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Japan's Corporate Bond Market: Developments before & during the COVID-19 Pandemic

Introduction

The spread of the COVID-19 pandemic dealt a shock to Japan's financial markets while also seriously affecting the nation's real economy. However, swift and proactive responses by the Japanese government and the Bank of Japan (BOJ) based on lessons learned from past financial crises and other disruptive events helped the markets regain stability rather quickly. For example, corporations have been able to stably secure funding in the corporate bond market, with corporate bond issuance in 2020 reaching an all-time high of nearly JPY16 trillion (Figure 1).

This smooth functioning of the corporate bond market can also be attributed to efforts since the 1980s to liberalize bond issuance in Japan and promote market activity. Since developing a more liberal system for bond issuance in the 1980s and 1990s, Japan has continued to promote initiatives to stimulate its primary and secondary bond markets in the 2000s.

In recent years, we have seen the

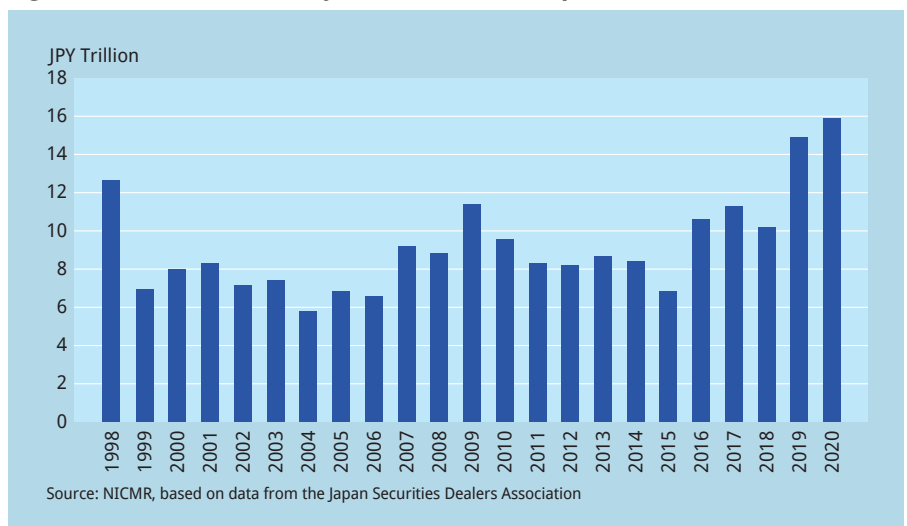
bond market expanded by the increase in issuance of green bonds, social bonds, sustainability bonds and other bonds collectively referred to as Sustainable Development Goals (SDG) bonds,¹ which are used to fund projects that contribute to realizing the SDGs being promoted by the United Nations.

This article summarizes the efforts to vitalize Japan's corporate bond market in the 2000s, presents the key characteristics of the market during the COVID-19 pandemic, and concludes with a brief outlook on the future expansion of Japan's corporate bond market.

Development of Japan's Corporate Bond Market

During the 1980s and 1990s, Japan implemented measures that liberalized issuance in its corporate bond market. In the 2000s, initiatives in the corporate bond market

Figure 1: Issuance of Publicly Offered Bonds in Japan



focused on increasing transaction safety and convenience, leading to the launch of a bond transfer system that introduced a completely paperless settlement system for transferring bond ownership rights. The Lehman Shock in September 2008 and the following Global Financial Crisis triggered a greater awareness of the need to diversify corporate financing methods, expand investors' investment options, and create a more liquid market in order to vitalize the corporate bond market.

With that goal in mind, in July 2009 the Japan Securities Dealers Association (JSDA) established the “Study Group to Vitalize the Corporate Bond Market” (hereinafter, the “Study Group”) to deliberate on issues facing the corporate bond market and consider potential initiatives. The Study Group prepared and published its initial recommendations in June 2010 in a report entitled “Toward Vitalization of the Corporate Bond Market”. The report outlined four key topics to be given greater consideration by newly established subcommittees: (1) a review of underwriting examinations conducted by securities companies, (2) the granting of covenants² and information disclosures, (3) corporate bond management, and (4) the development of infrastructure for disseminating corporate bond price information. The subcommittees' recommendations were summarized in the Study Group's July 2012 report entitled “Measures for Vitalization of the Corporate Bond Market” (hereinafter “the Study Group's report”).

