The Infrastructure for Japan's Municipal Debt Market: Present and Future Outlook

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I. Introduction

More and more local governments are being rated by the credit rating agencies. Starting with Yokohama City's rating in October 2006, seven of the 42 local government entities that issue publicly offered bonds for the national market had received a solicited rating as of 1 October 2007. Some, such as Kyoto City, have been rated by more than one rating agency.

As Japan's government has become more decentralized in recent years, local governments have had to play an increasingly important role through their issuance of municipal debt. Growth in the municipal bond market is in turn putting local governments under increasingly greater pressure to devise measures to attract funds from investors. It is within this context that Japan has made strides in developing an infrastructure for the municipal bond market, typified by the assigning of solicited ratings.

This paper looks at recent moves to enhance the infrastructure for the now transforming municipal bond market, with a particular focus on reforms to public accounting rules and the trend of local governments holding investor briefings and obtaining credit ratings. [1, 2]

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1 Auditing mechanisms are also a critical component of the municipal bond market, but we do not deal with that component in this paper. These include the system of Audit and Inspection Commissioners, which has been around for quite some time, but has limitations, both in its autonomy (because commissioners are appointed by the government head with the consent of the local assembly) and in its degree of expertise. See, for example, Hiroshi Nakachi, general editor, and Nakachi Koukaikei Kennkyusho, editor, "*Jichitai Kaikei no Atarashii Keiei Houkokusho*" (New public management reports on local governments), Gyosei Corp., 2006. To accommodate this, a system of outside auditors was introduced in 1998, but this system still appears to suffer from a narrowly defined scope of audits and the exclusion of any review of financial results. For more on this, see chapter 3 of "*Henkakuki no Chihousai Shijou -- Chihousai no Genjou to Tenbou*" (Japan's changing municipal bond market -- current and future outlook of municipal bonds), edited by the Nomura Institute of Capital Markets Research, Kinzai Institute for Financial Affairs, 2007.

II. Debate over the credit risk of municipal debt

1. Market for municipal bonds is growing

The term municipal debt is generally used to refer to either (1) all local government liabilities with a term exceeding a single fiscal year or (2) debt issued and sold in a securities (bond) format. To avoid confusion, we will use the term municipal debt to refer to the first (broader) definition.

Total municipal debt outstanding exceeded ¥202.3 trillion as of the end of FY2004. This amount had grown consistently during the late 1990s, increasing by roughly ¥50 trillion during the five-year period from 1995 to 2000.[3] The primary balance for local governments overall has been in surplus since FY1999, however, and this recovery in local government finances has led to a gradual slowing of the rate of growth in outstanding municipal debt issuance.

In step with this, the source of the funds invested in municipal bonds has changed substantially.

The source of funds can be broadly categorized as either private-sector or public, with the latter funneled through the Fiscal Investment and Loan Program (FILP). Publicly funded municipal debt can be further categorized as that funded by government funds and that funded by the Japan Finance Corporation for Municipal Enterprises (JFM), which is a government-affiliated financial institution that provides long-term, fixed-rate loans at favorable interest rates for the infrastructure projects of local governments, while private-sector funded municipal debt includes that placed with the banks (limited to funding by such banks as local regional financial institutions), and those offered publicly to the broader market. The debt offered publicly and some of the debt placed directly with the banks is in the form of securities (bonds), while the remainder of the debt sold to the banks and all debt funded publicly is issued in the form of loan agreements.

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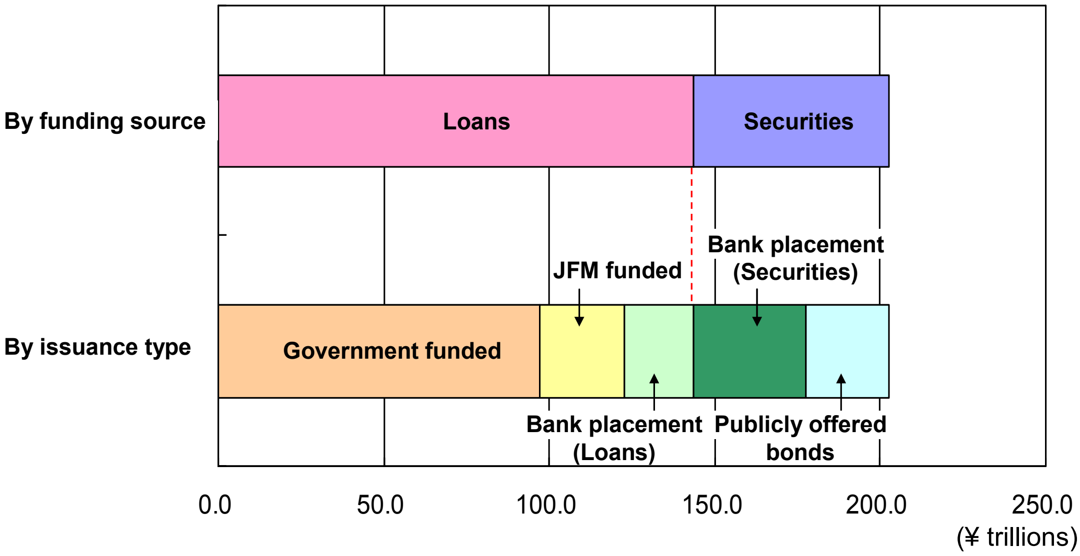
[2] The following references (all in Japanese) were used to write this paper: *Henkakuki no Chihousai Shijou -- Chihousai no Genjou to Tenbou* (Japan's changing municipal bond market -- current and future outlook of municipal bonds), edited by the Nomura Institute of Capital Markets Research, Kinzai Institute for Financial Affairs, 2007; Masahiko Igata, Yuko Numata, and Hiroki Miyake, *Beikoku no Chihousai Shijou kara erareru Nihon he no Shisa -- Hatten no Kagi wo Nigiru Kakei to Toushi Shintaku* (Clues for Japan from the US municipal bond market -- Households and investment trusts hold the key) Nomura Institute of Capital Markets Research, Capital Markets Quarterly, Winter 2007; Yuko Numata and Hiroki Miyake, *Beikoku Chihousai no Kisai Purosesu -- Wagakuni Chihousai ni Hitsuyou to sareru Infura to Senmonteki Kinou* (Process for issuing municipal bonds in the US -- the infrastructure and specialized functions needed for Japan's municipal bonds), Nomura Institute of Capital Markets Research, Capital Markets Quarterly, Spring 2007; Yuko Numata and Hiroki Miyake, *Beikoku Chihousai Fando Shijou no Genjou -- Minkan Shikin wo Hikitsukeru Shijou Infura to shite no Kanousei* (The current status of the market for US municipal bond funds -- its potential as a market infrastructure to attract private-sector funds), Nomura Institute of Capital Markets Research, Capital Markets Quarterly, Summer 2007.

