Board	2nd Board	Main Market	ACE Market	Total		
2000	66,326.10	9,082.60	–	–	75,408.60	211,806.10	32,248.20	–	–	244,054.30	795	444.35
2001	43,681.00	5,983.00	–	–	49,663.00	75,467.00	9,545.00	–	–	85,012.00	812	464.98
2002	47,024.30	8,193.30	–	–	55,630.20	102,566.40	14,171.90	–	–	116,951.40	865	481.62
2003	80,374.00	22,444.90	–	–	112,183.20	141,660.80	35,514.90	–	–	183,885.90	906	640.28
2004	78,131.30	18,515.80	–	–	107,610.20	180,408.30	24,948.00	–	–	215,622.80	963	722.04
2005	73,815.79	15,160.81	–	–	102,338.21	157,445.35	12,288.44	–	–	177,321.07	1021	695.27
2006	121,285.92	21,946.21	–	–	197,508.80	205,180.52	16,585.19	–	–	250,641.02	1027	848.70
2007	253,287.71	32,750.74	–	–	360,370.45	483,352.56	21,924.09	–	–	540,173.08	987	1106.15
2008	108,479.29	9,564.13	–	–	141,004.51	279,368.91	5,348.75	–	–	289,249.51	977	663.80
2009	127,379.78	10,407.31	72,224.75	7,150.60	234,256.32	156,470.26	3,787.47	114,645.01	1,704.51	280,022.53	960	999.45

Source: Bank Negara Malaysia

In the PDS market, as mention above, reflects that the ratio of bond with bank guarantee decreased after a crisis greatly and direction of the bank credit shifted to the working capital, the market becomes the financing source of the long-term capital of the issuers such as an infrastructure sector or the financial institution having high creditworthiness. Although the maturity is depend on the interest environment, the ratio of medium term note (maturity 1 to 5years) and long term bond have been increasing. On the contrary, issuing of the short term bond within one year is very limited generally. In addition, the corporate finance of the multinational enterprises such as the manufacturing industry relatively depends on internal reserves, and the medium and small-sized firms relatively depend on the borrowing from the development financial institutions (DFIs).

(3) Bond markets in Malaysia

(i) Regulatory agencies

Regarding the Malaysian bond market, central bank (Bank Negara Malaysia: BNM) and Securities Commission: SC are the regulatory agencies. BNM mainly relate to develop the market infrastructures and foreign exchange policies to facilitate cross border investment and market access. In addition, BMN licensed and regulated government securities dealers. With respect to the development of the market infrastructures, Automated trading system (Fully Automated System for Issuing/ Tendering: FAST), settlement system (Real Time Electronic Transfer of Funds and Securities: RENTAS) and computerized database (Bond Information and Dissemination System: BIDS) were developed by the BNM.

With respect to the SC, it was established on 1 March 1993 under the Securities Commission Act 1993 and became the main regulatory agency of the Malaysian capital market from 2000. Namely SC is approving authority for corporate bond issues, regulating all matters relating to securities and futures contracts. Moreover, The SC administers the Capital Markets and Services Act 2007 (CMSA), which governs the domestic corporate debt securities and corporate sukuk market. In addition, SC released Capital Market Masterplan (CMP) On 22 February 2001 which is 10-years (2001-2010) comprehensive plan to develop capital market. In CMP, there are six key objectives were identified. These objectives are that to be the preferred fund-raising centre for Malaysian companies, to promote an effective investment management industry and a more conducive environment for investors, to enhance the competitive position and efficiency of market institutions, to develop a strong and competitive environment for intermediation services, to ensure a stronger and more facilitative regulatory regime and to establish Malaysia as an international Islamic capital market centre. In order to achieve its objectives, the CMP sets out 152 detailed recommendations. Out of 152 recommendations, 17 recommendations were related to the Malaysian domestic bond market. As at end year of 2010, 95% of the 152 recommendations were successfully completed.

(ii) Market infrastructure and taxation

The issuing and auctioning of government and corporate debt securities are automated through the Fully Automated System for Issuing/ Tendering (FAST) which was upgraded to web-based application in 2005. The settlement of the primary and secondary market transactions in government securities and unlisted corporate debt securities are done by the Scripless Securities Trading System (SSTS), which is part of the Real Time Electronic Transfer of Funds and Securities (RENTAS) system established in 1999. Meanwhile, in order to enhance transparency of secondary market information, the Bond Information and Dissemination System (BIDS) was established in 1997. BIDS is a database on ringgit debt securities, providing information on the terms of issues, prices of trades, details of trades done including transactions on repo activities and relevant news on the various debt securities issued by both the government and the corporate sector. Financial institutions have the obligation to report into BIDS details of trade done within 10 minutes of execution.

Regarding the Taxation, in order to develop the bond market, several tax incentives were implemented. Tax treatment for issuers and investors are showed in Table 3.

Table 3: Tax treatment

For Issuers
Issuance for PDS are exempted from stamp duty
Tax deductions on expenses incurred in the issuance of sukuk
Exemption from stamp duty (All instruments for the purpose of securitisation and sukuk issuance approved by the SC)
Securitisation exempted from real property gains tax
Tax–neutral for the originator and SPV in a securitization
Tax deductions for SPV in a sukuk transaction
For Investors
Exemption on interest income from ringgit–denominated debt securities and sukuk
Exemption on interest income from foreign currency–denominated sukuk
No stamp duty on transfers of MGS, PDS and sukuk
No capital gains tax

Source: Bank Negara Malaysia and Securities Commission (2009)

(a) Government bond market

(i) Outline of the government bond market

In government bond market, four types of securities that Malaysian Government Securities (MGS), Malaysian Treasury Bills (MTB), Government Investment Issues (GII) and Malaysian Islamic Treasury Bills (MITB) are issued. MGS are interest bearing long-term bonds and likewise, in order to develop benchmark yield curve, original maturity is composed by 3-year to 20-year (3-year, 5-year, 10-year, 15-year and 20-year). MTB are short-term securities with original maturity of less than one year (3-month, 6-month and 1-year). GII and MITB are long-term and short-term non-interest bearing securities based on Islamic principles[1]. Original maturity of GII is more than three year (3-year, 7-year and 10-year), MITB is one year.

MGS were originally issued to meet the investment needs of the Employee Provident Fund (EPF) and domestic financial institutions, and used for public sector's development expenditure. MTB are used for government's working capital. GII and MITB are issued for Islamic banks to enable to hold liquid papers as well as the investment instrument for Islamic banks. According to the Bank Negara Malaysia (2007), the conventional securities and the Islamic securities differ only in its structure in terms of complying with Islamic principles in its issuance and Islamic government securities are similar to conventional government securities in terms of their effective cash flows, issuance structure, legal status in being a direct obligation of the Government, its holdings and nature of transaction as financial products.

[1] For details of the structure of Malaysian government bond market, see Bank Negara Malaysia (2007)

Regarding the composition of outstanding of the Malaysian government bond as at 31 December 2006, MGS account 88%, and follow GII=10%, MTB=1%, MITB=1%.

