Corporate Credit Rating In Japan

By Yoshitaka Kurosawa

Five credit rating agencies have been established in Japan since April 1985 (Table 1). The Japan Bond Research Institute was separated out from the *Nihon Keizai Shimbun,* a leading economic daily newspaper, as an independent specialized agency for rating public and private bonds. The Japan Credit Rating Agency was set up by 109 companies, including institutional investors such as life and casualty insurance companies and trust banks. The Nippon Investor's Service was created by 118 organizations, including research institutes affiliated with banks and securities companies, for rating domestic and foreign bonds. Mikuni & Co., a financial consultant for corporations, has also entered this field, while Moody's Investors Service, a major U.S. rating agency, established Moody's Japan in Tokyo in April 1985. A number of other foreign rating agencies such as Standard & Poor's Corp., Fitch Investors Service and Duff & Phelp, Inc. are said to be considering expanding into the Tokyo capital market.

The fund procurement needs of Japanese corporations are diversifying and the Tokyo capital market is rapidly developing into an international money center. Japan's financial machinery has undergone structural change, with the capital market replacing banks as the primary supplier of corporate funds. For this reason, bond rating, designed to provide "risk information" on the capital market, is winning favor as a promising line of business.

Corporate fund procurement

In the early 1900s and for nearly 40 years thereafter, Japan's capital market was by many standards already highly advanced. Money raised through stock and bond issues made up more than 90% of externally procured funds. No restrictions were imposed on the maturity of bonds or the use of funds, and bonds of various maturities were available depending on whether the purchase was meant for investment or savings.

In 1937, however, the Japanese economy was placed on a war footing and special legislation was enacted to regulate fund flows. The bond market was controlled and restricted, shifting the bulk of fund procurement to bank loans. Financial authorities found it easier to control bank lending in order to effectively allocate funds to wartime industry. Japanese corporations came to depend chiefly on banks for their financial requirements, and bond issues came to account for less than 5% of externally procured funds. The capital market had virtually lost its functions.

This was particularly true of the recovery period immediately following the end of World War II and the high-growth period beginning in 1955. Japan's economy expanded rapidly as public and private savings concentrated in the banks were allocated preferentially to selected industries such as steel, electric power, shipping and chemicals.

By the mid-1970s, however, the Japanese economy had entered a period of maturity, even as it was hit by the sudden surge in oil prices that marked the first oil crisis. Investment in new plant and equipment slowed, ushering in a prolonged period of slack capital demand.

In the meantime, export industries such as automobiles, electric home appliances and electronics had begun to cash in on their comparative advantage in world trade markets, a position they had achieved by acquiring advanced technology and high-quality labor during the era of rapid growth. Thus Japan's exports continued to flourish, generating chronic surpluses in the balance of trade.

This was the situation when the Japanese government lifted foreign exchange controls in December 1980 to facilitate the flow of funds out of the country. This action opened the way for the rapid internationalization of capital flows. Fund outflows came to 10.6% of GNP in 1980–82, compared with 3.5% in 1971–73. However, the Japanese financial system was still far from liberalized. Financially strong enterprises began to reduce borrowings from domestic banks and expand issues of convertible and straight bonds on foreign capital markets where regulatory restraints were less onerous. The share of bank borrowings in external fund procurement dropped from 74.6% in 1975 to 34.5% in 1984 (Table 2). In the same period, the share of overseas bond issues in total funds raised climbed from 15.3% to 47.5% (Table 3).

Table 1 Rating Agencies in Japan

	Established	Paid-in capital (¥ million)	Employees
Japan Bond Research Institute	Apr. 1985	100	25
Japan Credit Rating Agency	Apr. 1985	3,450	38
Nippon Investor's Service	Apr. 1985	5,810	48
Mikuni & Co.	June 1980	25	20
Moody's Japan	Apr. 1985	6.25	7

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Table 2 Routes of Fund Procurement (%)

	1975	1980	1984
Bank borrowings	74.6	69.5	34.5
Stocks	9.8	23.6	37.6
Bonds	15.6	6.9	27.9
Total	100	100	100

