Rating Research Services

Executive Comment:

Taiwan's International Bond And Financial Debenture Markets Could See Higher New Issuance Volume In 2014

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Taiwan Ratings Corp. believes the new issuance volume in Taiwan's bond markets could slightly increase in 2014 compared to 2013. This is supported by a number of factors, including the higher issuance of financial debentures for Tier II capital recognition following the low base last year, stable funding needs in the corporate sector, and the expectation of a potential interest rate rise amid the improving macro economy. Our assessment of stable-to-positive issuance momentum in Taiwan's bond markets also takes into consideration our belief that international bond issuances by domestic and foreign entities will continue to grow, particularly after the amendment to Taiwan's Insurance Act. However, ample market liquidity in Taiwan and alternative funding from bank borrowing could partly offset the potential for growth in new bond issuance. In the first half of 2014, New Taiwan dollar (NT$) 375 billion of new bonds were issued in Taiwan's bond markets compared to NT$286 billion and NT$631 billion in the first half of 2013 and full-year 2013, respectively.

In our view, many corporate issuers could continue to launch non-rated bonds throughout the rest of 2014, though most of these issuances will still have bank guarantees or investors will reference issuer ratings. Since the regulator removed the requirement for issue ratings in corporate issuance in August 2013, most local investors have used issuer ratings as proxies for issue ratings, or some investment guidelines are non-specific as to whether the ratings are issuer or issue. Nonetheless, we believe that investors should understand the clear and important distinctions between the two rating types.

Overview:

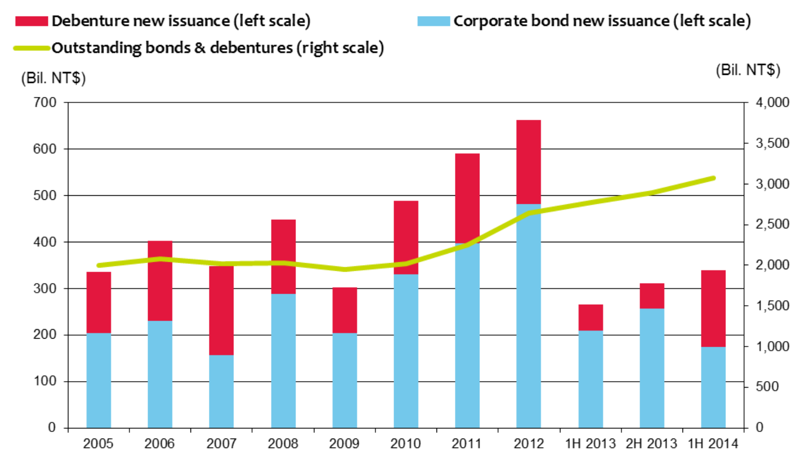
- Taiwan's new bond issuance volume is likely to post slight growth in 2014, particularly as a result of increasing financial debenture issuance to satisfy their Tier II capital requirement, as well as growth in international bond issuance.
- Higher-rated corporate bonds may not dominate the market by volume in the coming year due to a growing amount of unrated corporate bond issuance following deregulation in 2013.
- Credit spreads are likely to narrow under the improving global economic outlook, but more slowly because local investors remain risk-adverse.

In our opinion, credit spreads (the yield difference between five-year non-Taiwan government and government bonds) are likely to narrow in 2014, underpinned by a more stable economic outlook. However, the still risk-adverse nature of investors could slow the narrowing of credit spreads over the next few quarters. Moreover, we expect the Taiwan government benchmark rate to climb in conjunction with rising global bond rates, albeit to a lesser extent, leading to a rise in borrowing costs for issuers over the next few quarters.