[3] Estimates based on *Chihousai no Gaiyou to Saikin no Joukyou* (Overview and recent status of municipal bonds), Ministry of Internal Affairs and Communications (MIC), 2006

Measured in terms of issuance outstanding, the majority of Japan's municipal debt is purchased with public funds (Figure 1): 60.7% as of the end of FY2004.[4]

Figure 1: Municipal bonds outstanding by issuance type and funding source (as of end-FY2004)



Source: Nomura Institute of Capital Markets Research, based on *Chihousai no Gaiyou to Saikin no Joukyou* (Overview and recent status of municipal debt) and *Chihousai Toukei Nenpou*, (Statistical yearbook on municipal debt), Ministry of Internal Affairs and Communications (MIC), 2006 (in Japanese)

The overall amount of these public funds has declined over the past few years, however, in step with the FY2001 FILP reforms and postal privatization. When considering that the JFM is scheduled to be dismantled in FY2008, and that its successor entity, the New-JFM, will be downsized in stages, we expect public funding to remain in a declining trend, at least for the time being.

If the amount of municipal debt issuance outstanding is kept fairly constant while the share of that issuance bought with public funds declines, it is inevitable that the share of private funding will increase. In fact, recent issuance data on a flow basis shows that the private sector funded 67.4% of all municipal debt issuance in FY2005, up substantially from 49.3% in FY1995. Growth has been particularly great in the private-sector funding of publicly offered bonds, which increased to 35.2% in FY2005, up from only 8.7% in FY1995, making the publicly offered bonds the largest single source of funding for municipal debt[5] (Figure 2).

This trend will probably continue for some time yet. (Figure 3).

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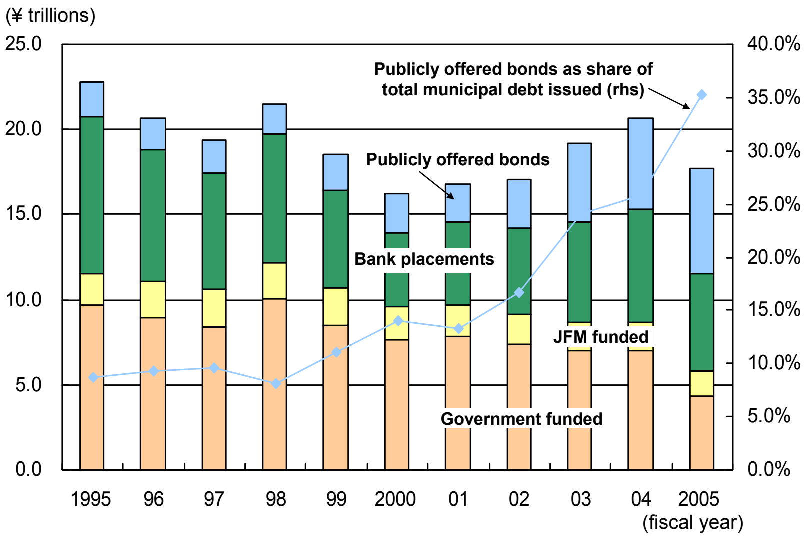
4 Ibid.

5 Estimates based on *Chihousai Toukei Nenpou* (Statistical yearbook on municipal bonds), MIC, 2006

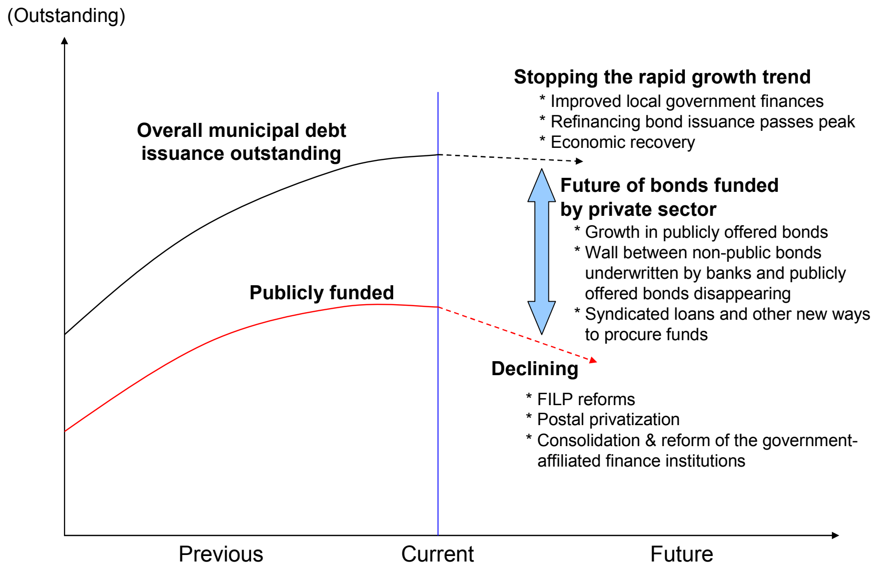
Figure 2: Municipal debt issuance amounts



Notes: 1. Numbers shown based on actual results except for the government funds portion for FY2005, which is an estimate.
2. Excluding specified funds etc.

