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Local Government Bonds

1. The basics behind rating local government bonds

JCR evaluates local government bonds in Japan by assessing local governments in conjunction with credit enhancement provided by the central government, not just by evaluating each local government as a single entity. The country provides solid credit enhancement to local government bonds, and thus, we assume that these bonds carry a "tacit guarantee" from the government.

2. Credit enhancement by the national government

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

The series of reforms and events related to local finance has had a powerful impact on the market since Heizo Takenaka took office as the Minister of Internal Affairs and Communications at the end of October 2005. While Takenaka was in office, he had been in a series of privately held meetings (entitled the 21st Century Vision for Decentralization or "Vision Meetings") with related parties on developing a legal system for bankruptcy rehabilitation. At the same time, the city of Yubari was designated to be under financial reconstruction. This caused concerns among market players, including financial institutions, about the effectiveness of the "tacit government guarantee" given to local government bonds.

A proposal to set up a legal system for bankruptcy rehabilitation within three years had been proposed during the Vision Meetings. As such a study group was formed to examine a specific framework for new legislation on local government financial rehabilitation. A bill on Act on Assurance of Sound Financial Status of Local Governments was drafted based on a report (dated December 8, 2006) issued by this study group and passed in June 2007 and became effective in April 2009 with some excluded provisions (hereinafter referred to as the "Financial Soundness Act").

The previous system for local government financial reconstruction (hereinafter "reconstruction system") had a number of problems, some of which were addressed by the Financial Soundness Act. The problems with the previous system were broadly divided into four areas: 1. inadequate financial information disclosure; 2. incomplete standards for the application of the reconstruction system; 3. Application of the reconstruction system was not compulsory; and 4. unclear responsibility of the relevant parties involved in the local government under financial reconstruction (see Table 1). As measures against these problems, the following initiatives were introduced: 1. reinforced auditing mechanism and thorough information disclosure; 2. new financial indicators; and 3. introduction of an early correction scheme.

However, adoption of debt adjustment, which was the most watched aspect of this new system, was still up for discussion in the context of a drastic reform of the local administrative system. In order to adopt debt adjustment, it became necessary to deny the validity of the government's "tacit guarantee." And in order to deny this tacit guarantee, which was based on the current local administrative and financial systems, it was necessary to implement a drastic reform of the local systems.

(2) Key points in rating in relation to the Financial Soundness Act

Below are the three key points in rating local government bonds in relation to the Financial Soundness Act.

(a) Improved transparency of financial conditions

Improved transparency of financial conditions of local governments helps attain detailed financial data for analysis and standardize measures.

The Financial Soundness Act defines the consolidated real deficit ratio and the future burden ratio in addition to the criteria included in the previous reconstruction system, namely, the real deficit ratio, and real debt service ratio, which was already used under the consultation system for the issuance of local government's bonds/loans (see Table 2). These four indicators (ratios) are regarded as the "soundness" ratios, and a local government that shows any of these ratios above a certain level is subject to financial rehabilitation. What is noteworthy is that areas outside of a local government's ordinary accounts in its financial statements are to be taken into consideration and that the future burden ratio (considered a "stock" indicator) was added to the group.

We note that the range of areas in the financial statements that the four "soundness" ratios relate to is slightly different from one another. That said, it is certain that adopting these financial indicators and a thorough disclosure of financial information have facilitated the understanding of the overall condition of local governments. Also, the document that describes the basis of the calculations of these indicators is referred to in the examination by the Audit and Inspection Commissioners. This reasonably ensures the reliability of the indicators. The document is also placed at the office of every local government, which makes it possible to utilize the financial indicators in different ways as necessary.

(b) Ensuring financial discipline in advance

The Financial Soundness Act introduced a scheme of early achievement of financial soundness. It also made it mandatory for a local government to conceive a fiscal rehabilitation plan if any one of the indicators ("judgment ratios") exceeds a certain level.

The previous financial reconstruction system did not include a scheme that enabled an early achievement of financial soundness among local governments, and applying for national government-led reconstruction was voluntary. As exemplified by Yubari City, therefore, there was a risk that bankruptcy would suddenly surface. There was often a delay in local governments shifting to a financial reconstruction status, resulting in a protracted period of rehabilitation.

