What if gov't agencies become fully privatized?

Rating and spread levels likely to change as private-sector business corporations

- Full privatization of government agencies will not be implemented unless financial condition sound; default risk thus low for now after full privatization, putting aside long-term risk
- However, there is risk of change in rating and spread levels as they are assessed relative to those of other private-sector business corporations in same sector; DBJ and Shoko Chukin Bank bonds partially factored in full privatization for some time, which can be used as reference

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Consideration on ratings and spreads in case of full privatization of gov't agencies

What if gov't agencies become fully privatized?

Although full privatization of Shoko Chukin Bank had been indefinitely postponed, the bank's improper financing scandal raked over the privatization issue. *Doraemon* (character in Japanese comic) has a gadget called the "What-if phone box." What will happen if we say "what if government agencies become fully privatized?" to the receiver in the box?

Bankruptcy risk means bond default risk

Government agencies have two credit risks—one is risk of bankruptcy and the other is risk of full privatization. The former means risk of bond default when government agencies are in a situation where management would find itself in a difficult position following the government's rejection of support for continued losses at agencies.

Risk of full privatization means that of change in rating and spread levels

The risk of full privatization does not immediately lead to defaults. Unless the financial condition is sound, full privatization would not be implemented. The default risk is thus low for the time being after full privatization, putting aside long-term risk. Government agencies' ratings and spreads are determined based on the premise of the existence of government support. However, once they become private-sector business corporations, government support would decline and stand-alone valuation (such as business risk and financial position) would be compared with other private-sector business corporations in the same sector. The risk of full privatization is, firstly, a change in rating and spread levels. Depending on the situation, there is a possibility of rating downgrades and widening of spreads.

Few cases of full privatization after starting to issue FILP agency bonds

J-Power only full privatization case of FILP agency

Even without a "What-if phone box," we can learn how ratings and spreads changed via surveys of past full privatization cases of government agencies. However, government agencies started to be assigned ratings and issue publicly offered bonds in the market (i.e., FILP agency bonds) in FY01. From FY01 onward, only Electric Power Development (J-Power) was fully privatized (in Oct 2004) among government agencies that issue FILP agency bonds. Furthermore, as the full privatization of J-Power was decided by the Cabinet in June 1997, its rating and issuance spread factored in full privatization from the initial launch, as explained later in this report.

Full privatization partially reflected at DBJ, Shoko Chukin Bank

In November 2005, on the other hand, the Council on Economic and Fiscal Policy announced a basic guideline for policy finance reform, and decided to fully privatize Development Bank of Japan (DBJ) and Shoko Chukin Bank. Although the decision has not yet been realized due to the influence of the Lehman crisis and Great East Japan Earthquake, their ratings and spreads have partially factored in full privatization for some time. These cases can be used as reference.

Ratings changed to level of private-sector business firms in same sector

After full privatization, ratings determined in comparison with private-sector business corporations in same sector

Here, we look at the basic way of thinking for ratings at the time of full privatization. Ratings of government agencies are decided based on their stand-alone valuation plus government support. Accordingly, in the case of or just before the implementation of full privatization, their ratings are decided based on stand-alone valuation in comparison with other private-sector business corporations in the same sector, reflecting the absence of government support or a valuation decline to the level of private-sector business corporations.

DBJ: Downgraded from Japan's sovereign rating level due to decision on full privatization policy

All ratings introduced in this report are R&I's. As of June 2001, DBJ's rating was AAA, the same as Japan's sovereign rating. However, the rating was downgraded by two notches from AAA to AA in February 2007, reflecting the decision on full privatization. The rating agency attributed the downgrade to factoring in DBJ's stand-alone valuation and government support during the transitional stage. Subsequently, full privatization was indefinitely postponed, but it has not yet been withdrawn. The current rating (AA) has not thus recovered to the same level as Japan's sovereign rating (AA+).

Shoko Chukin Bank: Rating outlook changed to negative due to reconsideration of full privatization

Shoko Chukin Bank was assigned a rating in January 2007 after the decision to fully privatize the bank. The rating was AA–, three notches lower than Japan's sovereign rating. The bank's rating was not downgraded together with DBJ's rating. However, once full privatization was reconsidered following the disclosure of the improper financing scandal, the possible decline in government's involvement or support intention was factored in, leading to a change in the rating outlook to negative in January 2018.

Due to full privatization, rating of J-Power moving in tandem with that of private-sector electric power firms

J-Power obtained a rating in February 2003, and it was fully privatized in October 2004. As mentioned earlier in this report, as the policy to fully privatize J-Power was decided by the Cabinet in June 1997, the firm was already assessed as a private-sector business corporation when the rating was assigned. The initial rating was AA+, which is the level of government agencies. However, it would be more accurate to say that it is the level of private-sector electric power companies. For example, Kansai Electric Power was also rated as AA+ in the same period. Since then, as J-Power has faced several downgrades due to the nuclear power plant accident caused by the Great East Japan Earthquake together with other electric power firms, its current rating is A+, the same as that of Kansai Electric Power. This is one case that ratings after full privatization are determined in comparison with private-sector business corporations in the same sector.

Japan Airlines was gov't agency, but faced default after full privatization

We can point out other examples of former government agencies. Japan Airlines, which was fully privatized in 1987, is now rated A–, and ANA Holdings, a private-sector firm from its establishment, is also rated A–. However, the rating of Japan Airlines was downgraded to D in January 2010 owing to business failure. This shows one case that former government agencies faced defaults due to deterioration in business conditions even if business conditions immediately after full privatization went well.

