Japan's Changing Municipal Bond Market

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Yield differentials have appeared in the secondary market in Japanese municipal bonds, reflecting financial and other differences among issuers. In fact, municipal bonds are increasingly becoming a subject of debate. One example of this is the controversy surrounding the move that was made at the beginning of the current fiscal year (2002) to reflect such differentials in the terms of new municipal bond issues—a move long advocated by financial institutions—by setting different terms on new bonds issued by the Metropolis of Tokyo from those issued by other local authorities.

This report examines some of the changes that have occurred recently in the Japanese municipal bond market and the issues they raise. First, however, let us take a look at how the market is organized.

1. Japanese Municipal Bond Market at Present

1) Definition of "municipal bonds"

Municipal bonds are financial obligations incurred by local authorities to fund a shortfall in their revenue and are discharged over a period longer than a single fiscal year.[1] They are governed by Section 230.1 of the Local Government Act, which stipulates that normal local authorities[2] may issue municipal bonds in accordance with their budgets and other legal provisions. "Other legal provisions" is basically a reference to Section 5 of the Local Public Finance Law, which restricts the purposes for which the proceeds of municipal bond issues may be used to five authorized purposes. In fact, however, some municipal bonds are issued by way of exception to

1 (1) Obligations that do not involve funding (e.g., debt guarantees) or (2) short-term debt repaid during the same fiscal year do not count as municipal bonds.

2 In addition to "normal local authorities" (i.e., the prefectures, the Metropolis of Tokyo, and towns and villages throughout Japan) there are "special local authorities": the 23 wards of Tokyo; roughly 3,000 joint ventures by normal local authorities (especially in areas such as education, sanitation and public welfare); roughly 4,000 so-called "common estate" wards (responsible for managing common land and legally separate from, although physically part of, towns, villages and the 23 wards of Tokyo); and 12 regional development agencies (joint ventures by normal local authorities, especially in areas such as housing, civil engineering, land acquisition and land readjustment projects), similar in purpose to the above-mentioned joint ventures.

this provision (by means, for example, of the Special Provisions Law for the Consolidation of Local Public Finances)..

Figure 1 Expenditure Which May Be Funded by Issuing Municipal Bonds

- Expenditure which may be funded by issuing municipal bonds
  - Expenditure permitted under Section 5 of the Local Public Finance Law
    - Expenditure on local public enterprises (local public enterprise bonds, Type 1)
    - Equity stakes and loans (equity stake and loan bonds, Type 2)
    - Refinancing of local government bonds (refinancing bonds, Type 3)
    - Expenditure on disaster repair and relief (disaster repair bonds, Type 4)
    - The cost of building public facilities and of purchasing land for public use (local construction bonds, Type 5)
  - Expenditure permitted by way of exception
    - Issuance of tax shortfall bonds, pension bonds, etc.

Source: NRI, from Zusetsu Chiho Zaisei [An Illustrated Guide to Local Public Finance in Japan], Toyo Keizai Shinposha.

2) Form of issuance

Japanese municipal bonds can be issued as either securities or in the form of a loan agreement. However, municipal bonds issued by public offering are always issued as securities, while those that are underwritten using public funds or by the Finance Corporation for Local Public Enterprises[3] are always issued in the form of a loan agreement. Municipal bonds issued by means of a private placement are likewise issued as either securities or in the form of a loan agreement. Just over 80% of the bonds issued by the prefectures, the Metropolis of Tokyo and quasi-prefectures[4] and placed privately is in the form of securities. In fact, some 90% (or ¥36 trillion) of the ¥40 trillion in privately placed municipal bonds outstanding as of end-February 2002 was in the form of securities.[5]

3) Municipal bond funding

Of the ¥16.5 trillion allocated for the funding of new municipal bonds (both normal account[6] bonds and local public enterprise bonds) in the current fiscal year, ¥7.6

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3 This is a government agency responsible for providing low-cost, long-term funding to companies run by local authorities. The funds to underwrite these bonds are raised by issuing government-guaranteed bonds on behalf of the local authorities concerned.

4 Quasi-prefectures are major cities (excluding Tokyo) with a population of at least 500,000 to which some administrative functions that are normally a prefectural responsibility have been devolved. Quasi-prefectures are designated as such by government ordinance.

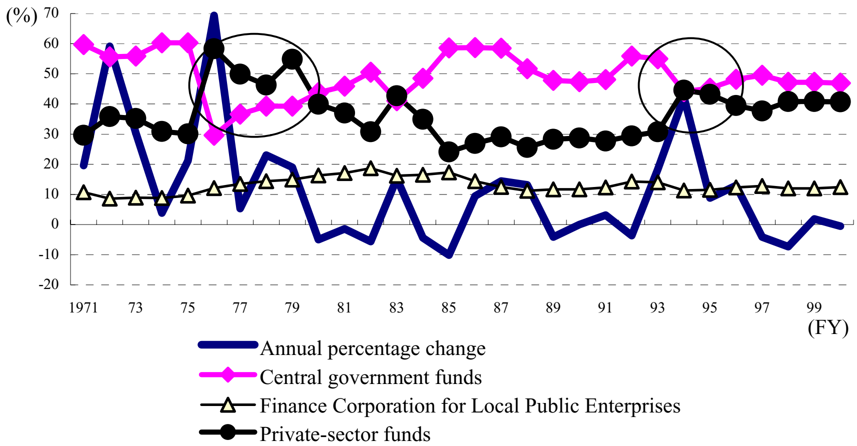
5 According to Chihosai Geppo [Municipal Bond Bulletin]. Most of the bonds (whether new or outstanding) issued by ordinary towns and villages and the 23 wards of Tokyo are in the form of loan agreements.