The Issuance Of Financial Debentures Surges In The First-Half Of 2014

We believe that financial debentures could be the one of the key drivers behind overall growth in new bond issuance in 2014. The volume of debenture issues surged over 150% year on year in the first half of 2014, mainly due to a lower base in 2013, when the impact of Basel III led banks to focus more on their Tier one capital ratio enhancement (see chart 1). The strong issuance volume in early 2014 primarily resulted from banks' refinancing needs for debentures issued over the past five years that are about to be amortized under rules on Tier II capital recognition. The regulatory required Capital Adequacy Ratio (CAR) for banks also supports the strong issuance of financial debentures in 2014, because debentures are eligible capital under the CAR calculation. The minimum regulation CAR ratio for Taiwan's banking sector was 8.0% over the past three years, which will rise to 8.625% in 2016, 9.25% in 2017, 9.875% in 2018, and 10.5% in 2019.

Chart 1
Issuance Volume In Taiwan's Straight Bond Market (Corporate Bonds & Debentures)



Note: Excludes the New Taiwan dollar (NT$) & foreign-denominated bonds issued in Taiwan by foreign institutions, and includes the NT$ & foreign currency-denominated bonds issued in Taiwan by domestic banks and local branches of foreign and mainland Chinese banks. Source: Taiwan's central bank.

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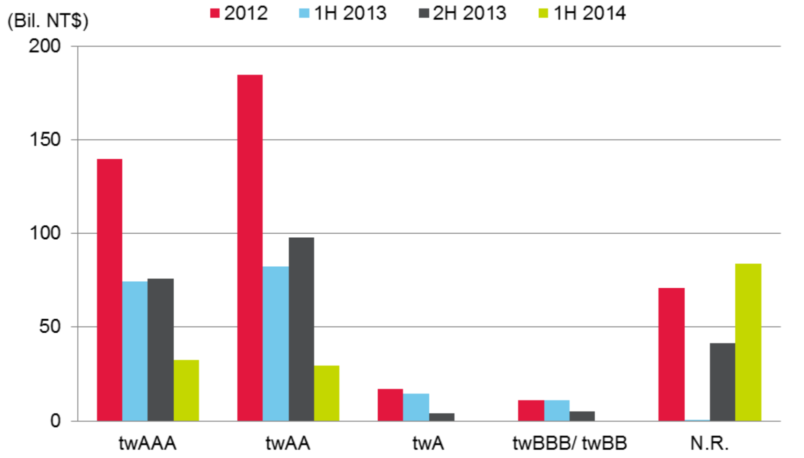
We expect the volume of new corporate bond issuances in Taiwan to remain largely unchanged in 2014 from 2013, despite a moderate drop in the first half of 2014 compared with the same period a year ago. Domestic bond issuance is dominated by several large corporates that will likely continue to seek funding sources to support their business expansion programs in the coming year and to take advantage of an improving economic outlook at home and abroad. Corporates may also choose to lock-in the prevailing low borrowing costs given the market's expectation of gradually rising interest rates that could accompany economic recovery. Nonetheless, it is possible that ample market liquidity in Taiwan and alternative funding from bank borrowings could partly offset potential growth in new bond issuance.

Higher-Rated Corporate Bond Issuances May No Longer Dominate

In our opinion, the removal of the regulatory requirement for an issue rating on corporate bonds could boost the issuance of non-rated corporate bonds in the coming years. Non-rated corporate bond issuances represented about 57% of total bond issuances in the first half of 2014, which is far higher than the level in the second half of 2013. However, Taiwan Ratings had assigned issuer ratings of 'twAA-' or higher to over 65% of the corporates issuing the non-rated bonds (see chart 2).

