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Rating framework for local/municipal bonds

1. Basic Approach to Credit Ratings for Local Government Debt

In rating local government debt, JCR does not simply assess each local government in isolation, but rather assesses local governments in conjunction with the credit support provided by the national government. The credit support that the national government provides to local governments is quite stable, and the assessments are based on the assumption that the so-called "implicit government guarantee" is operating.

This document starts with an approach to credit ratings in terms of the Law Relating to the Financial Soundness of Local Governments (hereafter "Financial Soundness Law"), and then sets forth JCR's approach to rating local government debt in the event of solicited ratings from the twin perspectives of the credit support provided by the national government on the one hand, and the financial status of each individual local government on the other, before discussing the withdrawal the former 'p' ratings.

2. Approach Relating to the Credit Support Provided by the National Government

(1) Establishment of the Law Relating to the Financial Soundness of Local Governments

Since Heizo Takenaka became Minister of Internal Affairs and Communications at the end of October 2005, there have been a series of reforms and events relating to regional finances that have had a strong impact on the market. As minister, Takenaka initiated a private panel known as the Forum on Visions of Regional Decentralization for the 21st Century (hereafter "Vision Forum"). Just as the Vision Forum was discussing the establishment of a "Regenerative Legal System for Addressing Bankruptcy," it became clear that the Yuubari Municipal government would be subject to financial reconstruction and doubts began to emerge among market players and financial institutions about the validity of the "implicit government guarantee."

Based on the proposal by the Vision Forum that a "Regenerative Legal System for Addressing Bankruptcy" be established within the next three years, the Study Group for New Systems for Rebuilding Regional Finances was held to consider specific mechanisms for creating legislation for new systems for regeneration. Legislation was drafted based on this study group's report (issued December 8, 2006, hereafter referred to as "*The Report*"), and the Law Relating to the Financial Soundness of Local Governments (hereafter "Financial Soundness Law") was enacted in June 2007, with all but a few regulations coming into effect from April 2009.

It has been pointed out that the current Fiscal Reconstruction System ("provisional reconstruction," both here and below) has many problems, and the Financial Soundness Law seeks to address these problems. (Refer to the October 2006 edition of "JCR Ratings" for detailed information about these

problems.) The problems with the current system that have been pointed out in the past can be broadly grouped into four main areas: 1) disclosure of financial information is inadequate, 2) criteria for the application of the reconstruction system are incomplete, 3) application of the reconstruction system is not compulsory, and 4) the responsibilities of the various parties when a local government becomes subject to reconstruction are not clear. Various measures have been devised to address these problems, including 1) stronger auditing functions and thorough disclosure, 2) the establishment of new financial indexes, and 3) the introduction of a scheme for early rectification.

However, consideration of the pros and cons of introducing debt adjustment, which has been the focus of the greatest attention, has been consistently based on the assumption of fundamental reforms to the system of local government finances. This is because in order for debt adjustment to be recognized the "implicit government guarantee" that has operated until now will need to be denied, but this implicit government guarantee underpins the current system of local government finances, and so this guarantee can only be denied if fundamental reforms are made to the system of local government finances. The pros and cons of introducing debt adjustment are scheduled for further consideration by the Council for Decentralization Reform, where discussions are currently taking place.

(2) Key points relating to assigning credit ratings in relation to the Financial Soundness Law

In this section we will raise three points from within the Financial Soundness Law that require particular attention in terms of making credit rating assessments.

(i) Better transparency with regards to financial status

Increasing the transparency with regards to the financial status of local governments leads to greater sophistication for the financial data that is used for analysis and provides a common scale for such data.

The Financial Soundness Law defines two new measures (the consolidated real deficit ratio and the future burden ratio) in addition to the real deficit ratio that is used in the evaluation criteria for the current Financial Reconstruction System and the real debt expenditure ratio that is already being utilized in the Local Government Debt Consultation System. These four indexes (ratios) are used to determine financial soundness, and local governments for which any of these ratios exceed certain levels are subject to financial reconstruction. As well as noting that the scope of the target accounts for each of these indexes has been extended beyond ordinary accounts, the establishment of a stock indicator in the form of the future burden ratio is particularly noteworthy.

