Growing More Market-oriented in Raising Funds

Japanese Local Governments

By Katsuhiko SAKAI

"We achieved a ¥700 million surplus in fiscal 2006 and are making aggressive efforts to sell idle assets and cut personnel costs," an official said in an impassioned speech delivered at a Tokyo hotel on Nov. 21, 2007, before analysts from securities firms and institutional investors, including foreign banks. The speaker at the investor relations meeting was not any chief financial officer from a listed company, but Niigata Mayor Akira Shinoda who was preparing for his municipality's first-ever public bond issue for nationwide sales to be placed in one month to raise ¥10 billion. Niigata boosted its population above 800,000 through a merger with neighboring municipalities in April 2007 and joined a group of ordinance-designated major cities authorized along with prefectures to publicly offer bond issues. Shinoda emphasized progress in his municipality's administrative reform and its sound financial profile at the meeting in a bid to win better terms for the bond issue. Local government moves to efficiently take in private-sector funds to make up for budget deficits have been attracting attention from financial markets.

Structural Changes in Funds Flowing into Local Gov't Bond Market

A decade ago, the central government and its financial institutions were buying more than 60% of local government bond issues. Following reform of the Fiscal Investment and Loan Program – known as the second budget – in fiscal 2001, however, the situation turned around dramatically. While local government bond offerings were declining on improvement of local public finances and curbs on public investment, private-sector funds invested in local government bonds exceeded public-sector funds in fiscal 2006 for the first time, according to annual local government bond issue plans prepared by the Ministry of Internal Affairs and Communications. The plan for fiscal 2007 ending in March 2008 indicates public-sector funds' share in total new local government bond purchases will fall to a level as low as 37.0% as postal savings and postal life insurance funds for local government bond investment are cut to zero due to the postal system's privatization in October 2007. Growth in the presence of the private sector is expected to accelerate in the local government bond market as well as in other areas.

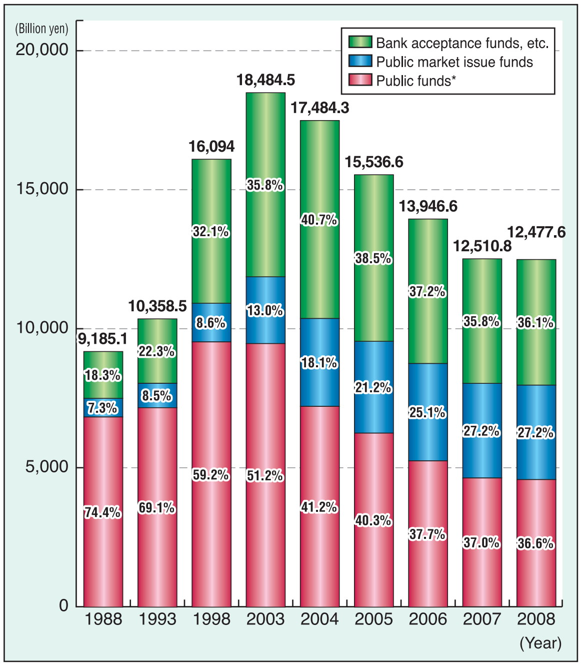
Major changes have also emerged in private-sector funds on which local governments have depended increasingly. Local governments used to raise funds primarily by making private bond offerings to local financial institutions through negotiations. In the past decade, however, such privately placed public bonds have declined sharply, doubling the share of public bond offerings in total local government bond issues purchased by the private sector. Small regional financial institutions such as "*shinkin* bank" credit associations and "*shinkumi* bank" credit cooperatives are still willing to purchase private bond issues from local governments to enhance their business relations with those governments. But megabanks and large regional banks are dissatisfied with low interest rates on private local government bonds. Despite clear financial capacity gaps among local governments, little difference is seen between interest rates on private local government bond issues. Market forces are little reflected in private local government bonds. This is the reason for the dissatisfaction on the part of large banks.

"Terms of private local government bonds are embarrassing to regional banks," says the president of a leading regional bank based in western Japan where a local prefectural government has already begun issuing bonds on a public placement basis. "Local governments unreasonably ask us to set interest rates on their private bonds at levels as low as those on (most creditworthy) Tokyo metropolitan government bonds, while their bonds lack liquidity. We have urged prefectural governments to publicly offer bonds and undergo market tests. We expect a decline in the amount of private bonds purchased and held until their maturity by regional banks." The number of local governments that publicly offer bonds has risen year by year. For fiscal 2007, the number reached 42 – 25 prefectures and the 17 ordinance-designated major municipalities. The Ministry of Internal Affairs and Communications has indicated it will promote measures to expose local government bonds to market forces. The remaining 22 prefectural governments are expected to introduce a public bond placement system in the near future.

