

RAM Bond Market Conference 2009

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YBhg Tan Sri Dato Seri Siti Norma

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Tan Sri-Tan Sri, Datuk-Datuk, distinguished guests

Assalamualaikum and a good afternoon to all

Thank you for the kind introduction. I am deeply honoured by the invitation extended for me to address this annual and important conference. We are, as you know, a very young organisation, just under six months into establishment. Being new, and being fairly unique, at least in the Malaysian sense, we do not have the advantage of any institutional memory or experience, and therefore have had to rely extensively on the experience of others in determining how to organise ourselves. We are a fairly unique entity in that this is the first time a financial guarantee insurer has been established in the country. In addition to being the first FGI, we are also unique in that, internationally, there have not been many financial guarantee insurers that focuses on guaranteeing corporate debt. So today I thought that I would attempt to share a little on some of the lessons that we've learnt or that we have discovered since the inception of Danajamin. By doing this, I hope that I will be able to shed some light on the background thinking of why we do some of the things that we do, and also perhaps give a sense of the underlying philosophy of our organisation.

As you will well know, financial guarantee insurers are not new. They have been a feature, albeit perhaps a somewhat obscure one, in the American bond market for approximately the last four decades. MBIA, one of the larger and more prominent FGIs, was founded 36 years ago in 1973, and had a relatively stable, profitable and generally non-plussed existence for much of that time. That is, until the credit crunch began two years ago. So for 34 years, it had uninterrupted profits—in 2006 it reported profits of \$800m against equity of \$7b, all generated with a staff force of just 300+ globally, but when the financial storm hit, the company promptly buckled. It lost its coveted AAA rating, claims arising from default on the underlying obligations that it had guaranteed shot through the roof, and without the gold-plating that a AAA rating bestows, no new business could be

underwritten. This is where they are today, prior to a restructuring plan that brings them back to their roots, and is being executed as we speak.

Closer to home, a regional FGI, funded by a consortium of private and sovereign-linked investors, was established in 1995 called Asia Ltd, headquartered in Singapore. Asia Ltd targeted BBB-type of credits throughout the region, and was itself rated A by the international agencies. Initial paid-up capital was \$150 million. Unlikely MBIA however, Asia Ltd had a very short history. Two years after establishment, the Asian financial crisis hit, and by January 1998, Asia Ltd had been downgraded from A to BB, from investment grade to junk, and was hit by fairly sizeable claim events, particularly in Indonesia, and was unable to raise additional capital and eventually had to cease writing any new business.

From these two case studies—and there are many more—a few important lessons can be found.

One, given the nature of the business model, risk management is of top priority and must be given top priority by all in the company. The FGI business model is, at the core, successful only if risks are priced appropriately, risks are mitigated properly, and only if the risks that you believe you are taking at the point of origination will in fact turn out to be the risk that you ultimately take over the course of the wrap. Going back to the example of MBIA, it was a large shift in the risk profile of its portfolio—now made very clear with hindsight—that ultimately caused its problems. MBIA had for a long time been an insurer of public finance type of liabilities—mostly tax-exempt municipal bonds. The name MBIA, in fact, originally stood for “Municipal Bond Insurance Association” and was founded by a group of four property-casualty insurance companies. Sometime earlier this decade, however, MBIA, along with most US bond insurers, shifted from public finance towards insuring structured finance liabilities, wrapping what was then thought to be highly-rated and therefore highly-safe mortgage backed securities. The subsequent implosion of the structured finance market ultimately brought down, without exception, all of the bond insurers (and of course, much of Wall Street as well). Asia Ltd, on the other hand, was caught with currency mismatches, when the currencies of all Southeast Asian countries devalued dramatically in 1997. The local-currency equivalent of the dollar liabilities that Asia Ltd wrapped became unserviceable by the underlying obligors. The takeaway of this

lesson is that risk management matters, both at the FGI, and also at the companies that we wrap. The FGI business model, like all financial institutions, requires top-notch management of risks of all types—not just credit risk at the micro level, but also management of macro-type of risks such as the overall composition of the portfolio and correlations between the constituents of the portfolio. Any failure of the business model ultimately comes down to bad decisions on risk-taking, so therefore, the risk management function must be one that is top-notch.

