RATING METHODOLOGY

RATING MALAYSIAN STATE GOVERNMENTS

INTRODUCTION

This document, which sets out MARC's approach to assigning credit ratings to states in Malaysia, provides an insight into the factors we take into consideration. It supersedes the methodology for rating Malaysian state governments published in February 2015.

MARC's credit rating of a state represents our opinion of its capacity and willingness to repay commercial debt obligations in full and on time. It reflects our assessment of a state's capacity and willingness to honour senior obligations under financial contracts that include third-party credit guarantees or partial guarantees, liquidity facilities and similar products, given appropriate documentation and authorisation.

It is envisaged, however, 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 rating methodology is needed to assess the state government's capacity to provide financial support. It will therefore augment MARC's GRE methodology which assesses the willingness of the government to provide extraordinary support to a state government-related entity in financial distress.

We note the increasing trend of fiscally strong sub-national governments 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 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

Firdaos Rosli
Chief Economist
firdaos@marc.com.my

+603 2717 2900
www.marc.com.my

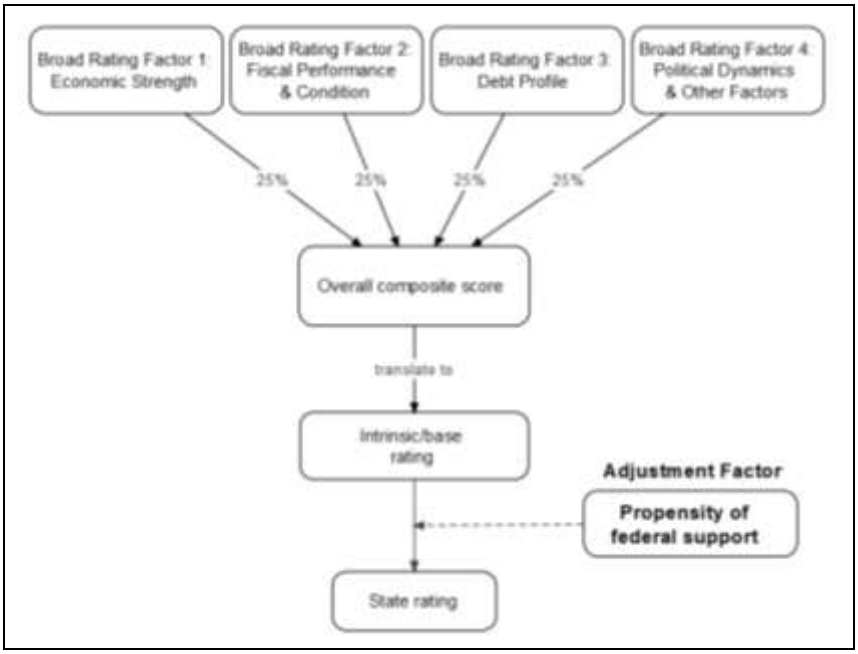
ANALYTICAL FRAMEWORK

In formulating state credit ratings, MARC focuses mainly on structural issues impacting the credit fundamentals of the state rather than on transitory changes in creditworthiness due to economic cycles.

The 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 rating approach attempts to measure the state's shock absorption capacity. While most information used in the rating process is historical, MARC does incorporate expectations for future performance based on current developments, and this may drive the credit rating.

Our analytical framework (Chart 1) focuses on four broad rating factors: a) economic strength; b) fiscal performance and condition; c) debt profile; and, d) political dynamics and other factors. The factors will be assessed using various metrics, each of which may in turn depend on several indicators. Each metric's indicators are scored individually on a scale from 1 (strongest) to 5 (weakest) and then averaged out to give the total metric score. We then average out the scores of all the metrics of each broad rating factor to develop its composite score.

Chart 1: Schematic of analytical framework



To get the overall composite score of the four broad rating factors, we calculate the average of their composite scores, which we then translate to an intrinsic/base rating. We arrive at the state's rating after adjusting – using the adjustment factor – for the propensity of federal government support, including the likelihood and timeliness of extraordinary financial support for states facing financial distress.

Given the current environment of rising volatility, uncertainty, complexity and ambiguity, we believe that the propensity of federal support has become an increasingly important credit factor.

BROAD RATING FACTORS

1. Economic strength

The economic strength of a state is the primary determinant of its ability to generate sufficient revenue 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 shocks.

