



R&I's Analytical Approach to Short-Term Ratings

(This report is an English translation of the original report in Japanese.)

- A Short-term Rating is R&I's opinion concerning an issuer's certainty to repay its short-term financial obligations as provided in its financial agreements. R&I assigns such ratings to short-term programmes such as commercial paper (CP) and to an issuer's payment ability with regard to its short-term financial obligations and individual obligations. Short-term Ratings are expressed with rating symbols different from those for an Issuer Rating or Long-term Issue Rating assigned to bonds or loans.
- Although R&I uses different rating symbols for short-term and long-term ratings, there is no change in R&I's viewpoint that a rating is an assessment of the certainty of performance of an obligation. When assigning a Short-term Rating, R&I makes its evaluation based on creditworthiness of the issuing firm. R&I also sufficiently investigates short-term factors, including cash management characteristics, the details and level of liquidity on hand during the period and short-term fund raising capacity.

What is a Short-term Rating?

When assigning a rating for an individual long-term obligation such as a corporate bond or a loan, R&I first judges the probability of the issuer falling into bankruptcy, such as a default (default risk analysis), then judges the probability of a loss (probability of recovery) at the time of default (recovery risk analysis). The former analysis, which R&I refers to as an Issuer Rating, serves as the basis for a rating for an individual obligation. Because ratings for individual obligations are evaluations based on an Issuer Rating and are influenced by recovery risk, they may have different ratings even if the issuer is the same, in order to reflect considerations such as collateral or the specific details of the agreements.

■ Diagram 1 Short-term Rating definitions

Rating	Definitions
a-1	Certainty to meet short-term obligation is high.
a-2	Certainty to meet short-term obligation is high but some factors need attention.
a-3	Certainty to meet short-term obligation is sufficient for the time being, though some factors need close attention in times of environmental changes.
b	Certainty to meet short-term obligation is not equal to that of a-ratings. There are factors which raise concerns about meeting obligation.
c	Lowest rating. In default or is extremely likely to be in default.

* Plus sign (+) may be added to a-1 ratings to indicate a particularly high level of repayment certainty.

On the other hand, because investors have stronger expectations towards the timely payment of short-term debt, a Short-term Rating evaluates the certainty of performance of a short-term obligation and does not reflect the probability of loss at default.

The rating symbols and definitions for each Short-term Rating are shown in Figure 1. For financial institutions R&I sometimes assigns a rating to express a capacity to meet short-term financial obligations. For corporates, however, R&I typically assigns a Short-term Rating for commercial paper (CP) programmes.

■Diagram 2 long-term rating and short-term rating correspondence relationship

long-term rating	short-term rating		
AAA			
AA +			
AA	a-1+		
AA -			
A +		a-1	
A			
A -			a-2
BBB +			
BBB			
BBB -			a-3
BB +			
BB			
BB -			b
B +			
B			
B -			
CCC +			c
CCC			
CCC-			
CC			
C			

(Note) The above diagram shows the correspondence relationship in principle.

CP positioned as "short-term corporate bond" has a shorter term to maturity than general corporate bonds and is a funding method that emphasizes flexibility. Consequently, the issue is so frequent that it is unrealistic to assign a rating for every separate CP issue, and R&I assigns ratings for CP programmes that assume total CP issues will remain within the scope of an "issue limit" determined beforehand by the issuing firm.

Relationship to long-term ratings

A "Short-term Rating" is R&I's evaluation of an issuer's certainty to repay its short-term financial obligations. Although the rating symbols are different from those for a long-term rating, it is impossible to sever the rating entirely from an evaluation of medium to long-term creditworthiness, and an Issuer Rating provides the basis of the assessment. Therefore as a rule, there is a general relationship between the long-term rating and short-term rating.

