Article Title: ARCHIVE | Criteria | Corporates | General: Rating Implications Of Loan Waivers For Japanese Corporates Data: (EDITOR'S NOTE: — This article has been fully superseded by "Reflecting Subordination Risk In Corporate Issue Ratings," published on Sept. 21, 2017. This criteria article was originally published on Sept. 23, 2003.) In Japan, lender banks often grant loan waivers to troubled corporate borrowers, a practice more popular here than in many other developed countries. A clear understanding of how loan waivers are treated in the rating determination process is very important for users of credit ratings, especially in view of the varying approaches to loan waivers adopted by different rating agencies. As part of Standard & Poor's ongoing global initiative to capture local market practices in its credit analysis methodologies, this article overviews the loan waiver practice in Japan and summarizes how Standard & Poor's incorporates this practice into its credit ratings. Loan Waiver Practice In Japan Loan waivers by lender banks are very common in Japan. According to a survey by Standard & Poor's, among the industrial corporates listed in the first section of the Tokyo stock exchange, about half of all defaults since 1999 took the form of loan waivers rather than bankruptcies. This practice stands in contrast to the situation in the U.S., where lender banks are often very aggressive in protecting their lending to troubled corporate borrowers. In the U.S., lender banks seldom take losses unless bondholders are also forced to do so, either in the form of bankruptcy, or through bond exchange offers without bankruptcy proceedings. In Japan, no publicly held bond has defaulted to date without bankruptcy proceedings. Implications For Issuer Ratings A Standard & Poor's issuer credit rating is a current opinion of an obligor's overall financial capacity to pay its financial obligations (its creditworthiness). This opinion focuses on the obligor's ability and willingness to meet its financial commitments as they come due. Standard & Poor's considers any loan waiver, including debt-to-equity swaps, as a form of default. Therefore, when a rated corporate receives a loan waiver, the entity credit rating ('ECR', a type of issuer credit rating) on the company is revised to 'SD' ("selective default"). An 'SD' rating indicates that the obligor has failed to pay one or more of its financial obligations (rated or unrated) when it came due. An 'SD' rating is assigned when Standard & Poor's believes that the obligor has selectively defaulted on a specific issue or class of obligations, but will continue to meet its payment obligations on other issues or classes of obligations in a timely manner. Once a loan waiver is fully delivered, Standard & Poor's reviews the "post-waiver" credit profile of the company and revises the ECR from 'SD' to a rating that reflects Standard & Poor's opinion of the obligor's overall financial capacity to pay its financial obligations in the future. Standard & Poor's annual default study focuses on ECRs and classifies both 'D' and 'SD' ratings as defaults. This ensures consistency between the definition of the ECR and the framework of the annual default study, both of which examine the frequency of any form of issuer default, including loan waivers. With such consistency assured, Standard & Poor's default study is a valuable tool to examine the quality of issuer ratings. Any default study that did not classify loan waivers in the same manner as defined in the ratings would not be a useful rating validation tool. Implications For Issue Ratings A Standard & Poor's issue credit rating is a current opinion of the creditworthiness of an obligor with respect to a specific financial obligation, a specific class of financial obligations, or a specific financial program. It incorporates both default probabilities and recovery prospects with respect to the specific instrument in question. In some cases, an issue rating on a specific debt instrument can be higher or lower than the ECR. Such rating differentials reflect the differences in default probabilities and/or recovery prospects among various debt instruments of the same issuer. Difference in default probabilities If the probability of default of the instrument is deemed materially lower (or higher) than on any other debt held by the same issuer, the instrument can be rated higher (or lower) than the ECR on the issuer. For instance, preferred creditor status obligations (obligations from multilateral lending institutions such as the World Bank) are sometimes rated above the ratings on the issuer sovereign when Standard & Poor's recognizes the sovereign's stronger incentive for, and thus higher likelihood of, timely payment on the preferred creditor status obligations than on other sovereign debts. Another example is deferrable instruments such as preferred stocks, which often have higher non-payment probabilities than nondeferrable instruments of the same issuer. Deferrable instruments are rated lower than the ECR on the issuer, usually by more than one notch. This reflects their higher nonpayment probability, not to mention their typically junior positions at liquidation, which pertains to recovery prospects. Difference in recovery prospects A debt issue can be rated below the ECR when the debt is judged to be