Review of underwriting examinations conducted by securities companies

The process used by securities companies when conducting corporate bond underwriting examinations was reviewed from the perspective of securing flexible issuance of corporate bonds while strengthening the examination contents to ensure investor protection. For example, regarding the contents of the basic underwriting examination, the Study Group's report stated that, assuming the issuer and its auditor have submitted sound and accurate financial statements and other documents, the examination should focus on the issuer's principal and interest payment capacity and risk factor disclosure, which are considered to be the key factors influencing investors' decisions to invest in corporate bonds.

As for the continuous disclosure examination of corporate bonds, the report said that the typical common examination questions should be changed to “common questions” (reference model) based on the

actual situation at each issuing company and reviewed as necessary in the future. The Study Group's report also pointed out that underwriting examinations conducted at the time securities reports and quarterly reports are filed have sought responses to the common questions from the issuing company and its auditor. However, to ensure more flexible issuance of corporate bonds, the Study Group's report recommended that securities companies conduct internal reviews of the issuing company's disclosed quarterly reports, press releases, credit rating information, and other publicly available information. Based on these considerations, JSDA compiled the “Guidelines for Corporate Bond Underwriting Examinations Under the Securities Company Issuance Registration System.”

Along with this review, the Study Group considered and presented its view of how underwriting securities companies should examine issuers' financial statements and other documents. Specifically, the Study Group pointed out that, under Article 21-1 (iv) of the Financial Instruments and Exchange Act (hereinafter, “FIEA”), the underwriting financial institution as well as the issuer and the auditor may be liable for damages incurred by investors if the financial statements or other documents submitted when issuing securities contain false statements or lack statements on important matters or material facts. Similarly, Article 17 of the FIEA states that a person who sells securities using a prospectus containing false statements or insufficient information also may be liable for damages. Based on the views presented in the Study Group's report, the JSDA compiled its “Guidelines for Underwriting Examinations of Financial Statements, etc.”

Granting of covenants and information disclosures

The Study Group's report also pointed out that vitalization of the corporate bond market should include expanding the primary corporate bond market, which was focused on bonds issued by companies with relatively low credit risk, to provide more opportunities for companies with relatively high credit risks to issue bonds. To achieve this expansion of the primary bond market, the Study Group's report stated that it was necessary to develop an environment that enabled the granting of covenants that more flexibly and appropriately reflected the capital and financial policies of issuers while also meeting investor needs. It added that these covenants should be fully reflected in the issuance

conditions for corporate bonds. The report pointed out that the main type of covenant attached to corporate bonds at the time was the negative pledge clause (a clause prohibiting the issuer creating any security interest over certain property specified in the provision). The report also noted that these collateral provision restriction clauses were usually effective only among corporate bonds. Considering that banks providing corporate loans generally had access to a relatively large amount of information about corporate bond issuers, the Study Group pointed out that this situation essentially made corporate bond obligations subordinate to bank loans. Under such conditions, investors must have access to information about the covenants and status of a bond issuer's bank loans as well as its corporate bonds.

The report also pointed out that corporate bond investors often were not provided with disclosure information sufficient for making sound investment decisions. In response, the Study Group indicated that it would prepare a reference model of standard covenants for corporate bond issues as a reference for issuing companies, investors, and securities companies. Based on the Study Group's recommendations, the JSDA announced “Disclosure Criteria on the Status of Covenants and Examples (Examples of Disclosure of Covenants)” in September 2016. This list of examples introduced disclosures made by previous bond issuers as well as a reference guide to criteria for judging disclosure and the contents of disclosure to support voluntary disclosures by issuing companies related to typical entries in the disclosure system, such as “Notes on Additional Information” and “Notes on Important Subsequent Events.”

Corporate bond management

The Study Group pointed out that corporate bond issues require, in principle, the appointment of a corporate bond administrator, with the exception of cases where the issuance amount is JPY100 million or higher. However, it also noted that at that time about 80% of bonds issued in the domestic primary bond market, did not have an appointed administrator.³ The report noted that it was necessary to consider establishing a corporate bond management system that would help vitalize Japan's corporate bond market by improving the environment for corporate bond issuance by companies with relatively high credit risks while also responding to changes in investors' understanding of corporate finance.

