



MIC



MIC

Local Government Bonds System in Japan

**Ministry of Internal Affairs and
Communications**

July 2019

Credibility –Supported by the Central Government

I Securing Financial Resources

II Checks and Controls Balance

III Financial Disciplines

Appendix

I. Securing Financial Resources

(Local allocation tax to ensure the redemption)

II. Checks and Controls Balance

(Consultation system for issuance)

III. Financial Disciplines

(Disclosure and Financial disciplines restoring system)



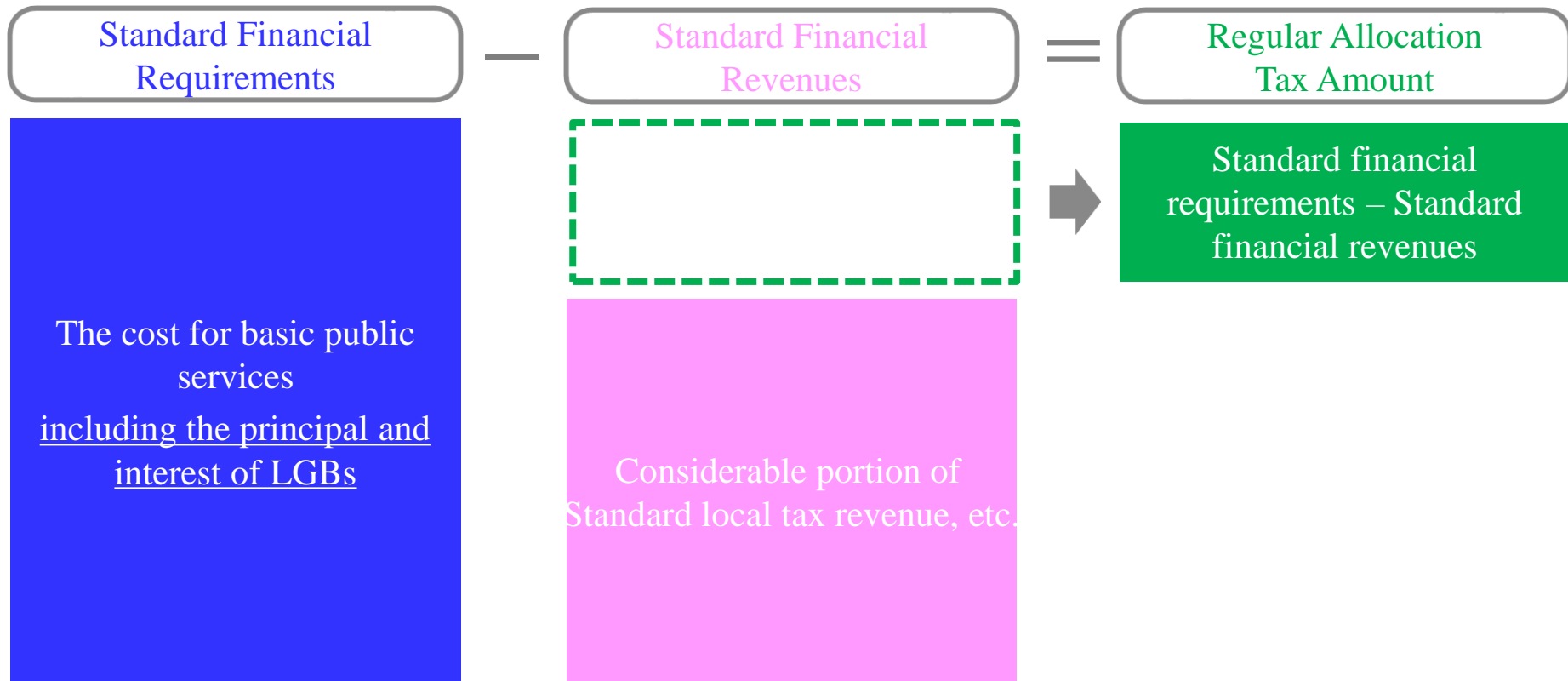
The interest and principal payments of Local Government Bonds(LGBs) are fully guaranteed.

※ No Local Government(LG) has ever fallen into the default.



