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For Public Comments on Revision of Rating Methodology for Local Government Bonds

Japan Credit Rating Agency, Ltd. (JCR) is considering to revise Rating Methodology for Local Government Bonds to Rating Methodology for Local Public Bodies and presents its outline as follows, and JCR welcomes any comments/ opinions on the draft for it.

1. Outline

JCR has been rating local government bonds, but has not assigned rating and rating outlook to local public bodies, issuers of those bonds. JCR decided to revise the Rating Methodology for Local Government Bonds to Rating Methodology for Local Public Bodies to improve convenience of investors and JCR's credit rating quality as shown in the attached.

2. Next Steps

JCR would like to invite public comments on the draft methodology. Comments are welcomed by an E-mail until May 12 under "Contact Us" on JCR's website. JCR plans to finalize it as a credit rating methodology in approximately two weeks. With revision to the rating methodology, JCR expects no existing rating to be reviewed, but plans to assign afresh an issuer rating and a rating outlook to local public bodies.

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Proposed Revision

Attachment
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Rating Methodology for Local Public Bodies

In rating a local public body, JCR assesses each local public body's tax-bearing capacity, fiscal conditions, fiscal management, and so forth, along with credit enhancement provided by the Japanese government. The following is an outline of JCR's rating methodology for local public bodies.

1. Credit Enhancement by the Japanese Government

Creditworthiness of local public bodies is supported by the government's credit enhancement including local public finance program, local allocation tax system, financial reconstruction system, local bond system. With strong government's credit enhancement, ratings for local public bodies are extremely high, but are susceptible to the government's rating.

(1) Position of Local Public Bodies

Administrative activities that are closely related to people's living such as development of social infrastructure including welfare, school education, fire protection, roads, rivers, etc. are mostly performed by local public bodies. In calculation of National Accounts of Japan, local governments are larger final consumption expenditure bodies than the central government, accounting for 11.9% (FY2014) of gross domestic product (expenditure approach, nominal), 2.5-fold as large as that of the central government. By body of final consumption expenditure, local governments account for 41.1% (FY2014) of the government final consumption expenditure and 69.8% (FY2014) of public gross fixed capital formation. As shown by these figures, local public finance has important status in the country's economy in parallel with national finance.

(2) Local Financial System

The Japanese government guarantees revenue sources for local public bodies through local public finance program by way of local allocation tax and local bonds so that they can play their important roles, regardless of gaps among regions due to differences in population and industrial concentration and also differences in tax revenues from fiscal year to fiscal year.

The total amount of fiscal transfer from the central government to local public governments primarily through local allocation tax is determined every fiscal year in the process of the central government's budgeting. The transition of total amount of general revenue sources, which consist of local tax, local allocation tax, extraordinary financial measures bonds, shows a significant drop in FY2004, reflecting the triple reforms promoted under the Koizumi administration. As a result, each local public body struggled with budget compilation. Since FY2005, the Japanese government has been giving due consideration to the local bodies' fiscal management so that they can perform stable fiscal management, placing a great value on maintaining/ ensuring a sufficient level of the general revenue sources. Following a subsequent significant worsening of economy after Lehman Shock and the resulting considerable drop in tax revenue, the Japanese government increased local allocation tax in addition to the already defined local allocation tax from FY2008 to FY2011. In and after FY2011, while local tax recovered, local allocation tax has not been reduced much. As a result, the total amount of general revenue sources has been increasing constantly since Y2005, exceeding the level before the triple reforms. Under the initiative of unified fiscal and economic reform, the Japanese government plans to set the total amount of general revenue sources at the same level as the FY2015 local public finance program's so that the total amount that is required for stable fiscal management of local public bodies receiving local allocation tax and other local public bodies cannot fall below this FY2015 level.

(3) Act on Assurance of Sound Financial Status of Local Governments

Act on Assurance of Sound Financial Status of Local Governments (hereinafter referred to as the "Act") became fully effective in April 2009 in order for the Japanese government to promptly take action in cases where financial soundness or rebuilding is required, with unified indicators clearly showing fiscal conditions of local public bodies. The Act defines 4 indicators: real deficit ratio; real debt service ratio; consolidated real deficit ratio; and future burden ratio, as soundness ratios for local public bodies, and a local public body is required to formulate a financial soundness plan if any one of the indicators exceeds a certain level (early financial soundness scheme). Using three indicators among the soundness ratios, excluding the future burden ratio, as the ratio for determining rebuilding, if any of the three indicators exceeds the financial rebuilding standards, a financial rebuilding plan must be established (financial rebuilding scheme).