6 Local authorities' "normal accounts" comprise a general account and special accounts, excluding the special account for local public enterprises.

trillion (or 46%) is due to come from central government sources (such as the Post Office savings and insurance schemes, and the proceeds of bonds issued as part of the Fiscal Investment and Loan Program), ¥1.9 trillion (or 11.5%) from the Finance Corporation for Local Public Enterprises (financed mainly by government-guaranteed bonds), and ¥7 trillion (or 42.5%) from the private sector. Of the private-sector funds, ¥5 trillion is due to come from private placements with banks, and ¥1.94 trillion from public offerings of municipal bonds.[7]

There is a tendency (as can be seen in Figure 2, which shows the annual percentage change in the total planned issuance of municipal bonds and their three sources of funding) for the planned issuance of municipal bonds to become increasingly reliant on the private sector as it (i.e., the planned issuance of municipal bonds) soars during periods of economic slowdown. In both the late 1970s and fiscal 1994 private-sector funds accounted for a greater proportion of the funding of municipal bonds than did funds from central government. The former period was when local authorities tried to offset the revenue shortfall caused by the recession that followed the First Oil Crisis by issuing large amounts of deficit-financing bonds, while the latter period was when they took similar action to offset the revenue shortfall resulting from the tax cuts made in response to the recession that followed the end of the asset boom of the late 1980s.

Figure 2 Annual Percentage Change in the Total Planned Issuance of Municipal Bonds and Their Sources of Funding



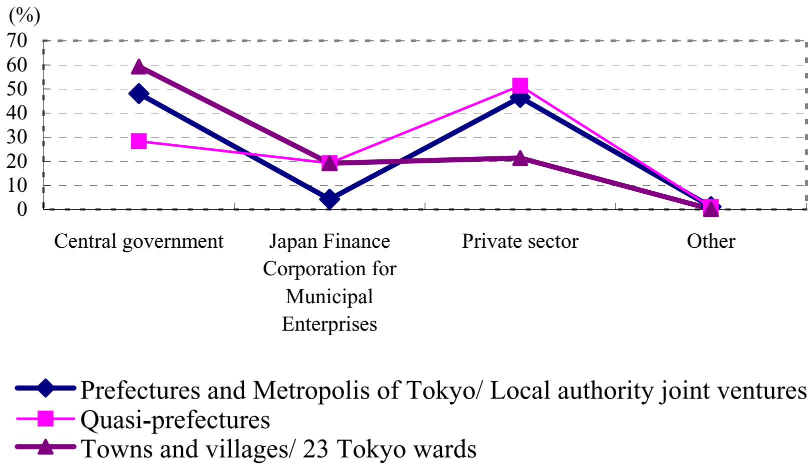
Source: NRI, from Chiho Tokei Nenpo [Annual Municipal Bond Statistics].

Figure 3, on the other hand, shows the proportion of each source of funding for the various types of local authority on the basis of the amount approved for the issuance of municipal bonds. The smaller types of local authority (such as towns and villages,

7 The amount of publicly offered municipal bonds (including refinancing bonds) scheduled to be issued in fiscal 2002 is ¥2.65 trillion.

and the 23 wards of Tokyo) would appear to rely more heavily on central government funding than the prefectures, the Metropolis of Tokyo and the quasi-prefectures.

Figure 3 Sources of Municipal Bond Funding for Local Authorities (Fiscal 2000)



Source: NRI, from Chiho Tokei Nenpo [Annual Municipal Bond Statistics].

Since the April 2001 reforms to the Fiscal Investment and Loan Program, the Post Office savings and pension schemes are no longer obliged to deposit their funds with the Trust Fund Bureau. Similarly, the Post Office life insurance scheme is no longer obliged to lend its funds to government corporations. However, by way of exception and within the terms established by Diet resolution, the Post Office savings and life insurance schemes, and the new Fiscal and Investment Loan Program can lend to local authorities directly.[8]

4) Private placements of municipal bonds

Private placements of municipal bonds take two main forms: bonds issued for placement with banks and insurance companies with close ties with the local authority concerned, and bonds issued for placement with mutual aid associations. However, only ¥0.2 trillion worth of municipal bonds was placed privately with mutual aid associations in fiscal 2000,[9] while the lion's share (¥3.7 trillion) was placed with banks and insurance companies.

Any local authority can issue bonds that are placed with banks and insurance companies—in contrast to municipal bonds that are offered publicly. In the past the banks and insurance companies concerned usually underwrote the full amount of such

8 Following the abolition of loans to local authorities in fiscal 2000, funds from the Post Office pension scheme are now invested entirely in the market.

9 According to Chihosai Tokei Nenpo [Annual Municipal Bond Statistics] for fiscal 2001.

private placements, but nowadays syndicates are often formed for the large issues by some local authorities.

The terms of privately placed municipal bonds are negotiated with the banks and insurance companies concerned. In the case of the prefectures and the Metropolis of Tokyo, terms of issuance tend to be similar to those on municipal bonds that are offered publicly, while underwriting fees tend to be quite low. As a result, it is considered to be generally cheaper to issue municipal bonds by private placement than by public offering.

5) Public offerings of municipal bonds

Unlike private placements of municipal bonds, which are aimed at a select group of financial institutions, public offerings are aimed at a wide range of investors, both retail and institutional. In order to make public offerings, however, a local authority needs to be "designated" by the Ministry of Public Management, Home Affairs, Posts and Telecommunications. In judging the merits of such an application, the Ministry takes into account a number of factors, including the local authority's track record in issuing bonds by private placement. This fiscal year 28 authorities have been authorized to issue bonds by means of a public offering.