(ii) Primary and secondary market

Government bond is issued by market auction and private placement. MGS and GII are issued according to the issuance calendar which is released in December prior to the issuance year and contains the following information namely types of Government securities (MGS or GII), whether the issue is new or reopening, method of issuance (private placement or market auction) and month of issuance.

The participant of market auction is the Principal Dealers (PDs) and counterpart of the private placement is an identified institution approval from the Ministry of Finance. In addition, the central bank has the option to participate in MGS auction for the purpose of market operations. In the case of GII, all Islamic banks can participate to the auction. In the market auction, all bids are submitted by PDs via Fully Automated System for Issuing/Tendering (FAST) and if bids are successful, Real Time Electronic Transfer of Fund and Securities (RENTAS) system will allot the securities to the bidder and also settlement would be made automatically in this system. Primary investors of government securities are the Employees Provident Fund (EPF), Petronas which is largest petroleum company, financial institutions, insurance companies including Islamic insurers, asset management companies and other corporations.

With respect to the secondary market, government securities are traded in the secondary or over-the-counter market. All transactions are made through the Bond Information and Dissemination System (BIDS) and all trading in the OTC market are also captured by BIDS system. The settlement in the secondary market is made in Real Time Electronic Transfer of Fund and Securities (RENTAS) system. Repurchase Agreement (Repo) market is also developed.

(b) Corporate bond (Private Debt Securities: PDS) market

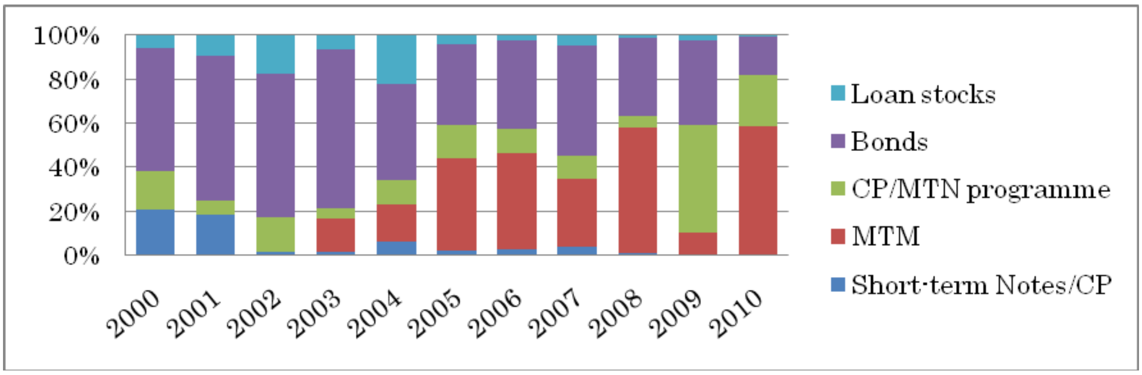
PDS market is governed by the Capital Markets and Services Act 2007 (CMSA) and guidelines; Guidelines on the Offering of Private Debt Securities and Guidelines on the Offering of Islamic Securities. Under these guidelines, issuer can issue the PDS more speedy because SC can give approval within a period of not more than 14 working days from the date of receipt of the application. In addition, by issuance of the Guidelines on the Offering of Private Debt Securities, examination system for the bond issuance was changed from Merit Base Qualification to Disclosure-Based regulatory: DBR regime[2].

[2] Under the Merit Base Qualification, issuer who met an industrial policy of the

Under the DBR regime, issuers can issue the bond when they disclose enough information the market and investors judge that issuers are worth to invest. Moreover, a requirement of the minimum credit rating was also dispensed. Thus, by implementing these policies, bond issuers became able to issue bonds on the market base condition.

Regarding the types of securities, following types of debt securities are issued namely straight bonds, Medium-term Notes (MTNs), Commercial papers (Cps), convertible bonds, bond with warrants and zero coupon bonds. Debt securities which listed on the exchange market are known as loan stocks. Besides these securities, Asset-backed securities (ABS), securities which issued by Khazanah Nasional Berhad, the investment holding arm of the government (Khazanah bonds) and securities which issued by Cagames Berhad, national mortgage corporation (Cagamas papers) are also issued. Excluding the Khazanah bonds and Cagamas papers, breakdown of the debt securities are shown in figure 1. From figure 1, the ratio of the straight bonds has been decreased.

Figure 1: Breakdown of the debt securities: conventional + Islamic

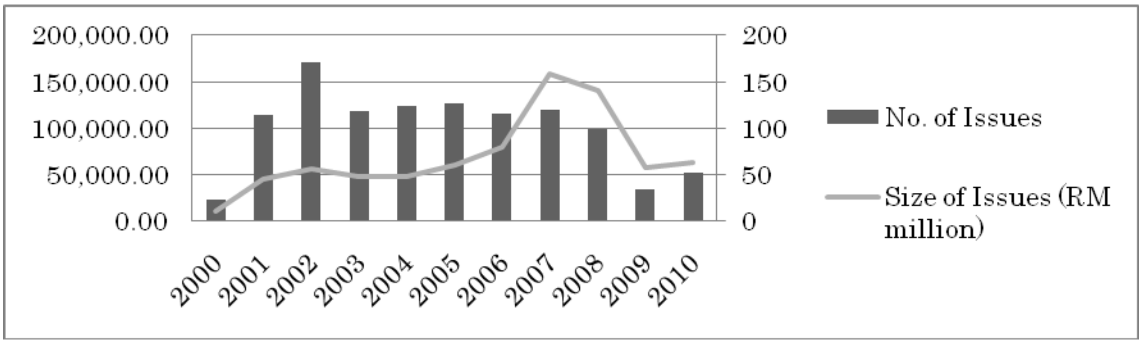


Source: Annual reports of Securities Commission.

The change of the PDS issuance is shown in figure 2. From figure 2, we can see PDS issuance had significantly grown from 2000 to 2007. According to the BNM's annual report, main factor of bond issuance is debt restructuring and refinancing before 2004 and after 2004, finance for the new business activity is driver for the market expansion. On the other hand, bond issuance is decreased from 2007 to 2009. This cause is effect of international financial crisis. In addition, decrease of lending rate of banks due to expansionary financial policy may be the one of the factors.

government was able to issue a bond.