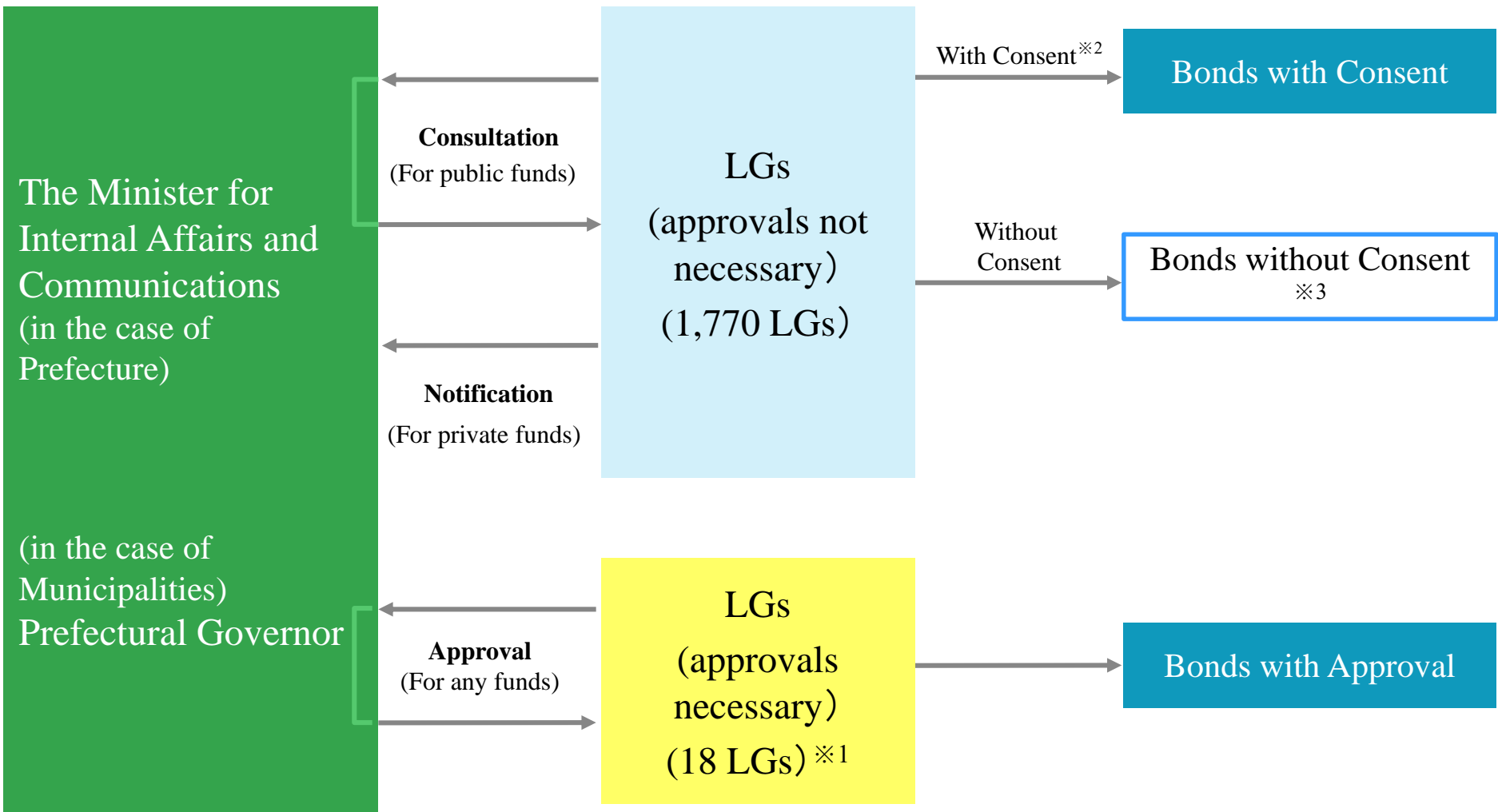
MIC I. Securing Financial Resources

- The Central Government(CG) ensures the revenue source for redemption of interest and principal of LGBs through Local allocation tax.
- The CG reallocates tax revenues as Local allocation tax to local governments that have weaker financial capabilities.





MIC II. Checks and Controls Balance



※ 1 Determined by payment situation of debt service in each municipality. The numbers of LGs as at end-November, 2018

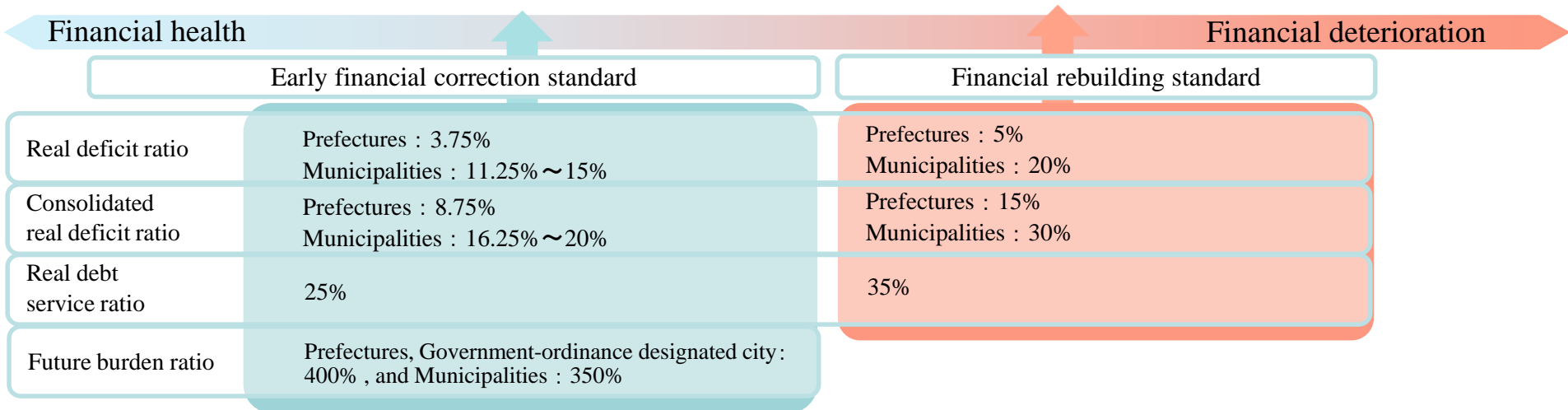
※ 2 Consent from The Minister for Internal Affairs and Communications or Prefectural Governor.

