

# RATING MALAYSIAN STATE GOVERNMENTS

## MARC RATING METHODOLOGY

### INTRODUCTION

This document sets out MARC's approach in assigning ratings to state governments in Malaysia. It provides an insight into the factors we take into consideration during the rating process.

MARC's credit rating of a subnational government represents our opinion of the subnational government's capacity and willingness to repay commercial debt obligations in full and on time. It reflects MARC's assessment of the state's capacity and willingness to honour senior obligations under financial contracts such as obligations under currency swaps, interest rate swaps, third-party credit guarantees or partial guarantees, liquidity facilities and similar products, given appropriate documentation and authorisation.

However, it is envisaged that this state rating methodology will be principally employed to support ratings assigned to state government-related entities (GRE) in the capacity of issuer or obligor in a structured transaction. This state rating methodology is needed to assess the state government's capacity to provide support. It will therefore complement MARC's GRE methodology which assesses the willingness of the government to provide extraordinary support to a GRE in financial distress.

We note the increasing trend of fiscally strong sub-national governments (which includes states, provinces and counties) in emerging economies looking to the capital markets to fund their infrastructure investment needs. We also note the significance of sub-national credit markets as a key component of the domestic capital markets in most developed economies. This state rating methodology may therefore be foreseeably used for assigning ratings to state government debt issuances in the less immediate future.



#### Contacts:

**Quah Boon Huat**  
Senior Economist  
[boonhuat@marc.com.my](mailto:boonhuat@marc.com.my)

**Nor Zahidi Alias**  
Chief Economist  
[zahidi@marc.com.my](mailto:zahidi@marc.com.my)

**+603 2082 2200**  
[www.marc.com.my](http://www.marc.com.my)

## ANALYTICAL FRAMEWORK

Similar to the rating of sovereign governments, the rating approach for state governments in Malaysia involves an analysis of relevant quantitative and qualitative factors. Quantitative analysis will involve, among others, macroeconomic analysis to assess the state's economic strength. Qualitative analysis, on the other hand, involves analyzing factors such as political dynamics that can affect the creditworthiness of state governments.

In formulating its state government credit ratings, MARC focuses mainly on structural issues impacting the credit fundamentals of the state government rather than on transitory changes in creditworthiness brought about as a result of economic cycles. This focus on structural issues is consistent with MARC's approach of assigning credit ratings 'through the economic cycle' rather than 'at a point in time'. At the same time, MARC's state government rating approach attempts to measure the shock absorption capacity of the state. While most information used in the rating process is historical, MARC does incorporate expectations for future performance, and this may drive the credit rating.

MARC's analysis focuses on the four broad rating factors listed in the table below.

Table 1: Rating factors for Malaysian state governments

Broad Rating Factors	Weightage	Indicators/Factors #
Economic strength	25%	<ul style="list-style-type: none"> <li>• Real GDP growth</li> <li>• GDP per capita</li> <li>• Economic structure</li> <li>• Population</li> <li>• Inflation</li> </ul>
Fiscal performance & condition	25%	<ul style="list-style-type: none"> <li>• Revenue/GDP (%)</li> <li>• Expenditure/GDP (%)</li> <li>• Fiscal balance/GDP (%)</li> <li>• Fiscal balance/Revenue (%)</li> <li>• Cash (incl. investments)/Total expenditure (%)</li> <li>• Cash (incl. investments)/Debt (%)</li> </ul>
Debt profile	25%	<ul style="list-style-type: none"> <li>• Debt/GDP (%)</li> <li>• Debt/Revenue (%)</li> <li>• Debt per capita</li> <li>• Debt service/GDP (%)</li> <li>• Debt service/Revenue (%)</li> </ul>
Political dynamics & other factors	25%	<ul style="list-style-type: none"> <li>• Federal-state relations</li> <li>• Alignment of federal-state policies</li> <li>• Border security</li> </ul>

# Note: Indicators/Factors used in the analysis may include but are not limited to those listed.

In MARC's assessment of a state government's creditworthiness, the eventual rating is a result of an interaction of multiple factors. No single quantitative or qualitative factor has an overriding effect. Depending on the unique circumstances surrounding each state, some factors can gain prominence over others. However, the level of transparency and disclosure of state-level quantitative data, particularly financial data, can pose challenges when analyzing state creditworthiness.

There are limitations on the authority of states to tax or to spend; there are also differences, such as those introduced by the 1963 amendment to the federal constitution to admit Sabah and Sarawak. While some states are able to raise

enough revenue to cover all expenditures, others need to depend on fiscal transfers from the federal government. While this is taken into consideration in MARC's state rating methodology, bail-out expectations are not a significant driver in its rating approach.