The central government's involvement in the financial rebuilding scheme is clear when comparing with the early financial soundness scheme. More specifically, under the early financial soundness scheme, authorities responsible for receiving report of the plan and report on the progress of implementation and making recommendations to the head in cases where such local bodies face difficulties in achieving their plans are the Minister of Internal Affairs and Communications and prefectural governors, but under the financial rebuilding scheme, such authorities are limited to the Minister of Internal Affairs and Communications only. A local public body can issue local government bonds only with consultation with the Minister of Internal Affairs and Communications under the early financial soundness scheme, but issuance of local government bonds is limited without the consent under the financial rebuilding scheme except in cases of disaster recovery or other emergencies. Furthermore, only if a local body has obtained the consent of the Minister of Internal Affairs and Communications, it can issue rebuilding transfer special bonds within the range of its balance shortfall. In principle, the central government is to provide appropriate funds for the special bonds as far as the central government's fiscal situation permit it to do so. In addition, the financial rebuilding scheme specifies the relationship between a local body's budget and its financial rebuilding plan, suggesting the influence of the central government's strong involvement in the financial rebuilding body's budget compilation.

(4) Local Government Bond System

Notification system was introduced in FY2012 on behalf of the past consultation system to the local government bond issuance for the local public bodies which meet certain requirements. In FY2016, unnecessary criteria for the consultation were softened, expanding the coverage of notification system and shifting the previous consultation issues in principle to the notification system's.

The Japanese government guarantees sources for expenditure constituting the redemption of principal and interest on local government bonds, through formulation of local public finance program and calculation of local allocation tax. It also ensures safety of redemption of principal and interest on local government bonds by controlling bond issues in advance by a local public body whose debt service burdens exceed a certain limit, through a permission system of bond issuance as a prompt corrective system, in order for each local public body not to have difficulty in its principal redemption and interest payment.

(5) Local Administrative and Financial Systems

It is necessary to pay attention to not only local bond system and local financial system but reform of local administrative system. Given that local financial system is inextricably linked to local administrative system, credit rating is influenced by the state of local administrative system. That is, if the local administrative system changes, then the local financial system will change, causing a way of thinking about credit rating to change. However, there have been no important reforms and changes in these systems to date in terms of rating decisions.

Based on Decentralization Reform Promotion Plan formulated in December 2009, the related legislative acts were enacted and came into force 4 times. These reforms that have been made, however, are centered on revisions of the central government's frame of responsibilities and delegation of authority to the local bodies. The revisions of frame of responsibilities were not intended to revise administrative servicing itself, but were intended to revise control of the method of implementation of their services, etc. These reforms were reductions and revisions of national subsidies, which have not led to revisions of local financial system. In March 2013, headquarters of Decentralization Reform Promotion was established with the Prime Minister as the head.

Based on "Basic Policy on Economic and Fiscal Management and Reform 2015" that was decided by the cabinet in June 2015, the Minister of Internal Affairs and Communications released "Points to Consider Regarding Promotion of Local Administrative Services Reform," requesting local public bodies to make more efforts to promote administrative services reforms. The trend of

Decentralization Reform will remain an important factor for JCR's ratings for local public bodies.

(6) Japanese Government's Fiscal management Stance

It is important to look at the central government's fiscal conditions and its stance on fiscal management to examine local finance. It is necessary for the central government's fiscal deficit or debt level to remain at a sustainable level in order to maintain a sufficient level of fiscal transfer from the central government to local public bodies. If the fiscal transfer is significantly reduced, because the central government loses sufficient margin of the fiscal management, gaps among local public bodies will become clear. In particular, JCR pays attention to the financial measures for redemption of principal and interest payment on extraordinary financial measures bonds, of which the balance has been remarkably increasing in recent years. The central government shall transfer funds for the principal redemption and interest payment in full for the bonds. Meanwhile, the total amount of the central government's fiscal transfer to local public bodies is decided by budget compilation every fiscal year. If the total amount of transfer is reduced, the financial sources for the redemption of extraordinary financial measures bonds will then be reduced.

2. Fiscal conditions of Local Public Bodies

Assessing fiscal conditions of individual local public bodies is both quantitative and qualitative.

(1) Quantitative Assessment

A quantitative assessment is based primarily on the most recent already fixed financial results using 3 criteria: (i) tax-bearing capacity; (ii) ordinary account's status of income and expenditure; and (iii) conditions of liabilities (including public enterprises and auxiliary organizations such as 3 public corporations, etc.).