※ 3 Debt payments of LGBs without consent are not included in Local Allocation Tax System. Bonds without consent have never been issued.



MIC III. Financial Disciplines

Normal stage	Restoring financial disciplines stage	Rebuilding stage
<p>Establishment of indices and thorough disclosure</p> <ul style="list-style-type: none"> ◆ Flow indexes: Real deficit ratio, Consolidated real deficit ratio, Real debt service ratio ◆ Stock indices: Future burden ratio = indexes by real liabilities, including public enterprises, third-sector enterprises, etc. <p>→ Subject to auditor inspection, reported to the council and publicly announced</p>	<p><u>Restoring financial disciplines through their own efforts</u></p> <ul style="list-style-type: none"> ◆ Formulation of financial disciplines plan (approval by the council), mandatory requests for external auditing ◆ Report on progress of implementation to the council and public announcement every financial year ◆ If the early achievement of financial disciplines is deemed to be significantly difficult, the minister for Internal Affairs and Communications or the prefectural governor makes necessary recommendations <p>⇒ Not applicable since FY2013</p>	<p><u>Solid rebuilding through involvement of the CG</u></p> <ul style="list-style-type: none"> ◆ Formulation of financial rebuilding plan (approval by the council), mandatory requests for external auditing ◆ Agreement on the financial rebuilding plan can be sought through consultation with the Minister for Internal Affairs and Communications ◆ If financial management is deemed not to conform with the plan, the Minister for Internal Affairs and Communications makes necessary recommendations, such as budget changes <p>⇒ Only 1 LG since FY2013</p>
<p>⇒ All LGs issuing public offering bonds are classified in this stage</p>		



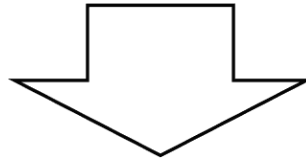


MIC Treatment under Basel III risk weight framework

I. Securing Financial Resources

II. Checks and Controls Balance

III. Financial Disciplines



Japanese Local Government Bonds

Risk weight 0%

(Standardized Approach for Credit Risk)

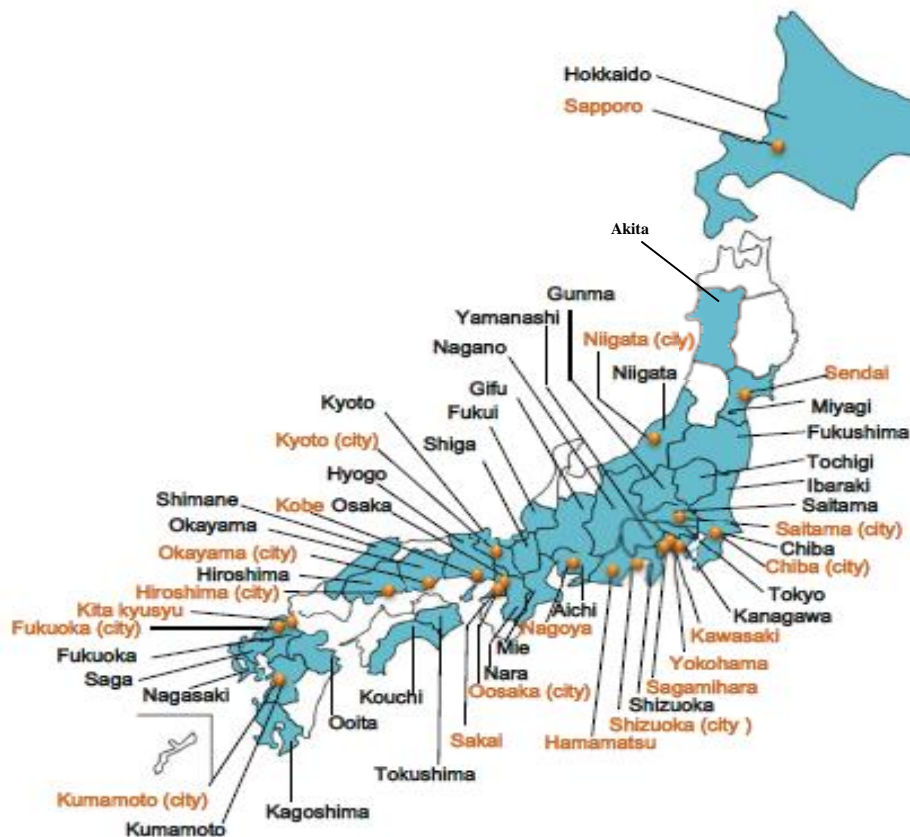
- Zero risk weight are for domestic investors in Japan.
- For overseas investors, risk weights depend on each regulator.