Collapsing Lock-step Mentality

The local government bond market saw major developments in 2006. One was the so-called Yubari shock causing drops in local bond prices. In June 2006, a financial failure surfaced at the debt-ridden Yubari municipality in Hokkaido Prefecture. Investors then grew sensitive to credit risks of financially plagued local governments, prompting prices of outstanding local bonds to fall. In a major institutional change, local governments put an end to uni-

Changes in funding composition of initial local government bond issue plans



Note : *Public funds include government funds and Japan Finance Corporation for Municipal Enterprises funds.
Source : Compiled by JEF from "Current Conditions & Overview of Local Bonds," Ministry of Internal Affairs & Communications

form terms for their public bond issues in September 2006. Coupons ranged from 1.8% to 2.0% on 10-year public bond issues placed by 14 local governments in October 2006. The maximum coupon gap amounts to some ¥1 billion in interest payments over 10 years on a ¥50 billion issue. The system for basing bond issue terms on the market forces of supply and demand has prompted local government bond issuers to change their attitudes. Earlier, bond rating agencies had unilaterally assigned "unsolicited ratings" on debt issues of local governments in Japan based on published data. In October 2006, however, Yokohama became the first Japanese municipality to get a requested debt rating. It received an *AA-* rating from Standard & Poor's, one of the two leading US debt rating agencies.

Kobe, Tokyo and Kyoto followed suit in 2007, encouraging other issuers of public local bonds to obtain debt ratings on a requested basis. They can no longer ignore debt ratings that are linked directly to fund-raising costs. Local governments' "lock-step" mentality has collapsed. The Tokyo metropolitan government obtained *Aa1,* the second highest rating for local government bonds, and the highest rating of *Aaa* on foreign-currency bonds from Moody's Investors Service, the other major US rating agency. "We would like to emphasize Tokyo's financial soundness toward the world in order to win the race for hosting the 2016 Summer Olympics," a senior metropolitan government official said. The Kyoto municipality has become Japan's first local government to get bond ratings from both S&P and Moody's. A city spokesman says, "We would like to establish an appropriate market reputation and attract overseas investors who are expected to participate in the local government bond market."

Investment from Abroad Expected to Rise

Bond-issuing local governments have grown conscious about overseas investors since interest payments to nonresident holders of Japanese local government bonds became exempt from tax in January 2008. Earlier, such interest income was subjected to a 15% tax. Unlike investors from the United States and Britain having bilateral tax treaties with Japan for avoidance of double taxation, European Continent investors had been required to pay tax. European Continent investors have growingly been expected to inject funds into the local government bond market. "If due infrastructure, including information disclosure and debt rating systems, is developed fully, nonresident investors could play a central role in the local bond market," a market analyst says.

Taking advantage of these changes to tap into Japan's ¥200 trillion local government finance market is French-Belgian bank Dexia Credit Local SA that provides financial services exclusively to local governments throughout the world. In only one year after launching its Tokyo Branch in late 2006, Dexia got more than 40 local governments as customers in Japan by drawing on its unique financial analysis and risk management to offer loans of more than 10 years that Japanese banks hesitate to provide. Its outstanding investment in Japan has exceeded ¥900 billion, including local government bond purchases. Dexia would like to provide extra-long-term finance services to all Japanese prefectural and city governments, says Tokyo Branch CEO Robert Verdier.

Local Gov'ts Need to Communicate with Market

Local governments struggling to facilitate fund-raising operations will have to diversify bond issues and enhance information disclosure to stably sell bonds to a wide range of Japanese and foreign investors. Particularly, they will have to take investors' viewpoints into account and adopt fine-tuned measures to attract foreign investors sensitive to credit risks.

The Shizuoka prefectural government, which is one of the most market-oriented local governments in Japan with public issues accounting for 90% of its bonds, introduced its first 30-year bond issue last November, in addition to five-, 10- and 20-year issues. Since 2002, the prefectural government has annually held an investor relations meeting where the governor briefs investors on its financial profile. Its outstanding bond issues now total some ¥2 trillion. The prefectural government has already got debt ratings from multiple rating agencies. These ratings are as high as those for Japanese government bonds. In a bid to further save refunding costs, the prefectural government plans to launch an English homepage for investor relations and hold an investor relations meeting in Europe in fiscal 2008, indicating that the time has come for local governments in Japan to step up communication with the market. JS

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