Care is required in so far as the target accounting scope for each of these four indexes is slightly different in each case, but there is no doubt that the establishment of these indexes for determining the soundness of local government finances, and their comprehensive disclosure, has made it much easier to comprehend the overall picture of the financial status of local governments. Moreover, in the process of announcing these indexes, "the documents listing the items that form the basis of the calculations" are

reviewed by supervisory auditors so that the reliability of these indexes can be regarded as having been ensured appropriately and, given that the documents in question will be made available at the offices of each local government, to a certain extent it should also be possible to process each of these financial indexes if necessary.

(ii)

With the Financial Soundness Law, an "Early Financial Soundness" scheme has been introduced, so that local governments are now obliged to establish financial soundness plans and financial rebuilding plans in the event that these key ratios exceed certain criteria.

The system for the reconstruction of local government finances that has been in place until recently did not establish a scheme for early financial soundness, and whether to apply for financial restructuring was left solely to the discretion of the local governments in question. This meant that there was a risk of local governments suddenly becoming insolvent, as was apparent in the case of the Yuubari Municipal Government, and there was also a tendency for local governments to put off reconstruction, with the end result that reconstruction periods may become longer than would otherwise have been the case.

The Financial Soundness Law requires that local governments establish a financial reconstruction plan if any of the ratios for determining soundness exceed the early financial soundness criteria. Moreover, three of the ratios for determining soundness (the ratios other than the future burden ratio) are taken as ratios for determining rebuilding, so that local governments must establish a financial rebuilding plan if any of these indexes exceed the financial rebuilding criteria. The early financial soundness criteria and financial rebuilding criteria are as determined by a cabinet order dated December 28, 2007.

By responding to these systems, it can be expected that the financial discipline of local governments will be ensured in advance, making it unlikely that there will be revelations that a local government has suddenly become insolvent, as happened with the Yuubari Municipal Government. Moreover, even if a local government does become subject to financial restructuring, the deterioration of its financial status will probably be relatively restrained compared to what might have been the case under the former system.

(iii) Stronger credit support from the national government

For the rebuilding scheme in the Financial Soundness Law, not only can we expect deep involvement from the national government, but support from the national government in terms of funding has actually been systematically built in to the legislation.

Comparing the early financial soundness scheme and the rebuilding scheme in this law, involvement by the national government is clear cut in the case of the rebuilding scheme. Specifically, the person who receives reports about rebuilding plans and the implementation status (and who has the right to make recommendations to the head of the local government in the event that achieving the goals

in the plan is believed to be difficult) is the Minister for Internal Affairs and Communications rather than the prefectural governor. Local governments can consult with the Minister regarding their rebuilding plans, and can seek the Minister's agreement, but if this agreement is not forthcoming, the local government's ability to issue bonds is limited to cases such as recovering from natural disasters. Furthermore, the rebuilding scheme stipulates the relationship between budgets and rebuilding plans, and so in reality the national government is likely to be deeply involved in preparing the budgets for local governments undergoing reconstruction.

When a local government has received the agreement of the Minister for Internal Affairs and Communications with respect to its rebuilding plan, the local government can issue rebuilding transfer special bonds up to the amount of the balance shortfall. The law states that, with respect to rebuilding transfer special bonds, the national government shall make appropriate considerations to the extent allowed by funding circumstances. Also, the fact that we can now expect government funds to be appropriated in principle is significant supporting material in terms of determining ratings. However, we should probably also bear in mind that, as local governments refinance from private sector funds to rebuilding transfer special bonds, there still remains a possibility that private sector funding may see interest reductions or exemptions, or term deferrals.