Appendix



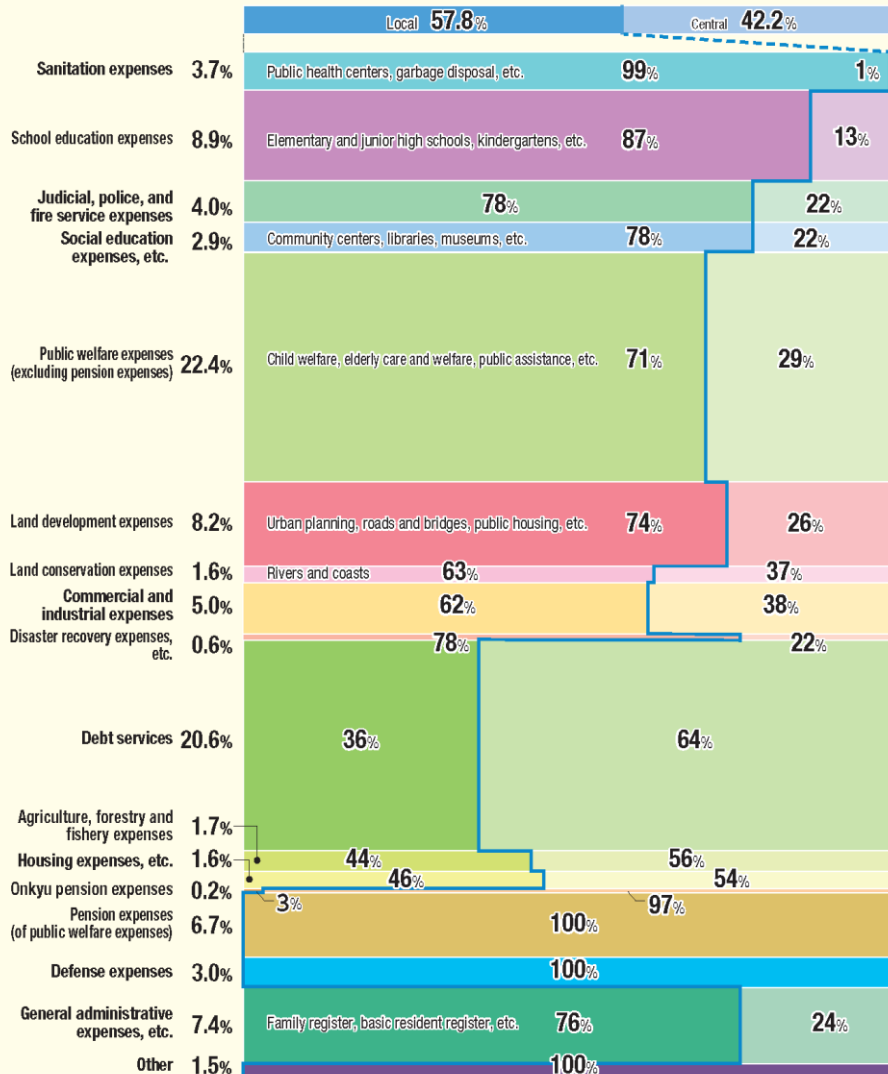
MIC Issuers of public offering LGBs

- ◆ Some LGs successfully issue public offering bonds, supported by the credibility of the local public finance system in Japan.



- ◆ 55 LGs plan to issue public offering bonds in FY 2018.
 - ▶ 35 prefectures (in black)
 - ▶ 20 government-ordinance-designated cities (in red)

Share of Expenditures by Purpose of Central and Local Governments (final expenditure based)