Terms of issue such as the coupon and issue price are first of all discussed in general terms by a liaison group consisting of representatives from the Ministry of Public Management, Home Affairs, Posts and Telecommunications and the securities companies and financial institutions that form the various underwriting syndicates. The group's recommendations are then used by the issuers and syndicates concerned as a basis for discussing and fixing the terms of particular issues. In the past, yield differentials in the secondary market for municipal bonds issued by public offering were disregarded when fixing the terms of new issues as it was felt that their issuers were equally creditworthy. Since the beginning of the current fiscal year, however, 10-year municipal bonds issued by public offering have been subject to a new system, whereby the terms of bonds issued by the Metropolis of Tokyo, which enjoy the highest market rating, are different from those of all other issuers.

6) Past reforms to the municipal bond market

Over the years efforts have been made to boost the prices of municipal bonds on the secondary market and reduce the cost of issuing them by, for example, trying to increase the liquidity and attractiveness of publicly offered bonds, in particular.

As can be seen from Figure 4, a number of changes have been made to municipal bonds to make them more attractive to investors. These include increasing the minimum issue amount for publicly offered bonds (to ¥10 billion), making all such bonds redeemable only at maturity, amending the Local Public Finance Law in order to abolish early redemption by lottery, and allowing local authorities to issue publicly offered bonds with a five-year maturity.

Figure 4 Reforms to the Municipal Bond Market (since 1990)

April 1990	Private placements of ¥3 billion-plus declared eligible collateral by BOJ
August 1991	Private placements of ¥1 billion-plus declared eligible collateral by BOJ
December 1991	Underwriting commission for public offerings cut from 125BP to 108BP
April 1992	Introduction of redemption only at maturity for public offerings Minimum issue amount for public offerings increased to ¥4 billion
January 1994	Risk weighting cut from 10% to 0%
April 1994	City of Chiba becomes 28th local authority to be eligible to make public offerings
June 1994	Underwriting commission for public offerings cut from 108BP to 97BP
July 1995	Minimum issue amount for public offerings increased to ¥10 billion
November 1996	Underwriting commission for public offerings cut from 97BP to85BP
November 1997	Abolition of bond registration certificates
December 1997	Start of Japan Bond Settlement Network (JBNet)
April 1998	JBNet begins settlement by delivery versus payment (DVP)
October 1998	Abolition of accelerated redemption for public offerings
April 2000	Amendment to Local Public Finance Law abolishes early redemption by lottery Local authorities allowed to issue publicly offered bonds with a five-year maturity Underwriting commission for public offerings cut from 85BP to 75BP
April 2002	New system adopted for fixing terms of 10-year publicly offered bonds Underwriting commission on 10-year publicly offered bonds cut from 75BP to 48BP
June 2002	Underwriting commission on 5-year publicly offered bonds cut from 43BP to 34BP (Metropolis of Tokyo only)

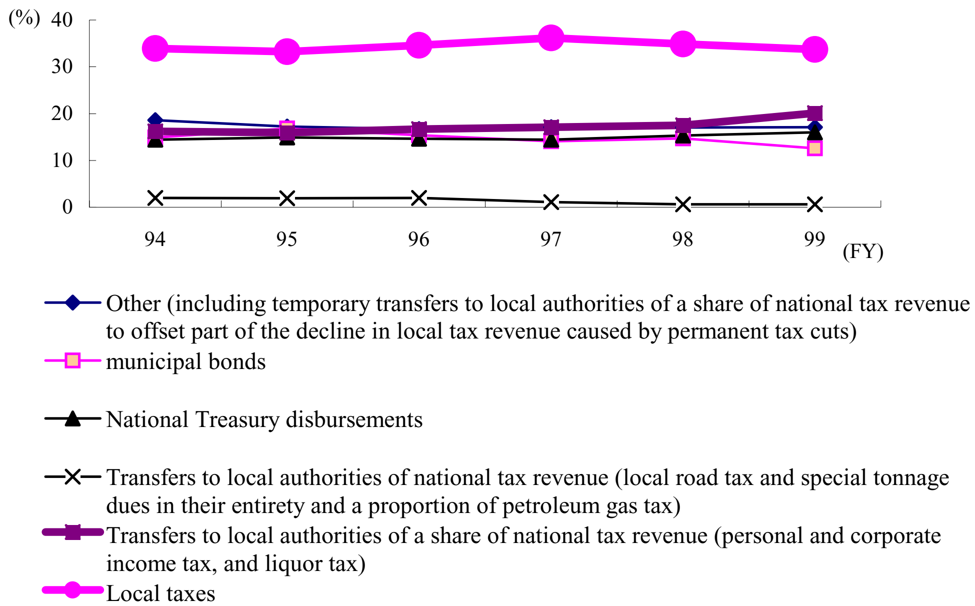
Source: NRI.

7) Central government support for municipal bonds

Although one might assume that local authorities would be obliged to pay the principal and interest on municipal bonds from local tax revenue in accordance with their taxation rights under Section 223 of the Local Government Act,[10] they cannot, in fact, do without central government support (e.g., in the form of a share of national tax revenue) in order to maintain their creditworthiness as issuers. This is partly because local taxes account for less than half of total local government revenue (see Figure 5).

[10] Although local public enterprise bonds are normally serviced using revenue from the company concerned, final responsibility lies (as with normal account bonds) with the general account.