(3) Recent developments other than the Financial Soundness Law

Other examples of recent developments concerning local government finances (other than the Financial Soundness Law) are early redemption with indemnity exemptions for public funds, the rectification of imbalances in corporate enterprise taxes, the creation of a special framework for central government tax revenues allocated to local governments, and the debate concerning financial resources that are specifically set aside for road construction.

Early redemption with indemnity exemptions for public funds refers to the process whereby local governments were allowed to make early redemptions on outstanding local government bonds with an annual interest rate of more than 5% that had been purchased using public funds, without having to pay the indemnity that is usually payable in such cases. This process was recognized as a condition for the establishment of financial soundness plans and plans for the financial soundness of publicly managed enterprises. This scheme applies to about five trillion yen in public funds over three years starting from 2007. On December 22, 2007, a plan relating to the simplification of government administration (which had been submitted by local governments seeking to making early redemptions) was approved, and 1524 local governments made early redemptions amounting to a total of ¥5.03 trillion in public funds, resulting in a reduction of the interest burden that was worth ¥865 billion at the time of approval. Although the vast majority of local governments were subject to this process, the detailed breakdown of the total is not clear. Nevertheless, it is believed that the interest burden reductions for each individual local government will be limited to a suitable level.

The rectification of imbalances in corporate enterprise taxes refers to the designation of ¥2.6

trillion of revenue from corporate enterprise taxes as Special Local Corporation Tax, and the distribution of these funds to prefectural governments according to population (50%) and the number of persons employed (50%), in order to address the difference in tax revenue (particularly in relation to corporate taxes) between metropolitan centers (particularly Tokyo), where this has become a political issue, and other regions. This is expected to result in the transfer of more than ¥400 billion from seven metropolitan prefectures (such as Tokyo and Aichi Prefecture) to the other forty prefectures. (See Figure 5.) Looking at the impact of the revision of this system on a prefecture by prefecture basis, we see that the impact on corporate enterprise tax revenue and local government tax revenue has been particularly large in those regional areas with relatively little tax revenue. However, looking at the impact on the total amount of general financial resources (including central government tax revenues allocated to local governments and so on), we see that the overall impact is not particularly large, with the largest increase going to Nagasaki Prefecture at +3.6% and the largest decrease associated with the Tokyo Metropolis at -5.6%. Furthermore, for local governments receiving revenue allocations from the central government, the financial impact of these rectifications is expected to be offset to a certain extent by increases or decreases in revenue allocations.

The creation of a special framework for central government tax revenues allocated to local governments refers to a development which secures the total amount of revenue allocations by booking the costs associated with local government rebuilding measures in the annual expenditure of the local financing program, in a form comparable to the ¥400 billion arising from the imbalance rectification discussed in the previous paragraph. The amount for prefectural governments is calculated at about ¥150 billion, while the amount calculated for municipal governments is calculated at about ¥250 billion. The calculations take into account such factors as the proportion of the workforce engaged in primary production and the proportion of elderly people in the population, as well as cost differences associated with population size. However, looking at individual prefectural governments, the degree of impact on the total amount of general financial resources will be limited, with even the prefecture receiving the greatest increased contribution, Tottori Prefecture, only seeing a 1.4% increase.

As for the debate concerning financial resources that are specifically set aside for road construction, at present it is difficult to foresee how this debate will unfold, and so for now we simply note that it will be necessary to pay close attention to developments in this area.

(4) Points that will require attention in future

Several of the national government's credit support systems that have formerly supported the creditworthiness of local government bonds (including the system for approving local government bonds, the financial planning system, the system for allocating central government revenues to local governments, and the financial reconstruction system), several have been subject to a series of revisions since 2006. Specifically, we have seen such changes as the abolition of the system for approving local government bonds and a move towards a consultative system, the introduction of a new system for

allocating central government revenues and a new system for rebuilding local government finances, and the abolition of the protocol of uniform negotiating conditions for publicly offered local government bonds. Nevertheless, these changes can hardly be described as fundamental reforms, and the framework of credit support from the national government remains basically unchanged.