Source: Nomura Institute of Capital Markets Research, based on *Chihousai Toukei Nenpou*, (Statistical yearbook on municipal debt).

Figure 3: Scenario for development of municipal debt funding sources



Source: Nomura Institute of Capital Markets Research

2. Arguments regarding an 'implicit central government guarantee'

With the private sector now the most important source of funds for purchasing municipal debt, and with the municipal bond market expected to grow, the question of municipal bond risks, especially credit risks, is now being debated.

There are numerous opinions regarding the existence and extent of credit risk in municipal bonds (Figure 4).

Figure 4: Summary of arguments regarding an "Implicit Central Government Guarantees"

System	Details	"Implicit central government guarantees"	Criticism of concept of an "Implicit Central Government Guarantees"
Local taxes	Local government's own revenue source. Residents tax, fixed asset tax, etc.	Ultimate source of funds to pay P&I on municipal debt	Current fiscal difficulties for local governments and future outlook
		In reality, local governments are able to decide on their own to broaden their tax base or raise tax rates	Transfer of taxing authority to local governments creates disparity in fiscal strength among local governments
Local Finance Program	Estimate of total revenue and expenditures for entire local government budget	This program accounts for total debt expenditure	MIC only manages ordinary account when setting a plan
Municipal bond plan	Set plan for municipal bond issuance by project and by funding source	Allotments to fund municipal debt	There is no guarantee of funding for each local government
FILP plan	Government's investment and loan plan	Allotment of government funds	Plan and actual differ
System of prior consultation	Consultation between central government and local government regarding issuance of municipal debt	Government funding is possible when central government approval is obtained	Central government approval is not the same as a government guarantee to repay the P&I of issued debt
	A system of approving debt issuance exists partially	Ensuring minimal fiscal conditions are maintained when municipal debt is issued	Possible to issue debt with the approval of the central government
Local allocation tax system	System for fiscal equalization among local governments	The amount local governments need to make P&I payments on municipal debt is added to standard fiscal demand amount for following fiscal year	When considering that funds available from local allocation taxes have been insufficient for the past few years and that the central government's fiscal condition has deteriorated, there is reason to doubt the sustainability of the system.
	All local government entities are guaranteed the funding required to provide necessary public services		
Financial Reconstruction System	Local governments in bad fiscal condition are ordered to reconstruct under the strict supervision of the central government.	Final fiscal reconstruction plan for local governments	Because fiscal reconstruction is not attempted until the local government applies, it is impossible to respond quickly to fiscal deterioration
		Fiscal support from the central government	There is no rule providing for the central government or next higher level of local government to take over P&I payments
BIS regulations	Banks calculate their risk-weighted capital based on the riskiness of each of their assets	Since 1994, municipal bonds have had a risk weight of 0%	When the BIS capital adequacy rule were first introduced in 1988, municipal bonds were assigned a risk weight of 10%
			Germany is one of the few industrialized countries that assigns a zero risk weighting to municipal bonds

Source: Nomura Institute of Capital Markets Research, based on Shinji Okabe, *Gaishikei Shoukengaisha kara mita Kyoudou Hakkou Shijou Koubosai* (The market for jointly issued municipal bonds, from the perspective of foreign-capitalized securities firms), an article in the June 2003 issue of the *Chihousai Geppou*, published by the Japan Local Bond Association; Toshiki Tomita, *Zaito Kaitai Ron Hihan* (Critique of the argument for disbanding the FILP), Toyo Keizai Inc., 2007; Taketoshi Tsuchiya, *Zaito Kikansai Toushi Handobukku* (Handbook for investing in FILP agency bonds), Kinzai Institute for Financial Affairs, 2003; Yuka Tanba, *Chihousai no Shinyouryoku* (Creditworthiness of municipal bonds), an article in the January 2004 issue of *Norin Kin'yu*, published by the Norinchukin Research Institute; Takero Doi and Shun-ichiro Bessho, *Nihon no Chihousai wo meguru shoseido to sono Hensen* (Rules governing local government debt in Japan and changes in those rules), Policy Research Institute, 2004.

The Ministry of Internal Affairs and Communications (MIC) generally adheres to the argument that municipal bonds have an 'implicit central government guarantee', and that the redemption of principle is assured based on certain mechanisms[6].

A number of different rule regimes play a role in Japan's municipal debt system. When the debt is first issued, the central government is involved to a certain extent, including by formulating a 'Local Bond Plan'. This plan covers debt issuance by all local governments and is based on the 'Local Finance Program' and other documents. It also aims to coordinate FILP targets with funding sources.