Note: Figures for corporations capitalized at ¥1 billion or more

Table 3 Fund Procurement on Capital Markets

	1975	1980	1984
Domestic capital market			
Stocks	903 (27.9)	1,160 (38.1)	815 (13.6)
Convertible bonds	331 (10.3)	96 (3.2)	1,614 (26.9)
Straight bonds	1,504 (46.5)	994 (32.7)	720 (12.0)
Total	2,738 (84.7)	2,250 (74.0)	3,149 (52.5)
Foreign capital market			
Stocks	21 (0.6)	108 (3.6)	49 (0.8)
Convertible bonds	182 (5.6)	515 (16.9)	1,661 (27.7)
Straight bonds	293 (9.1)	168 (5.5)	1,135 (19.0)
Total	496 (15.3)	791 (26.0)	2,845 (47.5)
Grand total	3,234 (100)	3,041 (100)	5,994 (100)

Notes: 1. Figures in ¥ billion, those in parentheses are percentages.
2. Convertible bonds include bonds with warrant.

Regulatory constraints

Bond issues in Japan must meet eligibility standards set by underwriters. These standards consist of five numerical indicators, namely, the net asset ratio, the equity ratio, the gross working capital-profit ratio, interest-paying ability and the dividend rate. These values are calculated on the basis of the net worth of each corporation. Only corporations measuring up to these standards can issue bonds.

In the case of straight bonds, qualified corporations are classified into four groups, AA, A, BB and B. The rate at which bonds are issued rises progressively, as a 0.1% differential is added to the coupon rate for each drop in the rating. In addition, bonds cannot be issued without security except in special cases. In the event of default, the commissioned bank purchases the unredeemable bonds and recovers the credit by taking possession of the collateral. This 50-year-old practice frees investors from default risks, and there is consequently little difference in the yields of secured bonds on the secondary market.

Foreign corporations were first allowed to float bonds on the Japanese capital market in 1979. Five companies have now done so since Sears, Roebuck, a major U.S. retailer, set the precedent. Foreign bonds also must meet Japanese eligibility standards, and any foreign corporation issuing bonds in Japan must have at least a single-A rating from a U.S. rating agency. But the bonds themselves do not have to be secured.

Three specific standards apply to foreign issuers. First, the net worth must be the equivalent of ¥110 billion or more. Secondly, the equity ratio must be 45% or more, and thirdly, at least three of the following four requirements must be met: the capitalization ratio (less than 30%), the gross working capital-profit ratio (8.5% or more), the interest coverage ratio (3.5 times or more) and the cash flow ratio (less than 250%). Corporations are generally considered eligible if they meet these four requirements.

Japanese corporations are also technically allowed to issue unsecured bonds. But the standards established in March 1979 were so stringent that only two companies—Matsushita Electric Industrial Co. and Nissan Motor Co.—were able to meet them. These eligibility requirements have since been eased to enable more companies to issue unsecured bonds. A total of 186 firms currently satisfy the eligibility standards for unsecured convertible bonds, while 57 firms are eligible to issue straight bonds.

The flotation of yen-denominated bonds on the Euromarket was permitted in December 1984 for nonresidents and in April 1985 for Japanese corporations. Thus far 43 nonresident corporations and 15 Japanese corporations have taken advantage of the new rules. Euroyen bond issues are governed by the rules for the domestic yen bonds of foreign corporations in the case of nonresidents and by the rules for domestic unsecured bonds in the case of Japanese corporations.

Road to rating agencies

The question of a credit rating system for Japan was first discussed in earnest by the Securities and Exchange Council in 1977. The main theme of the report produced by the council, however, was the issuance and circulation of national bonds. This was because the unavoidable flotation of vast quantities of national bonds after 1975 made it urgently necessary to reform the bond market in order to facilitate the sale of these government debt securities. Nonetheless, the report did address issues affecting the private bond market and one such proposal was that a rating system similar to that in the U.S. be introduced to encourage the issuance of unsecured bonds.