The Financial Soundness Act requires that a financial recovery plan be established when any of the soundness ratios is above the "early financial soundness standards". And using three indicators among the soundness ratios, excluding the future burden ratio, as the reconstruction judgment ratios, if any of the three indicators exceeds the financial reconstruction standards, a financial reconstruction plan must be established. The early financial soundness standards and financial reconstruction standards were established by a Cabinet ordinance issued on December 28, 2007, as presented in Table 3.

We can expect these systematic indicators to ensure fiscal discipline among local governments and prevent a sudden emergence of fiscal breakdown as in the case of Yubari City. Even if a local government were to be designated as being under financial reconstruction, the new system would be able to curb a further worsening of the financial condition compared with the previous system.

(c) Strengthening the central government's credit enhancement

The reconstruction scheme in the Financial Soundness Act enables strong involvement by the central government and incorporates a systematic financial support of the central government.

The central government's involvement in the reconstruction scheme is clear when comparing the early financial soundness scheme and reconstruction scheme in the Financial Soundness Act (see Table 4): More specifically, the Minister of Internal Affairs and Communications, not the local governors, is the one that receives reports on plans and its progress and is responsible for providing advice to the heads of local governments facing difficulties in achieving their plans. Local governments may consult their reconstruction plans with the Minister of Internal Affairs and Communications to seek his/her consent, but without consent, the issuance of local government bonds will be limited, except in the event of disaster recovery or other emergencies. In addition, the reconstruction scheme specifies the relationship between a local government's budget and its reconstruction plan, suggesting the influence of the central government's strong involvement on budgeting during financial reconstruction.

Further, if a local government 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. As such, this type of funding support from the central government is also a major positive factor for rating assessment. Caution must be used, however, that when private sector funds are involved when these special bonds are refinanced, there is a possibility of issues including an interest rate reduction or exemption and a deferred redemption.

(3) Key points going forward

Some of the national credit enhancement programs -- such as the approval system of local government's bonds/loans, local government's finance program, local allocation tax system, and financial reconstruction system -- that have conventionally supported the credit capacity of local government bonds have been successively revised since 2006. These include the repeal of the approval system of local government's bonds/loans and shift to a consultation system; the introduction of a new local grant tax; the adoption of a new financial reconstruction system; and the repeal of the system of negotiations under uniform conditions for public offering local government bonds. These, however, are hardly considered drastic institutional reforms, and the framework of credit enhancement provided by the central government basically remains unchanged.

Rating local government bonds requires attention to reform-related trends not only of the local government bond system and local financial system, but also of the local administrative system. The rating assessment is affected by the state of the administrative system due to the close and inseparable relationship between the local financial and administrative systems. In other words, administrative system reforms changes the local financial system and in turn changes the concept behind rating local government bonds.

Table 5 summarizes the actual and projected institutional changes as a result of the shift from the conventional centralized administrative and financial systems to decentralized systems, which are closely related to rating local government bonds. The systems that already been changed are limited, suggesting that drastic institutional reforms have yet to take place.

We are interested in the direction of future discussions regarding this topic because rating assessments will inevitably focus on the fiscal condition and management of individual local governments once the institutional changes are complete.

(4) Direction of ratings in relation to national credit enhancement

The series of institutional reforms based on the Financial Soundness Act and other regulations have solved the problems surrounding the local financial reconstruction system. Though temporary, this has increased the involvement of the central government in local public finance. The institutional reforms of local government bonds since 2006 are likely aimed at a conversion into a local government bond system that is based on market mechanics, and we can see the present as a transitional phase. These institutional reforms are not considered drastic as they have been made on the assumption of a tacit guarantee from the government, delaying the adoption of debt adjustment, which became the issue to be addressed in the future, with the function of the local grant tax remaining unchanged.

In light of the central government's credit enhancement, local government bond ratings will conceivably be at an extremely high level and their direction should generally be upward. The ratings of all local governments are expected to range, in most cases, for AA and above except for certain organizations like those undergoing financial reconstruction as per the Financial Soundness Act. JCR revised its outlook for Japan from negative to stable in August 2006, which made the upper limit of local government bond ratings at the same level as that of Japan (AAA/outlook: stable for both the yen and foreign-currency based assessments).