In assigning credit ratings to local government bonds, it is necessary to pay attention to developments in terms of reforms to the local government administration system, as well as reforms to the local government bond system and the local government finance system. In so far as the local government finance system has an inseparable relationship with the local government administration system, this means that credit rating assessments are also influenced by the administrative system. In other words, if the administrative system changes then the finance system will change, and our approach to assigning credit ratings to local government bonds will also change accordingly.

One development that will be focus of particular attention in the future is the debate concerning the nature of local jurisdiction enterprises, which is a precondition for reforms to the system of local government finances. This is because it can be expected that a revision of the rights and roles of local governments will lead to the liberalization of fund-raising activities, with local governments securing autonomous sources of funding, such as taxes, in line with their new rights and roles, yet at the same time such as revision is likely to lead to greater calls for self-responsibility when it comes to paying back debts.

Although the relationship between the central government and the regional governments has changed from a vertical “master/servant” relationship to an egalitarian, cooperative relationship as a result of the Devolution of Power Law, which was passed in 1999 and came into effect in 2000, the work of expanding and clarifying the rights and responsibilities of individual agencies and enterprises with respect to the regions is yet to be begin, and the basic division of duties between the national and regional governments remains unchanged. The outstanding issues of revising the division of roles between the national and regional governments and fundamentally reforming the system of local government finances are currently being debated by the Council for Decentralization Reform, which is scheduled to make recommendations from this Spring onwards. Based on these recommendations and in accordance with the Decentralization Reform Promotion Law, a Decentralization Reform Plan will be established to proscribe the legislative and financial measures that will be required. Future debates within the Council for Decentralization Reform, as well as the details of the Decentralization Reform Plan, will be extremely important in terms of assigning credit ratings to local government bonds.

(5) Direction of credit ratings from the perspective of credit support from the national government

Given that the problems with the system for rebuilding local government finances have been resolved as a result of the series of system reforms based on the Financial Soundness Law and so forth, the involvement of the national government in local government administration has probably strengthened rather than weakened in recent times, if only temporarily. The system reforms associated

with local government bonds that have taken place since 2006 probably anticipated a system of local government bonds founded on market functions, but the current situation can best be described as a transition phase as we move from one system to another. The recent system reforms have been persistently founded on an assumption of the implicit guarantee by the national government, with issues such as debt restructuring being postponed for future consideration and the function of the allocation of tax revenues from the national government to regional governments still being maintained, so that these recent system reforms do not constitute fundamental reform.

Moreover, although there is a view that the recently implemented changes (such as early redemption with indemnity exemptions for public funds, rectification of imbalances in corporate enterprise taxes and creation of a special framework for central government tax revenues allocated to local governments) are a first step on the way towards further transfers of tax resources to local governments, these changes can also be perceived as running counter to the trend towards decentralization.

In the light of these trends of credit support from the national government, the credit ratings for local government bonds are at an extremely high level, and in recent times their direction has probably been generally upwards. In the former ‘p’ ratings, the floor for local government ratings was effectively “AA-p,” but even looking at the ratings for all local governments, the ratings are almost all “AA” or higher, except for a few local governments that are subject to financial rebuilding under the Financial Soundness Law. Moreover, in August 2006 JCR changed the rating outlook for the Japanese national government from “negative” to “stable,” suggesting that there is a high probability that local government bond ratings will spread over a wider distribution range, reaching as high as the same rating as for the Japanese national government (“AAA” for both yen-denominated and foreign-currency-denominated bonds).

JCR will continue to review its approach to national government credit support for local government bonds as we carefully assess the specific details of future decentralization reforms.

3. Approach Relating to the Financial Status of Individual Local Governments

Assessments relating to the financial status of individual local governments are a synthesis of quantitative assessments and qualitative assessments. Moreover, the assessments relating to individual financial statuses that were adopted in determining the ‘p’ ratings focused mainly on quantitative aspects, with almost no qualitative assessments being incorporated, which means that solicited credit ratings will differ from the ‘p’ ratings in this respect. In this section, I will explain these assessment methods, on the assumption that they will be used for solicited credit ratings.