Figure 5 Breakdown of Local Government Net Annual Revenue



Source: NRI, from Chiho Zaisei Hakusho [White Paper on Local Public Finance].

This support consists of general financial backing (in the form of an approval system for the issuance of municipal bonds, the Fiscal Consolidation System and local public finance plans) as well as special transfers of national tax revenue.

(1) Approval system for the issuance of municipal bonds

(a) Current system

In order to issue municipal bonds, the prefectures and the Metropolis of Tokyo have to obtain approval from the Minister of Public Management, Home Affairs, Posts and Telecommunications, while towns and villages have to obtain approval from the governor of their prefecture or, in the case of the Metropolis of Tokyo, the Governor of Tokyo.[11] Under the Comprehensive Law on Local Government Devolution, which came into effect in 1999, a "system of agreement" is due to be adopted in fiscal 2006. This will allow local authorities to go ahead and issue bonds even if they fail to reach agreement on the terms with the Ministry, the governor of their prefecture or the Governor of Tokyo.

The approval system follows guidelines ("Policy for Approving Municipal Bond Issues") and more detailed implementation rules ("Rules Governing the Implementation of the Policy for Approving Municipal Bond Issues") agreed by the Ministry of Public Management, Home Affairs, Posts and Telecommunications and

[11] Under Section 252.19.1 of the Local Government Act "prefectures and the Metropolis of Tokyo" includes quasi-prefectures.

the Ministry of Finance, and the municipal bond issuance plan for the current fiscal year.

(b) Limits on bond issuance

In order to ensure that local government finances are kept on a sound footing, the guidelines use a debt service ratio (i.e., the ratio of a local authority's debts—adjusted for special transfers of national tax revenue—to its standard fiscal amount) to limit the amount of bonds local authorities can issue (see Figure 6).[12]

When the ratio is exceeded, local authorities are not permitted to issue any of the bonds concerned. Once a system of agreement is adopted in fiscal 2006, these limits will have legal force.

(c) Transition to a system of agreement

Once a system of agreement is introduced in fiscal 2006, it will replace the current system of approval in most cases. Under the new system, municipal bonds will be treated differently according to whether or not they are issued with the agreement of the Minister of Public Management, Home Affairs, Posts and Telecommunications. Whereas bonds issued with the Minister's agreement are (1) eligible for purchase with funds from central government or the Finance Corporation for Local Public Enterprises and (2) have the assurance of having their principal and interest included in the local government finance plan for that fiscal year, those that are issued without

Figure 6 Limits on Bond Issuance

(1) Formula for determining when limits apply

Local authorities whose average debt service ratio (adjusted for special transfers of national tax revenue) for the past three fiscal years, as calculated using the following formula, is as indicated in (2) below are not normally permitted to issue any of the types of bonds indicated.

$$\frac{A-(B+C+E)}{D-(C+E)}$$

A: Principal and interest on bonds issued on local authorities' general and special accounts (excluding local public enterprises' accounts). (In the case of bonds issued on condition that their entire principal is repaid on maturity, this refers to the sinking fund, accumulated through regular payments, that is used to fund the repayment.) However, amounts for accelerated redemption are excluded.

B: Specific funds allocated to A.

12 In addition to limits on bond issuance, there are limits on (1) local authorities in arrears with (re)payments of principal and interest, (2) local authorities which have a poor record of collecting local tax arrears, and (3) the percentage of the expenditure of public racing organizations that can be funded by issuing municipal bonds.

C: The amount included as debt servicing costs in a local authority's standard fiscal expenditure requirements when calculating its normal share of national tax revenue (disaster repair costs, the cost of redeeming deficit-financing bonds, etc.)

D: A local authority's standard fiscal amount for the fiscal year in question calculated using the figure for standard fiscal revenue used in calculating its share of national tax revenue

E: The amount included as debt servicing costs (adjusted for the percentage of the cost of local public works projects covered by special transfers of national tax revenue) in a local authority's standard fiscal expenditure requirements when calculating its normal share of national tax revenue

(2) Limits in detail

(a) Local authorities whose average debt service ratio for the past three fiscal years is 20% or more but less than 30%:

Bonds issued by local authorities to fund local general projects

(b) Local authorities whose average debt service ratio for the past three fiscal years is 30% or more:

Bonds issued by local authorities to fund general projects (i.e., the construction of local authority housing, schools, social welfare facilities and general waste disposal plants; local general projects; construction work in the Greater Tokyo area; the accelerated purchase of land for public use; but excluding disaster repairs) and equity stakes in (or subsidies to) local public enterprises included in local authorities' normal account

Source: Chihosai Kyoka Hoshin [Policy for Approving Municipal Bond Issues].

his agreement (1) have to be reported to the Diet and (2) are not eligible for purchase or backing with public funds. In addition, issuers that (1) are in deficit, (2) have a high (i.e., unsatisfactory) debt service ratio or (3) whose finances cast doubt on their creditworthiness have to obtain the Minister's approval of any bond issues. Similarly, a local authority which has collected all its general tax[13] at less than the standard rate will not be able to issue construction bonds under the Local Public Finance Law until fiscal 2006, when they will require approval for such issues.