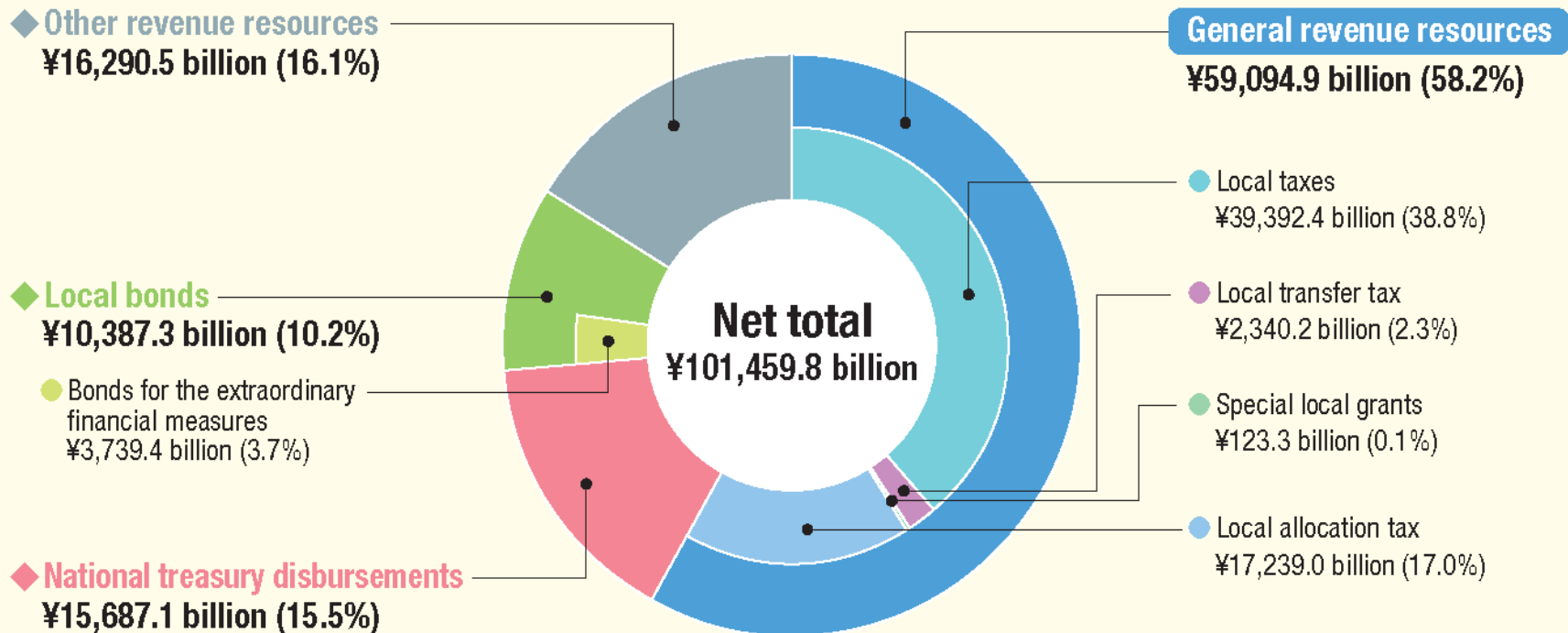


- ◆ LGs take responsibility for and play a major role in the lives of the citizens of the nation.
- ◆ The share of LGs' expenditures is higher in areas that are deeply related to daily life, such as public health and sanitation, school education, social education, and police and fire services, etc.