The idea of credit enhancement provided to local government bonds by the central government will be reviewed as appropriate after identifying the specifics of future decentralization reforms.

3. Views regarding financial conditions of individual local governments

Assessing the financial position of individual local governments is both quantitative and qualitative.

(1) Quantitative assessment

(a) Basic concept

A quantitative assessment is based primarily on finalized up-to-date financial results using three criteria: 1. tax-bearing capacity of each local government; 2, the fiscal condition of ordinary account; and 3. the state of local public corporations, third-sector enterprises, etc. (see Table 6).

JCR's basic policy in selecting fiscal and economic indicators regarded as important in the assessment is to keep it "simple and clear." We employ basic indicators that are used by the general public as much as possible. JCR does not create or modify indicators on its own except for the "stock" indicators that had not been used by the general public in the past.

We will apply to our ratings assessment the soundness ratios that have been introduced by the Financial Soundness Act after verifying the validity of their calculation methods as described later. In particular, the disclosure of the future burden ratio is thought to contribute substantially to our ratings assessment. The ratings, however, are our comprehensive evaluation that includes the central government's credit enhancement, and the ratings are not directly affected by any change in the status of a local government to one designated for early fiscal recovery or financial reconstruction.

(b) Understanding the tax-bearing capacity, and ordinary accounts

The indicators that we focus on for assessing the tax-bearing capacity of a local government include the fiscal power index and gross prefectural (municipal) domestic product. We also focus on property tax valuation by carefully examining local governments that are structured to receive a large part of its tax revenue in the form of property tax revenue.

In terms of ordinary accounts, our assessment is based on dividing them between income and expenditures and debt.

When assessing income and expenditures, we look at factors including the ordinary balance ratio, status of revenue shortfalls and funding initiatives, and the balance of available reserves for financial activities. As for the ordinary balance ratio, when the sinking fund reserves to pay off bullet bonds are insufficient, the reserve method is modified if it is significantly different from that of other organizations. At the prefectural level, the ordinary balance ratio tends to fluctuate markedly every fiscal year due to trends in corporate and related taxes. Therefore, we think it is appropriate to use methods like moving averages to eliminate such fluctuations. We would deem a local government's income and expenditures being in a relatively difficult state if revenue shortfalls and funding initiatives need to be covered by various borrowings, such as from funds and other accounts, or through the issuance of administrative reform promotion bonds or other special bonds.

As for debt conditions, we look at the future burden ratio and the basis of the calculation of this ratio as much as possible.

(c) Understanding local public corporations, the third-sector enterprises, etc.

For extra-departmental organizations such as local public corporations and the third-sector enterprises, we must consider the level of burden on ordinary accounts caused by transferred funds and additional investments and loans. The disclosure of the future burden ratio by local governments contributes substantially to ratings. In this context, the method used to calculate the amount of burden on the ordinary accounts is the most contentious.

Based on our policy of using as often as possible the indicators that are generally used by the public, we plan to apply the method of calculating the future burden ratio to our assessment as long as the method can be verified to be appropriate. We individually analyze the management and financial conditions of local public corporations and major third-sector enterprises, and we will individually verify the validity of the calculation of the amount of burden on ordinary accounts of such organizations.

(2) Qualitative assessment

The important points in qualitative assessment are future financial prospects and the stance of the local governments regarding fiscal management that forms the basis of the prospects. Even in qualitative assessment, JCR strives to obtain as much quantitative information as possible that could help estimate the extent of an improvement or a decline in the fiscal indicators, rather than simply try to determine the direction alone.

Our key points for assessment include: 1. review of annual expenditures and debt management and other efforts aimed at financial soundness; 2. prospects of initiatives aimed at fiscal balance and funding for the local government's ordinary accounts; and 3. fiscal outlook and efforts to strengthen the management base of local public corporations and third-sector enterprises.

We also take into account efforts and the strength of the will of the local governments in achieving fiscal health, in addition to details of administrative and financial reform plans as well as their financial recovery plan. This is because reforms could fail even with an outstanding plan depending on views of the local assembly or local residents. If we can confirm the strength of the will of the entire local government while taking into account the trends in the local assembly, we would be able to incorporate into our ratings the effort made toward fiscal health at least during the existing administration. In such a case, we acquire as much quantitative information as possible on the prospects of improvement in indicators such as the ordinary balance ratio and outstanding loans and incorporate our findings in the ratings.