Municipal bond issuance switched to a system based on prior consultation in FY2006, which in principle allows local governments that meet certain fiscal conditions to freely issue municipal debt, with or without approval from MIC. Those local governments whose fiscal situation has deteriorated beyond a certain point (measured by their real deficit ratio and real debt service ratio) are excluded from this, however, and still must obtain approval from the central government to issue debt. The real deficit ratio is the real fiscal balance of the ordinary account (the budget for the fundamental public services offered by the local government) as a percentage of that government's standard general revenue (with which the local government has the authority to decide what public services it offers). In contrast, the real debt service ratio is the amount of principal and interest (P&I) payments on municipal debt owed by a local government in a fiscal year, as a percentage of that government's general financial resources. If a local government's real deficit ratio exceeds the range of 2.5% to 10%, or if its real debt service ratio exceeds 18%, it is designated as an approval-requiring government, and must obtain approval from the central government to issue debt.

In addition to the central government's involvement with issuance, another mechanism that helps local governments pay back the principal and interest (P&I) on municipal debt is the Local Allocation Tax System, which is Japan's system for equalizing fiscal revenues via transfers. The costs for P&I payments on municipal debt issued with central government approval are taken into consideration when calculating the amount of local allocation taxes distributed to each local government.

One system designed to restore fiscal soundness to local government entities in fiscal crisis is the Financial Reconstruction System[7]. Under this system, local governments in financial trouble apply for designation as 'a reconstruction entity' under the system, and then try to reconstruct under control of the central government. The central government becomes heavily involved in administering the finances of that local government, from the initial proposal of a fiscal reconstruction plan to monitoring the status of that plan's implementation, and also provides some fiscal incentives. Although the MIC's study group on debt adjustment is looking at ways to adjust municipal debt, at this point there is no law that stipulates the procedures for such an adjustment.

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6 From the MIC website.

7 The Law Relating to the Financial Soundness of Local Governments was passed in June 2007 to replace the Financial Reconstruction System. See the next section for further details.

Thus, in addition to mechanisms enabling the central government to provide support to local governments in making P&I payments on municipal debt, local governments ultimately have the right to levy their own taxes as a way to raise funds for making such payments. In Japan, local governments have the authority to enact a new local tax with the central government's agreement, and also have some authority to change tax rates. If push comes to shove, local governments should be able to raise tax revenues by exercising their right to levy taxes, thereby enabling them to secure the funds required to make P&I payments.

The argument that there exists an "implicit central government guarantee" essentially holds that the source of funds to make P&I payments on Japan's municipal debt is assured, albeit not explicitly, and that the credit risk of that debt is the same for all local governments and equally as low as for JGBs issued by the central government.

There are others who are skeptical over the validity of this implicit guarantee. This camp notes that there is no written law or regulation that requires the central government to back the P&I payments on municipal debt, and that as long as this "implicit" government guarantee is not made explicit, there can be no guarantee of such payment. There are also those who argue that, in light of the central government's sustained deficit in the primary balance, and with total JGBs outstanding having reached ¥733.4 trillion by the end of FY2006, there may not be sufficient funds available through the local allocation tax system. They note that even the Fiscal Reconstruction System does not provide for a central government bail-out, but requires that the reconstruction entities pay back all debts through their own fiscal reform efforts. Taking these factors into account, an argument can be made that municipal bonds have some degree of credit risk.[8]

3. The Law Relating to the Financial Soundness of Local Governments

Amid debate over the credit risk of municipal bonds, there is a growing awareness of the need for a system capable of properly gauging the fiscal condition of local governments, and implementing improvements quickly in cases where that condition has deteriorated. Because of this, the Law Relating to the Financial Soundness of Local Governments was passed in June 2007 to replace the Financial Reconstruction System, which had been a key pillar supporting the implied central government guarantee (Figure 5). This new law is scheduled for full implementation from FY2009.

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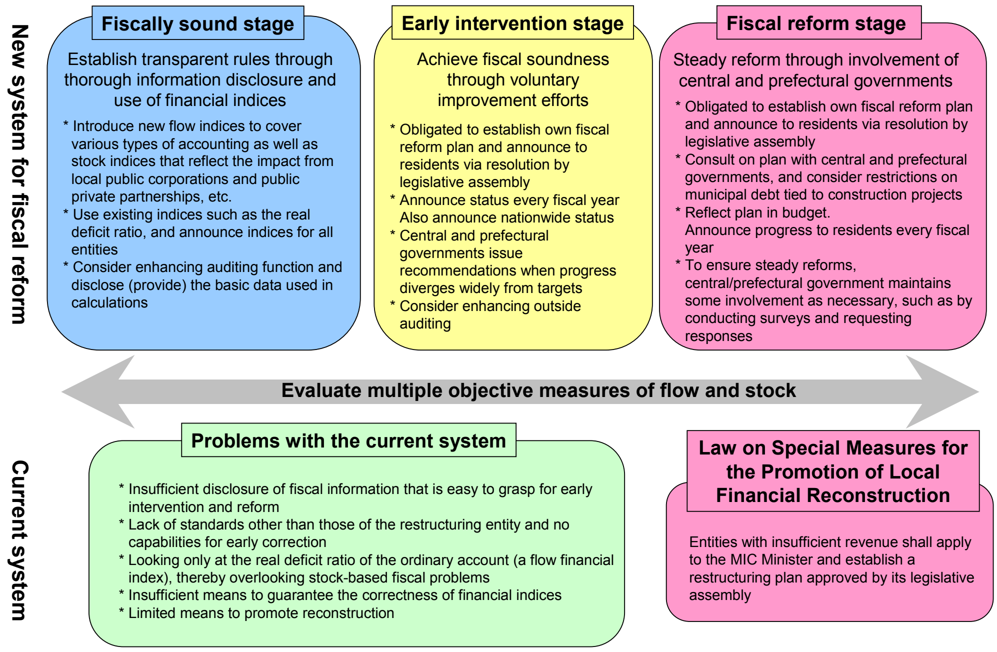
8 See Nobiru Adachi, *Chihousai ni taisuru Kuni no Anmoku no Hoshou* (The implied central government guarantee of municipal debt), PRI Discussion Paper Series, 2006, Policy Research Institute (Ministry of Finance, Japan), and Rating and Investment Information, Inc. edited *Chihousai Kakutsuke Jichitai wa Honto ni Tsuburenai no ka* (Municipal bond ratings: Is it really true that local governments cannot fail?), Nihon Keizai Shimbun, Inc., 1999.

