Emergence and Development of Credit Ratings in Bond-funded Companies of Mongolia

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〈 Abstract 〉

Bond financing is one of the most applied financing methods in developed countries and its repayment guarantee is assessed and evaluated by credit rating organizations. This is an activity aimed to reduce a risk of investors and to increase their trust toward debt financing and the evaluation itself is based on the internationally accepted techniques.

While a bond financing process along with its rating has evolved in USA since the late 19th century, it has only taken shape in Japan since 1970's.

Mongolia gained opportunities to develop stock market from 1990s, but lately, over a year and half, there are no companies that have issued new bonds in Mongolia. This stagnant situation is occurred due to the lack of repayment guarantees for long-term borrowings and absence of credit ratings. Hence, it is deemed necessary that Mongolia has to introduce and use the internationally accepted credit rating techniques adapted to the specific country conditions.

Key word : Bond, Assessment, Solvency

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I. Introduction

Under the market economy, many entities of different forms of properties were established and a competition at the market is increasing significantly. One of many new activities introduced in business environment was issuance of corporate securities. The financial market situation where banking sector was singlehandedly carrying the burden of the financing needs for Mongolian companies is changing and shifting toward more optimal structure of fundraising. Along with the development of the stock market through which many companies issuing stock securities and bonds, the Government of Mongolia has issued bonds numerous times to finance its grand-scale projects and programmes.

Solvency is the most important issue for both investors and companies that have financed or are seeking for debt financing. Accordingly the credit rating for the bond issuers is a necessary step toward creation of more efficient capital market. In overall, there are 13 companies in Mongolia that have issued their bonds for debt financing (refer to Table 3 for total corporate bond trading statistics in Mongolia).

The bond financing activities are shaping up very slowly in Mongolia and major reason for this is a lack of credit rating for corporate bonds /probability of default defines the payback guarantee of securities/. The situation where not a single issuance of bond by Mongolian companies in 2013 and 2014 shows that the investors see uncertainties in bond payback and hence decline in faith. It relates to unstable political, socio-economical and legal environments as well. Therefore, it is necessary for us to see how the developed countries succeeded in the past in developing, nurturing and maintaining the trusted environments and how the system of credit ratings evolved to be today.

Studies on valuation and ratings:

Solvency assessment of the debt is performed by a Credit rating agency. The Big Three Credit rating agencies are Moody's, Standart and Poors (S&P) and Fitch Group. These three agencies hold a collective global market share of more than 90%.

There are several agencies such as Rating and Investment information center (R@I), Japan Credit Rating Agency (JCR) and San Goku Jimu in Japan. In most cases, bond rating agency perform an evaluation by the request of the issuer of bonds and inform the public of the results only on authorization of the issuer.

An attempt is made in the present communication to assess the development of corporate bond in US, Japan and Mongolia. Attempt will also be made to provide possible solutions to the hurdlers financing, market facing to the bond siltation in Mongolia.

II. Emergence and Development of Corporate Bond Valuation: in USA

In most books it is noted that the Bond valuation in USA was established in early 20th century. But in fact Dun & Bradstreet traces its history back to July 20, 1841, with the formation of The Mercantile Agency in New York City by Lewis Tappay, later called R.G. Dun & Company. The company was formed to create a network of correspondents who would provide reliable, objective credit information. In 1933, Dun merged with competitor John M. Brad street to form today's Dun & Brad street as it was parent company of today's "Moody's". Based on the fact, trade credit rating was indeed in place in 19th century.

"Poor Publishing" company traces its history back to 1860, with the publication by Henry Varnum Poor of History of Railroads and Canals in the United States. This book compiled comprehensive information about the financial and operational state of 120 U.S. railroad companies and considered to be the first magazine issued by the rating company. In other instance, Jonh Moody (1868-1958) first started bond evaluation assessment. In 1909, the new manual called "Moody's Analyses of Railroad Investments" is published and it quickly found a place in investors' hands. Most researchers consider it the first valid guideline for the valuation. Poor publishing company started using its rating symbols from 1922 and merged with Standard Statistics, which begun its valuation in 1924, in 1941 to form S&P company. Fitch has started its valuation service in 1924 as well.

By the end of 1920s, the most companies which issued bonds on the market were covered by the credit ratings. But investors paid less attention. This situation is changed suddenly due to New York stock market collapse on 24 September 1929, the beginning of world economy collapse.

More than 30 percent of bonds defaulted on payback and only those companies, which evaluated highly by Credit rating companies such as Moody's, were able to repay. As a result these Credit rating agencies received recognition by the investors. Meanwhile McFadden Act limited banks to establish their branches in other states, effectively curving the ability of banks to provide full financing and encouraging companies to go for bonds. It in turn, raised the necessity of more reliable rating of bonds and credits.