(1) Quantitative assessments

(i) Basic approach

Quantitative assessments are based on information that has already been finalized, mainly balance sheets, up to and including the most recent results. Quantitative assessments are made based on the following three points: 1) the tax revenue base and tax capacity of each local government, 2) the financial status of the ordinary accounts, and 3) the status of auxiliary organizations, such as public managed enterprises and the three major public corporations.

JCR's basic policies in selecting which economic and financial indexes to emphasize in assessments are "simplicity" and "clarity," and we do our best to use basic indexes that are in general use. Except for stock indexes for which there previously were not any general indexes, JCR does not create or manufacture original indexes.

JCR's policy is to utilize the ratios for determining financial soundness that have been newly introduced in accordance with the Financial Soundness Law, after verifying their appropriateness as discussed below. In particular, disclosure of the future burden ratio is likely to make a substantial contribution to credit rating assessments. However, credit ratings are ultimately comprehensive assessments that include the credit support from the national government, and so the process of a local government becoming subject to early financial soundness or rebuilding requirements in and of itself will not necessarily directly affect the credit ratings.

(ii) JCR's perspective on tax revenue bases, tax capabilities and ordinary accounts

When considering the tax revenue base and tax capability of a local government, JCR will emphasize indexes such as the financial capability index and the total production for the prefecture or municipality. In municipalities where taxes on fixed assets make up a large proportion of tax revenue, we shall also emphasize indexes such as the assessed value of fixed assets.

Ordinary accounts can be considered in terms of either the balance situation or the liabilities situation.

With regards to the balance situation, JCR will emphasize indexes such as the ordinary balance ratio, the situation in terms of recent revenue shortfalls and revenue measures, and reserve balances that can be utilized for financial management. In terms of the ordinary balance ratio, as well as utilizing figures that include bonds to supplement tax cuts and bonds for extraordinary financial measures on the denominator, we shall also make corrections if the reserve method differs substantially from that of other governments in cases where the reserves set aside for amortization funds for bullet bonds are not sufficient. Also, for prefectural governments, we will consider using rolling averages to exclude deviations as appropriate, since the ordinary balance ratio tends to be subject to annual deviations resulting from movements in the revenue from corporate taxes. Furthermore, in considering the situation in terms of recent revenue shortfalls and revenue measures, if it has been necessary either to borrow from funds or other accounts, or to issue administrative reform promotion bonds, then we will regard the balance as having been correspondingly tight.

With regards to the liabilities situation, JCR will define and utilize its own liabilities ratio*, but we

will also consider utilizing figures expressing the total amount of general revenue for the denominator in the formula for calculating the liabilities ratio. Furthermore, JCR's policy is to review the liability index after the Financial Soundness Law comes into effect and, as far as possible, to utilize the future burden ratio and the items used as the basis for calculating the future burden ratio.

*: Liability ratio = (Outstanding local government bonds (excluding bonds for extraordinary financial measures) – reserves on hand – real balance) ÷ standard financial scale

Formerly, JCR has also emphasized the debt service ratio, but in future our policy is not to make this ratio itself (or the real debt expenditure ratio that replaces it) subject to assessment, although we will refer to the individual elements of the numerator when making credit rating assessments. Until now there has not been an appropriate figure to act as a stock index that takes into account the proportion of tax revenue allocation measures associated with the outstanding balance of local government bonds, and so JRC emphasized the debt service ratio (which is a flow index) instead. However, in future our policy is to use the future burden ratio, because this measure makes the proportion of tax revenue allocation measures clear on a stock basis.

(iii) JCR's perspective on local publicly managed enterprises, three major corporations, and third sector corporations, and so on

As for auxiliary organizations such as local publicly managed enterprises, three major corporations, and third sector corporations, JCR's approach is to take into account the extent of the burden on the ordinary accounts due to such things as transfers and additional loans, and to add these factors to the numerator of the liability index for the ordinary accounts. This basic approach is the same as the approach adopted by the future burden ratio. This means that, although the disclosure of the future burden ratio will make a significant contribution to the assessment, at this point it will be the method of calculating the liability amount in the ordinary accounts that is the focus of the greatest discussion.