junior to other debt issues of the issuer and therefore to have relatively worse recovery prospects. Conversely, a debt instrument can be rated above the ECR when the debt is judged to be senior to other issues and principal is expected to be fully recovered. These rating differentials based on different recovery prospects are often referred as to "notching." Incorporating the loan waiver practice Due to the loan waiver practice, it is particularly important in the rating analysis of Japanese corporate debts to consider differences in default probabilities among debt instruments of the same issuer. When Japanese corporates receive loan waivers from their key lenders, they usually continue to honor other debts on a timely basis. As such, the default probabilities vary for loans from key lenders and for other debt, when there is a good chance that a company default will take the form of loan waivers rather than outright bankruptcy. Standard & Poor's has recently concluded that, in some cases, it is reasonable to reflect in its ratings such differences in default probabilities among different debt issues of the same Japanese industrial corporates. This view is already incorporated in some bond ratings. For instance, the unsecured bond issued by Japan Airlines System Corp. (JALS) is rated 'BB', equivalent to the ECR of the issuer. The default probability of this unsecured bond is deemed to be lower than that of some other debts, such as certain bank loans, because there is a reasonable probability that any default (in a purely hypothetical situation) by JALS would take the form of loan waivers by the company's creditors. On the other hand, the recovery prospects for this bond in the event of bankruptcy are relatively weak, due to the secured status of many other debt issues held by the company. Taking into account both the relatively lower default probability and the weaker recovery prospects of this bond, Standard & Poor's currently rates this bond at the ECR level. Criteria For Rating Debt Above The ECR In general, Standard & Poor's is more likely to assign a debt rating that is higher than the ECR on an issuer when: The ECR is low. The higher the ECR, the more difficult it is to predict what will happen to the company, as well as how strong a relationship it can maintain with its lender banks, when it eventually defaults. In general, only firms with ECRs in the speculative-grade range are likely to benefit from upward rating adjustments on some of their debt instruments. The possibility of bank loan waivers is too remote to consider when the ECR is in the investment grade. The company is large. Historical data shows that loan waivers are more common for large companies. As mentioned earlier, since 1999, loan waivers have accounted for approximately half of all defaults (based on Standard & Poor's definitions) of industrial corporates listed in the first section of the Tokyo Stock Exchange, which covered 1,495 companies as of Dec. 31, 2002. Among Japanese industrial corporates rated by Standard & Poor's—a narrower universe covering approximately 200 companies—the ratio is far higher at 80%, indicating that seven out of nine defaults took the form of loan waivers (see table below). Lender banks have a lenient policy toward keeping borrowers afloat without forcing them into legal proceedings. Any possibility of a change in banks' lending practices over time should also be considered. The company's financial problems are largely attributable to its heavy debt burden, while its core business maintains good competitiveness. If this is not the case, loan waivers would not be of help to the company in restoring its profitability. Table 1 Defaults to Date of Japanese Industrial Corporates Rated by Standard & Poor's COMPANY FORM OF DEFAULT DATE OF RATING CHANGE ECR CHANGED TO: ECR CHANGED FROM: Kumagai Gumi Co. Ltd. Loan waiver 2003/09/22 SDpi CCpi Tomen Corp. Loan waiver 2003/04/01 SDpi CCpi Snow Brand Milk Products Co. Ltd. Loan waiver 2003/02/06 SDpi CCpi Daiei Inc. Loan waiver 2002/08/20 SDpi CCpi Misawa Homes Co. Ltd. Loan waiver 2002/04/17 SDpi CCpi Mycal Corp. Bankruptcy 2001/09/14 D CCpi Kumagai Gumi Co. Ltd. Loan waiver 2000/12/28 SDpi CCpi Hazama Corp. Loan waiver 2000/09/28 SDpi CCpi Nagasakiya Co. Ltd. Bankruptcy 2000/02/14 D CCCpi Kanematsu Corp. Loan waiver 1999/07/28 SDpi CCpi The ECR on Kumagai Gumi was changed to 'SD' twice, in December 2000 and September 2003 because the company received loan waivers twice. Standard & Poor's expects the loan waiver practice to remain popular in Japan for at least the next few years, partly due to the recent establishment of Industrial Rehabilitation Corp. of Japan (IRCJ). IRCJ is expected to purchase loans to troubled corporates from banks, and to facilitate the corporate rehabilitation process mainly through the loan waiver scheme rather than court bankruptcy proceedings. At the same time, the loan waiver practice may change over time, even in Japan. Standard & Poor's will assess the probability of loan waivers occurring in a forward-looking manner, rather than relying solely on previous experiences. Also, Standard & Poor's will continue to review any ongoing changes in the practices of Japanese lenders, and communicate any subsequent developments in its rating methodologies to the market. 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