The second important observation is that capital matters and, and perhaps this is not appreciated well enough, who the providers of capital are matter even more. While Asia Ltd had perhaps the unlucky fortune of starting business in possibly the worse time, just as we were leading up to the Asian financial crisis, a time when credit was ample and guards were down, it ultimately suffered the double misfortune of being unable to raise capital at the juncture when it matters most and was needed most. It is absolutely critical for an FGI to have strong shareholders that are able to give the equity buffer necessary when the going gets rough and capital is called upon; capital needs to be available throughout the credit cycle, and not just when conditions are sanguine. I think this was demonstrated fairly well here this year, when capital raising by Malaysian banks were executed without any hiccups. In this sense, of course, we are fortunate that we are wholly-owned by the Malaysian government and at the onset, we already have built-in capital on call of RM1billion, in addition to the RM1billion already paid-in.

The third observation is that while leverage can wipe you out, too much leverage will definitely wipe you out. The US FGIs were 50-100 times leveraged; Asia Ltd was targeting 40 times leverage; an impending Asian Development Bank initiative, called the Credit Guarantee Investment Mechanism or CGIM, a supra-national sponsored FGI scheduled to come on-stream in the near future, is possibly targeting 20 times leverage. Targeting the appropriate level of leverage is one of the most important and most difficult tasks that an FGI will ever make. In keeping with the spirit of prudence, and going back to this thesis that we have no institutional memory and therefore should proceed with caution, we have taken what we believe is a fairly conservative approach: without delving into the details of how we arrived at it, our target leverage based on the total RM2 billion capital committed by the

Government will be up to 7.5 times. We are playing it fairly safe, and keeping our target leverage closer to levels that are adopted by Malaysian banks, rather than setting it high and possibly regretting it later.

Fourth observation, and this is less related to the experience of other FGIs but more so learning from the experience of other publicly funded and publicly owned institutions: corporate governance matters. Not what I would call “box-ticking” governance, but a full-blown governance infrastructure designed not just to prevent both over-concentration of power and authority but an infrastructure that supports, augments and complements the mission and objectives at hand. Not just approving authorities in the form of the board or board committees and the like, but committees that add value, that add the depth of collective experience and can provide colour to the issues at hand. Often times, when the question is asked why one public institution is deemed a success while others are not, the answer inevitably comes down to leadership and governance.

It is from these lessons and observations—and certainly there will be many more to be learnt as we progress—that we have attempted to design the establishment of Danajamin. Danajamin as the national financial guarantee insurer has two primary roles to play.

In the short term, we are tasked to ensure that deserving companies continue to have access to the capital markets. In a sense, we are a counterweight or a balance to any market dislocations that may occur. If and when they do occur, we will be ready to step-in in instances when private investors normally would, but now would not because of abnormal market conditions. In the medium term, our role is to attempt to reverse the gradual, but persistent, risk aversion that has permeated. Earlier in this decade, AAA and AA issuances comprised 40% of the market and single-A and lower rated credits formed the majority. Today, it is the complete opposite and more—the market, as we know, is dominated by AAA and AA issuances. We have not gone about it in a scientific way but anecdotally, speaking to a number of large bond investors in the market, most would tell us that their respective investment committees either are careful about single-As or will just not consider any single-A papers at all. This is a reflection of risk appetites on the supply side of credit; it is not a reflection of the distribution of companies that exist in the

Malaysian economy. Just taking Bursa Malaysia listed companies as a subset and running through the list, it will be immediately apparent that the vast majority of companies do not qualify for a AA rating. The conclusion therefore is that the vast majority of companies, even largish companies, have no access to the bond market today.

How do we propose to do this?

Our approach to underwriting credit is very much an approach that is “back to basics”, with a strong emphasis on the fundamentals of the company and the purpose of the financing. This approach is underpinned by firstly, Danajamin being established as part of the second stimulus package, and therefore giving priority to new and viable investments that provide positive knock-on effects to the economy and secondly, perhaps more importantly, the belief that providers of capital, any form of capital, have a responsibility in making informed judgements on the reasonableness and viability of any capital investment that it is proposing to finance. We strongly believe that it is only with such responsibility and oversight that the market will play the role that it should: the efficient allocation of capital from savers to investors.