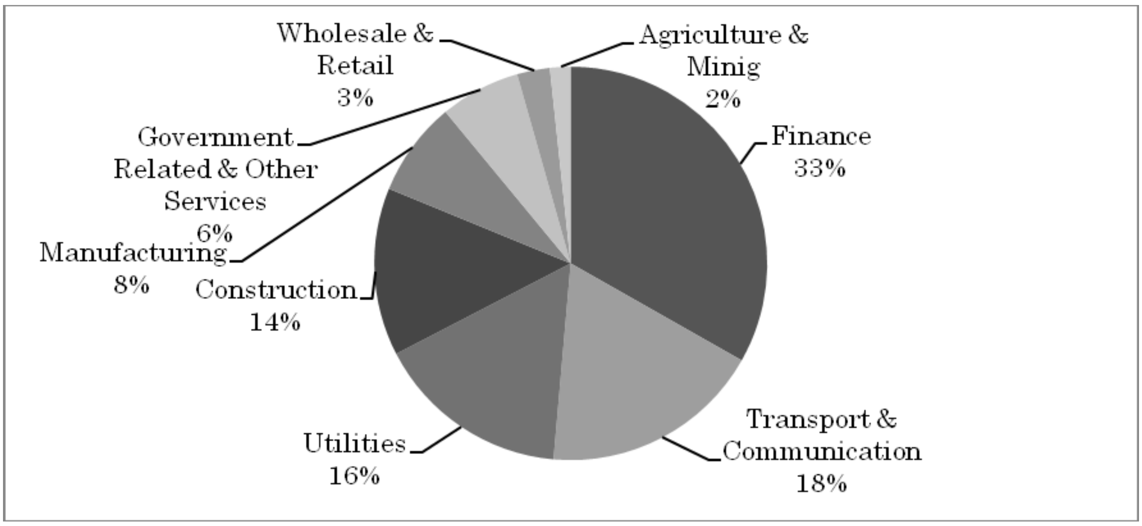
Figure 2: PDS Issues approved



Source: Annual reports of Securities Commission.

Regarding the bond issuer and investor profile, as see in figure 3, transport & communication, utilities and construction sector is main issuer and with respect to bond investor profile, institutional investors such as pension fund, insurance company and mutual fund are main investors. Among these investors, the ratio of the pension fund is high. In Malaysia, there are some pension funds such as Employees Provident Fund: EPF, Social Security Organization: SOCSO, Armed Forces Fund and Teachers Provident Fund, and EPF is the most important investor. Although it was requested that EPF applied more than 70% of investment by government bonds until the early 1990s, after that, the ratio has been decreased. Because asset of EPF is basically invested in domestic market, it can be guessed that the investment with the corporate bond has been increased. Based on the author's calculation, EPF hold the about 11% of the outstanding amount of the corporate bond as at 2006.

Figure 3: Bond Issuer profile: 2000-2008

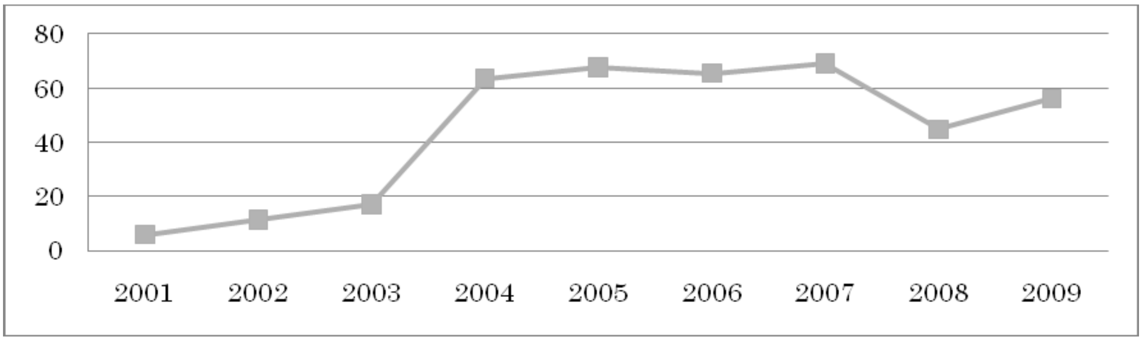


Source: Bank Negara Malaysia and Securities Commission Malaysia (2009).

Regarding the cross border investment, it was increased after 2004 because of market infrastructure development (Figure 4). For example, Bank Negara Malaysia liberalized its foreign exchange regulation on April 2004 which allowing multilateral development banks (MDBs) or multilateral financial institutions (MFIs) to issue Ringgit denominated bonds. Then on April 2005, foreign exchange administration rules further liberalized as income from investment in Ringgit-denominated debt securities is exempted from withholding tax. These liberalizations of the foreign exchange regulation may contribute to the increasing of the cross border investment. Although after 2007, the level is decrease temporary because of international financial crisis, it is recovered from 2008.

Figure 4: Cross border investment (Long-term debt securities)

(USD million)



Source: IMF: Portfolio Investment: Coordinated Portfolio Investment Survey (CPIS) Data - Geographic Breakdown Tables

(c) Corporate Islamic bond (sukuk) market

Malaysia is well known for the one of the most successful international Islamic financial center of the world. Malaysian government is eager to have developed the Islamic finance especially since Asian currency crisis. Indeed, as mention above, development of Islamic finance was one of the main objectives of the Financial Sector Masterplan, and also, in 2006, central bank released the policy of "Malaysian International Islamic Financial Center".

According to the Bank Negara Malaysia and Securities Commission (2009), sukuk are the financial document on certificate of equal value that represent an undivided interest in the ownership of an underlying asset, usufruct, services or investments in particular projects or special investment activities. Correspondent to this concept, sukuk are issued under the Islamic principles and concepts which comply with Islamic law Shariah. Shariah concepts and principles which applied to sukuk are showed in Table 4. Regarding the feature of sukuk, sukuk investors have some level protection which may not be available from conventional bonds because sukuk are backed by assets. On the other hand, sukuk have some similarities with conventional bond, in that they are similarly structured based on assets that generate revenue.

Table 4: Definition of the Shariah concepts and principles

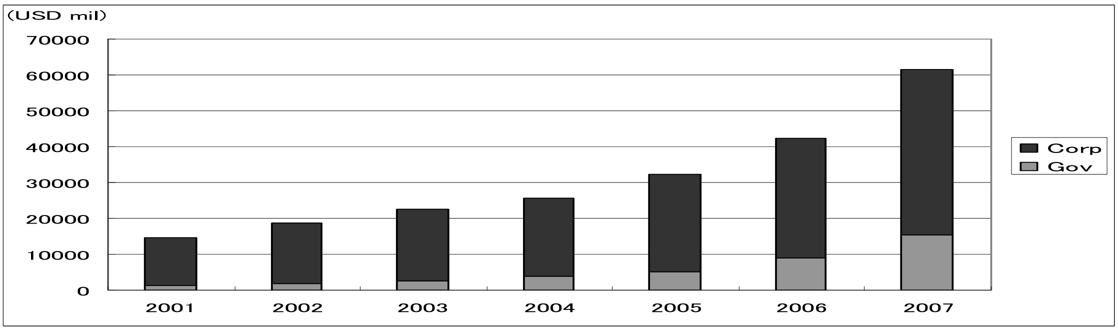
Musyarakah (Profit and Loss-sharing)	A partnership arrangement between two parties or more to finance a business venture, where all parties contribute capital either in the form of cash or in kind for the purpose of financing the business venture. Any profit derived from the venture will be distributed based on a pre-agreed profit-sharing ratio, but a loss will be shared on the basis of equity participation.
Mudharabah (Profit-sharing)	A contract between 2 parties to finance a business venture. The parties are a rabb al-mal or investor, who solely provides the capital; and a mudharib or entrepreneur, who solely manages the project. If the venture is profitable, the profit will be distributed based on a pre-agreed ratio. In the event of a business loss, it shall be borne solely by the provider of the capital.
Ijarah (Leasing)	A manfaah (usufruct) type of contract, where a lessor (owner) leases out an asset or equipment to its client at an agreed rental fee and pre-determined lease period upon the 'aqad (contract). The ownership of the leased equipment remains in the hands of the lessor.
Bai' Bithaman Ajil or BBA (Deferred-payment Sale)	A contract that refers to the sale and purchase transaction for the financing of an asset on a deferred and instalment basis, with a pre-agreed payment period. The sale price will include a profit margin.
Istisna' (Purchase Order)	A purchase contract for an asset, where a buyer will place an order to purchase the asset that will be delivered in the future. In other words, the buyer will require a seller or a contractor to deliver or construct the asset that will be completed in the future, according to the specifications in the sale and purchase contract. Both parties in the contract will decide on the sale and purchase prices as they wish, and settlement can be delayed or arranged based on the schedule of work completed.
Murabahah (Cost-plus Sale)	A contract that refers to the sale and purchase transaction for the financing of an asset, where the cost and profit margin (mark-up) are made known and agreed to by all parties involved. The settlement of the purchase price can be either on a deferred lump-sum basis or an instalment basis, which will be specified in the agreement.