In general, however, the debt characteristics of short-term and long-term obligations differ. Long-term obligations such as bank borrowings or bonds are funds fixed for the long term for capital investment, for example, and in manufacturing in particular the cash flow generated by the issuer frequently becomes a repayment source. If capital investment is required continuously, borrowers often must redeem their obligations through refinancing, such as new bank loans or bond issuance. Short-term obligations, on the other hand, are often used for the purpose of supplementing revolving differences in operating capital and one-time payments, such as bonuses, and typically are repaid using cash flow generated through working capital recovery and cash on hand, for example. In light of these considerations, when assigning ratings to short-term obligations R&I thoroughly investigates short-term factors, such as cash management characteristics, the details and level of liquidity on hand during the period as well as short-term fund raising capacity. The weight of these factors in the assessment is higher than when assigning a long-term rating.

Key analytical points for a Short-term Rating

The key points evaluated for a Short-term Rating, particularly CP programmes are explained below.

(1) CP issue amount and use of funds

R&I begins by examining the purpose for which the funds will be used, the frequency with which the borrower will issue CP and the amount the borrower plans to issue. In particular, for a large issue limit amount, R&I will investigate the amount the borrower plans to issue as actual demand, such as working capital, and the reasons for setting an issuance limit that exceeds this amount. R&I also will study the effect the issue limit amount will have on the issuer's financial position, after confirming points such as whether using CP to raise funds will result in a net increase in debts or whether total debts will not increase because the issuer will use the issuance as an alternative to bank borrowing.

(2) Cash management

Based on monthly cash management statements, settlement terms and conditions, etc., R&I will review the characteristics of funds inflows and outflows during the fiscal year and investigate how the issuer controls these actual cash flows. R&I confirms the differences in the timing of payment proceeds and payments, the amounts each time scale and seasonal cash needs for items such as bonuses, dividends and corporation taxes, and closely examines short-term fund requirements during the fiscal year. When an issuer has introduced a group-wide CMS (cash management system), R&I will review the specific mechanisms and control procedures.

R&I also verifies what an issuer plans to use as a source of funds for redemption of the CP. For example, this might include recovery from working capital surplus, rollover of the CP, borrowings from financial institutions or a sale of current assets. R&I confirms whether such plans are reasonable by considering them in light of the

borrower's actual cash management and current assets conditions and its business relationship with financial institutions. When the short-term funds procured using CP are used for long-term purposes, funds from refinancing become the source of funds for repayment of the CP. In this situation, R&I will confirm what alternative means the issuer has arranged to raise funds if it cannot complete a CP rollover.

(3) Relationship with financial institutions

To evaluate an issuer's ability to raise funds from outside financial institutions, R&I examines the stability of the issuer's transactions with its main banks and the strength of the relationships. R&I also confirms the contents of overdraft agreements or other arrangements the issuer has concluded with financial institutions, and borrowing conditions during the fiscal year.

(4) Liquidity assessment

It also is important to comprehend the level of liquidity, including cash and deposits during the fiscal year. R&I studies the direction of fund management policies and actual funds investment when excess cash is generated, and closely examines the extent to which cash and deposits increase or decrease during the fiscal year and what working capital is ensured.

R&I's approach to backup lines

A backup line (BL) is a specialized borrowing facility used solely for CP settlements. A BL provides a means of liquidity enhancement to prevent obstacles to redemption from occurring when refinancing cannot be accomplished because of confusion in the CP market on the CP maturity date. Investors frequently utilize CP as an investment alternative for short-term surplus funds, and anticipate the CP will be redeemed at maturity. Issuers also often plan from the start to roll over their CP as it comes due. Nevertheless, if an issuer cannot issue new CP because of market turmoil it is possible the borrower will be unable to redeem its CP, regardless of whether it boasts sufficient creditworthiness. Consequently, CP issuers must ensure beforehand the funds or means they will be able to use for redemption in a market crisis that does not necessarily result from a credit event.