Figure 5: New system for local government fiscal reconstruction



Source: Nomura Institute of Capital Markets Research, based on documents from the MIC study group on local government fiscal reconstruction

The Law Relating to the Financial Soundness of Local Governments has two main aspects. The first is that it uses multiple financial indices to determine the fiscal health of local governments, whereas designated reconstruction entities relied solely on the real deficit ratio to do so. The new law requires calculation of another flow-based measure in addition to the real deficit ratio, the consolidated real deficit ratio, which looks at the local government's entire budget, including that for local public enterprises. It also requires another stock-based measure in addition to the real debt service ratio, the future burden ratio, which is the outstanding debt of a local government as a percentage of its general financial resources.[9] This introduction of consolidated-basis fiscal measures is also of note.

The second main aspect is that a local government's fiscal condition is categorized as one of three different levels (the fiscally sound stage, the early intervention stage, and the fiscal reform stage), based on objective financial indices described above. Under the Financial Reconstruction System, there are only two levels, either fiscally sound or in the process of fiscal reform as a designated reconstruction entity. In addition, for a local government to become designated it must have a real budget deficit and must apply for designation on its own initiative. Once a local government has designated status, its fiscal administration becomes subject to stringent controls from the central government. Local governments, disliking the loss of autonomy in fiscal administration that results from the way the system is set up, tend to avoid applying for designation, and this creates the possibility that their fiscal reconstruction will be delayed.

9 The rules require the calculation and publication of these financial indices within one year of promulgation.

Under the new law, fiscal reconstruction measures are initiated if a local government meets any one of the outlined criteria,[10] irrespective of what the local government itself wants to do. A new category, early intervention, is established to prevent local governments from deteriorating to the point where reform is necessary. The constraints on fiscal operations are more lenient for the early intervention stage than they are for the fiscal reform stage.

These measures are aimed at optimizing the fiscal reconstruction process for local governments.

III. The infrastructure needed for the municipal bond market

1. Public accounting rules

As the municipal bond market grows and increasing attention is placed on the risks involved, local governments will have to attract investors to their municipal bond issues, and this will require, to a greater degree than before, the accurate, clear, and timely disclosure to investors of information required to make investment decisions. This information includes that local government's fiscal conditions as well as details on the specific rules governing local government spending and borrowing activity.

Public accounting is used to report on the local government's fiscal condition, and in principle makes it possible to obtain quantitative data. A number of problems have been pointed out with the current accounting rules, however.

The first is that there is no system of consolidated accounting that looks at a local government's entire fiscal picture. Local governments currently engage in a broad spectrum of fiscal activity requiring multiple accounting approaches, including ordinary accounting and public enterprise accounting, as well as accounting for local public corporations and public private partnerships. Traditional public accounting does not make it easy to obtain the information in an integrated manner and assess the overall fiscal condition of the local government.

The second problem is that there is no requirement for producing a balance sheet that presents a picture of each local government's fiscal condition on a stock basis. Consequently, it has been difficult to ascertain local governments' outstanding debt and to assess that debt relative to the size of its general financial resources and total assets.

A third problem lies in the difficulty in extracting the information required to assess the government's administrative efficiency. Public accounting has been done on a cash basis, rather than the accrual basis normally used for corporate accounting. In

[10] All four financial indices are used to determine whether a local government should be categorized in the early intervention stage, but only three (excluding the future burden ratio) are used to determine whether a local government should be categorized in the fiscal reform stage. As of 1 October 2007, no decision had been made as to the specific numerical criteria for either the early intervention or fiscal reform stage; this is to be determined by administrative order.

addition, the information required to conduct cost-benefit analyses of specific businesses was not prepared in advance, and thus had to be prepared anew when analyzing a business' costs versus benefits.[11] This made it difficult to use the data generated by public accounting to improve administrative efficiency.

Another criticism was that the time lag between the end of the accounting period and the announcement of results was too long.

The MIC responded by initiating reforms in public accounting several years ago.[12] In 2000 it announced methods for creating a balance sheet for ordinary accounts, and in 2001 introduced elements of the accrual method as a way to account for depreciation and other non-cash expenditures on a statement of administrative costs, at the same time unveiling a method for creating a non-consolidated balance sheet for local government that included both ordinary and public enterprise accounts. In 2005, MIC established standards for consolidated balance sheets that covered, in addition to the non-consolidated account, such extra-governmental entities as local public corporations and public private partnerships. Prefectural governments and government -designated cities have actually started compiling financial statements based on the standards established by MIC in the process of making reforms (Figure 6).

