SOME RECENT DEVELOPMENTS IN THE JAPANESE BOND MARKET

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(Originally published in Canada as an information circular by Watts, Griffis and McOuat Limited, Consulting Geologists and Engineers, this memorandum may be of value to our members in view of the increasing Australian interest in the activities of the main Japanese brokerage houses. It is published with the agreement of the author and his Company.)

1. INTRODUCTION

Most sectors of the Japanese economy, and in particular the manufacturing industry, have suffered from the reduction in the rate of growth of the Japanese economy during 1971. Investment dealers have been an exception. The larger investment dealers have recorded increases in profits of as much as 28 percent over that of 1970. This compares with an average decrease in profits of 16 percent for all companies listed on the Tokyo Stock Exchange.

Increased brokerage fees and commissions have contributed to the growth in income. However, the greatest change has taken place in the underwriting of new issues, both equity and debt instruments and particularly the latter. While one cannot be assured that the growth in the underwriting of new issues, especially in the bond market, will continue unabated, the future does appear to be most promising.

The purpose of this article is to briefly review the major changes that have taken place in the Japanese bond market over the last two years.

2. NEW TERMS FOR CORPORATE BOND ISSUES

Until July 1971, the terms under which new corporate bonds could be issued in Japan was rigidly controlled by government financial authorities through a system that had been in effect for the past 25 years. The major effect of the changes introduced in the past year has been to allow more flexibility and elasticity in the bond market.

Previously Class A corporate bonds, the highest rated, had been priced such as to allow a fixed yield of 8.046%. Needless to say, this yield would frequently be quite inappropriate for conditions prevailing in monetary markets at that time. This was changed in July 1971 to allow yields to vary within plus or minus 0.25% of a yield determined by the government to be appropriate for a particular bond classification with reference to monetary conditions in effect at that time. In late 1971, this rate was lowered to 7.73% and recently was dropped further still to 7.50%. There is considerable discussion in Japan presently on what this rate should be and also as to what differences in yield should exist between central government, local government and corporate bonds. However, the fact that such discussion is taking place and that some flexibility has been introduced is something new and significant to the Japanese financial community.

Other less significant changes affect the life of a bond and the minimum total value of any new corporate bond issue. The maximum period of redemption has been extended from seven years to ten years. The minimum value of a new issue has been raised to 100 million yen or approximately $325,000.

3. THE EFFECT OF THE CHANGES

There has generally always been a large gap between prime interest rates and bond yields in Japan. This has made bond financing a very expensive alternative for Japanese industry. The

FINANCIAL RESULTS OF SOME MAJOR JAPANESE INVESTMENT DEALERS FOR 12 - MONTH PERIODS ENDING SEPTEMBER 30TH, 1970 & 1971

Millions of Canadian Dollars*

Company	Nomura		Nikko		Daiwa		Yamaichi		Shin Nippon	
	1971	1970	1971	1970	1971	1970	1971	1970	1971	1970
Brokerage Commissions										
- Stocks	101.8	102.4	76.0	68.9	59.7	62.4	56.3	52.3	29.4	28.3
- Bonds	28.2	21.8	21.6	18.8	19.7	18.3	21.2	18.0	8.6	6.9
- Investment Funds	18.9	17.2	13.1	14.0	15.6	15.3	11.9	10.2	2.4	2.6
TOTAL	148.9	141.4	110.7	101.7	95.0	96.0	89.4	80.5	40.4	37.8
Underwriting Commissions										
- Stocks	22.9	7.8	5.2	0.3	5.5	0.2	3.5	1.9	(0.8)	4.9
- Bonds	7.8	(0.9)	6.5	(2.1)	2.3	(9.4)	3.3	(7.2)	1.0	(2.3)
- Investment Funds	-	(0.3)	(0.8)	(0.7)	1.3	3.2	0.5	2.7	-	0.4
TOTAL	30.7	6.6	10.9	(2.5)	9.1	(6.0)	7.3	(2.6)	0.2	3.0
Operating Income	63.0	39.1	32.9	23.4	28.4	19.9	22.2	13.4	8.1	8.8
Total Income Before Taxes	82.1	60.6	46.4	37.9	37.0	30.8	25.3	16.9	9.7	10.4
Net Income After Taxes	36.4	34.1	23.8	21.9	18.5	18.0	10.6	13.4	4.2	3.6

*Conversion from yen to dollars at the rate of 308 yen per Canadian dollar.

major proportion of new bond issues has usually been subscribed to by large banking concerns. As bond issues in Japan are generally secured, the raising of funds through bond issues was in effect the granting of large mortgages by the banking community.

Thus the usual objective of corporate bond issues, to raise capital from the public, was somewhat distorted. The new regulations are intended to return the bond to its proper status as an instrument for the raising of funds, the absence of which has severly affected Japanese financial markets for some time.

The individual Japanese investor has never invested in corporate bonds. He traditionally has placed his money in savings account deposits, either at local banks or in post offices. For those who have been knowledgeable about inflation and concerned about its eroding effect, investments in real estate and in common stocks have been the prime means for protection against inflation. Insurance companies and other institutions with large sums to be invested have also avoided bond purchases because of the lack of sufficient protection against the rate of inflation in Japan which has been somewhat higher than that in Canada. Inflation is now being better controlled and insurance companies, pension funds, etc. are beginning to place some of their funds in the bond market. The control of inflation will be a key to the continued revival of the Japanese corporate bond market.

The fact that there has been a loosening of the restrictions affecting the bond market, affording greater flexibility to all concerned, will in itself be sufficient to generate considerably more activity, as was evidenced in 1971.

Under previous conditions, the corporate bond underwriting departments of most large investment dealers were generally non-profitable. In 1971, a dramatic reversal took place and most companies were able to show substantial improvements in profits accruing from their activities in the bond markets. This is illustrated in the accompanying table.

The president of Nomura Securities, the largest investment dealer in Japan, stated recently that he anticipates the total value of all bonds underwritten in Japan to approach 15 billion dollars in the near future. This would be approximately five times the volume of last year. He went on to say he expected 1972 to be a very profitable year for his company, and that eventually, profits derived from the underwriting sector would be sufficient to cover operating costs for all departments.

In Japan, under Article 65 of the Security Act, banks are prohibited from acting as underwriters of any new issues. Prior to the war, such a restriction did not apply. At present, the banks are negotiating with the Ministry of Finance in an attempt to have this rescinded. If they are successful, the banks will have made a major step forward in their plan to become involved in a continually broadening range of financial activities. Japanese banking groups are already joining international consortia in Europe and Australia, and are participating in the financing of large projects and even venture funds.

The gradual liberalization of more and more aspects of the manner in which financial activities in Japan are conducted lends support to our belief that Japan will soon become an ever increasingly large exporter of capital. The expected increase in investment abroad by Japanese financial institutions has not materialized at the pace expected since the first steps toward liberalization last July. This, however, is due to the uncertainty that was attached to exchange rates. Influential concerns in Japanese investment circles are now asking the Ministry of Finance to allow securities purchased abroad to include government and corporation bonds in addition to stocks listed on the ten major stock exchanges of the world.