The corporate bond management company system was introduced when Japan's Commercial Code was revised in 1993. The Study Group's report pointed out that a company's main bank usually served as the bond administrator. However, it also noted that, in the case of bonds issued by companies with relatively high credit risk, the main bank could hesitate to serve as administrator even when asked to do so by investors, owing to concern that it would not be able to balance its duties as bond administrator with its position as a creditor involved in loan preservation and collection activities. This situation may have led to cases where there was no appropriate party to serve as the corporate bond administrator.

The Study Group therefore indicated that further consideration needed to be given to designing a corporate bond management system that would secure administrators capable of providing appropriate corporate bond management. Specifically, drawing on the trustee system in the United States, the Study Group considered establishing a system of "Corporate bond trustees (provisional name)" that would, in principle, serve as the agents of bond creditors with tasks limited to the preservation and recovery of debts after corporate bond defaults.

In February 2013, the JSDA and the Corporate Bond Market Study Group followed up by establishing the Working Group on Market Infrastructure for Corporate Bonds (hereinafter, "Market Infrastructure WG") to consider measures to enhance the protection of corporate bondholders. The Market Infrastructure WG released a report in March 2015 entitled "Protecting Corporate Bondholders." This report proposed establishing a Bond Administrator System (provisional name) as a practical measure to protect to corporate bondholders and recommended further discussions about the contents of bond guidelines and outsourcing contracts as steps to promote the acceptance and use of this system.

Accordingly, the Market Infrastructure WG continued to study matters related to this system and the content of specific provisions, and in August 2016 it presented its findings in a report entitled "An Outline of Bond Issuance and Outsourcing Contracts with Respect to the Bondholder Supporting Agent System." The system's name was changed from the provisional "Bond Administrator System" to "Bondholder Supporting Agent System" based on the study conducted by the Market Infrastructure WG.

Development of infrastructure for disseminating corporate bond price information

Chapter 4 in the Study Group's July 2012 report entitled "Measures for Vitalization of the Corporate Bond Market" begins with the statement that vitalization of the secondary market for corporate bonds will require increasing the transparency and reliability of corporate bond price information. Corporate bond transactions are mainly conducted between the seller and the buyer, and third parties do not know the purchase price and other transaction details. To shed some light on bond prices, the JSDA has established a system that provides statistical data on Over-the-Counter (OTC) bond transactions.

The system was launched in March 1966 as a system for disseminating quotations on OTC bond transactions. In August 2002, the system was revised and renamed as the system for dissemination of reference statistical prices (yields) for OTC Bond Transactions to clarify that it is meant to be a reference for transactions and to improve the accuracy of the statistics provided. However, it later was pointed out that there were large differences between the reference statistical prices and the actual prices (contract price, bid offer, etc.) of corporate bond issues with low liquidity and from issuers perceived to have increased credit risk due to the occurrence of certain events.

The JSDA looked into these and other issues, and the Study Group's July 2012 report included two suggestions for enhancing the transparency and reliability of corporate bond price information: (1) publish reports about corporate bond transaction information, and (2) improve the reliability of the reference statistical prices of OTC bond transactions.

Responding to those recommendations, the JSDA established the Working Group on Development of Infrastructure for Disseminating Corporate Bond Price Information (hereinafter "Corporate Bond Price Information WG") in August 2012. In September 2013, this working group published a report on measures to improve the system for dissemination of reference statistical prices (yields) for OTC Bond Transactions in order to vitalize the corporate bond market. The report shows that the Corporate Bond Price Information WG studied the following issues: (1) designated criteria for designated corporate bond reporting association members (stricter criteria for Designated-Reporting Members, mandatory reporting of market prices by

the lead securities company); (2) enhancement and strengthening of guidance and management of JSDA's system for disseminating reference statistical transaction prices, and (3) a method for calculating reference statistical prices for corporate bond transactions (revision of the method for calculating reference statistical prices and of the minimum number of reporting companies), (4) introducing a time limit for reporting reference statistical prices for corporate bond transactions and delaying the release of those statistics, and (5) promoting better understanding of the reference statistical prices.