It is important to note that a sovereign rating provides the economic, fiscal and institutional context for a state rating because the state is affected by policies and regulatory frameworks decided at the federal level, e.g. fiscal and monetary policies, investment policies, etc. However, MARC does not equate its Malaysian state ratings with its sovereign rating on Malaysia.

## **BROAD RATING FACTORS**

### **1. Economic strength**

The economic strength of a state is the primary determinant of its ability to generate sufficient revenues to discharge its debt commitments. A state that has economic strength is one that is able to maintain long-term stability of its revenue structure in the face of economic cycles, job losses, and other negative economic conditions.

To assess the economic strength of a state, MARC looks at, among other things, how fast the economy is growing, whether growth has been stable, the economic structure, and drivers of economic growth. A state economy that has a good mix of economic drivers – e.g. manufacturing, services, wholesale and retail trade, agricultural, mining, government jobs – would receive a positive evaluation. On the other hand, a state that depends on a few dominant employers or industries would receive a negative evaluation as there is greater risk of overall poor economic performance that could put the creditworthiness of the state at risk.

MARC also takes into consideration the state's economy in relation to national and regional economies. A sustainable competitive and comparative advantage in a particular sector, for example, export-oriented manufacturing, is credit positive as it can be an important driver of economic activity and have meaningful long-term implications for state GDP growth.

Also taken into account is the state's growth potential, which is based on factors such as the state's resource endowments which include oil and gas, the extent to which it is strategically located, the quality of its business infrastructure and investments in the same, and the state government's ability to initiate policies to enhance the state's competitiveness. Some states have abundant natural resources, while others have to rely on sustainable competitive and comparative advantages in sectors such as manufacturing and services, as well as on the competence and innovativeness of local leaders. The demographic factor, with regard to population growth, density, the age distribution of the population and educational attainment, is also pertinent to the analysis of not only current but also potential economic strength.

## 2. Fiscal performance and condition

The success of a state's socioeconomic development efforts is directly linked to the availability and efficient utilization of its fiscal resources. Sound fiscal management is thus one of the keys to socioeconomic development.

MARC's analysis of a state's public finance is aimed at determining its fiscal performance and condition over time, and ultimately its fiscal sustainability, rather than its 'point in time' fiscal position, which is heavily influenced by cyclical factors. For example, the effectiveness of a state in balancing its budget cannot be determined by merely analysing fiscal data from a single year.

To assess the strength of a state's fiscal revenue, MARC examines the diversity and volatility of its revenue base, as well as whether revenue is recurrent or not. It looks at sources of revenue flows and overall growth trend, the number of years revenues declined, the largest one-year decline, etc. For example, a revenue base that is narrow, or a revenue flow that is volatile, is not viewed positively; neither is revenue that is non-recurrent. MARC also assesses the effectiveness of state revenue collection.

An important aspect is the degree of revenue flexibility. While a high reliance on fiscal transfers will be taken as an indicator of lower fiscal strength, predictability of intergovernmental transfers is important in that unpredictable intergovernmental fiscal arrangements add to uncertainty and risk. And as the type and amount of grants, e.g. capitation and road building grants, a state receives is determined by population and geographical size, MARC will take into consideration these important factors.

State government expenditure can take the form of current operating expenses, capital expenses and debt-servicing commitments. To assess a state government's ability to control expenses, MARC analyses, among other things, the composition of expenditure. For example, a state that has an inordinately large proportion of current operating expenses or debt-servicing commitments relative to its peers is given a negative evaluation.

MARC will investigate persistent operating budget deficits for mismatches between recurring revenue and expenses. It will also assess the state's ability to reverse the deficit through raising revenue or curtailing expenditures as opposed to borrowing to fund fiscal gaps, as well as the political will to rein in expenditure. To determine the reliability of a state's reported fiscal and financial performance, MARC will also pay attention to the rigour, transparency and the accountability in the budgeting and financial reporting process.

## 3. Debt profile

Public debt is an important measure to bridge a state government's financing gap. When used prudently, state public debt leads to higher economic growth, and helps the government to accomplish its social and developmental goals. It can add to capacity to service and repay external and domestic debt.

The analysis of a state's public debt profile is important as it would indicate the future debt-servicing capability and commitments of the state, as well as its financial flexibility. It enables one to determine whether, under current circumstances, there is risk of a situation arising that can hinder the state government's debt repayment or servicing efforts, or affect the sustainability of the state's fiscal position.