(i) Tax-bearing Capacity

In assessing tax-bearing capacity, JCR focuses on indicators such as financial capability indicator and per capital gross prefectural domestic product. JCR also focuses on fixed property tax valuation prices, etc. for cities, towns and villages. The financial capability indicator is calculated as the past 3-year average of the figures derived from dividing basic financial revenues by basic financial needs. A higher figure of financial capability indicator means more revenue sources are reserved in the calculation of ordinary local allocation tax, and that the local public body can be said to have a greater margin for revenue sources.

(Key indicators)

- Financial capability indicator
- Per capita gross prefectural (municipal) domestic product
- Per capita fixed property tax valuation price (cities, towns and villages)

(ii) Ordinary Account's Status of Income and Expenditure

When assessing ordinary account's status of income and expenditure, JCR places a great value on factors including ordinary balance ratio, current conditions of deficit in revenue sources/ financial measures, and balance of available reserves for the fiscal management. As for the ordinary balance ratio, ordinary general revenue sources with a special share of revenue decrease compensation bonds and also extraordinary financial measures bonds added to it is used as the denominator, and when the sinking fund to pay off bullet bonds is insufficient, the reserve method is modified if it is significantly different from that of other organizations. At a prefectural level, the ordinary balance ratio tends to fluctuate markedly every fiscal year due to trends in corporate and related taxes. Therefore, JCR thinks it is appropriate to use methods like moving averages to eliminate such fluctuations. JCR would deem a local government's income and expenditure being in a difficult state, if deficit in revenue sources/ financial measures need to be covered by various borrowings, such as borrowings from funds and other accounts, or through issuance of local administrative reform promotion bonds or other special bonds.

(Key Indicators)
- Ordinary balance ratio
- Appropriable funds for redemption of local government bonds

(iii) Conditions of Liabilities (including public enterprises and auxiliary organizations such as 3 public corporations, etc.)

As for conditions of liabilities, JCR looks at the future burden ratio and the basis of the calculation of this ratio. The range of areas in the financial statements that the 4 soundness ratios cover is slightly different from one another (see Table). The future burden ratio is the only stock index in the calculation, which uses net indebtedness to be borne by all the accounts/ corporations of local public bodies including public enterprises and auxiliary organizations, etc. in the future.

Regarding auxiliary organizations such as local public enterprises, 3 local public corporations, third-sector enterprises, etc., it is necessary to consider how much transfers to other accounts and additional financing can cause burden on the ordinary account. After making analyses of management and fiscal conditions of individual public enterprises and major auxiliary organizations, JCR examines adequacy of calculation of burden on the ordinary account for each of them.

(Key Indicators)
- Future burden ratio

(2) Qualitative assessment

The important points in qualitative assessment are future financial prospects and the stance of the local public bodies on the fiscal management that forms the basis of the prospects. Even in qualitative assessment, JCR makes efforts to obtain as much quantitative information as possible that could help estimate the extent of an improvement or a worsening in the fiscal indicators, rather than simply try to determine the direction alone. The key points for assessment include: (i) review of expenditures and debt management and other efforts aimed at financial soundness; (ii) prospects of fiscal balance/ financial measures for the local public bodies' ordinary account, etc.; and (iii) efforts to strengthen management base of public enterprises, auxiliary organizations, etc. and their fiscal outlook.

