Recommendations to Invigorate the High-Yield Bond Market as a Source of Corporate Financing

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Despite the overall bond market's recovery from the financial crisis triggered by the Lehman Brothers' collapse, Japan's high-yield corporate bond market still remains far from normal functioning. We examine structural issues that prevent the high-yield bond market from becoming an effective source of corporate financing, and propose measures to invigorate the market—specifically, the enhancement of disclosure requirements, establishment of bond managers and financial covenants, and use of multiple credit ratings.

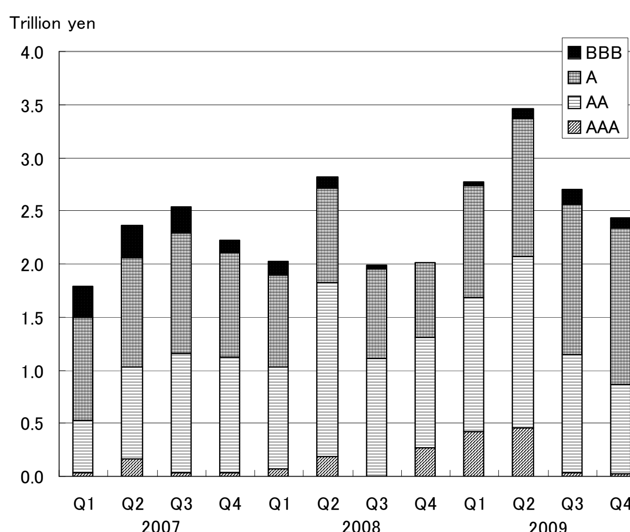
1. Conditions in the High-Yield Corporate Bond Market

1. Devastated by the Lehman Brothers' Collapse

As fiscal 2009 began, the corporate bond market finally showed signs of recovery from the financial crisis triggered by the Lehman Brothers' collapse of September 2008. Echoing this view, the Bank of Japan decided at the October 2009 monetary policy meeting to end open market purchases of commercial paper and corporate bonds at the end of fiscal 2009.

The Lehman Brothers' collapse devastated the bond market in the second half of fiscal 2008. Not only did the primary market for corporate bonds unravel, but issuance was halted for public bonds such as local government bonds and Japanese government-guaranteed bonds. Meanwhile, the secondary bond market failed to generate price quotes even for Toyota Motor's high-rated bonds. At the same time, Lehman's collapse and the public bailout of AIG paralyzed the credit derivatives market due to the incapacitation of these key market participants.

Exhibit 1 Recent Corporate Bond Issues (by credit rating)



Note: Shows the lower of two credit ratings by domestic agencies at date of determination of issuance terms.
Source: NLI Research Institute

Since April 2009, the corporate bond market appears to be enjoying a broad-based recovery due in part to recovery of the equity market. New bond issues have occurred continuously, while the secondary market is also functioning normally. Compared to the period before September 2008, spreads have tightened for local government bonds and high-rated FILP bonds and electric power bonds.

When the yield spread of investment-grade corporate bonds against Japanese government bonds narrows as it has to within +0.1%, JGBs may actually earn a higher return over any given period due to the bid-ask spread generated from normal trading activities. However, most buy-and-hold institutional investors still find even the slightest spread over JGBs to be attractive.

The strong performance of investment-grade corporate bonds can be attributed to a shift in the investment style of some large institutional investors since April 2009. They have moved away from JGBs and toward local government bonds, FILP bonds and investment-grade corporate bonds.

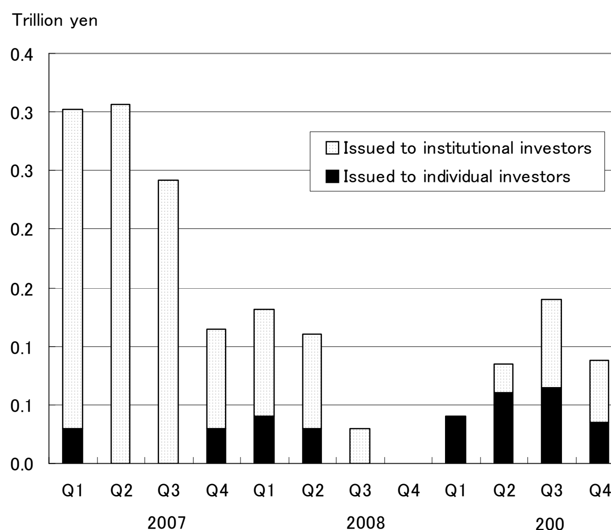
However, due to limited expertise in credit investment, they continue to avoid high-yield (lower-grade) corporate bonds, thus creating a divergence in the bond market.