MARC's debt profile analysis takes into account common debt burden measures like debt principal relative to local GDP and debt per capita. Debt affordability is another important consideration. For example, in instances where interest payments exceed a sizeable portion of a state's revenues, the debt is likely to be unsustainable and a default of interest commitments likely in the event of a revenue shock. Besides that, high debt servicing commitments would reduce expenditure and fiscal flexibility. This is an important issue because unsustainable levels of debt that result in the allocation of resources towards debt servicing rather than development projects will have dire repercussions for the economy. Where data is available, MARC will examine the state's level of reserves and cash balance to address issues related to liquidity.

The state credit rating assessment will take into consideration credit support commitments for debt instruments of majority state-owned enterprises for which the state is or may become responsible. Contingent liabilities may arise as a result of debt issued by majority-owned enterprises which are perceived to benefit from a high level of implicit support from the state government.

Another important consideration in the credit rating assessment is the purpose of debt. Debt that has been deployed for augmenting productive capacity in the economy is viewed more favourably than debt geared towards meeting operating deficits or towards projects that are not economically beneficial.

#### **4. Political dynamics and other factors**

MARC's rating approach takes into consideration the state of relations between the federal and state governments as the former provides the ultimate source of financial, socio-economic, and security support. Factors such as the composition of the state's legislative body, and alignment of state policies with those of the federal government are assessed.

Another important consideration in MARC's rating approach is the credibility of the state government, including its attitude towards responsible and stable fiscal management, which may be complicated by changes in the balance of political power at the different tiers of the government (federal, state and local) and the personnel involved in policymaking.

In addition, qualitative issues like border security are also taken into consideration. So is geographical location within the region. For example, a strategically located state will be evaluated positively on account of its potential of becoming part of a regional growth triangle.

---

Disclaimer

---

Copyright © 2015 Malaysian Rating Corporation Berhad and any of its subsidiaries or affiliates ("MARC") have exclusive proprietary rights in the data or information provided herein. This document is the property of MARC and is protected by Malaysian and international copyright laws and conventions. The data and information shall only be used for intended purposes and not for any improper or unauthorised purpose. All information contained herein shall not be copied or otherwise reproduced, repackaged, transmitted, transferred, disseminated, redistributed or resold for any purpose, in whole or in part, in any form or manner, or by any means or person without MARC's prior written consent.

Ratings are solely statements of opinion based on information gathered and available in public and information obtained from ratees and other sources which MARC believes to be reliable and therefore, shall not be taken as a statement of fact under any circumstance. MARC does not and is in no position to independently audit or verify the truth and accuracy of the information contained in the report and shall not be responsible for any error or omission or for the loss or damage caused by, resulting from or relating to the use of such information. NEITHER MARC NOR ITS AFFILIATES, SUBSIDIARIES AND EMPLOYEES, GIVE ANY EXPRESS OR IMPLIED WARRANTY, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTY AS TO THE ACCURACY, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OR USE OF ANY SUCH INFORMATION.

A rating is not a recommendation to buy, sell or hold any security and/or investment. Any user of this report should not rely solely on the rating and analysis contained in this report to make an investment decision in as much as it does not address non-credit risks, the adequacy of market price, suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security concerned.

Ratings may be changed or withdrawn at any time for any reason at the sole discretion of MARC. MARC may make modifications to and/or amendments in this document including information contained therein at any time after publication as it deems appropriate.

MARC receives fees from its ratees, and has structured reporting lines and compensation arrangements for its analytical members in a manner designed to promote the integrity of its rating process, and to eliminate and/or manage actual and/or potential conflicts of interest.

MARC and its affiliates, subsidiaries and employees shall not be liable for any damage or loss resulting from the use of and/or reliance on this document produced by MARC or any information contained therein. Any person making use of and/or relying on any document produced by MARC and information contained therein solely assumes the risk in making use of and/or relying on such reports and all information contained therein and acknowledges that this disclaimer has been read and understood, and agrees to be bound by it.

---

© 2015 Malaysian Rating Corporation Berhad

Published and Printed by:

**MALAYSIAN RATING CORPORATION BERHAD** (364803-V)  
5<sup>th</sup> Floor, Bangunan Malaysian Re, No 17 Lorong Dungun, Damansara Heights, 50490 KUALA LUMPUR  
Tel: [603] 2082 2200 Fax: [603] 2094 9397 E-mail: [marc@marc.com.my](mailto:marc@marc.com.my)  
H-page : [www.marc.com.my](http://www.marc.com.my)