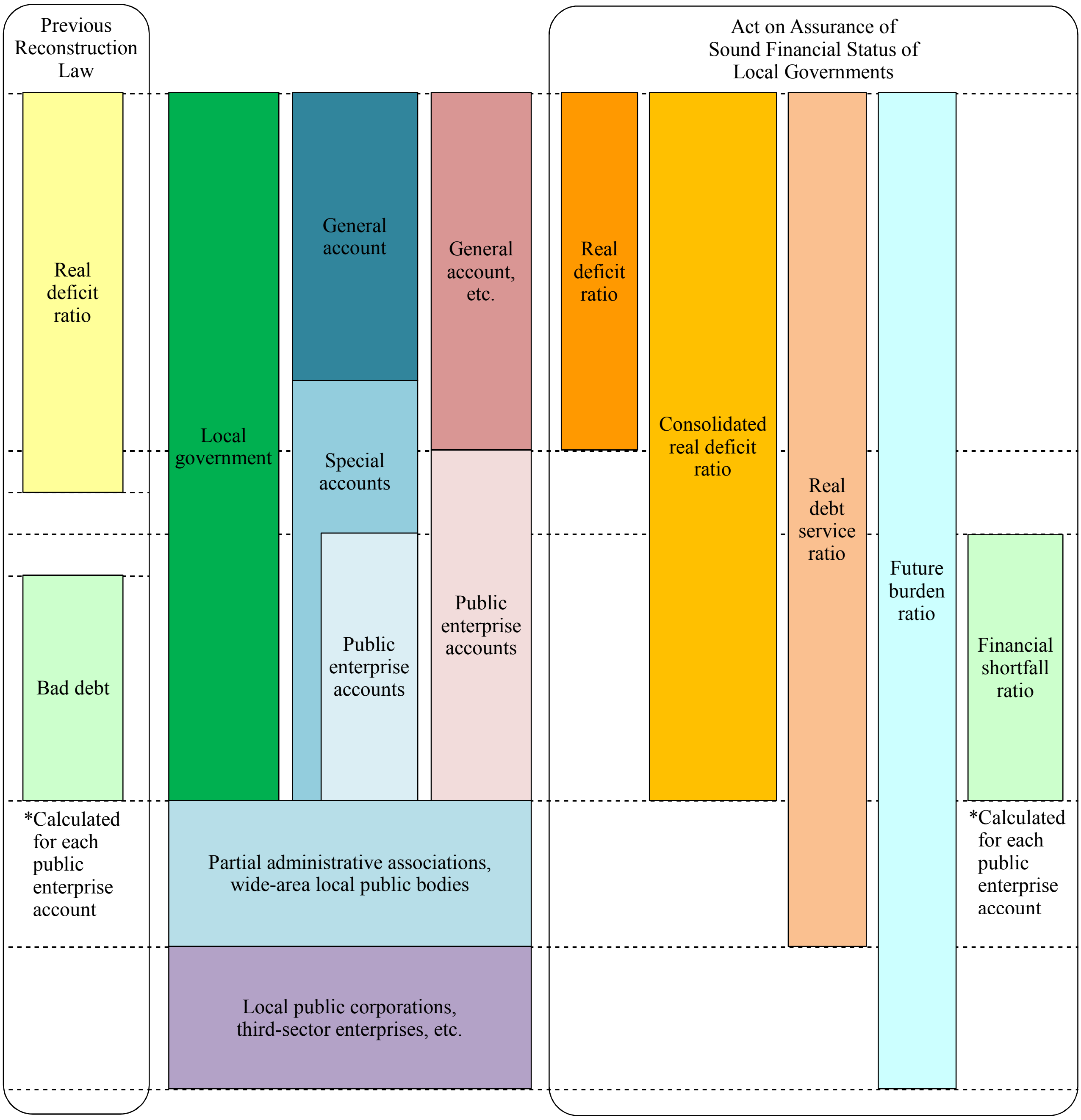
JCR also considers it is necessary to take into account the strength of the will of the local public bodies in achieving financial soundness, in addition to details of administrative and financial reform plans and other plans. This is because reforms could fail even with an outstanding plan, depending on views of the local assembly or local residents. If JCR can confirm the strength of the will of the local public body, while taking into account the trends in the local assembly, JCR would be able to incorporate into ratings the efforts made toward financial soundness at least during the existing administration. In such a case, JCR acquires as much quantitative information as possible on the prospects of improvement in fiscal indicators such as ordinary balance ratio and outstanding debt balance and incorporates its findings into the ratings.

As for the debt management, numerical targets for the outstanding balance and issue amount of local government bonds should be set as clearly as possible based on the future prospects of local government bond balance.

For the prospects of fiscal balance/ financial measures for the local public bodies' ordinary account, etc., JCR examines the details of the financial measures to find revenue sources for expected revenue shortfalls. Any reliance on borrowings from funds or issuance of special bonds due to failure in reducing annual expenditures will leave the burden into the future. Thus, this is not desirable. As the prospects of fiscal balance vary significantly depending on assumption of annual revenues and expenditures, JCR needs to verify whether the assumptions are appropriate.

JCR is particularly interested in future cash flows and outlook for debt repayment funds in assessing efforts to strengthen management base of public enterprises, auxiliary organizations, etc. and their fiscal outlook. Since the amount of burden on ordinary account from outstanding debt balance of these organizations is basically derived from the most recent financial results, JCR's quantitative assessment does not include effect of improvement in future management. An increase of cash flow from operating activities associated with improved management of these public enterprises, auxiliary organizations, etc. is expected to reduce the amount of burden related to their debt redemption on ordinary account.

Table: Area Covered by Soundness Ratio



(Source: the Ministry of Internal Affairs and Communications' home page)

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