(2) Fiscal Consolidation System

If a local authority finds that its real fiscal deficit is, in the case of a prefecture or the Metropolis of Tokyo, 5% or more or, in the case of a town or village, 20% or more of its standard fiscal amount[14] on its normal account, it will not be allowed to use the

[13] Under Section 4 of the Local Taxes Act, prefectures are required to collect the following general taxes: residents' tax, business tax, local value-added tax, property purchase tax, tobacco tax, golf course tax, motor vehicle tax, mine-lot tax, hunting license tax, etc. Under Section 5, towns and villages are required to collect the following general taxes: residents' tax, property tax, light vehicle tax, cigarette tax, mine product tax, special property ownership tax, etc. In addition, local authorities are required to collect hypothecated (or "earmarked") taxes.

[14] A local authority's "standard fiscal amount" is the total of the general fiscal resources it needs to carry out its normal administrative responsibilities. Its "real fiscal deficit" is the real balance of its fiscal revenue and expenditure on an accrual basis.

proceeds of a bond issue to fund expenditure permitted under Section 5.1.5 of the Local Public Finance Law unless it has drawn up a fiscal consolidation plan and is subject to fiscal consolidation. In Japan, the notion of insolvency does not apply to local government. However, the Fiscal Consolidation System is the nearest thing to it. It is also meant to stop local government finances from deteriorating and helps to maintain the quality of municipal bond issues in general.

(3) Financial backing provided by local public finance plans

Local public finance plans contain official government estimates of the revenue and expenditure of local authorities for each fiscal year. As well as giving an overview of local government finances, they also enable the government to coordinate local and national finances and ensure that local authorities have the funds necessary to provide a proper public service. Therefore, if these funds are not available, the government will try to remedy the situation by (1) raising the proportion of national taxes it transfers to local authorities, (2) borrowing on the special account for transfers to local authorities or (3) allowing the local authorities concerned to issue construction bonds.[15] Under this system, the principal and interest on bonds issued with approval is entered as public debt in the local public finance plan for that fiscal year, thereby ensuring that the government makes available the necessary funds for their issue as part of its general planning.

(4) Special transfers of national tax revenue to local authorities

Normal transfers of national tax revenue to local authorities are meant to cover the difference between their standard fiscal expenditure requirements[16] and their standard fiscal revenue.[17] Special transfers of national tax revenue to local authorities, on the other hand, allow local authorities to add all or part of the principal and interest on their bonds to their standard fiscal expenditure requirements for the next fiscal year at a certain rate.

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15 These construction bonds are issued by local authorities—either by increasing the percentage of expenditure that can be funded by issuing municipal bonds or widening the scope of the projects eligible for funding—to offset what is expected to be a serious shortfall in general revenue.

16 This forms the basis for calculating normal transfers of national tax revenue to local authorities. It is the cost—calculated using a standard formula—for a particular local authority of providing a reasonable and appropriate level of public service.

17 This forms the basis for calculating normal transfers of national tax revenue to local authorities. It is the local tax revenue—calculated using a standard formula—that a particular local authority can expect in a standard set of circumstances and is used to calculate that authority's financial strength.

2. Debate on Municipal Bonds

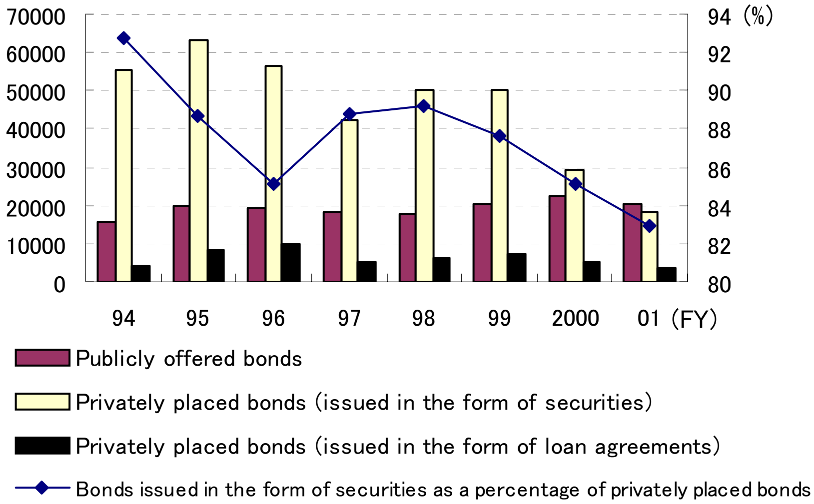
The following is an overview of some of the recent developments in the Japanese municipal bond market and of the debate that has arisen as a result.

1) Preference for bonds issued in the form of a loan agreement

As can be seen in Figure 7, there has been a recent tendency for an increasing proportion of privately placed municipal bonds to be issued in the form of loan agreements rather than securities. This is partly because the fact that local authorities have been cutting back on local public works projects in order to put their finances on a sounder footing has led to a much greater reduction in bonds issued in the form of securities rather than loan agreements, and partly because the adoption of market-value accounting has made the financial institutions that underwrite municipal bonds prefer bonds of the latter type as they do not have to be revalued at the end of each fiscal year. With local authorities also able (as an extension—intended to protect public funds—of the government's depositor protection scheme that came into effect in April of this year following the abolition of the former blanket guarantee on deposits) to offset such obligations against any deposits with a bank that fails, this trend towards municipal bonds issued in the form of loan agreements is likely to continue for the time being. However, opinion is divided as to whether it really is a good thing to be issuing more privately placed municipal bonds in the form of illiquid loan agreements when this may be distorting the secondary market.

Figure 7 Percentage of Privately Placed Municipal Bonds Issued in the Form of Securities

(The figure for fiscal 2001 is the total to February 2002, ¥100 million)



Note: The figures are for prefectures, the Metropolis of Tokyo and quasi-prefectures only.
Source: NRI, from Chihosai Geppo [Municipal Bond Bulletin].