Chart 2
Corporate Bond Issuances By Rating Category

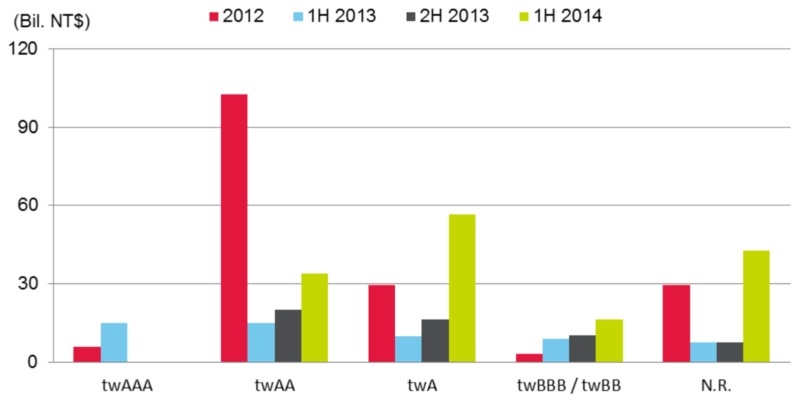


Note: Data include all publicly offered corporate bonds issued by domestic issuers. NR includes issuances without ratings or not rated by Taiwan Ratings Corp. Source: Market Observation Post System, GreTai Securities Market, Taiwan Ratings Corp. © Taiwan Ratings Corp. 2014

We believe there is an important distinction to be made between an issue and issuer rating, despite the fact that most local investors use issuer ratings as proxies for issue ratings, or some investment guidelines are non-specific to whether the ratings are issuer or issue. In short, an issuer credit rating generally indicates the likelihood that a company may default with regard to all its financial obligations, whereas an issue rating is based on a blend of default risk and the priority of a creditor's claim in bankruptcy associated with the specific debt being rated (see Related Research).

Taiwan Ratings assigned issue ratings at 'twAA-' or above on about 43% of the corporate bonds and 23% of debentures it rated in the first half of 2014. This includes bonds with strong creditworthiness issued by **Taiwan Power Co., China Steel Corp.,** and **Bank of Taiwan** (see charts 2 & 3). Interestingly, while higher-rated bonds have tended to attract more investor interest, the issuance of lower-rated ('twBBB' and below) financial debentures, as well as lower-rated ('twBBB' and below) and non-rated corporate bonds surged in the first half of 2014, and represented about 44.72% of total bond issuance. However, the majority of these bonds either carried bank guarantees or were linked to higher issuer ratings.

Chart 3
Financial Debenture Issuances By Rating Category



Note: Data include all publicly offered financial debentures issued by domestic issuers. N.R. includes issuances without ratings or not rated by Taiwan Ratings Corp. Source: Market Observation Post System, GreTai Securities Market, Taiwan Ratings Corp. © Taiwan Ratings Corp. 2014

Foreign-Currency Bonds May Boom Following Regulatory Changes

We believe there is growing interest among domestic corporations with offshore operations, as well as overseas-based entities to issue foreign-currency denominated bonds (also known as international bonds) in Taiwan. This follows an amendment to Article 146-4 of the Insurance Act (effective June 2014) and allows life insurance companies to exclude their investments in international bonds when calculating their maximum permitted total foreign investments. Most life insurance companies operating in Taiwan have approached their foreign investment cap of no higher than 45% of total funds. We expect the regulatory amendment to spur interest among insurance companies to invest in the international bond market. International bond issuances in first half of 2014 totaled about NT$35 billion, far higher than the issuance level of NT$21 billion for the same period in 2013. The issuance amount has surged further since the June 4th amendment. Most international bond issuers are international financial institutions and over 80% of those issuing new bonds in the first eight months of 2014 carry Standard & Poor's ratings of 'A-' or above. Some of the major issuers include **Standard Chartered Bank (Taiwan) Ltd.**, **Morgan Stanley**, and **Société Générale**.

New Convertible Bond Issuance Is Unlikely To Grow In 2014

We expect convertible bond issuances in full-year 2014 to remain on par with the level in 2013, irrespective of the relatively high Taiwan Stock Exchange Weighted Index. The increasing equity value of large-capitalization corporations has been the primary driver behind the rising stock index over the past few quarters, while the equity price of most small-to-mid size enterprises--the key convertible bond issuers--has remained relatively flat. This means no major change in the attractiveness of convertible bonds and no significant drop in the likelihood that investors could increase their returns by converting their bonds to equity. This is evidenced by the similar volume of new convertible bond issuance in first half of 2014 to that in the same period of 2013 (see chart 4).