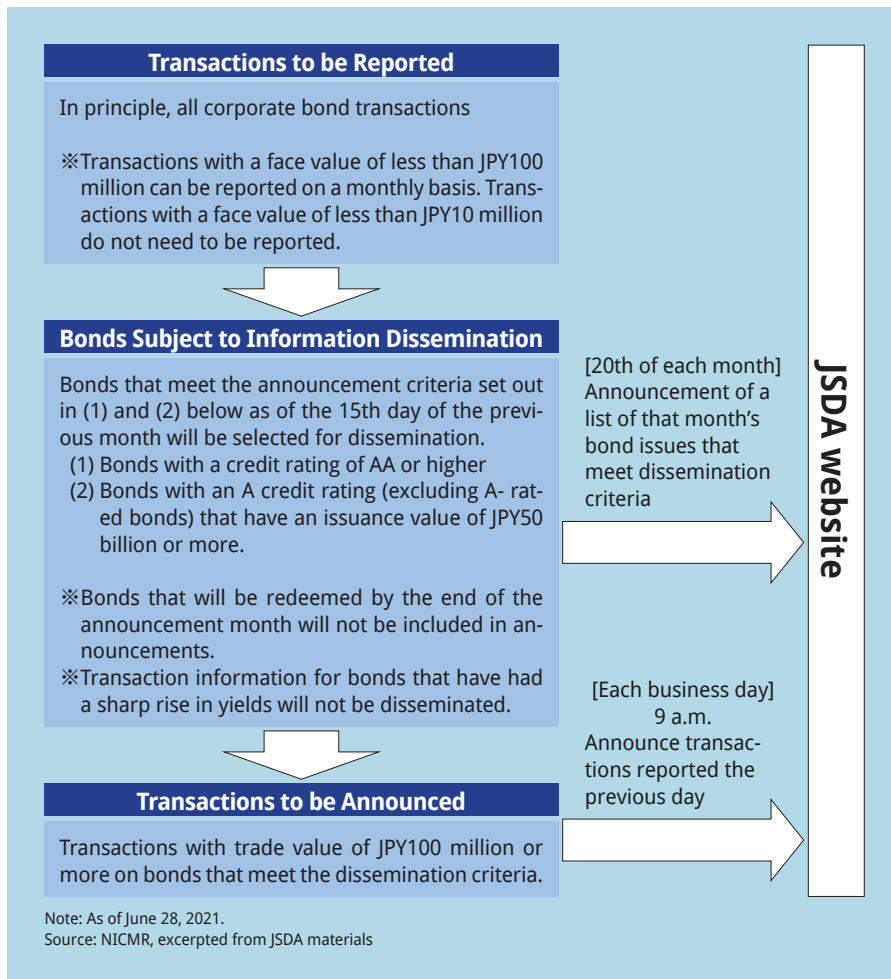
After soliciting opinions on the proposed revisions, in December 2013 the JSDA announced partial amendments to the relevant regulations and guidelines proposed in the Corporate Bond Price Information WG's report.

The Corporate Bond Price Information WG continued its studies of measures to improve the reliability of transaction reference statistics and regulations for reporting and announcing corporate bond trading information. As a result, in March 2014 the JSDA revised its regulations for reporting corporate bond trading information and launched a new public announcement system. The newly established system in principle requires that all corporate bond transactions be reported. However, reporting is optional for trades with a transaction volume of less than JPY10 million (Figure 2).

Announced corporate bond transactions are those that meet the following criteria as of the 15th day of the month previous to the announcement month: the bond has an issue amount of JPY50 billion or more (excluding those with subordinated provisions and 20 or more years to maturity) and (1) has a rating equivalent to AA or higher and (2) was issued by a company with an A rating (A-rated issuers are excluded).⁴ Transactions on bonds that will be redeemed by the end of the announcement month will not be announced. In addition, the announcement of transaction information for bonds that have had a sharp rise in yields will be suspended. Announced bond transactions are transactions that have a traded amount face value of JPY100 million or more on bonds subject to the announcement requirements.

The information on corporate bond transactions announced by the JSDA consists of the following nine items: (1) contract date, (2) issue code, (3) issue name, (4) redemption date, (5) coupon rate, (6) trading volume (on a face-value basis), (7) contract price, (8) buy/sell indicator, and

Figure 2: Japan's Corporate Bond Transaction Information Announcement Framework



Stable funding environment supported by the BOJ's strong monetary easing measures

Spreads on Japanese corporate bonds rose along with the spread of COVID-19 infections, but the rise was held in check at a rather moderate level by the swift and proactive responses by the Japanese government and the BOJ, which were able to rely on past lessons learned during the Global Financial Crisis triggered by the Lehman Shock as well as other past crises.