2) High hopes placed on private-sector money

(1) Privately placed municipal bonds

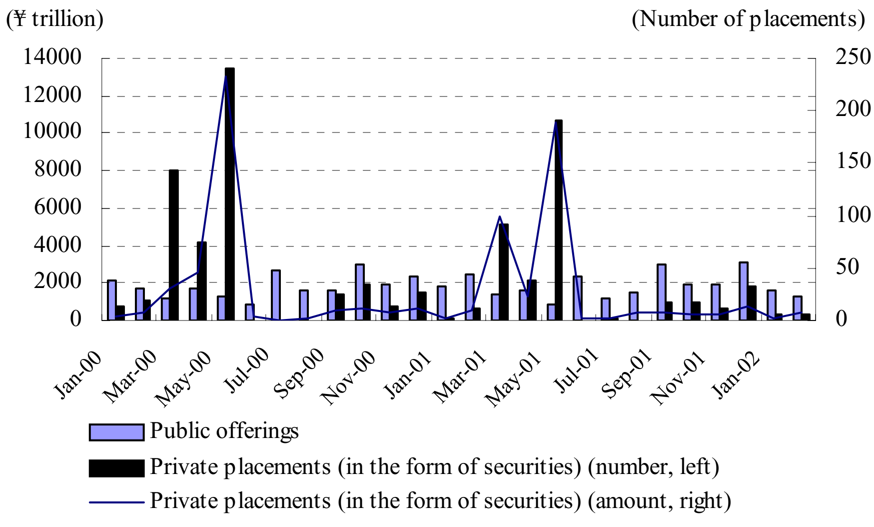
Although there is a large secondary market in privately placed municipal bonds issued in the form of securities (just as there is in publicly offered bonds), action to improve its liquidity has been relatively slow in forthcoming.

Figure 8 shows the amount of municipal bonds that have been either privately placed (in the form of securities) or publicly offered for every month since January 2000. What is clear is that, whereas the amount of publicly offered bonds issued is spread evenly throughout the period of observation, the amount of privately placed bonds is concentrated either at the end of each fiscal year or during the account settlement period (March-May). Since issuing a large amount of privately placed bonds over a relatively short period could sometimes threaten to destabilize the bond market as a whole, trying to even out the amount of such bonds issued at any one time is important not only in order to ensure their smooth placement but also the stability of the Japanese bond market as a whole.

Figure 9 shows that the bulk of privately placed municipal bonds are underwritten by city and regional banks, whose source of funds is relatively short-term. The main reason banks used to be able to underwrite large amounts of such bonds in spite of the fact (1) that this produced a mismatch between their assets and their liabilities and (2) that there was sometimes a disparity between the issue terms of such bonds and secondary market yields was that they used to value their bond holdings at cost. Since fiscal 2000, however, they have had to value these holdings at market, while the percentage of privately placed municipal bonds issued in the form of loan agreements (that are difficult to sell) has increased and financial institutions are questioning the benefits of being a designated underwriter of such issues. Local authorities may therefore find it increasingly difficult to find institutions prepared to underwrite privately placed bonds. The percentage of private-sector funds invested in privately placed municipal bonds has been declining since the late 1990s as the percentage invested in publicly offered bonds has been increasing (see Figure 10), and reliance on the latter is likely to increase further.

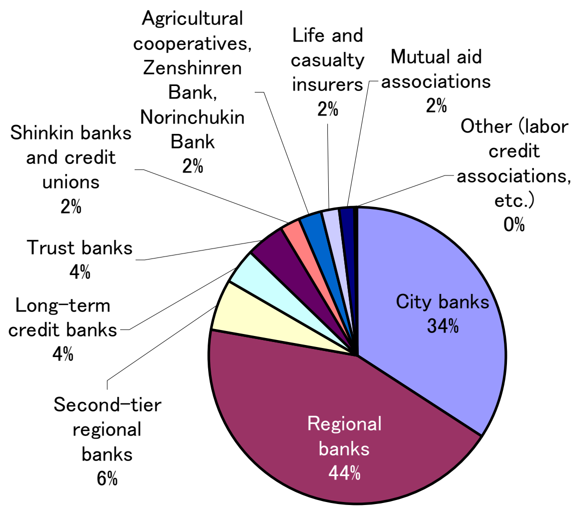
It has been suggested that, if more privately placed municipal bonds were redeemable only at maturity, their liquidity would improve. Unlike redemption by lottery, however, where it is difficult for bondholders to predict their cashflow, redemption at fixed intervals is a well recognized procedure. Therefore there would appear to be no compelling reason to change this feature. A better alternative would be to vary some of the features of privately placed municipal bonds (e.g., by sometimes issuing them as medium-term notes, or MTNs) in order to appeal to a wider range of investors.

Figure 8 Amount and Number of Municipal Bond Private Placements

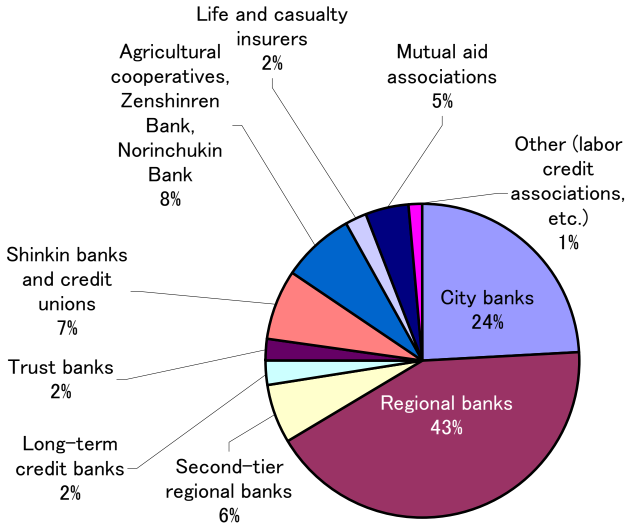


Note: The figures are for prefectures, the Metropolis of Tokyo and quasi-prefectures only.
Source: NRI, from Chihosai Geppo [Municipal Bond Bulletin].