Figure 6: Ordinary accounting balance sheet reporting by local governments

Ordinary account balance sheet				
Details	Balance sheet for ordinary account			
	Does not include public enterprises, public private partnerships, and other extra-governmental entities			
Provide?		Prefectures	Government-designated cities	Munici-palities
Yes	Only using MIC method	41	14	930
	Only using own method	3	0	17
	Both	3	0	9
	Total	47	14	956
No		0	0	873
Total		47	14	1,829

Balance sheet covering all local public entities				
Details	Balance sheet includes both ordinary account and public enterprise account			
	Does not include private-public partnerships and other extra-governmental entities			
Provide?		Prefectures	Government-designated cities	Munici-palities
Yes	Only using MIC method	40	14	143
	Only using own method	4	0	16
	Both	3	0	1
	Total	47	14	160
No		0	0	1,669
Total		47	14	1,829

Statement of administrative costs				
Details	Total of local government activity results for that fiscal year and the spending (use of resources) required for that activity			
	Also includes non-cash expenditures (including depreciation) not reflected in normal budgets or results			
	Equivalent to the income statement used in corporate accounting			
Provide?		Prefectures	Government-designated cities	Munici-palities
Yes	Only using MIC method	41	14	527
	Only using own method	3	0	21
	Both	1	0	6
	Total	45	14	554
No		2	0	1,275
Total		47	14	1,829

Consolidated balance sheet				
Details	Balance sheet that includes private-public partnerships and other extra-governmental entities in addition to ordinary accounting and public enterprise account			
Provide?		Prefectures	Government-designated cities	Munici-palities
Yes	Only using MIC method	43	14	43
	Only using own method	3	0	18
	Both	1	0	1
	Total	47	14	62
No		0	0	1,767
Total		47	14	1,829

Note: Based on an MIC survey of local governments on FY2004 financial reporting (Survey was conducted on 31 May 2006).
Source: Nomura Institute of Capital Markets Research, based on MIC materials

11 Recognition of this problem led the Tokyo Metropolitan Government to publish a manual on creating balance sheets for each business in 2002. The manual uses a public high school operation as an example.

12 For here and below, see Koichi Tange, *Zaisei Unei Shisutemu to Yosan no Shintenkai* (Fiscal management systems and new developments in budgeting), Gyosei, 2007.

In 2006, MIC established both a study group and a working group on public accounting for local governments. The groups dealt with certain problems with the MIC approach, namely the failure of smaller local governments to adopt them and the fact that they were different than the accounting standards used by the central government, and proposed two new public accounting standards, a standard model and a modified MIC model. The two standards are being used on an experimental basis by Hamamatsu City in Shizuoka Prefecture and Kurashiki City in Okayama Prefecture. The new public accounting proposals based on these standards are scheduled for adoption by local governments within the next three to five years, starting with the relatively larger entities, the prefectural governments and government-designated city governments.

Apart from the public accounting reforms led by MIC, some local governments are studying public accounting issues and instituting reforms on their own. The Tokyo Metropolitan Government has begun compiling a "Functioning Financial Statement" with its FY1999 results. To better understand its own financial situation and achieve greater administrative efficiency, in parallel with cash-basis public accounting it has instituted double-entry bookkeeping and accrual accounting based on its own standards, which differ from the MIC approach.[13]

2. Municipal bond investor relations

The reforms to public accounting described above are now making it possible to accommodate both stock-basis and consolidated accounting. Merely enhancing public accounting rules, however, will not necessarily ensure that municipal bond investors can access enough information to make informed investment decisions. The primary objective of public accounting is to ensure that the fiscal activity of local governments is in compliance with rules and regulations, whereas investors are primarily interested in the local government's current fiscal health, its outlook for future fiscal activity, and its ability to fund that activity. Thus there is not a perfect alignment of interests between the two objectives. There is also a need for qualitative information to ensure that investors understand the rules governing municipal bonds and local government fiscal activity, as well as the administrative guidelines that local governments follow. This probably means that satisfying the concerns of investors will require more information than just that obtainable from public accounting.

Local governments will therefore need not only to get their public accounting methods up to speed, but also to proactively provide those investors considering investment in municipal bonds with the information they need, in an as easy-to-understand format as possible. One way to do that is through municipal bond investor relations.

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[13] In order to establish its own public accounting standards, the Tokyo Metropolitan Government has spent ¥2.2 billion on developing a system to enable local government employees to easily obtain accurate financial and accounting information. See *Zaimushohyo wo Katsuyou shita Tosei Kaikaku no Suishin ni tsuite* (Municipal reforms to make better use of financial statements), an article in the April 2006 issue of the *Chihousai Geppou*, published by the Japan Local Bond Association.

Investor relations is primarily the responsibility of the entity seeking to procure funding, and consists of providing investors to the extent possible with the information they are looking for, and doing so equitably, credibly, continuously, clearly, and in a timely manner.

The Tokyo Metropolitan Government and other local governments in major urbanizations started engaging in investor relations in 1998, the year that they declared a fiscal crisis and the deterioration of local government finances had become widely known. Since then, the local government entities that issue their own publicly offered bonds have increasingly engaged in investor relations, both on their own and in joint efforts with other municipal bond issuers. The number of municipal bond investor meetings held grew from five in FY2001 to 19 in FY2006.[14]

Recently, some local governments have been devising new twists in their approach to investor relations. In some cases, the local government head (the governor or mayor) will actually speak at the investor meetings and discuss administrative policies, and a growing number of local governments now hold such briefings several times a year (Figure 7). Many governments hold their investor meetings in Tokyo, since that is where the institutional investors are based, and some hold meetings for retail investors when issuing bonds in markets participated in by such investors. To reach overseas investors, the Japan Local Bond Association has begun posting municipal bond information in English on its website, and the Tokyo Metropolitan Government held a briefing for overseas investors in May 2007 in London.[15]

Figure 7: Municipal bond investor meetings (FY2006)