Source: White Paper on Local Public Finance, 2018 "FY2016 Settlement" by Ministry of Internal Affairs and Communications

- ◆ The revenue of LGs consists mainly of local taxes, local allocation tax, national treasury disbursements, and local bonds, in order of share size.

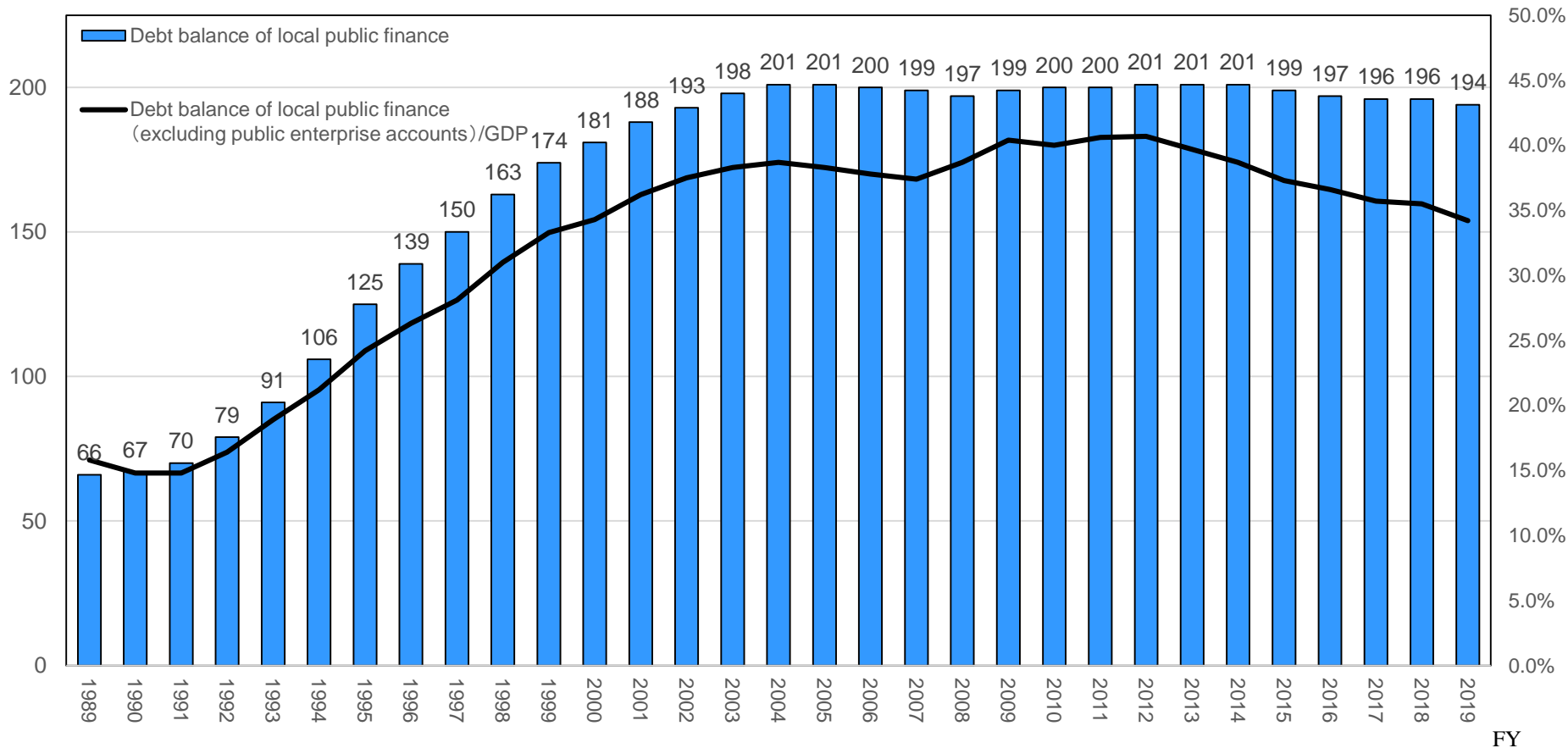
Composition of Revenues (FY2016 settlement)