Source: Bank Negara Malaysia and Securities Commission Malaysia (2009)

Correspond to the series of government's policies, presence of sukuk have been increasing. From figure 5, outstanding amount of sukuk have increased since 2001. Especially, corporate sukuk market expanded rapidly in comparison with that of government bonds. Moreover, with respect to the proportion between corporate sukuk and conventional corporate bonds, the ratio of sukuk have been increased steadily, and as at the December 2007, sukuk accounts for shares more than 60% in corporate bond market (Figure 6). In addition, Malaysian sukuk market marks a leading position in the world. From Table 5, the amount outstanding of sukuk in Malaysia dominates that of other countries.

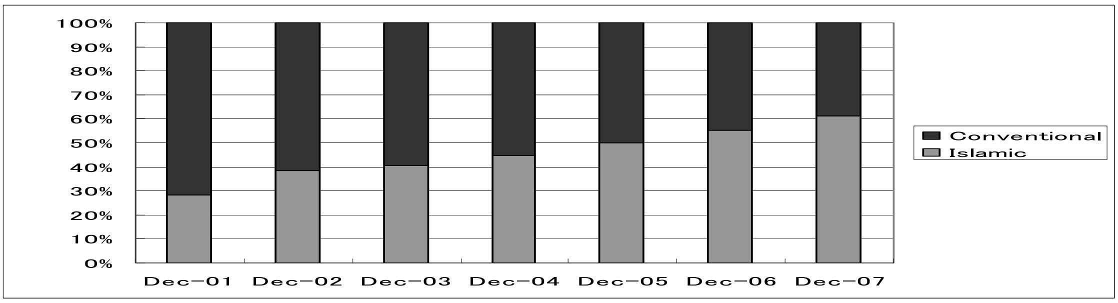
Figure 5: Change of the outstanding amount of the sukuk in Malaysia

(USD million)



Source: Asia Bond Indicator.

Figure 6: Ratio of sukuk among corporate bond markets in Malaysia



Source: Asia Bond Indicator.

Table 5: Leading sukuk issuing countries: 2007

(USD million)

Country	Government	Corporate	Total
Bahrain	617	400	1,017
Brunei Darussalam	222	—	222
Cayman Islands	—	100	100
Indonesia	81	113	193
Kuwait		993	993
Malaysia	3,777	22,752	26,529
Pakistan	339	725	1,065
Qatar	—	450	450
Saudi Arabia	—	4,350	5,683
Sudan	—	130	130
United Arab Emirates	3,425	7,292	10,717
Total	8,461	37,306	47,100
Percentage	18.00%	79.20%	

Source: Extracted from Askari et al. (2009), p22.

Regarding to the Issuer profile of corporate sukuk, as see in Table 6, sukuk are issued mainly by infrastructure & utilities, financial services, diversified holdings and property & real estate sector in value base. On the other hand, if we look in the number of issues base, industrial products sector can be added as a one of the main issuers.

Table 6: Corporate Sukuk issuer plofile as at December 2009

(%)

	by value	by number of issues
Infrastructure & utilities	47	24
Financial services	14	6
Diversified holdings	11	4
Property & real estate	9	15
Trading & services	6	7
Asset-backed securities	4	11
Industrial products	3	13
Construction & engineering	2	4
Mining & petroleum	1	2
Plantation & agriculture	1	9
Consumer products	1	1
Transportation	1	3
Public Finance	0	1
Total	100	100

Source: Islamic Banking and Finance Institute Malaysia, (2009).

With respect to the breakdown of the Shariah concepts for sukuk, Malaysian sukuk market started by Bai' Bithaman Ajil: BBA (Deferred-payment Sale) and variety of Shariah concepts which apply for the sukuk have been expanded (Table 7). Until 2003, Shariah concepts which are based of sukuk consist of the BBA, Murabahah (Cost-plus Sale) and Istisna' (Purchase Order). Then Ijarah (Leasing) scheme was introduced in 2004 and from 2005 sukuk which based on Musyarakah (Profit and Loss-sharing) and Mudharabah (Profit-sharing) were issued. This expansion of Shariah concepts for Sukuk may contribute to facilitate to bond issuing and market development. As at December 2009, the ratio of Musyarakah is highest (36%), and follows with Murabahah (27%), BBA (22%) in value base (Table 8). On the other hand, with respect to the number of issues base, the ratio of the Murabahah, BBA and Ijarah is high.

Table 7: Change of the Shariah concepts (value base)

(%)

	2001	2002	2003	2004	2005	2006	2007
BBA	77	67	40.8	56.88	36.3	6.2	2
Murabahah	10	33	12.7	38.27	33.5	9.4	19
Istisna'	13		46.5	2.8	14.5	2.1	9
Ijarah				2.05	2.9	4.9	11
Musyarakah					12.6	70	58
Mudharabah					0.2	7.5	1

Source: Annual reports of Securities Commission.

Table 8: Breakdown of the Shariah concepts for Corporate Sukuk market as at December 2009

(%)

	by value	by number of issues
Musharakah	36	11
Murabahah	27	34
BBA	22	29
Ijarah	8	20
Istisna	6	3
Mudharabah	1	3
Total	100	100

Source: Islamic Banking and Finance Institute Malaysia, (2009)

2. Credit Rating Agency

(1) Requirements for the credit rating agency

In order to be recognized as credit rating agencies (CRAs), applicant must meet criteria which are issued by SC in 2006; *PRACTICE NOTE issued pursuant to the Guidelines on the Offering of Private Debt Securities and the Guidelines on the Offering of Islamic Securities.*

Recognition criteria and important notices are as follows.

(a) Capital requirement and financial resources

- A CRA shall maintain minimum shareholders' funds of RM10 million at all times.

(b) Shareholding structure

- A CRA shall have an appropriate shareholding structure that will ensure and maintain its independence and objectivity in rating bonds.