Meanwhile, other institutional investors such as local financial institutions and pension funds were slow to make the shift, and were further discouraged from doing so when the yield spread began to tighten quickly from April 2009.

2. BBB Rated Straight Bond Issues are Targeting Individual Investors

The strength of investment-grade corporate bonds is a localized phenomenon and does not necessarily reflect the direction of the overall corporate bond market. Even after entering 2009, BBB rated bond issues have mainly been limited to companies in infrastructure-related industries such as railways and communications, and even these have primarily targeted individual investors. This pattern marks a significant change from 2007, when most BBB rated bonds were mostly offered to institutional investors (Exhibit 2).

Exhibit 2 Recent Issues of BBB Rated Corporate Bonds (by targeted investor)



Note: Shows the lower of two credit ratings by domestic agencies at date of determination of issuance terms.
Source: NLI Research Institute

Considering that the high-yield corporate bond market has not fully recovered, the BOJ arguably should have continued its open market purchases of commercial paper and corporate bonds. However, we should note that the policy was limited from the start to high quality corporate bonds rated A or better, with beneficial effects expected to spread down to the high-yield bond market.

Although the BOJ conducted several open market purchases in 2009, targeted results were never achieved even once. The BOJ has been criticized, perhaps justifiably so, for delaying its policy decision until February (the first open market purchase occurred in March 2009). In retrospect, it appears that the BOJ expected the policy announcement effect itself to stabilize financial markets, and never intended to unnecessarily put its balance sheet at risk.

Exhibit 3 Recent Defaults on Straight Bonds

Date	Company
2001 Sep	MYCAL Corp.
2008 Jun	Suruga Corporation
Jul	Zephyr Corp.
Aug	Urban Corporation
2009 Feb	Japan General Estate Co.
Mar	Pacific Holdings
Jun	ES-CON Japan

Thus the BOJ has effectively provided no direct support to the high-yield corporate bond market even after the Lehman shock. This fact, combined with the recent string of corporate bond defaults, has kept the market far from recovery (Exhibit 3). Moreover, the high-yield corporate bond market was already riddled with serious problems, several of which have recently surfaced.

2. Ways to Invigorate the High-Yield Corporate Bond Market

1. Enhancement of Disclosure Requirements

Unlike the U.S., Japan does not have a functioning high-yield corporate bond market. In the past, this was explained by the lack of aggressive, high-return oriented investors in Japan. This characterization is basically true, although we should also note the important role of bank financing as an alternative source of corporate financing.

The low risk tolerance of major institutional investors in Japan is partly explained by the fact that in the typical corporate organization, the fund manager's position is rotated among permanent salaried employees. Understandably, employees tend to be concerned that poor investment results could hinder their career prospects. In contrast, foreign fund managers can adopt a more aggressive investment style because their accountability effectively ends when they move to a new employer.

To invigorate the corporate bond market, Japan's non-aggressive fund managers must be encouraged to adopt a more high-risk, high-return investment style and invest in high-yield bonds. An essential prerequisite for this is the enhancement of disclosure requirements of bond issuers. As seen by the FSA disciplinary action against Urban Corporation and BNP Paribas Securities regarding their failure to disclose complex swap transactions, disclosure requirements should be tightened to give shareholders and bondholders timely access to material information on straight bond performance.

At the same time, it should also be impressed upon bond issuers and underwriters that unless they make timely disclosure of such material information, they potentially face not only lawsuits from investors, but punitive actions from regulators and the industry's self-regulatory body, the Japan Securities Dealers Association.