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

For the prospects of financial balance and revenue shortfalls in ordinary accounts, we examine the details of the local government's initiatives 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 for the future. Thus, this is not desirable. Because the prospects vary significantly depending on the assumption of annual revenues and expenditures, we must verify whether the assumptions are appropriate. A local government might have been slightly increasing its annual expenditures in reports to the local assembly, for example, but in many cases the increase might have been intentional so that the local government could stress its "financial tightness" to the assembly. Such prospects, however, are not useful for market players. These local governments must present more feasible prospects to market players by, for instance, presenting different scenarios.

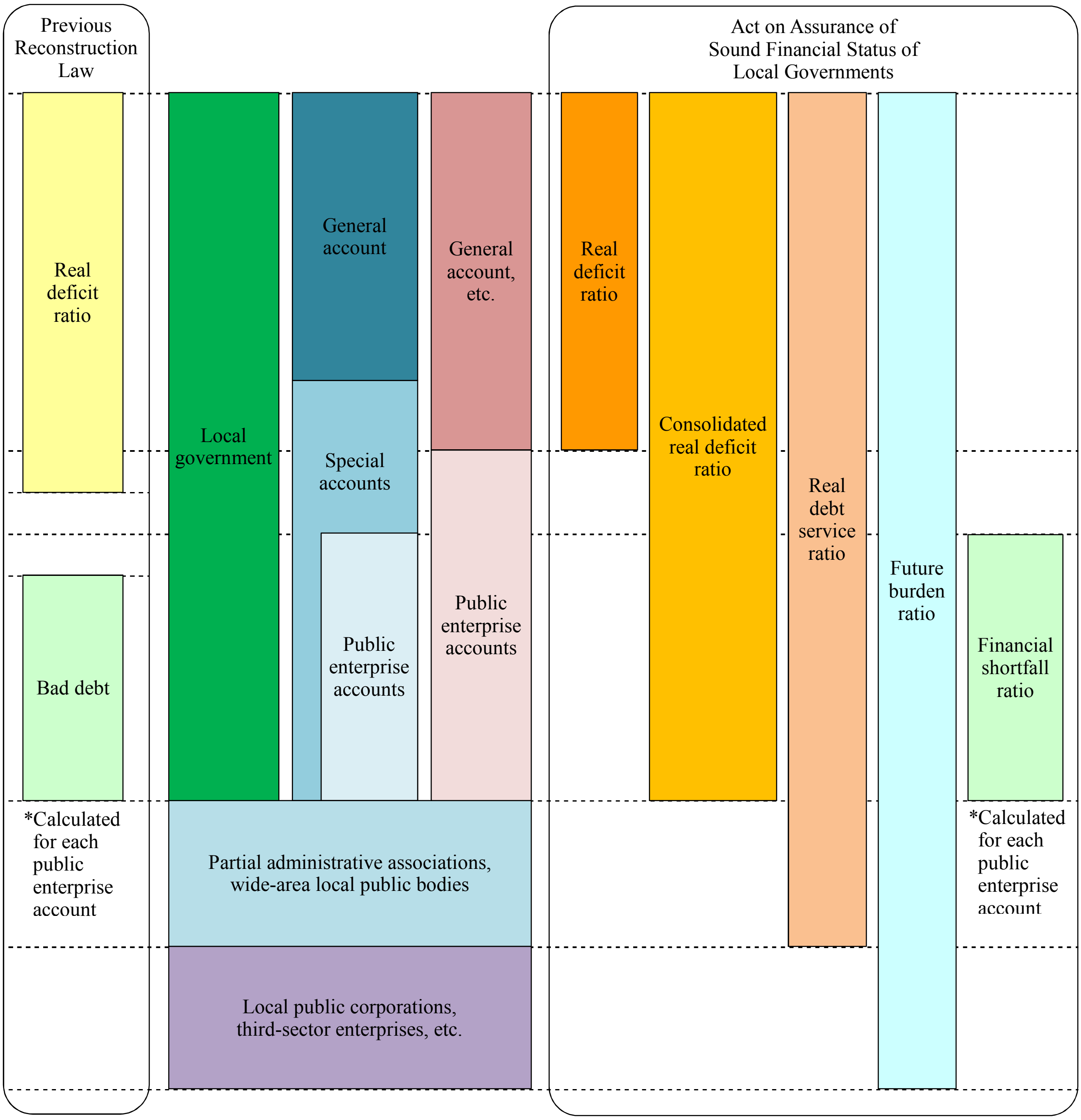
We are particularly interested in future cash flows and the outlook for debt repayment funds in assessing efforts to strengthen the management base and financial prospects of local public corporations or third-sector enterprises. Because the amount of burden on ordinary accounts from outstanding loans of these organizations is basically derived from the latest financial results, our quantitative assessment does not include the effect of improvement in future management. An increase in cash flow from operating activities associated with improved management of these local public corporations and third-sector enterprises is expected to reduce the amount of burden related to their debt redemption on ordinary accounts.