Figure 9 Sources of Funding for Privately Placed Municipal Bonds in Fiscal 2000



(securities + loan agreements)

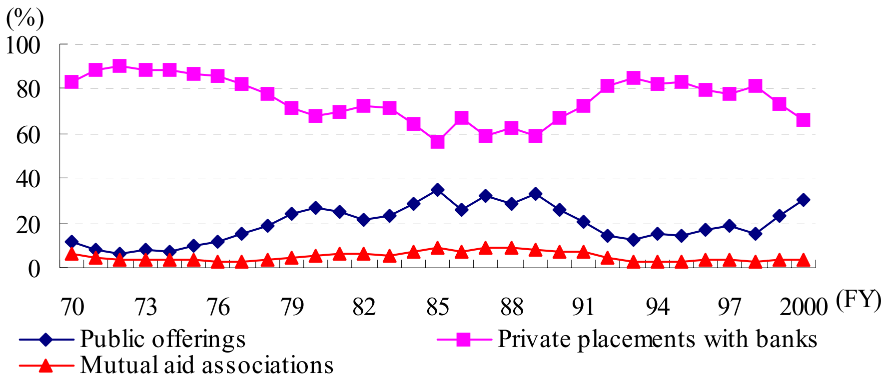


(securities only)

Note: Both charts represent the total for prefectures, the Metropolis of Tokyo, quasi-prefectures, towns, villages and the 23 wards of Tokyo.

Source: NRI, from Chihosai Tokei Nenpo [Annual Municipal Bond Statistics].

Figure 10 Composition of Private-Sector Funding of Municipal Bonds on the Basis of the Amount Approved for Their Issuance



Source: NRI, from Chihosai Tokei Nenpo [Annual Municipal Bond Statistics].

3) Publicly offered municipal bonds

Unlike privately placed municipal bonds, which are underwritten only by a limited number of institutional investors, publicly offered municipal bonds are aimed at a wide range of investors, including individuals, nonfinancial corporations and foundations as well, of course, as financial institutions.

Since the adoption of new system this April, whereby issue terms reflect secondary market conditions more closely, the market in publicly offered municipal bonds has seen a number of developments. For example, in April, negotiations between the City of Yokohama, which wanted to issue bonds on the same terms as the Metropolis of Tokyo, and the underwriting syndicate broke down, and, in June, the issuer formed a new syndicate in an attempt to obtain better conditions. Similarly, the cut in underwriting commissions that accompanied the adoption of this system led to the defection of a number of city banks from the syndicates of some less popular issues and their places being taken by foreign banks.

Therefore, although a number of matters have still to be resolved, including how best to deal with less popular issues, the trend is towards terms that reflect the market rating of each issuer.

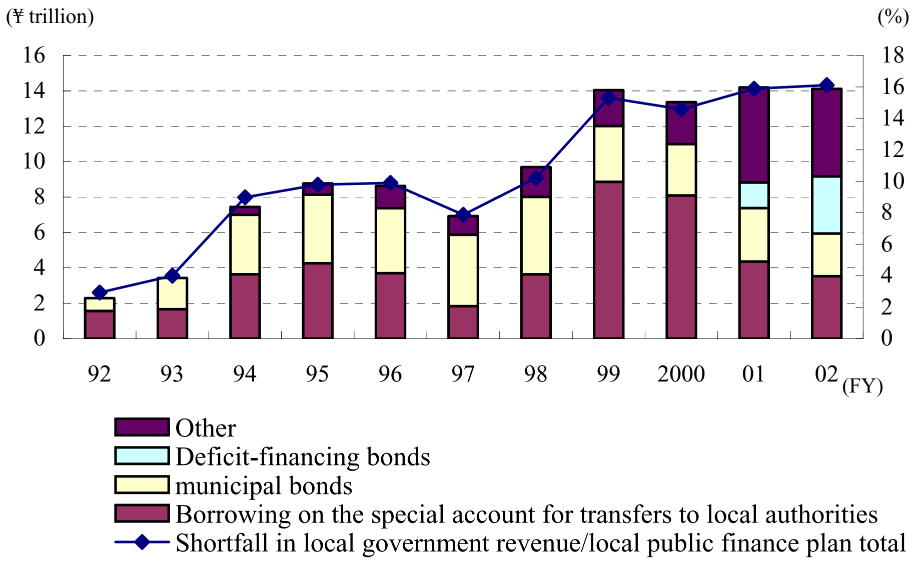
4) Creditworthiness of municipal bonds

Yield differentials have developed on the secondary market in municipal bonds, reflecting the financial status of the issuers. Given the various forms of central government support that exist under the current system (ranging from paying principal and interest to funding new issues), such differentials should not occur. That such differentials do occur in spite of the fact that this support system still functions properly suggests that the market is either not fully aware or not fully convinced that this is the case. In other words, the fact that public finances are stretched at both national and local levels and the increasing debate about the need to reform the system of transferring a proportion of national taxes to local authorities may have raised doubts in the market about the sustainability of central government support for municipal bonds.