Japanese industry completed its shift to heavy and chemical industries by the late 1960s. Thereafter, the weight of service industries increased, giving momentum to fund procurement by corporations with relatively few fixed assets. Such corporations, including trading companies and supermarket operators, found it difficult to offer collateral in kind. They felt a need to issue unsecured bonds on the strength of their own strong financial positions, and their impressive earning power.

The internationalization of the Japanese financial system also made it necessary to bring the bond flotation system into line with that in the United States and the Euromarket, where unsecured bond issues were an established practice.

However, the spread of this practice in Japan was considered disadvantageous to the nation's traditional corporate giants, such as steel, power and chemical companies. The profit ratio and financial position of companies in key heavy industries were relatively weak because of the large volumes of capital they had borrowed from banks on the merits of their huge fixed assets. Also, the issuance of secured bonds gave the commissioned banks an opportunity for further profits, while unsecured bonds would cost them lending opportunities. With banks and heavy industry opposed, moves to issue such bonds made only slow progress, and the establishment of rating agencies was delayed.

The breakthrough finally came with an agreement on the internationalization of the yen reached in May 1984 by the Japan-U.S. Yen-Dollar Committee. The committee called not only for the liber-

The Japan Credit Rating Agency's employees provide risk information on the capital market to a variety of clients.

alization of the Japanese financial and capital markets, but also for deregulation of Euroyen bond issues by nonresidents and residents alike. It further proposed that selection of bond issues be based on ratings by leading rating agencies. .

Today ratings are used, along with the aforementioned eligibility standards, for yen-denominated foreign bonds (so-called "samurai" bonds) and Euroyen bonds issued by nonresidents. For resident Japanese corporations, ratings are applied only in determining the coupon rate of some domestic convertible bonds. Generally, the selection of issues is based on eligibility standards. However, there are various problems with this method and it is likely to be replaced in the near future by one based on ratings by neutral agencies.

There are a number of reasons for this. First, application of uniform eligibility standards using only a few specific indicators makes fair qualification of issuers impossible, particularly now that preferential fund allocation to selected industries has become unnecessary, unlike the case in the postwar recovery and high-growth periods.

Secondly, the number of financially strong corporations has increased, and unsecured bond issues are expected to rise accordingly. It is impossible to use past financial indicators as a standard, because it is only possible to redeem unsecured bonds with earnings to be generated in the future. What are needed are not fixed standards, but ratings evaluating the redeemability of bonds.

Thirdly, even in the case of secured bonds, it is becoming harder for the issuer to provide sufficient security because the size of bond issues is on the increase. This means that commissioned banks may not be able to afford to buy up default bonds as they have in the past. If a bank purchases inadequately secured bonds to compensate investors for their losses, it would create a conflict of interest between the bank's own shareholders and depositors.

Finally, progress in the diversification of corporate fund procurement could soon make it possible to issue commercial paper. In any case, bond issues by new venture enterprises will have to use ratings instead of eligibility standards for selection.

There is now fierce competition among the five existing rating agencies, as there has been since the system was initiated. Ratings are designed to provide investors with risk information on the redeemability of bonds and only agencies with high assessment abilities and accurate information can hope to, or even should, survive. At the same time, this means the door is open to any third-party agency with no interest in bond flotation, regardless of nationality.

A May 1985 survey by the Bond Underwriters Association found that 83.9% of the respondents hoped eiligibility would be determined on the basis of ratings rather than the existing uniform standards, and that the ratings would be reflected in the terms of issue.

The Japanese capital market is expected to develop further in parallel with progress in financial deregulation, while foreign investors are seeking extensive information on Japanese corporations. Under the circumstances, the prospects for the rating industry seem bright.

What are the most important points in evaluating Japanese corporations? Many companies in Japan have succeeded thanks to the support of financial groups centered on main banks and the diffusion of risks among industrial and corporate groups. For these reasons, Japan has many companies which are technologically strong and highly competitive, despite unfavorable quantitative indicators in their financial statements. Conversely, there are also high-risk companies with deceptively positive indicators. In evaluating the debt redeemability of Japanese corporations, it is necessary to take full account of their managerial environment and the systems and practices they have chosen to use. ●