Spreads also changed similar to level of business corporations in same sector

After full privatization, spreads decided as corporate bonds

We now look at the basic way of thinking on spreads at the time of full privatization. Creditworthiness of government agencies is decided based on their stand-alone valuation plus government support. Accordingly, in the case of or just before the implementation of full privatization, their spreads are decided based on stand-alone valuation in comparison with other private-sector business corporations in the same sector. With respect to the order of spreads, government-guaranteed bonds currently rank top, followed by municipal bonds, government agency bonds, and corporate bonds. Accordingly, the category shifts from government agency bonds to corporate bonds.

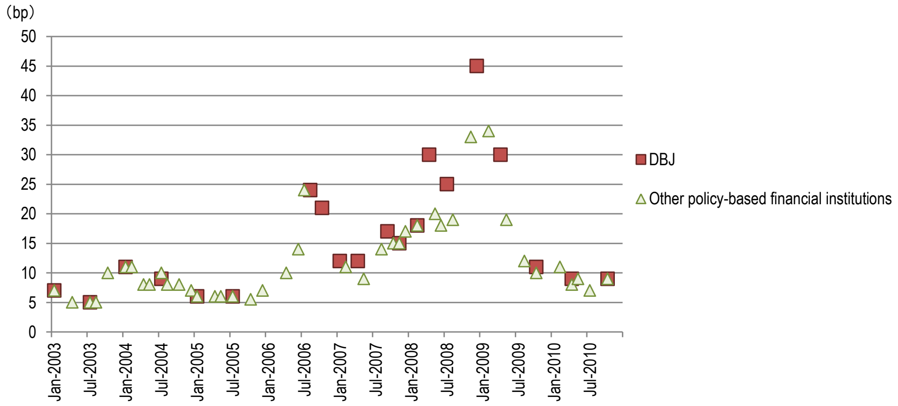
DBJ's spread decided in comparison with megabank bonds, factoring in full privatization

Regarding DBJ, the policy to fully privatize the bank was determined in November 2005 at the Council on Economic and Fiscal Policy. After a bill concerning policy finance reform was enacted at the ordinary Diet session in 2007, DBJ became a joint-stock company in October 2008. Chart 1 shows the issuance spread of 5-year bonds launched by policy-based financial institutions. Around late 2008 to early 2009 when DBJ became a joint-stock company, the difference between the spread of DBJ and that of other institutions widened to around 10bp. This was not the result of factoring in possible default but the widening of the issuance spread in comparison with private-sector megabanks. In other words, the issuance spread widened in advance, factoring in a shift to a private-sector financial institution due to implementation of full privatization.

Due to postponed full privatization, spread of DBJ returned to same level of other policy-based financial institutions

However, due to the global financial crisis triggered by the Lehman Brothers bankruptcy, full privatization of DBJ was postponed. In the latter half of 2009, the issuance spread tightened to the level of other policy-based financial institutions. Subsequently, full privatization was postponed again due to the Great East Japan Earthquake, and then it was shelved. To date, the issuance spread has been at the same level as that of other policy-based financial institutions.

Chart 1: Issuance Spread of 5-year Bonds Launched by Policy-based Financial Institutions

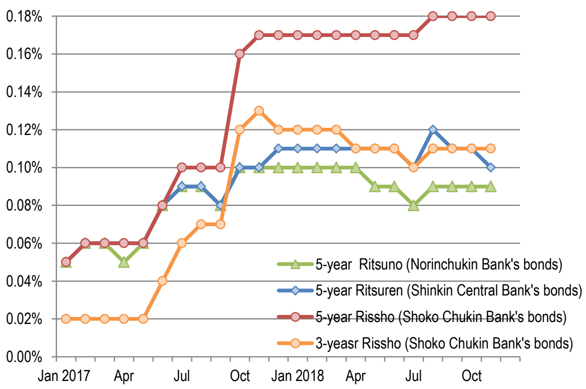


Source: Compiled by Daiwa Securities.

Improper financing scandal caused resurgence of speculation on full privatization of Shoko Chukin Bank, leading to wider spread

Similar to DBJ, the full privatization of Shoko Chukin Bank was shelved after having been postponed twice. Following disclosure of the inappropriate financing scandal in autumn 2016, a full-scale internal investigation started in spring 2017. Speculations on full privatization thus resurged in autumn 2017, immediately before the announcement of the investigation result, pushing up the issuance yield of both 3-year and 5-year bonds (Chart 2). In January 2018, the third-party committee at the Small and Medium Enterprise Agency proposed that full privatization should be reconsidered after Shoko Chukin Bank provides new services for four years. Speculations on full privatization are thus lingering and the issuance yield remains at a high level. That being said, partly because Shoko Chukin Bank is reducing the bond issuance amount, the bank is still providing lower yields than private-sector banks whose stand-alone valuation at rating agencies is similar to that of Shoko Chukin Bank.

Chart 2: Issuance Spread of 3-year and 5-year Coupon Bank Debentures



Source: Compiled by Daiwa Securities.

J-Power's FILP agency bonds regarded as private-sector electric power company bonds from initial launch

J-Power issued its first FILP agency bonds (10-year) in February 2003, with the issuance spread of 14bp. The spread of Tokyo Electric Power's 10-year bonds, also launched in February 2003, was 13bp, while that of New Tokyo International Airport Authority (public corporation, currently Narita International Airport) was 27bp. This reflected strong uncertainty about the outlook of government agencies because the Koizumi administration was considering the reform of special public corporations at that time. These spreads show that the market already regarded J-Power bonds as private-sector electric power company bonds before full privatization.

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■ Credit Rating Agencies

[Standard & Poor's]

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[Moody's]

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[Fitch]

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May 2018

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• In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction. In some cases, our company also may charge a maximum of ¥ 2 million (including tax) per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
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• There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
• There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
• Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

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