In addition, the financial control agencies such as the Office of the Controller of the Currency (OCC), Federal Board of Revenue (FBR). Federal Deposit Insurance Corporation (FDIC) and National Association of Insurance Commissioners (NAIC) started using services of Credit Rating companies. For instance, OCC developed the policy to prohibit banks to purchase corporate bonds not rated by no more than 2C by rating companies and any member bank of the FBR is prohibited to invest in to a corporate bond with lower than grade 4 (BBB and above), the standard set in 1957.

Ⅲ. Emergence and Development of Corporate Bond Valuation: in Japan

Bond market and bond rating process was established and developed in Japan since 1970s. After intensive economic growth in 1960s, the necessity of limiting bond financing for the companies is seen contradictive to a sense of market economy. Before this period, the system that obliged banks to bear the default risk and limit the company risk was operational. But companies recognized that it is cheaper to get financing directly from the market than to get financing from banks. Thus the most of companies preferred to issue bonds and follow the competitive nature of the market.

In 1973 the Mitsubishi company issued the first unsecured bond called "Temporary mortgage" bond which has resulted a debate whether Japanese bond market is needed unsecured debt issuance, among securities and financial market activists. This has directly led to a importance of protection of investors and a need of credit rating such that implemented by the Western countries. Since 1980s corporate bonds in Japan started to take many varying shapes and forms becoming greatly flexible securities.

In May 1984, USA-Japanese joint committee introduced its report "on ratio of American dollars and Japanese yen, banking, financial and capital investment market issues" where USA requested of Japan to open up the market to gain access and direct and indirect involvement of international investors to Japanese financial market. Report findings significantly influenced Japanese capital market to become more flexible and competitive, toward free market orientation. In 1985, Japanese financial group NIS, Government of Japan sponsored Japanese Bond Research Institute (JBRI) and Japan Credit Rating Agency were established. Moreover, services of Moody's and S&P of USA introduced to the Japanese market.

Ⅳ. Emergence, Development of Corporate Bonds in Mongolia and Valuation Status

Evaluation in stock market of Our country is below $2 billion. Number of registered companies (336 registered companies) is few, capacity is small, and the biggest companies are in metallurgy and mining sector. Top-20 registered companies in Mongolian Stock exchange takes 86% of all market evaluation. Mongolian Stock exchange average turnover per day is $200,000 which is compared to similar countries with lower turnovers. This small amount of turnover is sensitive from change of global stock flow and appetite of financial risks. In the other hand, the main issue is that Top-20 index of Mongolian Stock exchange has no paying capacity. /World bank, Organization of vice president of financial and private sector development in Southeast Asia. Financial Sector Assessment Program Development Module-2014/

<Table 1> Eurasia Competitiveness

Countries	Levels /139 countries/	Development of financial market	Regulation of the Securities Exchange	Regulation of the Securities Exchange
Armenia	98	110	121	121
Azerbaijan	57	71	103	103
Georgia	93	108	124	124
Kazakhstan	72	117	119	119
Kyrgyzstan	121	111	132	132
Moldova	94	103	116	116
Mongolian	99	129	129	129
Ukraine	89	119	127	127

Source /Global Competitiveness Report 2014. The World Bank /

A bond trading process in Mongolia has officially initiated on 25 October 1996 with Government bond trading. While the Government of Mongolia started to issue bonds in 1996 for purpose to finance its budget deficit, the activity since drastically increased and in 2011 alone the Government bond trading took place 14 times to finance 65.0 bln tug "Long-term loan Program for 4000 public staff housing" and 171.1 bln tug "Small and medium enterprise support program for wool, cashmere and other industries", with total numbers of 2.4 mln bonds sold.

The first corporate bond trading was organized on 8 June 2001, with so called "New century" bond from "Construction Corporation" company. Since then, there were 19 bln tug worth of trading on the primary market, by 13 companies, of which most of them are from construction industry. In addition, four of those companies were the limited liability companies indicating that even limited companies can get cheap financing via bond market. Government bond maturities are from 3 months up to 5 years and the yields ranging from 5.4% to 14.5%. From 2011 Government has started trading bonds with maturity of longer than 1 year, only.

For the corporate bonds, the maturity were in the range of 8 months to 2 years with yields of 16.2% to 21.6% (monthly 1.35% to 1.8%).

In 2012, there was 1 government bond trading on the primary market and 1 on the secondary market where 7.5% 5 bonds with face value of 100,000 tugs each, and maturity of 366 days were sold for total of 525,000 tugrugs.