Debt balance of local public finance

◆ Debt balance of local public finance is about 200 trillion yen at the end of FY2018.

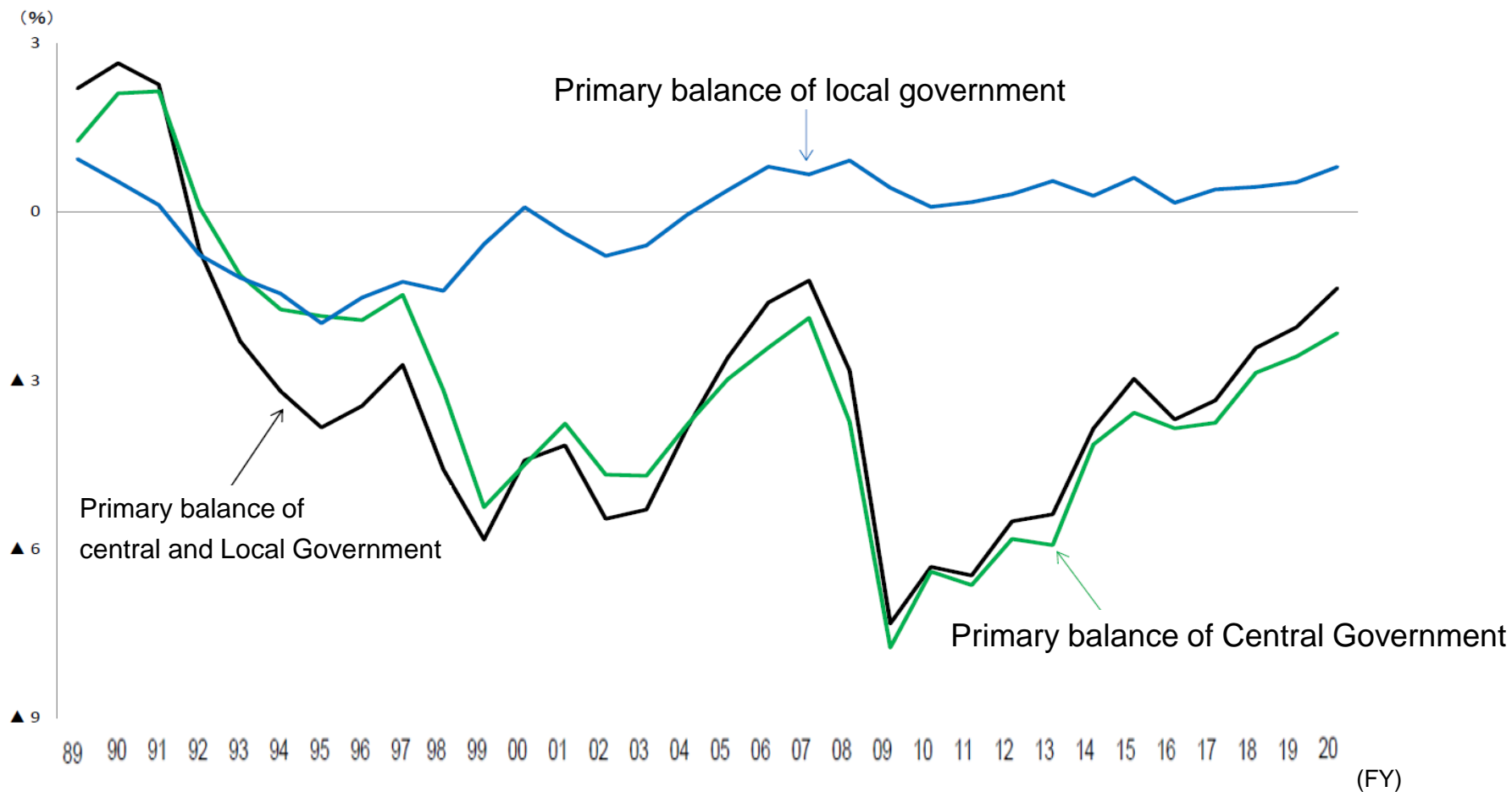
Unit: Trillion yen



Note: 1. Debt balance of local public finance = FY1989 ~ 2017 :settlement based, FY2018:actual valued expected, FY2019:prospection
 2. GDPs for FY1989 to 2017 actual value basis, for FY2018 actual valued expected base, and for FY2019 prospection base.
 3. Number of decimal places is rounded off

Trends in Primary Balance of Central and Local Governments against GDP

Primary Balance of LGs was surplus in the past more than 10 years

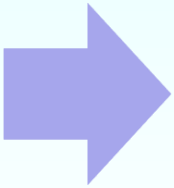


Source: FY1989-2016: Cabinet Office "Annual Report on National Accounts"

FY2017-2020: Cabinet Office "Economic and financial Projections for Medium to Long Term Analysis"

Checks and Controls Balance by CG

- LGs are required to consult with, or notify the Minister of MIC (or the prefectural governor) before issuing LGBs.
- LGB issuance without the consent of the Minister of MIC (or the prefectural governor) is not eligible for public funds nor for local allocation tax system (Although LGs can issue LGBs without consent, there have never been such a case.).
- In addition, LGs in deteriorating financial condition are required to obtain an approval of the Minister of MIC (or the prefectural governor) when they issue LGBs. In this case LGs can't issue LGBs without approval.

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- The CG (or prefectures) check all the LGBs.
 - The CG guarantees the redemption of LGBs by approving the issuance of LGBs.
 - Issuance of LGBs by LGs in deteriorating financial condition is restricted.
(the number of LGs necessary to obtain the approval FY2018: 18 (total LGs : 1,788))

Consultation system for the issuance of JLGB

- ◆ JLGB system was transferred from approval system to consultation system in FY2006 in the process of distributing or dispersing functions, powers, people or things away from a central location or authority (decentralization) . Moreover, notification system was introduced to improve LGs' autonomy while LGs planning to use public funds should adopt consultation system.

1. Consultation

LGs are required to consult with, or notify the Minister of MIC (prefectures and government-ordinance-designated cities) or the prefectural governor (municipalities) before issuing LGBs.

2. Allocation of public funds to LGBs with consent

Only LGs with the consent of the Minister of MIC or the prefectural governor may finance from public funds: Government funds, JFM funds, and so on.

3. Inclusion of the debt payments for bonds with consent in Local Allocation Tax system

Debt payments for LGBs with the consent of the Minister of MIC or the prefectural governor are included in Local Allocation Tax system.

4. Obligation to report issuance of bonds without the consent to the council

In order to issue LGBs (Consultation is required) without consent, the head of the LG is required to report the council.