Moreover, securities firms also need to enhance disclosure to investors. As lead manager candidates, securities firms typically issue a credit analyst report prior to bond issuance. However, subsequent reporting tends to be less rigorous. Thus after bond issuance, the lead manager could help invigorate the market by releasing analyst reports on a regular basis. In addition, the lead manager also needs to be held accountable for making a market for the bonds, which is not currently the case.

Most important, however, is that unless investors are knowledgeable and can fully understand the investment risks, the above enhancement of disclosure will avail to nothing.

2. Establishment of Bond Manager and Financial Covenants

Another requirement is to construct a scheme for investors to take appropriate action in case the issuer encounters financial difficulty or default. Investors need alternatives other than to simply stand idly by or dispose of bonds in the thinly traded secondary market. One solution is to use bond managers and financial covenants.

Exhibit 4 Conventional Financial Covenants Attached to Corporate Bonds

Sensor clauses
- Net worth maintenance clause
- Net income maintenance clause
- Dividend restriction clause

Subordination avoidance clauses
- Negative-pledge clause (and covenant of equal grade or *pari-passu*)
- Collateralizing clause

Ever since the deregulation of bond issues with financial covenants in 1996, the accompanying framework and arrangements have gradually eroded due to strong disinterest among bond issuers and fee-seeking securities firms. As a result, the spirit of investor protection and market discipline has not always been fully observed.

We propose first that in principal, underwriters should urge issuers of high-yield corporate bonds to appoint a bond manager. While a bond manager is required under the Japan Companies Act, an exemption is made for bonds with a value of 100 million yen or more, which are targeted at institutional investors. Nonetheless, despite this legal hurdle, the market could still encourage the practice of appointing a bond manager as a rule.

However, the problem then arises as to the choice of bond manager. An entity other than the main bank is not necessarily capable of monitoring the bond issuer's financial position. On the other hand, the main bank potentially faces a conflict of interest in the event of default. As seen in numerous cases, main banks have called in loans ahead of an impending default. Thus we propose that in the event of default, a main bank with outstanding loans to the issuer must be made to step down as bond manager, or else appoint a representative bondholder to perform the bankruptcy procedure.

If appointing a bond manager can help reduce the burden on bondholders in the event of default,

high-yield bonds will likely attract more investors. As a result, confidence in the bonds would grow, reducing the spread and justifying the cost of the bond manager.

Moreover, the bond manager would greatly enhance the sensor functions of any financial covenants attached to bonds (Exhibit 4). Prior to deregulation, financial covenants were attached to BBB rated corporate bonds, and served as sensor functions of net worth maintenance and net income maintenance. However, due to the strong disinterest of issuers, sensor clauses were subsequently removed from BBB rated bonds.

If applying sensor clauses and appointing a bond manager can improve confidence in high-yield bonds among investors, these measures could potentially stimulate more demand for such bonds. In addition, other sensor clauses could have significant implications such as the change of control clause (as in the case of Sapporo Holdings bonds) and credit rating maintenance clause (as in the case of syndicated loans). In recent years, debate has emerged regarding the use of covenants for bank loans, primarily syndicated loans. We believe similar merits can be achieved by attaching covenants to corporate bonds.

3. Expansion of *Pari-passu* Clause

The *pari-passu* clause (covenant of equal grade) determines the order of priority of payment to lenders in case of default. It is part of the negative-pledge clause, which protects lenders of equal grade by barring the borrower from pledging assets without consent. The problem is that at present, bondholders in general are not of equal grade to other lenders. Although this problem has been noted ever since the deregulation of financial covenants in 1996, certain events in recent years have finally brought the matter to the broad attention of investors and other market participants.

In most recent unsecured corporate bond issues, *pari-passu* is limited to equal grade for domestic bonds or equal grade for designated corporate bonds. This means that with the exception of bonds that have conventional financial covenants such as a net worth maintenance clause, unsecured corporate bonds are subordinated to other classes of debt.