Table 1: The local financial reconstruction system: Issues, problems and initiatives

	Issues in the local financial reconstruction system (national government-led reconstruction)	Problems caused by issues stated on the left	Description of proposals in "reports"
1	Financial information disclosed is not comprehensive. Cannot fully guarantee the objectivity and accuracy of the financial indicators and the methods used for calculation.	Understanding the overall financial condition of local governments is extremely difficult for residents, financial institutions, market players, etc.	Consider strengthening the audit mechanism of local governments such as by including the calculation of financial indicators in auditing. Ensure complete information disclosure such as by placing documents that explain the calculation method for financial indicators at offices. Consider necessary measures such as using a third-party institution to ensure the objectivity and accuracy of the indicators.
2	The deficit ratio based on real income and expenditures in ordinary accounts is the only indicator used to determine whether a financial reconstruction system is needed.	The real income and expenditures balance does not necessarily indicate the exact fiscal condition of a local government. This is partly because local governments are institutionally allowed to cover their deficit in cash flows through measures such as issuing local government bonds and borrowings from other accounts.	Create new "flow" indicators in addition to real deficit ratio and consolidated real debt service ratios. Create a new "stock" indicator to compare real debt and redemption capacity, including the scale of public finance. Consider local public corporations and third-sector enterprises that are likely to experience a burden on ordinary accounts as de facto liabilities. In terms of a method that sets levels of financial indicators for early correction and reconstruction, consider one that takes into account the authority, scale of finance, etc. of each local government. Values that span over multiple years may be used as criteria.
3	Applying for national government-led reconstruction is completely voluntary.	As exemplified clearly by Yubari City, the application to become designated as an entity subject to reconstruction is often delayed. This may cause a protracted reconstruction period.	Introduce an early correction scheme. Make it a requirement to include a financial recovery and reconstruction plan in both the early correction and reconstruction schemes.
4	Once designated to undergo a government-led reconstruction plan, not clear who the responsible party is (governor / mayor, local assembly, residents, central government, or the lending financial institution for the reconstruction plan) during the life of the plan.	Financial discipline may not be exercised in providing credit to local governments because the lender is not held liable. In combination with issue 2, a local government may not declare bankruptcy until its debt has grown very large.	Organize the reconstruction scheme into two categories: 1. reconstruction is carried out within the basic framework of the current local administrative and financial systems; and 2. reconstruction is carried out through drastic reform of the local administrative and financial systems. **Debt adjustment is assessed as an option for Case 2.**

Source: Prepared by JCR based on a report of a study group for a new system of local government financial reconstruction (Dec. 28, 2006), etc.