Chart 4
Taiwan's Convertible And Exchangeable Bond Market

Source: GreTai Securities Market and Market Observation Post System.
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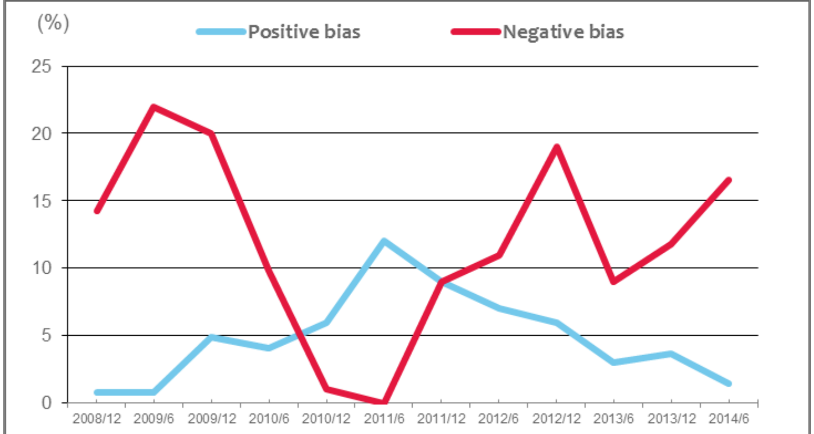
Negative Rating Bias Should Lessen In The Second-Half Of 2014

We expect the negative rating bias in our rated pool to decrease in the second half of 2014, from a relatively high level as of the end of June 2014, because we have recently removed some of the ratings from CreditWatch with negative implications and assigned a stable outlook. The recent high negative bias of 16.5% is not related to the state of the global economy, but mostly reflects the merger and acquisition plans that may impair the creditworthiness of certain financial institutions, as well as a weakening in the credit profile for the Formosa Plastics group (see chart 5). More than 80% of our ratings carried stable outlooks at the end of June 2014, reflecting our expectation that the global and local economies will continue to recover gradually throughout the rest of 2014. This is despite Standard & Poor's Rating Services decision on June 9, 2014 to revise downward its baseline forecast for GDP growth in Taiwan's trade-driven economy to 3.5% in 2014 from 3.7 previously, due to the delayed rebound in the U.S. economy.

Chart 5
Rating Bias Of Taiwan Ratings' Issuer Rating Pool

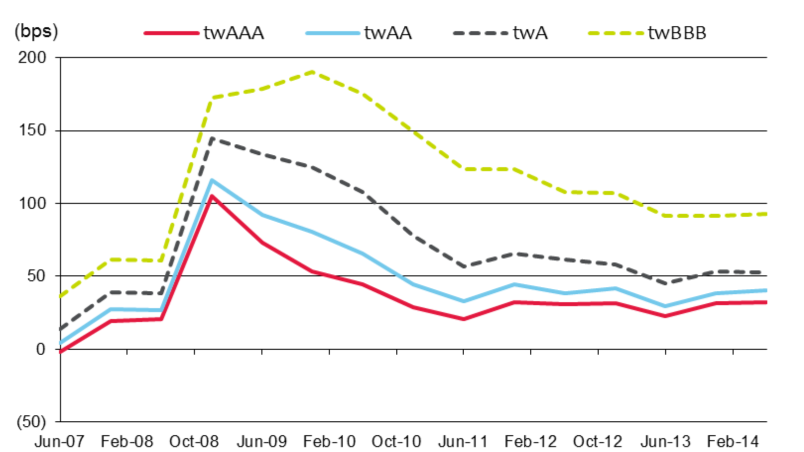


Note: Positive bias refers to the percentage of Taiwan Ratings' issuer ratings with positive outlooks or placed on CreditWatch Positive. Negative bias refers to the percentage of issuer ratings with negative outlooks or placed on CreditWatch Negative. Source: Taiwan Ratings Corp.