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 a greater risk of overall poor economic performance that could affect the creditworthiness of the state.

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 – e.g. export-oriented manufacturing – is credit positive as it can be an important driver of economic activity with 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 resource endowments (e.g. oil and gas), as well as the quality of its business infrastructure and investments in the same. Some states have abundant natural resources, while others must rely on sustainable competitive and comparative advantages in sectors like manufacturing and services. Labour market and demographics – as reflected by labour participation and unemployment rate, population growth and density, age distribution, educational attainment and income level – are also pertinent factors for analysis.

2. Fiscal performance and condition

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 revenue 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. For states that are highly reliant on fiscal transfers, the speed and predictability of intergovernmental

transfers are important because unpredictability adds to uncertainty and risk. It is important to note here that Sabah and Sarawak enjoy some degree of self-autonomy under the Malaysia Agreement 1963. The ability, for example, to enact laws to impose sales taxes, which states in Peninsular Malaysia do not enjoy, is a strong credit support for both states.

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 will be 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.

3. Debt profile

Public debt, when used prudently, leads to higher economic growth and helps the government accomplish its social and developmental goals. In addition, it can add to capacity to service and repay debt.

The analysis of a state's public debt profile is important as this would throw light on its future debt-servicing capability and commitments, as well as financial flexibility. It enables one to assess the risk of a state government facing difficulties repaying or servicing debt, or its fiscal position turning unsustainable.

MARC's debt profile analysis takes into account common debt burden measures such as 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 revenue, the debt is likely to be unsustainable. A revenue shock could, for example, trigger a default of interest commitments. Besides this, high debt servicing commitments would reduce expenditure and fiscal flexibility in that it could result in resources being allocated towards debt servicing rather than development projects. As this will have repercussions for the economy, it will be viewed negatively.

Another important rating consideration is the purpose of debt. Debt deployed for augmenting productive capacity in the economy, for example, will be viewed favourably. On the other hand, those geared towards projects that are not economically beneficial will be evaluated negatively.

The state credit rating assessment will also 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 state government support.

4. Political dynamics and other factors

MARC's rating approach takes into consideration political dynamics, for example, the composition of the state legislative assembly and alignment of state-federal political agendas. The former is vital in that it can mean the difference between a stable and unstable state government. Meanwhile, state-federal political agendas that are in sync are credit positive for the state (as well as the federal government) as this promotes positive policy synergies that can improve economic and financial outcomes.

Another important consideration in MARC's rating approach is the credibility of the state government. This includes 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.

MARC's rating approach also takes into account issues related to environmental sustainability and social inclusion. For example, states that encourage efforts by the tourism sector to adapt to changing climate conditions and mitigate carbon emissions and pollution will be evaluated positively.

In addition, qualitative issues such as 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.

ADUSTMENT FACTOR – FEDERAL GOVERNMENT SUPPORT ASSESSMENT

This section explains how MARC assesses the propensity of federal government support, including the likelihood and timeliness of extraordinary financial support for states facing financial distress.

In Malaysia, the federal government has a strong constitutional mandate to limit and control states in the legislative, executive and financial fields with the exception of Sabah and Sarawak. It should thus come as no surprise that a big gap in revenue generating capacity exists between the federal and state governments. Consequently, states are generally dependent financially – with smaller and less economically productive states relatively more reliant – on federal support to meet social and developmental goals and responsibilities.

Given the current environment of rising volatility, uncertainty, complexity and ambiguity, we expect a higher propensity of federal support for poorer and less developed states. We think a higher propensity of support is necessary to ensure that the federal government can achieve its Shared Prosperity Vision 2030.

One objective of Shared Prosperity Vision 2030 is to address economic disparities across income groups, ethnicities, regions and supply chains, and ensure that no one is left behind. The propensity of federal support for states will depend on several factors that tie in with this objective. The assessment factors include the state's: (i) economic development, e.g. regional development ratio; and, (ii) human development indicators related to population trends, health outcomes, education achievements, and work and employment.

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MARC RATINGS BERHAD 202001041436 (1397757-W)
19-07, Level 19, Q Sentral, 2A Jalan Stesen Sentral 2, Kuala Lumpur Sentral, 50470 KUALA LUMPUR
Tel: [603] 2717 2900 Fax: [603] 2717 2920
E-mail: ratings@marc.com.my Website: www.marc.com.my