Table 2: Targets of the Ratio for Determining Soundness



Source: Ministry of Internal Affairs and Communications "White Paper on Local Public Finance, 2011"

Table 3: Early financial soundness standards and financial reconstruction standards

	Prefecture	Municipality
Real deficit ratio		
Early financial soundness standards	3.75%	11.25—15%
Financial reconstruction standards	5%	20%
Consolidated real deficit ratio		
Early financial soundness standards	8.75%	16.25—20%
Financial reconstruction standards	15%	30%
Real debt service ratio		
Early financial soundness standards	25%	25%
Financial reconstruction standards	35%	35%
Future burden ratio		
Early financial soundness standards	400%	350%
	(Ordinance-designated cities = 400% of prefectures)	

Source: Financial Management Division, Local Public Finance Bureau, Ministry of Internal Affairs and Communications "Early financial soundness standards, etc. under the Act on the Assurance of Sound Financial Status of Local Governments" (Dec. 7, 2007)

Table 4: Early financial soundness scheme and reconstruction scheme

	Early financial soundness scheme	Reconstruction scheme
Points	Financial recovery through independent improvement efforts	Solid reconstruction measures with government involvement
Plan Formulation	Require formulation of a financial soundness plan. Formulation is subject to an assembly approval.	Require formulation of a financial reconstruction plan. The plan is subject to an assembly approval. Include plans for tax hikes and expenditure reduction that are more specific than the financial soundness plan.
Plan announcement	Announce the plan and report to the Minister of Internal Affairs and Communications / the prefectural governor. Announce the progress of the plan every year and report to the Minister of Internal Affairs and Communications / the prefectural governor.	Announce the plan and report to the Minister of Internal Affairs and Communications. The head of the local government adjusts the budget based on the reconstruction plan. Announce the progress of the plan every year and report to the Minister of Internal Affairs and Communications.
Central and prefectural government involvement	The Minister of Internal Affairs and Communications / the prefectural governor will make necessary recommendations to the head of local government if early financial recovery is extremely difficult in cases such as when the progress of the plan is substantially behind target.	The Minister of Internal Affairs and Communications may investigate the progress or seek reports on the reconstruction plan as necessary. The Minister of Internal Affairs and Communications may advise the head to take necessary measures such as changing the budget or the reconstruction plan if financial management of the local government is deemed not to conform with the reconstruction plan, etc. The head must report to the Minister of Internal Affairs and Communications the measures that were implemented based on the advice received from the minister. The head may consult with the Minister of Internal Affairs and Communications about the reconstruction plan to seek his/her consent.
Financing		Issuance of local government bonds is subject to the approval of the Minister of Internal Affairs and Communications. Without the Minister's consent, the issuance of local government bonds will be limited except in the event of disaster recovery or other emergencies. Only when the consent of the Minister has been obtained about the reconstruction plan, rebuilding transfer special bonds may be issued within the range of the balance shortfall. The rebuilding transfer special bonds must be redeemed during the period of the reconstruction plan. The central government is to provide appropriate funds for the rebuilding transfer special bonds within the scope allowed by its own fiscal situation.

Source: Prepared by JCR based on the Act on Assurance of Sound Financial Status of Local Governments, etc.

Table 5: Administrative and financial systems, and the national credit enhancement system for local government bonds

	Centralized administrative and financial systems	Decentralized administrative and financial systems
Relationship between central and local governments	Master and servant relationship (vertical)	Equal and cooperative relationship
Status of local jurisdiction administrative work	Involvement and requirement of the central government in local administration; reliance of local governments on the central government; unclear relationship of authority and revenue sources	Clear range of authority and responsibilities of the central and local governments Clear relationship between authority and revenue sources
Local tax	Impose statutory tariffs at the standard tax rate	Exercise autonomy
Function of local grant tax	Revenue source guarantee and revenue source adjustment	Maintain functions of revenue source adjustment Function of revenue source guarantee may be modified
Financial reconstruction system	Tacit guarantee of the central government	Debt adjustment is also an option
Disclosure of financial information	Inadequate	Thorough
Local government bonds		
Bond issuance regulation	The approval system of local government's bonds/loans, limited purpose for bond issuance (bond-issue standards), specified bond issuance rate	Liberalization and diversification of local government bonds
Conditions for issuance	System of negotiations under uniform conditions	Decisions based on individual conditions
Underwriting funds	Government funds	Private-sector funds
Local allocation tax grants	Fixed rate inclusion	Reduced rate of inclusion
Rating assessment of local government bonds	Assessment focuses on credit enhancement provided by the central government	Assessment focuses on fiscal condition, financial management, etc. of individual local government

Source: JCR
Note: Shaded sections are areas that we think are already reformed.

Table 6: Assessment process of a local government's own Credit Strength