Japan's corporate bond market was generally firm before the COVID-19 infections began to sweep across world, which pushed up yields from February to March 2020. In response, the BOJ announced a strengthening of its monetary easing policy on April 27, 2020, and the rise in bond yields was halted (Figure 3). Specifically, as part of its measures to ensure smooth funding for financial institutions and companies, the BOJ increased its upper limits for purchases of commercial paper (CP) and corporate bonds from about JPY5 trillion to about JPY20 trillion. In addition, the central bank raised the limits on the amounts it would purchase from a single issuer and extended the remaining maturity of corporate bonds eligible for purchase.⁶

An examination of corporate bond issuance in 2020 by years to maturity reveals that the issuance of medium-term bonds has increased as the market environment has been stabilized by continuation of the low interest-rate environment and the BOJ's monetary easing measures (Figure 4). Issuance of ultra-long-term bonds also remained rather buoyant.

Increased use of corporate bonds as long-term debt

Japanese companies, particularly large corporations, have been increasing their corporate bond issuance. The ratio of corporate bonds to total corporate long-term debt has risen in recent years, and the trend continued in 2020 (Figure 5).

More specifically, the share of outstanding corporate bonds⁷ (i.e., the corporate bond ratio) to total long-term corporate debt (bank borrowings + bond issuance) at large corporations with capital of at least JPY1 billion has been on an uptrend since 2016. In 2020, corporate bond issuance rebounded after the market environment stabilized in April, and the increase in issuance from June to July onwards drove the corporate bond ratio above its previous year level.

The two main reasons for corporate

(9) reference statistical price (average price of unit prices).⁵ As a general rule, the information is disseminated on the JSDA website by 9:00 a.m. on the business day after receiving the transaction report.

The new public bond OTC transaction reference statistical system and the reporting and public announcement system for corporate bond transaction information were launched on November 2, 2015.

affected the real economy and has caused turmoil in Japan's financial markets. Some industries have experienced large declines in income that have affected their funding needs, and financial markets were temporarily disrupted.

However, financial markets stabilized rather quickly thanks to the swift and proactive responses by the Japanese government and the BOJ that were based on past lessons learned during the Global Financial Crisis triggered by the Lehman Shock as well as other past crises. The past development of institutional infrastructure in the primary and secondary corporate bond markets has also contributed to relatively smooth financing and market transactions.

This chapter outlines (1) the generally stable funding environment supported by the BOJ's strong monetary easing measures, (2) the increased use of corporate bonds as a source of long-term debt, and (3) the expanding issuance of SDG bonds.

Japan's Corporate Bond Market during COVID-19

The COVID-19 pandemic has seriously af-

Figure 3: 5-year Corporate Bonds Yield Spread Against Benchmark Japanese Government Bond

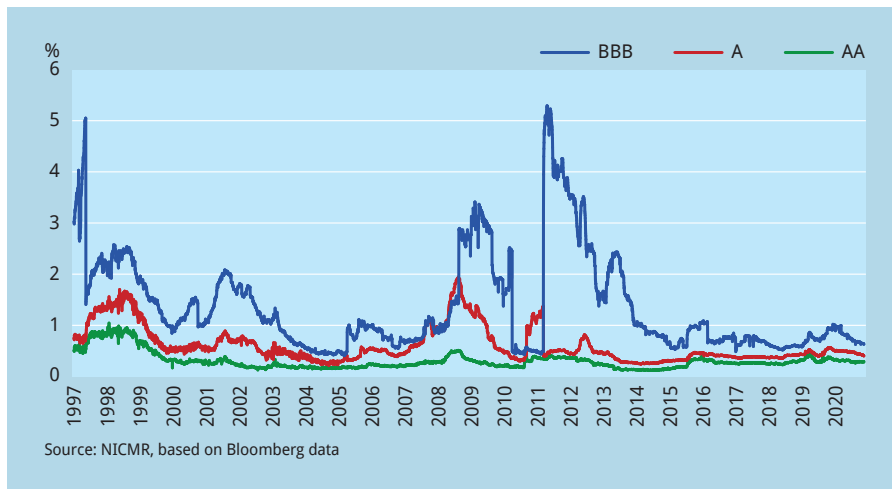


Figure 4: Issuance of Publicly Offered Bonds by Years to Maturity (excluding Financial Industry)