(c) Rating methodology and process

- A CRA shall use established rating methodologies and processes that are robust, systematic and apply them consistently. Rating methodologies shall be modified and tailored for each type of bond and industry to which they are applied. A CRA shall, where relevant, incorporate corporate governance analysis into its rating framework to assess any impact on credit risks.

(d) Transparency and disclosure

- The rating reports shall contain all pertinent information with sufficient analytical depth both quantitative and qualitative.

(e) Independence, objectivity and conflict of interest

- Where the analyst or rating committee member, or any of his family member, has an interest in the bond issue, the analyst or rating committee member of a CRA shall not be involved in the rating and monitoring process or decide on ratings.
- A CRA shall establish appropriate policies and procedures governing investments in and trading of securities by its employees.
- A CRA shall disclose all material conflicts of interest to the public in its rating reports.

(f) Monitoring of bonds rated by CRAs

- A CRA shall conduct rating reviews of outstanding bonds and publish its rating opinions and reports on a timely and consistent basis. Rating upgrades and downgrades from a CRA shall be timely.
- A CRA shall initiate immediate review of rating status upon becoming aware of any information that may reasonably be expected to result in a rating action.

(g) Human resources and expertise

- A CRA shall have sufficient number of analysts who are qualified to carry out rating assignments and subsequent monitoring of the bonds.
- A CRA shall provide adequate training for its analysts and notify the SC of the training programs and continuing professional education programs that its analysts attended at the end of each calendar year.

(h) Operational requirements

- A CRA shall have adequate infrastructure to provide reliable bond rating services and maintain its credit rating operations and a CRA shall maintain internal records to support its credit opinions for a reasonable period of time or in accordance with applicable laws.

- A CRA and its staff shall maintain confidentiality of the information obtained from its clients in accordance with the confidentiality agreements entered into with its clients.

(j) Fit and proper requirements

- A CRA and every person who is, or is to be, a director, chief executive and key personnel of the applicant shall be fit and proper persons.

(k) Adoption of the International Organisation of Securities Commission's Code of Conduct Fundamentals for Credit Rating Agencies (IOSCO CRA Code)

- A CRA shall adopt the IOSCO CRA Code in its own code of conduct and disclose it on its website.
- Where the CRA's Code of Conduct differs in substance from the provision of the IOSCO CRA Code, the CRA shall explain where and why these differences exist, and fully disclose this on its website.

(2) General features of credit rating agencies

In Malaysia, there are two domestic credit rating agencies such as Rating Agency Malaysia Berhad: RAM and Malaysian Rating Corporation Berhad: MARC are operating. Outline of these agencies are shown in Table 9. Rating Agency Malaysia Berhad was established in November 1990 as a first Malaysian domestic CRA. Today, Rating Agency Malaysia Berhad has been operated as a subsidiary of the RAM Holdings and renamed to "RAM Ratings". Other than Rating Agency Malaysia Berhad, RAM Holdings hold subsidiaries such as RAM Ratings (Lanka) Limited, RAM Consultancy Services Sdn Bhd. Also, RAM Holdings has given technical assistance to Bangladesh's Credit Rating Information and Services Limited (or CRISL) and affiliate with Standard & Poor's (S&P). Share holders of RAM Holding are consisted of domestic financial institutions, Asian Development Bank (ADB) and Fitch Ratings.

Malaysian Rating Corporation Berhad (MARC) was established in October 1995 and began operation from 1996. Share holders of MARC are consisted of domestic insurance companies, stock brokers and investment banks. Also MARC is affiliate with Fitch Ratings.

Regarding the rating definition, both agencies use same ratings symbols in long term rating from AAA to D. However, RAM Ratings applies subscripts 1, 2 or 3 in each rating category from AA to C and MARC applies subscripts plus (+) or minus (-) in each rating category from AA to B. with respect to the short term rating, RAM categorized rating as P1, P2, P3, NP and D. MARC categorized rating as MARC-1, MARC-2, MARC-3, MARC-4 and D.

Table 9: Outline of the Malaysian domestic credit agencies

	RAM Ratings	Malaysian Rating Corporation Berhad (MARC)
Incorporation	November 1990	October 1995
Rating Portfolio	Local and foreign corporates, multinationals, banks, insurance companies, government-linked and other public-financed entities, myriad complex investment vehicles and the ringgit-denominated securities they issue, structured-finance transactions backed by receivables or other financial assets, and Islamic securities (commonly known as sukuk).	Corporates and corporate debt issues, including Islamic capital market instruments, asset-backed securities, as well as financial strength ratings of financial institutions and insurance companies.
Types of Services	Corporate Ratings, Project Finance Ratings, Structured Finance Ratings, Sukuk Ratings and Financial Institution and Insurer Ratings	Corporate Debt Ratings, Issuer Ratings, Islamic Capital Market Instrument Ratings, Asset-Backed Securities (ABS), Financial Institution Ratings, Corporate Credit Ratings, Insurer Financial Strength Ratings, Islamic Financial Institution Governance Ratings and Sovereign Issuer Credit Ratings
Mapping	Long-term (AAA, AA, A ,BBB, BB, B, C, D). Short-term (P1,P2,P3,NP,D)	Long-term (AAA, AA, A ,BBB, BB, B, C, D). Short-term (MARC-1, MARC 2, MARC-3, MARC-4, MARC-5)
Shareholders	Wholly owned by RAM Holdings Berhad. Ultimate shareholders of RAM Holdings comprise major financial institutions in Malaysia, Asian Development Bank and Fitch Ratings.	The major life and general insurance companies, stockbrokers and investment banks in Malaysia. Each shareholder owns no more than 4.9% equity in MARC.
Breakdown of shareholders	Affin Bank Berhad 3.6%	**Insurance Companies**
	Affin Investment Bank Berhad 2%	Berjaya Sompo Insurance Bhd
	Alliance Bank Malaysia Berhad 3.2%	BH Insurance (M) Bhd
	Alliance Investment Bank Berhad 2%	CIMB Aviva Assurance Bhd
	AmBank (M) Berhad 3.3%	Etiqa Insurance Bhd
	AmInvestment Bank Berhad 3.5%	Great Eastern Life Assurance (Malaysia) Bhd
	Asian Development Bank 4.9%	ING Insurance Bhd
	Bangkok Bank Berhad 0.8%	Jerneh Insurance Bhd
	Bank of America Malaysia Berhad 2.1%,	Kurnia Insurans (Malaysia) Bhd
	Bank of Tokyo-Mitsubishi UFJ (Malaysia) Berhad 2.1%	Lonpac Insurance Bhd
	Boon Siew Credit Berhad 0.3%	Malaysian Assurance Alliance Bhd
	CIMB Bank Berhad 14.425%	Malaysian Reinsurance Bhd
	Citibank Berhad 3.5%,	Manulife Holdings Bhd
	Deutsche Bank (Malaysia) Berhad 0.8%	MSIG Insurance (Malaysia) Bhd
	EON Bank Berhad 1.8%	Prudential Assurance Malaysia Bhd
	Fitch Ratings Limited 4.9%	
	Hong Leong Bank Berhad 4%	**Stockbrokers**
	HSBC Bank Malaysia Berhad 3.5%	AmSecurities Holding Sdn Bhd
	J.P. Morgan Chase Bank Berhad 1.3%	Hwang-DBS (Malaysia) Bhd
	Kewangan Bersatu Berhad 0.7%	Inter-Pacific Securities Sdn Bhd
	Malayan Banking Berhad 6.9%	JF Apex Securities Bhd
	OCBC Bank (Malaysia) Berhad 3.5%	Rashid Hussain Bhd
	Public Bank Berhad 5.325%	TA Enterprise Bhd
	RHB Bank Berhad 8.85%	
	RHB Bank Berhad (RMBB Assets) 1.2%	**Discount Houses**
	SIBB BERHAD 1.2%	Abrar Discounts Bhd
	Standard Chartered Bank Malaysia Berhad 3.5%	Investment Banks Affin Investment Bank Bhd
	The Bank of Nova Scotia Berhad 1.3%	Hong Leong Investment Bank Bhd
	The Royal Bank of Scotland Berhad 1.3%	KAF Investment Bank Bhd
	United Overseas Bank (Malaysia) Berhad 4.2%	Kenanga Investment Bank Bhd
		Maybank Investment Bank Bhd
		MIDF Amanah Investment Bank Bhd
		OSK Investment Bank Bhd
		Public Investment Bank Bhd
Histroy	RAM Ratings was established in November 1990 as Rating Agency Malaysia Berhad. On 1 July 2007, Rating Agency Malaysia Berhad became the one of the three subsidiaries of RAM Holdings and remaned to RAM Ratings. RAM Holdings have three main subsidiaries: RAM Ratings and RAM Ratings (Lanka) Limited (which provide credit-rating services in their respective markets), and RAM Consultancy Services Sdn Bhd (which supplies innovative risk-management solutions as well as strategic business and advisory services)	MARC was established in October 1995 and commenced operations on 17 June 1996. Then, officially launched on 5th September 1996 by the Deputy Prime Minister and Minister of Finance, Malaysia.