To clarify the source of the problem, it is useful to compare the order of priority given to bonds and loans from banks or insurers. If for some reason the borrower pledges assets against an unsecured loan, the negative-pledge clause will provide the same protection to other loans of equal grade, but not to unsecured bonds. Thus if the borrower's financial position deteriorates, the debt recovery rate will likely diverge significantly between the two classes of debt.

This phenomenon first came to light in the default case of Urban Corporation, who filed for protection under the Civil Rehabilitation Law in August 2008. Earlier in June of the same year, banks called a syndicated bank loan when the company violated a credit rating maintenance covenant (ratings by either R&I or JCR dropped below BBB-) but declined to pledge assets. However, since the negative-pledge clause attached to unsecured straight bonds specified an equal grade for domestic corporate bonds, no action could be taken on existing straight bonds.

In a separate non-default case, a J-REIT called DA Office Investment Corporation complied with a request from lenders to pledge assets against unsecured loans. Collateral was also pledged against all other loans of equal grade. However, as in the above case, corporate bonds issued in the capital market were not of equal grade, and thus remained unsecured.

As these cases show, in order for high-yield corporate bonds to avoid subordination to loans, the *pari-passu* clause must be expanded beyond corporate bonds to include all (domestic) debt.

Previously, when Ito Yokado was free of debt, it once issued an AA rated unsecured straight bond with *pari-passu* for all domestic debt. While the clause was unnecessary in this case, it was a significant departure from the common practice of limiting *pari-passu* to corporate bonds. We believe this will be a necessary step to keep high-yield corporate bonds from being subordinated to loans.

If the *pari-passu* clause of bonds is altered to equal grade for domestic debt, cases like Urban Corporation would not prompt bondholders to demand full disclosure of financial covenants attached to all existing debt. However, under the present situation where *pari-passu* is limited to equal grade for corporate bonds, investors will understandably remain wary of high-yield corporate bonds until covenants attached to loans are fully disclosed.

4. Use of Multiple Credit Ratings

Finally, the attractiveness of high-yield corporate bonds could be improved by revising the current market practice on credit ratings. Specifically, high-yield bonds should be required to obtain a credit rating from each of the two domestic credit rating agencies. This requirement should be based not on administrative guidance issue standards, but on the self-regulated underwriting standards of securities firms.

Exhibit 5 Number of Bond Issues with Two Credit Ratings (first-time issuers)

	All bond issues	BBB rated issues
Both ratings	15	2
R&I rating only	18	3
JCR rating only	18	11
Total	51	16

Note: Shows data for first-time bond issuers from 2006 to 2009.
Source: NLI Research Institute

Since 2008, several defaults have occurred at issuers of straight bonds. In most cases, the bonds had been rated by only one agency. In fact, less than one-third of issuers in recent years have obtained ratings from both domestic credit rating agencies (Exhibit 5). For BBB rated bonds, only two issuers have received both ratings.

For high-rated corporate bonds, the significance of obtaining multiple credit ratings is not as great, and should be left to the discretion of the issuer. However, for A rated and BBB rated issuers, we believe ratings conducted from multiple perspectives would be desirable.

As seen by the cases of default and the unraveling of the subprime loan crisis, credit rating agencies are by no means infallible. For this reason, investors are well advised to avoid high-yield bonds that have been rated by only one agency.

At the same time, we must emphasize that promoting multiple credit ratings is not meant to reduce the responsibility of investors. Ratings are simply indicators that reflect the assessment of a third party, and as such should not be blindly followed.

3. Conclusion

Investment decisions are ultimately the responsibility of investors. As such, investors need to be better supported by the enhancement of disclosure requirements, establishment of investor protection measures, and investor education to strengthen decision making skills and knowledge. For many investors, the painful experience of the financial crisis was a wake-up call on the unparalleled importance of self responsibility.

Responsible credit investment requires a significant input of human resources and physical resources, with extensive experience as a guide. The key to successful investment lies in taking the time to nurture investment professionals with a broad perspective and keen sensitivity to information. Investors who simply pursue large spreads will likely continue to suffer losses whenever a credit event occurs.

However, we do not intend to revert to a bygone era that tried to shield investors against all risks in the high-yield corporate bond market. After all, if all risks could be avoided, there would be no yield spread.