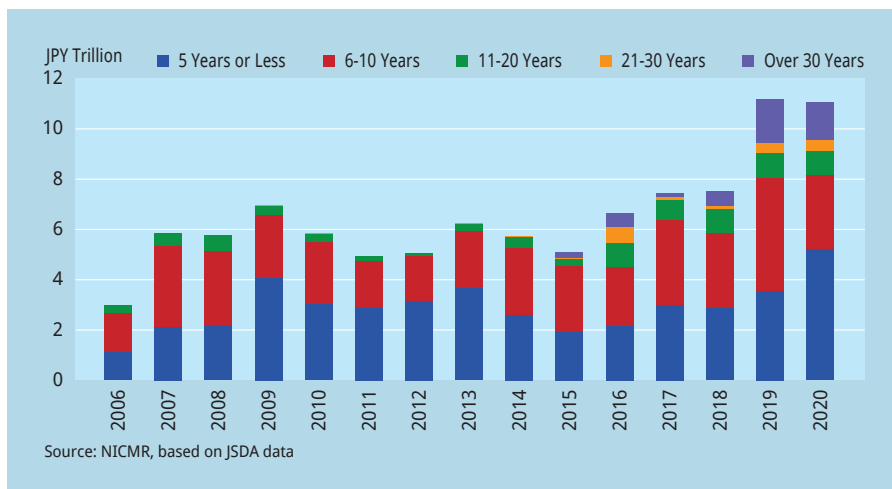
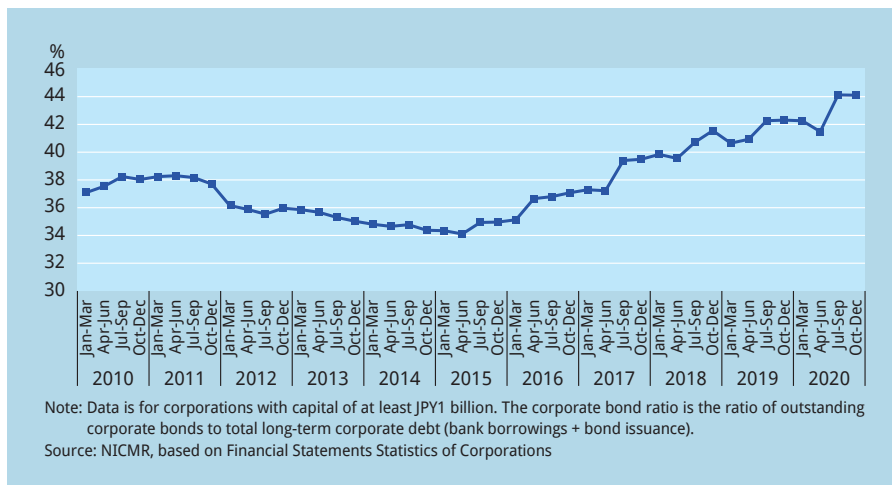


Figure 5: Corporate Bond Ratio of Large Japanese Corporations (excluding Financial Industry)



bond issuance are (1) to procure funds needed to redeem maturing bonds or bank loans and to secure cash on hand, and (2) to raise capital to finance capital expenditures. In 2020, issuance by land transportation companies, including railway companies, expanded as the companies needed to raise funds to compensate for significantly reduced revenues caused by government requests asking the Japanese people to refrain from travel and leaving their homes owing to the spread of COVID-19 (Figure 6). Among land transportation companies, East Japan Railway Company (JR East) was the biggest issuer of corporate bonds in 2020, making five issues with a total issuance amount of about JPY430 billion (JPY30 billion in January, JPY125 billion in April, JPY85 billion in July, JPY100 billion in October, and JPY90 billion in December). Proceeds from these bonds were used mainly to secure cash on hand and redeem other interest-bearing debt.