Conditions that prevent an issuer from issuing CP in the market will vary depending on the issuer. The time required to secure a new means of financing, other than a commitment line agreement with financial institutions with which the issuer currently has ties, will also differ for each issuer. If an issuer has a high credit worthiness, it will not be very difficult to seek out financial institutions that want to expand their business with the issuer. In contrast, an issuer with low creditworthiness might require some time to arrange a new line of credit. Therefore the level of liquidity and alternative liquidity R&I judges to be sufficient in comparison with the CP issue balance will be set higher for issuers with low creditworthiness.

In the U.S. market, except for issuers with extremely strong creditworthiness, all firms typically will provide for 100% liquidity, including alternative liquidity, against

their CP issue balance. The reason is that many borrowers issue short-term CP frequently, and there is a greater possibility than in Japan of such issuers being pressured by a short-term cash squeeze that could lead to default if new CP issue is delayed because of market confusion.

In Japan, on the other hand, where indirect finance is the main source of funds, the sense of crisis regarding market disruptions is not as acute as in the United States. Notices concerning CP including BL rules were abolished in 1998, and in Japan today, in reality, there are almost no instance of a company concluding a BL agreement to ensure alternative liquidity.

R&I believes measures to ensure redemption funds as protection against market confusion are necessary, even if such measures do not necessarily depend on a BL agreement. If there is an excess in the funds a firm has available from normal operations, it can use this temporarily as a source of funds for redemption, or as an alternative even if other options are available, such as an agreement enabling it to raise capital quickly using short-term marketable investment securities or from financial institutions. Therefore, R&I examines the details and terms of use of an overdraft agreements or commitment line agreements closely, in addition to the details and level of quick assets, and judges whether a borrower will be able to ensure funds for redemption in an emergency that results from market factors. In addition, for firms that procure short-term funding globally, R&I confirms whether the issuer has measures in place for the respective market and currency that will enable it to redeem its CP even during periods of market confusion.

Procedure for providing BL information

R&I used to announce the ratio of BL required for the issue balance at the time it assigned a rating to a CP programme. Now, R&I announces the evaluation of actions taken to prepare against CP market confusion by taking liquidity into consideration, including the actual establishment of a BL, and alternative liquidity and other factors. The reasons why R&I changed its procedure for providing information include: (1) as deregulation of CP issuance progresses, there have been cases where firms do not establish a BL even though a rating company shows the ratio, and it has been pointed out that publicly releasing such information has resulted in greater investor confusion, and (2) the waning interest of market participants in BL.

R&I currently releases its evaluation results in the format set out hereafter. For example, if a firm with a 20% liquidity shortfall establishes a BL to cover that shortage, the result is "a 20% BL has been established against the issue balance, and the level of liquidity is sufficient." When an issuer has not prepared a BL or other alternative liquidity even though its asset liquidity is inadequate, and R&I judges liquidity to be insufficient even if qualitative factors are considered, R&I will indicate that "measures to ensure alternative liquidity are required." For a firm that does not have plans to issue CP even though it has obtained a CP rating, R&I will also describe the liquidity enhancement policies or other measures the firm took when it issued the CP.

The methodologies and models R&I uses in connection with evaluation of creditworthiness (collectively, the "Rating Methodologies") are statements of R&I's opinions prepared based on R&I's own analysis and research, and R&I makes no representation or warranty, express or implied, as to the accuracy, timeliness, adequacy, completeness, merchantability, fitness for any particular purpose, or any other matter with respect to the Rating Methodologies. Further, disclosure of the Rating Methodologies by R&I does not constitute any form of advice regarding investment decisions or financial matters or comment on the suitability of any investment for any party. R&I is not liable in any way for any damage arising in respect of a user or other third party in relation to the content or the use of the Rating Methodologies, regardless of the reason for the claim, and irrespective of negligence or fault of R&I. All rights and interests (including patent rights, copyrights, other intellectual property rights, and know-how) regarding the Rating Methodologies belong to R&I. Use of the Rating Methodologies, in whole or in part, for purposes beyond personal use (including reproducing, amending, sending, distributing, transferring, lending, translating, or adapting the information), and storing the Rating Methodologies for subsequent use, is prohibited without R&I's prior written permission.

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