When held	Local government entity	Place held	Other
2007.03	Yokohama City	Tokyo	Mayor presented
2007.03	Kawasaki City	Tokyo	Mayor presented
2007.02	Kobe City	Tokyo	
2007.02	Osaka Prefecture	Tokyo	Governor presented
2006.11	Kyoto City	Tokyo	
2006.10	Kobe City	Tokyo	Mayor presented
2006.10	Kitakyushu City	Tokyo	
2006.10	Osaka City	Tokyo	Mayor presented
2006.09	Osaka Prefecture	Osaka	
2006.09	Osaka Prefecture	Tokyo	
2006.09	Shizuoka Prefecture	Tokyo	Governor presented
2006.08	Fukuoka Prefecture	Tokyo	Governor presented
2006.08	Kawasaki City	Kawasaki	Mayor presented
2006.07	Sapporo City	Tokyo	Mayor presented
2006.07	Saitama	Tokyo	Governor presented
2006.07	Yokohama City	Tokyo	Mayor presented
2006.06	Osaka Prefecture	Osaka	
2006.06	Osaka Prefecture	Tokyo	
2006.06	Kanagawa Prefecture	Tokyo	Governor presented

Note: Coloring in local government column indicates multiple investor meetings within the fiscal year.
Source: Nomura Institute of Capital Markets Research, based on data from the Japan Local Bond Association website.

14 Calculated based on data from the Japan Local Bond Association website.
15 *Tokyoto Hatsu no Kaigai IR ni tsuite* (Tokyo's first effort at overseas investor relations), an article in the July 2007 issue of the *Chihousai Geppou*, published by the Japan Local Bond Association.

Not only do these investor meetings provide a forum for local governments to inform investors in their role as issuers of debt, they also provide a forum for issuers to gather information, including on what investors are thinking and on the bond issuance terms that investors want to see. This explains why local governments should set aside plenty of time for Q&A at their meetings, and why they should pay personal visits to institutional investors. The idea behind this is that investor relations can become more meaningful by increasing the opportunities for the mutual exchange of information between local governments and investors.

3. Municipal bond ratings

Public accounting reforms and enhanced investor relations have made it possible for local governments to provide an increasingly higher quality and quantity of information on their fiscal condition and on their bond issues. It seems unlikely, however, that all investors are able to fully understand this information and make full use of it in their investment decisions. Substantial time and effort is required to understand the regulatory environment for municipal bonds, to assess the risk of each municipal bond issue based on that understanding, and to make valid risk comparisons with other municipal bond issues and other types of bonds. Because of this, as noted in the introduction of this paper, credit ratings have become increasingly important to the municipal bond market over the past few years.

Thus far, Rating and Investment Information, Inc. (R&I) and Japan Credit Rating Agency, Ltd. (JCR) have announced unsolicited ratings of municipal bonds issued in Japan, basing those ratings mainly on publicly available information.

The local governments themselves have not been very proactive in trying to obtain ratings, given the strong belief of MIC and others in the implied government guarantee, and given that until recently, most municipal bonds were purchased with public funds, and the municipal bond market had been fairly small.

As noted earlier, however, expectations of growth in the municipal bond market have stirred debate over the credit risk associated with that debt, and this has prompted local governments to start recognizing the significance of obtaining a credit rating. Some local governments have actually started obtaining solicited ratings from the rating agencies. Yokohama City was the first entity issuing national publicly offered municipal bonds to be rated back in October 2006, when it received an AA- rating from S&P.[16] In 2007, Kobe City received an AA rating from R&I, and the Tokyo Metropolitan Government, Fukuoka Prefecture, and Hamamatsu City all received Aa2 ratings (solicited) from Moody's. There are also a number of local government entities that have received a solicited rating from multiple rating agencies, including Kyoto City (Aa2 from Moody's and A+ from S&P), Osaka City (Aa2 from Moody's and AA- from S&P), and Shizuoka Prefecture (Aa2 from Moody's and AA+ from R&I) (Figure 8).

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[16] Before Yokohama City obtained its rating, Omihachiman City had obtained a solicited rating of AA from R&I, but the city then applied to have the rating removed in August 2007 (details unknown).

Figure 8: Issuer ratings for local government entities

Issuer (Prefecture, Metropolis)	R&I	S&P	Moody's	Issuer (City)	R&I	S&P	Moody's
Hokkaido	AA- op	-	-	Sapporo	AA op	-	-
Miyagi	AA op	-	-	Sendai	AA+ op	-	-
Fukushima	AA op	-	-	Saitama	AA op	-	-
Gunma	AA+ op	-	-	Chiba	AA+ op	-	-
Ibaraki	AA op	-	-	Kawasaki	AA op	-	-
Saitama	AA+ op	-	-	Yokohama	AA+ op	AA-	-
Chiba	AA+ op	-	-	Shizuoka	AA op	-	-
Tokyo	AAA op	-	Aa2	Hamamatsu	-	-	Aa2
Kanagawa	AA+ op	-	-	Nagoya	AA op	-	-
Niigata	AA op	-	-	Kyoto	AA- op	A+	Aa2
Nagano	AA op	-	-	Osaka	AA- op	AA-	Aa2
Shizuoka	AA+	-	Aa2	Sakai	AA op	-	-
Aichi	AA+ op	-	-	Kobe	AA	-	-
Gifu	AA op	-	-	Hiroshima	AA op	-	-
Kyoto	AA+ op	-	-	Kitakyushu	AA op	-	-
Osaka	AA op	-	-	Fukuoka	AA op	-	-
Hyogo	AA op	-	-				
Hiroshima	AA op	-	-				
Shimane prefecture	AA- op	-	-				
Fukuoka	AA op	-	Aa2				
Oita	AA op	-	-				
Kumamoto	AA op	-	-				
Kagoshima	AA- op	-	-				

Notes: 1. Ratings as of 1 October 2007.
2. S&P and Moody's ratings are for issuers that issue debt in their home currency
3. For R&I ratings, "op" indicates a rating based mainly on public information (i.e., an unsolicited rating).