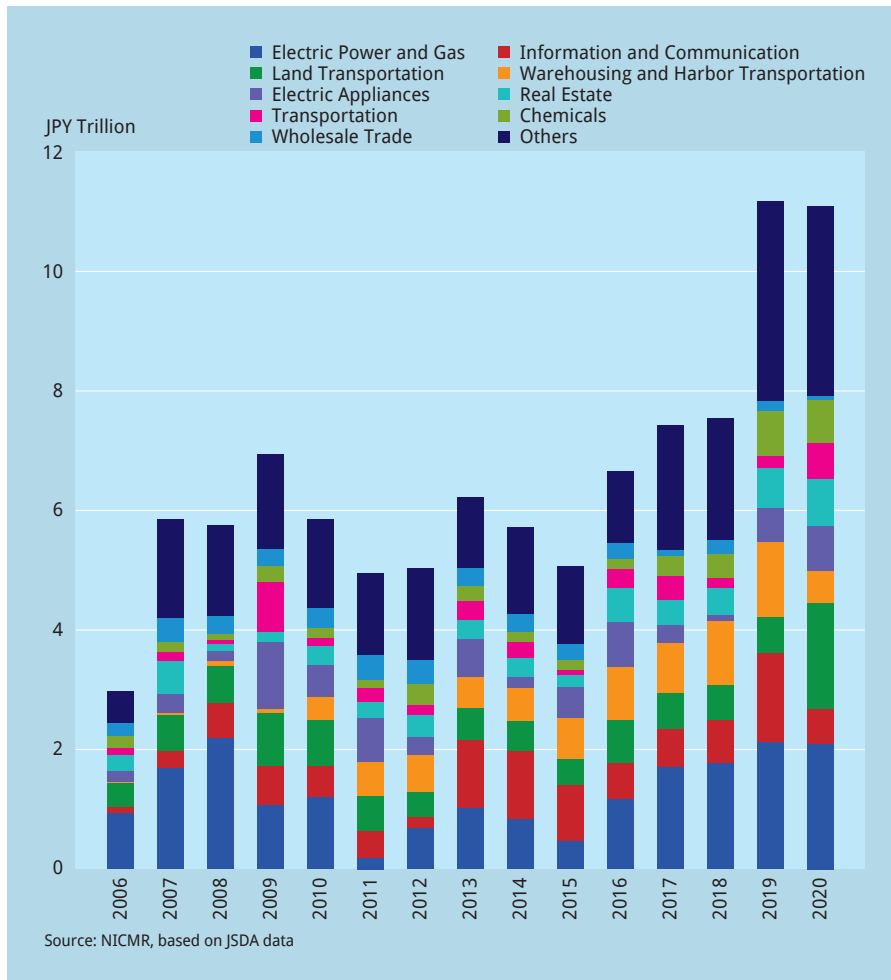
At its April 2020 financial results briefing, JR East announced that it would respond to the financial challenges presented by the COVID-19 pandemic by “securing a certain amount of cash on hand through ‘early, abundant, long-term’ funding.”

West Japan Railway Company (JR West) was the second largest issuer in the land transportation sector in 2020, raising a total of about JPY330 billion through three issues (JPY190 billion in May, JPY110 billion in August, and JPY30 billion in December). JR West mainly used these funds to repay debts and cover capital expenditures.

At its financial results briefing in July 2020, JR West indicated it would be raising large amounts of funds at an early stage, fundamentally using long-term funds.

In the JR West Group Medium-Term Management Plan 2022 announced in May 2018, the company indicated that its financing strategy would prioritize safety and growth investment while also enhancing shareholder returns and not reducing debt. However, considering the changes in the external environment caused by COVID-19, the company announced revisions to its plan in November 2020, reprioritizing its use of medium- to long-term funds. Investment in safety is now its highest priority, followed by debt reduction, capex for growth, and then shareholder returns. As for safety investments, JR West indicated that the total amount would be limited to some extent but that it would steadily advance investments necessary to enhance safety.

Figure 6: Bond Issuance by Industry (excluding Financial Industry)