Although Rating and Investment Information, Inc., for example, maintains quite a high minimum credit rating for municipal bonds on the grounds that bondholders are protected by the current system, it does differentiate its ratings (using publicly available information) to allow for certain financial risks (e.g., the possibility that the central government might have difficulty in dealing with a situation where cashflow problems temporarily forced a number of local authorities to alter the dates for redemption of principal or payment of interest on their bonds).[18]

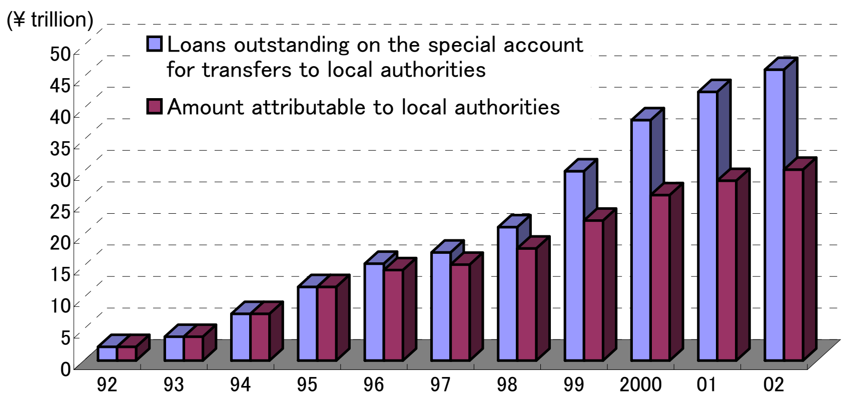
18 According to Retingu Joho [Credit Rating Information], Rating and Investment Information, Inc., April 1999.

Figure 11 Shortfalls in Local Government Revenue and Means of Funding Them



Source: NRI, from Chiho Zaisei Yoran [Compendium of Local Public Finance in Japan].

Figure 12 Loans Outstanding on the Special Account for Transfers to Local Authorities



Source: NRI, from Chiho Zaisei Yoran [Compendium of Local Public Finance in Japan].

Figure 11 shows the shortfalls in local government revenue since fiscal 1992. The initial shortfall for fiscal 2002 consists of a regular deficit of ¥10,665 billion and a deficit of ¥3,451 billion resulting from permanent tax cuts, giving a total shortfall of ¥14,116 billion. Various factors have been adduced to account for this huge figure, including (1) the effect of the recession on both local government tax revenue and transfers of national tax revenue to local government and (2) a greater increase in local government standard fiscal expenditure requirements than in standard fiscal revenue, which is linked to local government tax revenue, because of special transfers of national tax revenue resulting from issues of municipal bonds to fund an increase in public works investment. These shortfalls have been funded by increased transfers of national tax revenue and increased issuance of municipal bonds; but, as can be seen in Figure 12, this has resulted in increased borrowing on the special account for transfers to local authorities, the balance of which had reached ¥46 trillion by the beginning of fiscal 2002. The current system, including the question whether transfers of national tax revenue are really the most efficient way of funding public works, is therefore being questioned.

Depending on how the debate on aspects of devolution and local public finances such as the transfer of fiscal resources and reform of the system of transferring a share of national tax revenue to local government develops, the existing system of central government support for municipal bonds may change with the result that central government comes to play a relatively minor role while the focus shifts to the financial position of individual issuers.

Both central government and local authorities will probably therefore have to make greater efforts to cultivate investor relations in order to increase investor understanding of the municipal bond market.

5) Joint bond issues

Joint issuance of a municipal bond occurs when two or more issuers accept joint and several liability for (re)paying its principal and interest.[19] As well as enabling larger and, therefore, more liquid issues than would be possible if the local authorities involved acted separately, less popular local authorities are likely to be able to issue bonds more cheaply than otherwise once issue terms reflect secondary market conditions. Although joint issues should enjoy such advantages, not enough consideration has been given to whether these would be enough to make such issues more popular with investors, and more needs to be done to achieve this.

3. Unresolved Issues

Although this report has examined the various changes that have taken place in Japan's municipal bond market, a fresh look needs to be taken at the aims and effectiveness of some of the steps that have already been taken.

Stable sources of funding for municipal bonds are needed to ensure that local public finances are managed properly. In particular, more private-sector funding needs

[19] Local Public Finance Law, Section 5.7

to be tapped via the market. Continued efforts therefore need to be made to make municipal bonds more attractive to investors, and issue terms need to be in line with secondary market conditions. Only then will it be possible to reform the market by increasing issue amounts (e.g., by means of joint issues of publicly offered bonds) and issuing privately placed bonds at more regular intervals.

Nor should government bonds be seen as the sole model for trying to make municipal bonds a more attractive investment product. More customization should help to broaden their investor base and reduce the cost of issuing them.

Therefore greater consideration should be given to alternatives such as issuing municipal bonds in the form of medium-term notes, whose features can be matched to investor needs; funding debt servicing from the revenue from public works and projects (rather than from general sources) by issuing revenue bonds similar to those in the United States; and making greater use of private finance initiatives (PFIs),[20] of which Japan already has some experience.

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[20] For the current situation surrounding private finance initiatives in Japan and some of the unresolved issues involving them, see Masanobu Iwatani, "Wagakuni PFIjigyo no Tenkai to Shihon Shijo Katsuyo no Kanosei" [The Development of Private Finance Initiatives in Japan and the Opportunities They Present for Using Capital Markets], Shihon Shijo Kuwotari [Capital Market Quarterly], Autumn 2001.