The method of calculating the liability amount in the ordinary accounts in the formula for the future burden ratio is suitably conservative, as has been generally indicated by a cabinet ordinance announced on December 28, 2007 and a ministerial ordinance announced on February 5, 2008, and so this method can be regarded as appropriate. The method of calculating the liability amount in the ordinary accounts for auxiliary organizations such as public housing corporations and third sector corporations is yet to be clarified by cabinet ordinance and so the details of future announcements will be the subject of great interest.

If JCR is able to verify that the method for calculating the future burden ratio is appropriate, our policy is to utilize this measure in our assessments, in keeping with our policy of utilizing indexes that are in general usage as far as possible. This will involve first analyzing the management and financial status of each individual publicly managed corporation and major auxiliary organization, and then

individually verifying the validity of the calculations of the liability amounts in the ordinary accounts for each of these entities.

(2) Qualitative assessments

In making qualitative assessments, the key points are the future financial outlook, and the financial management stances on which this outlook is based. Despite the fact that these are qualitative assessments, we will still strive to comprehend quantitative data to the best of our ability, in order to be able to estimate the extent, as well as the direction, of the improvement or deterioration of financial indexes.

The key perspectives for the assessment are 1) efforts towards achieving financial soundness, such as reviewing annual expenditures and managing debt, 2) the outlook for the fiscal balance and revenue measures, in the ordinary accounts and elsewhere, 3) the outlook for the fiscal situation and efforts towards bolstering the management foundations of public managed enterprises and auxiliary organizations and so on.

With respect to efforts to achieve financial soundness, it is necessary to take into account the strength of the local government’s will to achieve financial soundness, in addition to details such as financial and administrative reform plans and financial soundness plans. This is because even the best laid plans can be set back by developments in the government assembly or by regional public opinion. If we are able to ascertain the strength of the will of the local government, based on things such as developments in the government assembly, then it should be possible to factor efforts towards financial soundness into our credit ratings, at least while the current head of government remains in office. In doing so, this will involve factoring the outlook for improvements to financial indexes such as the ordinary balance ration and net debt into our credit ratings, based as far as possible on our understanding of the quantitative data.

With respect to debt management, it is desirable that local governments establish, as far as possible, clear numerical targets regarding the value of the bonds outstand and the value of the bonds to be issued, based on the future outlook for outstanding local government bonds.

With respect to the outlook for the fiscal balance and revenue measures, in the ordinary accounts and elsewhere, the focus of attention will be the details of the revenue measures for addressing expected revenue shortfalls. Dependence on special bond issues or borrowings from funds and so on without being able to cut annual expenditures is basically undesirable as it simply postpones the burden into the future. Note that the outlook will vary considerably depending on assumptions about annual income and expenditure, and so it will be necessary to verify the appropriateness of these assumptions when considering these issues. In particular, until recently it seems that there have been many cases where annual expenditure has been overstated in order to intentionally stress “financial austerity” to the government assembly and others, and such outlooks are not very useful for market actors. For market actors it is probably necessary for local governments to submit outlooks with a high likelihood of

coming true, by establishing different outlooks based on different cases, and so forth.

With respect to the outlook for the fiscal situation and efforts towards bolstering the management foundations of public managed enterprises and auxiliary organizations and so on, particular attention will be paid to the outlooks for future cash flow and debt repayment capital. In the quantitative assessment, the burden on the ordinary accounts associated with the external debts held by these organizations is basically calculated on the basis of the most recent financial results, which means that the future benefits of management reforms have not been factored in. For these publicly managed enterprises and auxiliary organizations, if operating cash flow increases following management reforms then the burden on the ordinary accounts due to redeeming these debts can be expected to decrease.

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