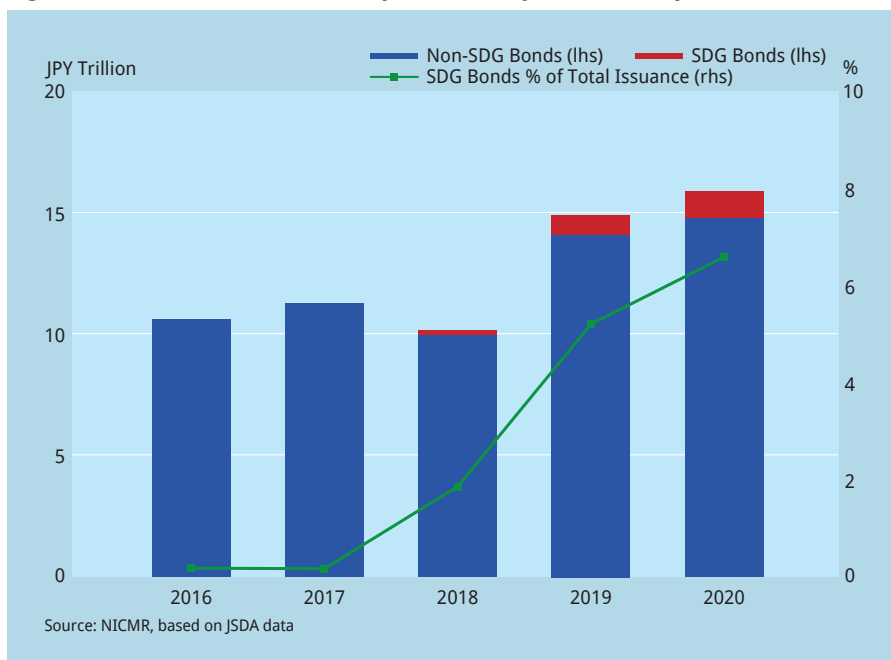


Expanding issuance of SDG bonds

The issuance of SDG bonds in Japan’s publicly offered corporate bond market has been increasing in recent years. Nomura Research Institute made the first offering of a green bond in September 2016. ASICS followed with the first sustainability bond issue in March 2019, and ANA Holdings issued the first social bond in May 2019 (Figure 7).

Green bonds account for the largest share of SDG bonds issued in Japan’s publicly offered corporate bond market, accounting for 48% of all such issues in 2020. The issuance of green bonds has been promoted by Japan’s Ministry of the Environment (MoE), which launched a green bond support program in 2017 and then in 2018 established its Financial Support Programme for Green Bond Issuance, which offers subsidies to help cover the expense of green bond issuance. To date, investment corporations, the real estate industry, and electrical machinery makers are among the largest issuers of green bonds. Looking ahead, electricity and gas utilities, which are regular issuers of corporate bonds, could issue a relatively large amount of green bonds. In recent years, we have also witnessed increasing interest in transition bonds, which are used to finance society’s transition to low-carbon and eventually carbon-free economies. Transition bonds are attracting attention in the Japanese corporate bond market.

Figure 7: SDG Bond Issuance in Japan’s Publicly Offered Corporate Bond Market



Conclusion & Future Outlook

COVID-19 dealt an initial shock to Japan’s financial markets and has continued to seriously affect the nation’s real economy. The financial markets, however, regained stability rather quickly, thanks to the Japanese government and the BOJ’s swift and proactive responses, which drew on lessons learned during past financial crises and other disruptive events.

Japan’s corporate bond market has evolved over the years. The 1980s and 1990s saw a number of measures to liberalize the issuance of corporate bonds, and then in the 2000s efforts were made to vitalize the market. These past efforts



to develop and vitalize Japan's corporate bond market have contributed to the market's relatively smooth functioning as a source of much needed funding during the COVID-19 pandemic.

Amid this pandemic, companies have continued to use the corporate bond market to raise funds, issuing bonds with a more diverse range of maturities as well as SDG bonds.

Looking ahead, initiatives to further stimulate activity in the primary and secondary corporate bond markets companies will continue as companies also continue to use the market to raise funds to overcome challenges presented by COVID-19. These trends will likely contribute to the sustainable expansion of Japan's corporate bond market.

Note

- 1 For convenience, this article refers to these bonds as green bonds, social bonds, and sustainability bonds.
- 2 Certain pledges made by debtors to secure their ability to fulfill debt obligations under bond guidelines or loan agreements when raising funds through corporate bonds or loans. Typical covenants include collateral provision restriction clauses, net asset value maintenance clauses, dividend restriction clauses, profit maintenance clauses, etc.
- 3 Japan Securities Industry Association, Study Group to Vitalize the Corporate Bond Market, "Initiatives Toward Vitalization of the Corporate Bond Market", July 30, 2012, pp.23. [Japanese only]
- 4 As of end-June 2021. The criteria for announced transactions have been revised from the initial criteria when the system was first implemented.

5 As of the end of June 2021.

6 The BOJ, "Enhancement of Monetary Easing", April 27, 2020.

7 Ordinary bonds, convertible bonds, etc.

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