Source: RAM web site (http://www.ram.com.my/) and MARC web site (http://www.marc.com.my/)

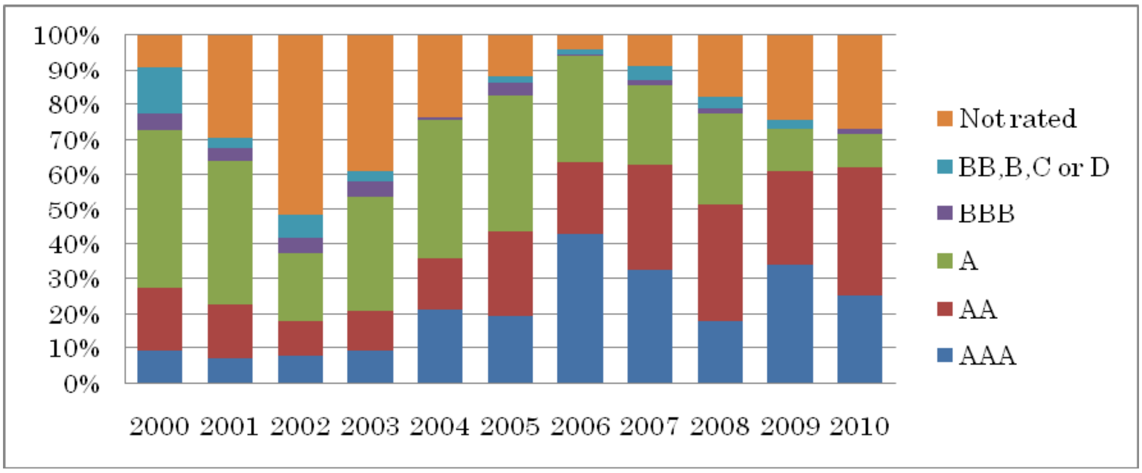
(3) Rating methodology

According to RAM's *Rating Methodology Corporate Credit Ratings* (2006), credit rating agencies consider following factors; industry risk, business risk, financial risk and management quality. For each factors, industry risk is evaluated by growth potential, vulnerability to industry factors, barriers to entry, threats of substitutes and level of competition. For estimation of business risk, the 2 areas normally covered, namely market risk which is consider basis of competition, market position and size, product/service diversity and customer analysis, and operating risk which is consider plant facilities and location, availability of raw materials, efficiency of assets, cost structure, labor relations, credit controls and inventory management. Financial risk is evaluated by profitability & coverage, funding structure, capital structure/leverage, cashflow stability and adequacy and financial flexibility & liquidity. Management quality contains following factors namely corporate goals & strategies, risk tolerance, financial policies, succession planning/family-owned outfit, credibility & integrity and other organizational considerations.

(4) Rating distribution

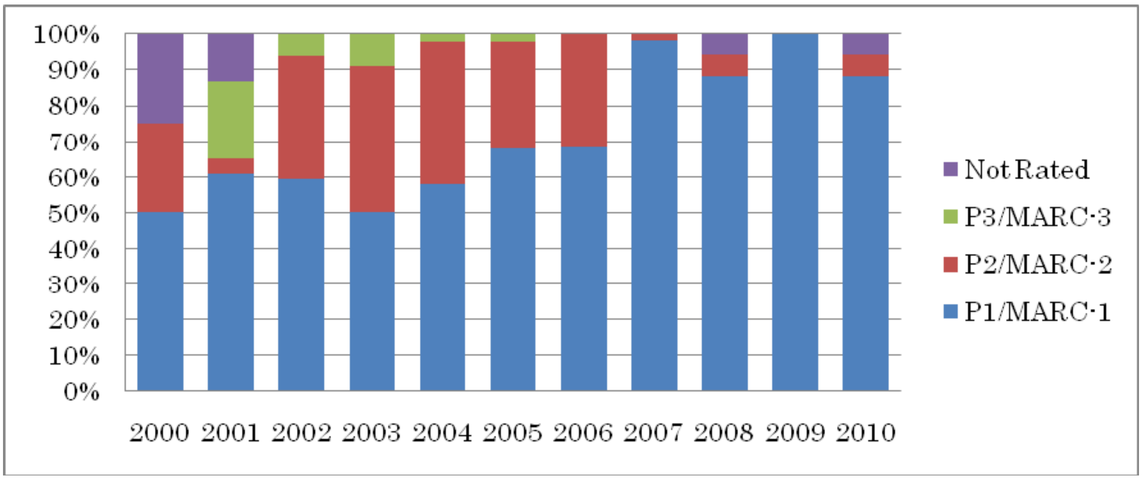
Regarding the long term rating, almost all rating consists of investment grade from AAA to BBB (Figure 7). In the first half of the 2000s, ratio of A is relatively high. Then after 2005, the tendency is observed that ratio of AAA and AA is increased. Simultaneously, ratio of the P1/MARC-1 has been increased in short term rating (Figure 8).

Figure 7: Rating distribution: Long term (No. of issues)



Source: Annual reports of Securities Commission.

Figure 8: Rating distribution: short term (No. of issues)



Source: Annual reports of Securities Commission.