Source: Nomura Institute of Capital Markets Research, based on data published by each rating agency

IV. Conclusion

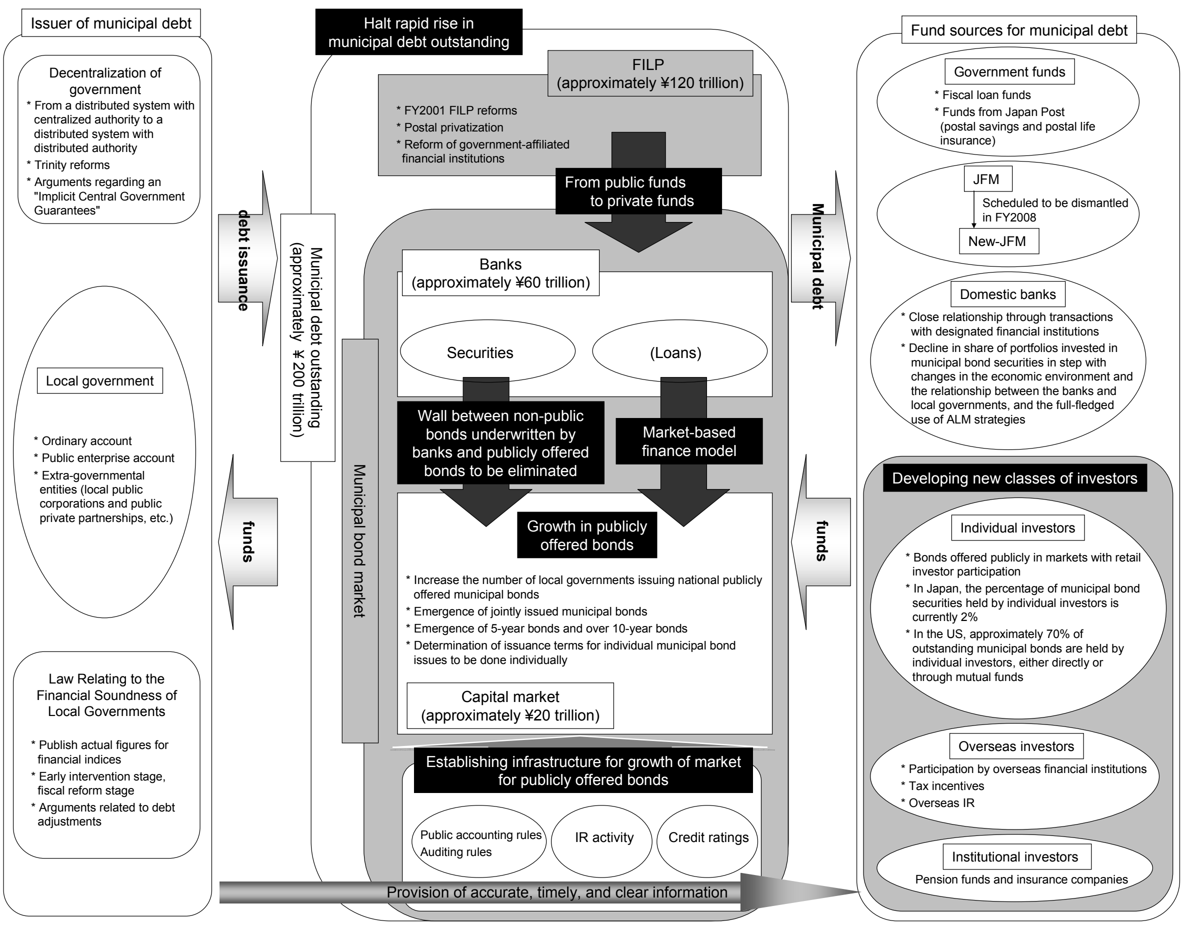
Japan's municipal bond market is now undergoing a major transformation (Figure 9).

In step with the trend toward greater decentralization of government, local government entities are gaining greater authority and responsibility for securing their own revenues, including by levying their own taxes. Local governments are also becoming increasingly autonomous in their issuance of municipal debt, as evidenced by the shift to a system based on prior consultation in FY2006 (which in principle allows fiscally sound local governments to issue municipal debt without restriction) and by the switch to negotiating issuance terms individually with financial institutions for nearly all municipal bonds sold to the private sector. With these changes has come greater accountability for local governments. The gradual elimination of transfers from the central government and the reduced level of public funding have made it increasingly necessary for local governments to reconsider how best to issue their own municipal debt. A major challenge for local governments is figuring out how best to ensure a large and stable source from investors through municipal bond markets.

This report looked at the infrastructure improvements to municipal bond markets being made by MIC and the local governments in this context. It showed that the need for this infrastructure arose because not enough information is being supplied to the market to help investors make rational investment decisions. Finally, the paper looked at recent developments, including public accounting reforms, municipal bond investor relations, and solicited credit ratings.

Japan's municipal bond infrastructure has just recently begun making significant strides forward, and there are thus numerous issues still at the discussion stage. It should be worthwhile to watch the direction that reforms take moving forward.

Figure 9: The changing municipal bond market



Source: Nomura Institute of Capital Markets Research