There were no trading on the primary bond market of Mongolia in 2013 and 2014 (refer to Table 3 for trade in volumes and years).

V. Conclusion

Bond financing in U.S has a history of more than 100 years and Credit Rating agencies were established based on investors' demand for comprehensive, accessible information on debt risk and rating.

Japanese bond market emerged strong due to the companies preference for the cheap, unsecured debts and Japanese-American governmental level joint effort to increase market access to the international investors and rating agencies. The bond rating history of Japan for the last 40 years has witnessed contributions from both private sectors and the government.

The financial market situation where banking sector was singlehandedly carrying the burden of the financing needs for Mongolian companies is changing and shifting toward more optimal structure of fundraising. However, the shift is very slow, especially in recent years where there were no single corporate bond trade on the capital market for the last year and a half.

One of the main reasons for the situation is a loss of the faith by the investors and a lack of credit rating for corporate bonds.

It is deemed necessary that Mongolia has to introduce and use the internationally accepted credit rating techniques adopted to the specific country conditions.

Recommendations

The credit rating is a source of valuation information fully independent from a bond issuer, a management and investors.

The debt principal and interest repayment probability estimation is based on professional studies and proprietary know-hows (international credit rating organizations).

The ratings by the professional agencies reduce "information costs". Information collection, analysis, and risk valuation requires time and cost. Focused specialized rating specific to the company and country conditions and available to the public allows cost reduction. The rating company is a unit that produces valuation information that enables efficient and effective market system.

Credit rating to be addressed within Government policy frame, similar to Japanese case, is crucial in support of private sectors seeking alternative financing and investors seeking to reduce their risks, ultimately contributing to more advanced financial market.

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Appendices:

<Table 1> Total corporate bond trading

BOND ISSUING COMPANY	BOND ITEM	TRADED BONDS (pcs)										TOTAL TRADED BONDS (pcs)	TOTAL AMOUNT OF PRICE (MNT)
		2001	2002	2003	2004	2005	2006	2007	2008	2011	2012		
“Barilga Corporation“ JSC	New century – 210	120.000	174.347	180.969	34.450	23,752	50					533,568	5,335.680.000
“Niislel urguu“ JSC	Niislel urguu	-	43.425	25.140	-	30.181	7,106	84.148				240.000	1.200.000.000
Puma group	Puma bond	-	-	-	3,429	46.571	50.000					100.000	1.000.000.000
ＭCS Electronics Co., Ltd	ＭCS Electronics bond/MNT/	-	-	-	7,272	-						7,272	872,640.000
ＭCS Electronics Co., Ltd	ＭCS Electronics bond /USD/	-	-	-	5.000	-						5.000	605.000.000
Anod bank	Anod bond	-	-	-	5,973	12.186	2.790					20.949	209.490.000
Altan Hot corporation Co., Ltd	Ikh barilga		99.493	199	-	-						99.692	996.920.000
“Gobi“ Corporation	Gobi	.	.	.	-	100.000						100.000	1.000.000.000
Ikh barilga project Co., Ltd	Ikh barilga project	-	-	16.000	10.000	-						26,000	1.300.000.000
“Moninjbar“ JSC	Buteen baiguulalt	-	-	-	-	37,147	12,853					50,000	500.000.000
Monfresh juice Co.., Ltd	Monfresh bond /USD/							15.692				15,692	182,811.800
“Ｍｏn Inj Bar“ Co., Ltd	Buteen baiguulalt	-	-	-	-	-	-	-	50.200			50.200	502,000.000
“Just Agro“ Co.., Ltd	Mongol makh									439.454	500	439.954	4.399.540.000
Secondary market		433	250	25.096	3,030	5,528	26.490	34,362			30.473	125.662	1.504.608.845
TOTAL		120.433	317.515	247.404	69.154	305.365	00.280	134.202	50.200	430.454	30.073	1.813.080	10,608.000.645

(Source: Financial Regulatory Committee report 2013)

<Table 2> Total bond trading in volumes and in years

Year	Trading days	Volume (thous.pcs)		Total value (ᴛ ln.tug)				
				Total	Daily average	By types purchased investors		
		Total	Daily average			Commercial banks	Companies	Individuals
2007	55	134.2	2.4	850.0	15.5	_	225.0	625.0
2008	1	50.2	50.2	502.0	502.0	502.0	-	-
2009	-	-	-	-	-	-	-	-
2010	-	-	-	-	-	-	-	-
2011	14	439.5	31.4	4,394.5	313.9	2,000.0	-	2,394.5
2012	6	30.9	5.2	309.6	51.6	-	266.3	43.3

(Source: Annual report of Mongolian Stock Exchange)