(5) Default rate

As see in Table 10, from the RAM's data, although default rate is high in 1998 by reflecting Asian currency crisis, the level is low as a whole. With respect to that of MARC, the tendency is similar. However, the level in 2009 is higher than that of RAM. Meanwhile, when we see the proportion between investment grade (AAA to BBB) and speculative grade, default rate of the speculative grade is much higher than that of investment grade for both rating agencies.

Table 10: Annual corporate default rate

(%)

	RAM (1997–2009)	MARC (2001–2009)
1997	0.6	–
1998	8.8	–
1999	2.5	–
2000	3.6	–
2001	2.3	0.0
2002	0.0	0.0
2003	1.9	0.0
2004	1.1	0.0
2005	3.3	2.4
2006	0.0	1.0
2007	1.0	4.5
2008	1.1	1.8
2009	1.6	5.6
Total	1.9	2.5
Investment grade	0.7(*)	1.6(**)
Sepeculative grade	9.1(*)	12.5(**)

Note*: weighted average of 1992-2009

Note**: average of 2001-2009

Source: Rating Agency Malaysia Berhad (2010a) and Malaysian Rating Corporation Berhad (2010).

Then, when we see the relation between default rate and industry from Table 11 and Table 12, it is worth to attention that the default rate of industrial products is high for both agencies. This cause can be thought that industrial products sector is more affected by the change of economic environment in comparison with other sectors. Indeed, according to the MARC (2010), the level of default rate in 2009 was reflected by the economic recession from second half of the 2008 which affected global financial crisis. If we consider this situation, it can be said that the ratio of industrial products sector among issuer rated by MARC is higher than that of RAM. On the other hand, according to the RAM (2010a), main issuers rated by RAM are consisted of finance and infrastructure & utilities sectors. Therefore, we can say that RAM's annual default rate in 2009 was less than that of MARC.

Table 11: Default rates and distribution by industry (1992-2009): RAM

Industry	% of total defaults													1992−2009 (%)	Error margin (%)
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009		
Property & real estate	−	8	−	4	2	−	−	2	8	−	−	−	4	4.3	0.31
Industrial products	2	12	−	6	−	−	2	−	−	−	−	2	−	3.2	0.27
Diversified holdings	−	2	2	2	6	−	−	−	−	−	−	−	−	2.7	0.45
Trading & services	−	2	2	−	−	−	−	2	2	−	4	−	2	2.8	0.4
Financial services	−	2	−	−	−	−	2	−	−	−	−	−	−	0.3	0.13
Transportation	−	2	−	−	−	−	2	−	−	−	−	2	−	5.9	1.96
Infrastructure & Utilities	−	2	2	−	−	−	−	−	−	−	−	−	−	0.5	0.23
Construction & engineering	−	2	2	−	−	−	−	−	−	−	−	−	−	2.9	1.47
Plantation & agriculture	−	−	−	−	−	−	−	−	2	−	−	−	−	2.8	2.78
Overall	2	33	8	12	8	−	6	4	12	−	4	4	6	1.9	0.04

Source: Reproduced from Rating Agency Malaysia Berhad (2010a), p9.

Table 12: Annual corporate default rate by major industry: MARC

(%)

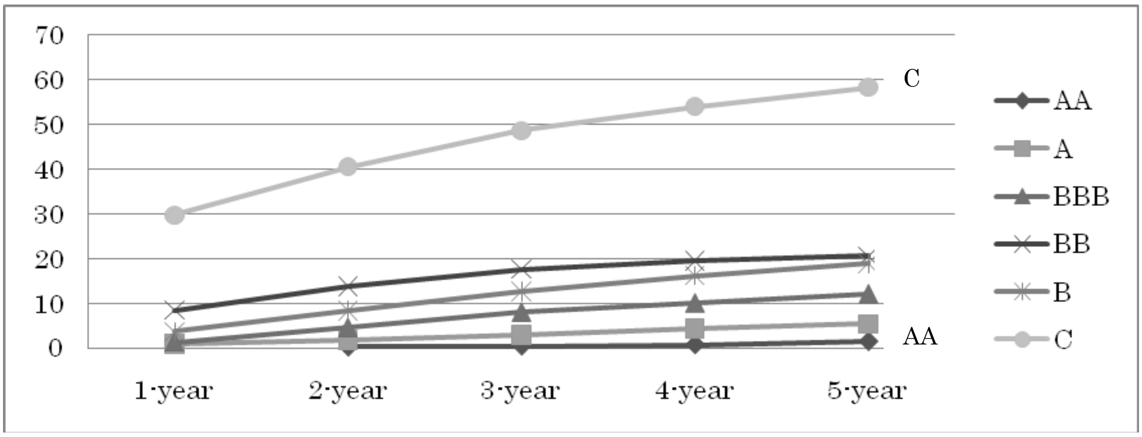
Sector	2001	2002	2003	2004	2005	2006	2007	2008	2009	Wtd. Average
Construction	−	−	−	−	−	−	12.5	−	−	1.9
Consumer products	−	−	−	−	−	−	−	−	−	0
Finance	−	−	−	−	−	−	−	−	−	2.2
Hotels	−	−	−	−	−	−	−	−	−	0
Industrial products	−	−	−	−	9.1	−	6.9	3.7	13	5.8
Infrastructure & utilities	−	−	−	−	−		4.2	−	−	1.3
Insurance company	−	−	−	−	−	−	−	−	3.8	0
Plantation	−	−	−	−	−	−	−	−	−	0
Property	−	−	−	−	−	5.6	5.3	6.3	−	2.4
Technology	−	−	−	−	−	−	−	−	−	0
Trading/services	−	−	−	−	−	−	−	−	9.1	1.8
All corporate	−	−	−	−	2.4	1	4.5	1.8	5.6	2.5

Source: Reproduced from Malaysian Rating Corporation Berhad (2010), p13.

(6) Cumulative default rates

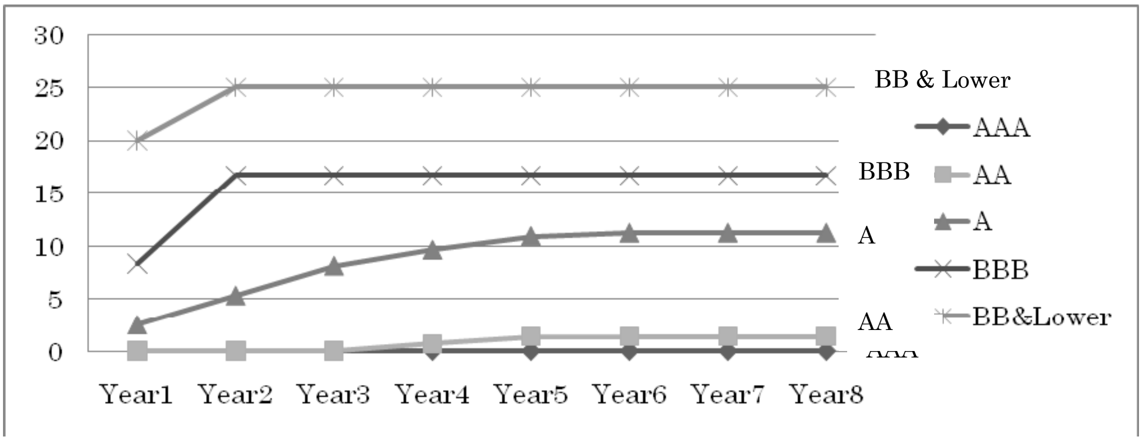
Regarding the RAM's cumulative default rates from one to five years, the high rating has low default rate, and a default rate is high in the low rating generally (Figure 9). However, when we see the BB and B, the default rate of B is lower than that of BB. It is explained that this cause is little number of the samples of low rating category. Meanwhile, MARC shows cumulative default rates from one to eight years, and basically the structure is almost same as that of RAM (Figure 10). However, it might be reflected it's shorter track record, distance between AA and A is broader than that of RAM and the rating of lower than BB is displayed in aggregate.