Limited Narrowing Of Credit Spreads And At A Slower Pace

We expect the credit spreads between five-year corporate bonds (including debentures) and government bonds to continue to narrow in the second half of 2014, amid improving local and global economies. This is similar to the trend over the past few years (see chart 6). Nonetheless, local investors remain risk-adverse, which slows and limits the movement of credit spreads. The impact on the local bond market from the U.S. Federal Reserve's tapering of asset purchases has largely passed, in our view. This is likely to shift investor focus toward the impact of rising U.S. short-term interest rates in the coming years.

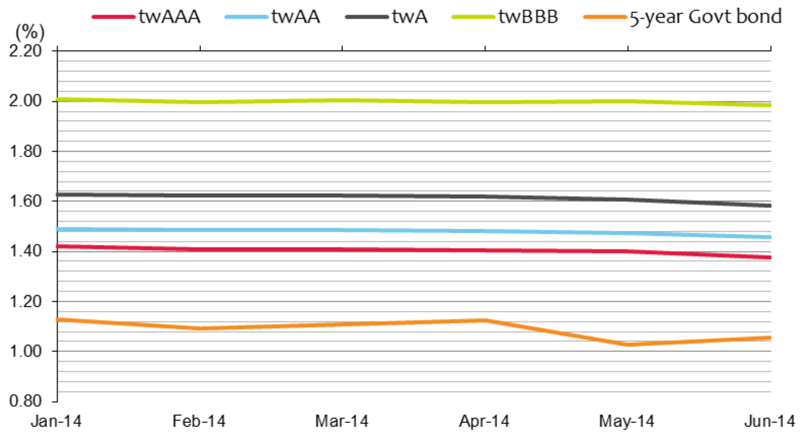
Chart 6
Credit Spread Of Corporate Bonds Over Government Bonds



Source: GreTai Securities Market.© Taiwan Ratings Corp. 2014

The borrowing cost for different rating categories and five-year government bonds exhibited some decline, albeit limited, in the first half of 2014. This was partly due to the positive correlation with the U.S Treasury yield, and the yield's decline over the past six months as a result of international geographic conflicts and financial turbulence in certain areas (see chart 7). Nonetheless, we expect the government benchmark rate to climb in conjunction with rising global bond rates, albeit to a lesser extent, leading to a rise in borrowing costs for issuers over the next few quarters.

Chart 7
5-Year Corporate Bond Yield Versus Government Bond Yield



Source: GreTai Securities Market. © Taiwan Ratings Corp. 2014

Taiwan's Ample Market Liquidity Continues To Lower Bond Market Price Volatility

We don't expect any significant change in Taiwan's market liquidity, prevailing low interest rate environment, or intensely-competitive banking sector over the next one to two years. Therefore we believe that most local and international corporations and financial institutions operating in Taiwan will maintain adequate access to liquidity through direct and indirect financing, which should help them to avoid financial turbulence and lower the price volatility in the bond market throughout the rest of 2014.

Under Taiwan Ratings' policies, only a Rating Committee can determine a Credit Rating Action (including a Credit Rating change, affirmation or withdrawal, Rating Outlook change, or CreditWatch action). This commentary and its subject matter have not been the subject of Rating Committee action and should not be interpreted as a change to, or affirmation of, a Credit Rating or Rating Outlook.

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- **Executive Comment: Formosa Bond Market Needs More Diversified Issuers And Investors To Reach Its Full Potential,** www.taiwanratings.com, Feb. 19, 2014
- **2014 Taiwan Credit Outlook: Global Economic Recovery Could Reduce The Negative Rating Bias On Corporate Credits; Other Ratings To Remain Stable,** Jan. 21, 2014
- **Credit FAQ: How A Debt Issue Rating Differs From An Issuer Credit Rating,** www.taiwanratings.com, July 29, 2013

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