In discharging this responsibility, there are three key areas that we focus intensely on: first, the intended purpose of the fund-raising. The intended purpose of the fund-raising must be realistic, must be reasonable and must fit into the business model of the company. The expected returns from the project or asset must sufficiently cover the cost of capital and the expected cashflow generated must be able to cover debt service obligations, both at the base case and on upon application of reasonable stressed assumptions.

The second area of focus is on the source of repayment. More often than not, there must a mechanism for channelling the cash being generated from the project or asset financed back to the original providers of capital, in particular senior debt capital. How this is achieved will vary from case to case, and from industry to industry. A fairly simple example would be where there is a single source of cashflow, i.e. a lessee or a contracted purchaser of the goods or services being provided. A mechanism for capturing this single source of cashflow would be built in to the terms and conditions of the guarantee. Less

obvious would be where the sources of revenue are numerous—e.g. a fast moving consumer goods company. In this instance, we would look at reserve account mechanisms to channel the cash generated back to the providers of capital.

The third area of focus would be on the structure of the bonds to be guaranteed. We would look at matching tenors with cashflow, the design of financial and non-financial covenants appropriate for each transaction, each company and each industry, and, this is very important, at avoiding **effective** subordination to other providers of capital.

What these three areas of focus provide is a certain expectation—or level of risk—that the obligations that we wrap will be repaid from the so-called “first way out.” The emphasis at the onset is to structure transactions such that the “first way out” will have a high probability—we understand that there is no such thing as certainty in finance—of indeed being the way out. The corollary to this is of course that there is less focus on security—or the second way out—at the onset and for most of our transactions, the only security that we ask for is the asset that we are funding.

These are the three key principles by which we (both at management level and amongst the board members) approach each and every underwriting proposal that is considered at the point of origination.

Our work of course does not end at origination. Credit is not static and invariably will change over time, sometimes for the better and sometimes for the worse. Our approach to this is to ensure that there is rigorous and continuous monitoring of the credit at all times—both at ends of financial periods when financial statements are produced and also in between—always finding out how the business is doing, and where circumstances have changed, adapting appropriately to the change.

I thought I would round off this speech by throwing out some ideas, some of which are new and some have been around but continue to remain just ideas, which would be useful in taking forward our credit markets. There are many of course, but for today, I will throw out, for good measure, just three:

- i) Corporate Governance. One of the more challenging aspects of the Malaysian market has been governance. Sifting through the data of investment grade defaults, it is clear that a substantial number of defaults have arisen from lapses in governance, or more specifically, arising from conflicting interests between controlling shareholders and both creditors and minority shareholders. It would be therefore useful if there is greater clarity in the fiduciary duties of directors, and that there is distinction between what those fiduciary duties are ordinarily and during periods of distress. While ordinarily, the fiduciary duties of directors should be to act in the best interest of shareholders, a shift in the fiduciary duty towards acting in the best interest of creditors during times of distress, as is practiced in the US, would shift the burden of responsibility onto the directors in protecting the interest of creditors.
- ii) The ability to transfer credit risks efficiently. Credit default swaps do not have a very good reputation right now. David Einhorn last week called them “anti-social”. Warren Buffett called them and derivatives in general “time bombs”. Notwithstanding, the need to transfer risks efficiently persists, especially for an organisation like ours and for many buy-side institutions. In practice, we can only transfer risk in, not out, which is not the ideal situation. It is somewhat akin to building a city with only dead-end roads; the traffic will inevitably clog up after a while. Some system-friendly, non-combustible solution must be found for this and the credit markets will be better off if one can be found.
- iii) Dual ratings. Internationally, investment grade companies tend to have at least two ratings from the agencies. We believe that this would be good for the market as multiple opinions are better than one; that is after all how markets function well, by having the collective opinion of all participants. We should find a way to incentivise this to happen.

Thank you very much.