Figure 9: One to 5 year cumulative default rates (1992-2009):RAM (%)



Source: Reproduced from Rating Agency Malaysia Berhad (2010a), p10.

Figure 10: Cumulative default rates by rating corhort: MARC (%)



Source: Malaysian Rating Corporation Berhad (2010).

(7) Rating-transition matrix

When we see the data of RAM in Table 13, the one year rating sustentation rate is high in the high rating (AAA and AA) and that of MARC is also high (Table 14). Because ratio of AAA and AA rating bonds are high in Malaysian market, it can be thought that stable rating is given to the published bonds. In addition, rating-transition matrix of the Malaysian domestic rating agency is more detailed than that of other ASEAN countries. This might be relatively abundant samples and track records of Malaysian domestic rating agencies.

Table 13: Cumulative 1-year rating-transition matrix (1992–2009): RAM

%	AAA	AA1	AA2	AA3	A1	A2	A3	BBB1	BBB2	BBB3	BB1	BB2	BB3	B1	B2	B3	C1	C2	C3	D	NR
AAA	94.6	0.8		0.8																	3.9
AA1	3.9	90.6	2.2	0.6																	2.8
AA2	2.1	12.8	77.3	2.8				1.4..													3.5
AA3		1.3	7.6	81.3	1.6	1.9.	1.3			1.3			0.3				0.3				3.2
A1	0.4	0.4	0.4	8.1	75.3	3.2	3.9	2.1	0.4	0.7											5.3
A2		0.3	0.6	0.6	7.4	75.3	5.8	1.6	1.3							0.3				1.6	5.1
A3				0.8	1.6	7.5	64.6	6.3	3.1	3.5			0.8	0.4						0.8	10.6
BBB1	0.5		0.5		1.1	1.1	8.7	58.7	5.4	5.4	2.7		0.5	0.5						0.5	14.1
BBB2						0.7	3.5	7.8	62.4	9.9	4.3		2.8		0.7					0.7	7.1
BBB3				0.9	0.4		0.4	3.5	3.5	58.5	6.1	4.8	3.1	0.9		0.9			2.2	2.2	12.7
BB1									2.5	7.6	46.8	2.5	7.6	3.8			1.3		1.3	6.3	20.3
BB2									1.3	1.3	1.3	58.8	7.5	5.0		1.3			2.5	8.8	12.5
BB3						1.3				6.3	2.5	1.3	44.3	5.1	1.3	2.5	1.3	1.3	1.3	10.1	21.5
B1											1.8	3.5		66.7	1.8	5.3			1.8	3.5	15.8
B2													4.3		82.6	4.3				8.7	
B3													6.5	3.2		58.1	6.5		6.5		19.4
C1																	58.8			29.4	11.8
C2																				100.0	
C3																			36.8	26.3	31.6

Source: Reproduced from Rating Agency Malaysia Berhad (2010b), p23.

Table 14: 1-year migrations at modifier level 1998-2009

	AAA	AA+	AA	AA−	A+	A	A−	BBB+	BBB	BBB−	BB+	BB	BB−	B+	B	B−	C	NR	Default
AAA	93.3	0.0	1.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	5.7	0.0
AA+	7.1	89.3	0.0	3.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
AA	0.0	5.7	80.0	5.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	8.6	0.0
AA−	0.0	0.0	8.0	76.0	2.7	0.0	1.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	12.0	0.0
A+	0.0	0.0	0.0	8.4	72.3	6.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	10.1	1.7
A	0.0	0.0	0.0	0.6	6.1	74.0	5.5	1.1	0.6	1.1	0.0	0.0	1.1	0.0	0.0	0.0	0.0	7.7	2.2
A−	0.0	0.0	0.0	0.0	0.0	8.5	66.0	3.2	0.0	2.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	16.0	4.3
BBB+	0.0	0.0	0.0	0.0	0.0	0.0	25.0	50.0	0.0	6.3	0.0	0.0	0.0	0.0	6.3	0.0	0.0	12.5	0.0
BBB	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	50.0	16.7	0.0	0.0	0.0	16.7	0.0	0.0	0.0	0.0	16.7
BBB−	0.0	0.0	0.0	0.0	0.0	0.0	0.0	7.1	0.0	57.1	0.0	7.1	0.0	0.0	0.0	0.0	0.0	14.3	14.3
BB+	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
BB	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	33.3	33.3	33.3	0.0	0.0	0.0	0.0	0.0
BB−	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	62.5	0.0	0.0	12.5	0.0	12.5	12.5
B+	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	100.0
B	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	50.0	50.0
B−	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	16.7	66.7	0.0	0.0	16.7
C	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Source: Reproduced from Malaysian Rating Corporation Berhad (2010), p27.

3. The problems to be solved for the bond market development

As we having discussed, Malaysia has the most developed bond market among ASEAN countries. By tightened up the prudential regulations for banks, bond market has acted the role as the financial source of the long term capital for the firms. Also a series of the government policies supported for the expansion of the market size. Moreover, domestic credit rating agencies contribute for the market development by offering the appropriate credit risk information to investors.

However, in order to create more developed bond market, we can indicate a problem to solve. That is rating band is concentrated into AAA and AA, and it is very difficult for relatively high-risk issuers to issue bonds. Surely credit rating agencies give the appropriating rating ex-post. However, basically only a company had high creditworthiness issue a corporate bond. As mentioned before, main issuers of corporate bond are finance and infrastructure and utilities sectors which are relatively hard to be influenced by the change of the economic environment and the cash flow is more stable than other industrial sectors. Therefore, it is thought that these issuers' bond have tendency to get high rating while issuer of other sectors are hard to access the corporate bond market.

In order to facilitate to market access for the lower rated issuers, enhancement of liquidity is very important. If liquidity rises, investors can hold relatively high risked bond more easily. Moreover, to enhance the function of bond market as financing source for issuers, it is necessary to expand the investor base. In Malaysia, presence of pension fund as investors is high and it is difficult for investment in a high-risk corporate bond in nature. Therefore, by expanding investor base including the cross-border investment, the function as the financing source of the bond market is enhanced and financing cost of issuers will decrease.

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