5. Consent standards

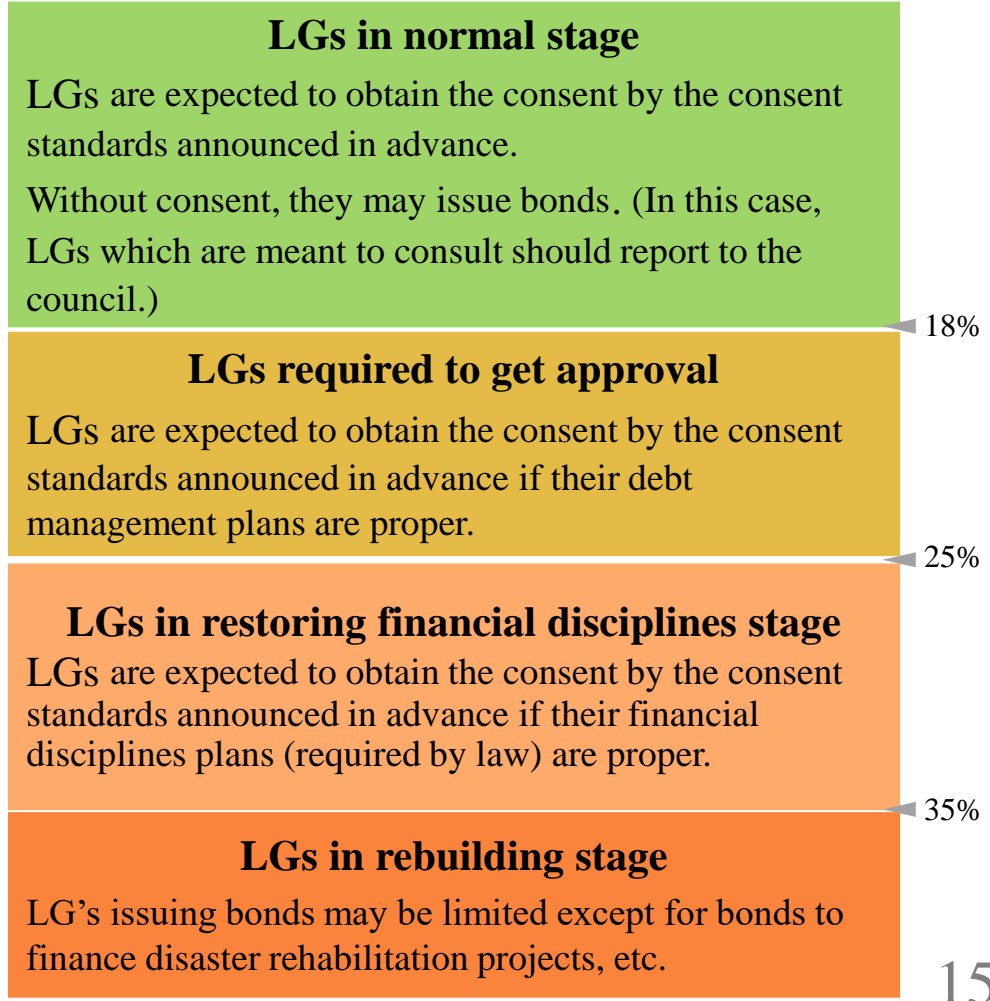
The Minister of MIC announces consent standards every financial year in public. LGs in deficit or with high real deficit ratio, or the public enterprises in deficit should be approved to issue bonds by the Minister or the governor.

Consultation system for the issuance of JLGB (2)

◆ In order to maintain financial disciplines, LGs with high real debt service ratio or in a certain level of deficit are required to get the approval for bond issuance instead of the consultation.


LGs with more than 18% of real debt service ratio are required to get approval.

- ◆ Issuers with real debt service ratio under 18% must consult with, or notify the MIC minister (or the prefectural governor) before issuing bonds.
- ◆ Issuers with real debt service ratio between 18% and 25% must submit the debt management plan and obtain the approval of the MIC minister (or the prefectural governor).
- ◆ Issuers with real debt service ratio between 25% and 35% must submit the financial disciplines plan(required by law) and obtain the approval of the MIC minister (or the prefectural governor).
- ◆ Issuers with real debt service ratio more than 35% must submit the financial rebuilding plan and obtain the approval of the MIC minister. Otherwise, Issuers are prohibited from issuing bonds except for bonds to finance disaster rehabilitation projects, etc.



Control of financial discipline

- In Japan, a system to maintain financial discipline was established. In this system, the CG checks financial conditions of LGs through the disclosure of financial information and takes prompt corrective actions to prevent LGs from deteriorating financially.
- Under this system, local residents, councils and auditor inspections confirm potential risk of not only LGs but also relevant entities (local public corporations, third-sector enterprises, etc.)
- These processes are designed to confirm both flow and stock indicators to maintain the disciplines of financial management in medium- and long-term.
- In addition, if the rehabilitation by LGs on their own is deemed to be difficult, the CG will play a role to ensure their rehabilitation.

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- The financial conditions of local governments are checked in detail in terms of both flow and stock.
 - The financial conditions of related entities are also checked in order to prevent unforeseen liabilities.
 - As of the end of FY2018, only 1 LG exceeds financial rebuilding standard (out of a total of 1,788 LGs).



MIC Control of financial discipline (2)

- ◆ LGs are required to report the following ratios to the council after subjecting to the auditor inspection and to announce publicly every financial year.

financial indicator	Definition
1. Real deficit ratio	The ratio of deficits to standard financial scale
2. Consolidated real deficit ratio	The ratio of consolidated deficits of all accounts to standard financial scale
3. Real debt service ratio	The ratio of debt payment to standard financial scale
4. Future burden ratio	The ratio of debts of LGs as a whole(including third-sector enterprises, public enterprises, etc) to standard financial scale
5. Finance shortfall ratio (for each public enterprise)	An index of the deficit of funds of public enterprises compared to the size of their income, which shows the size of business of local public enterprises, and represents the extent to which financial health has worsened

Limits for Early warning and reconstruction

Restoring financial disciplines stage Rebuilding stage

1. Real deficit ratio	Prefectures :	3.75%	Prefectures :	5%
	Municipalities :	11.25 - 15%	Municipalities :	20%

2. Consolidated real deficit ratio	Prefectures :	8.75%	Prefectures :	15%
	Municipalities :	16.25 - 20%	Municipalities :	30%

3. Real debt service ratio	25%	35%
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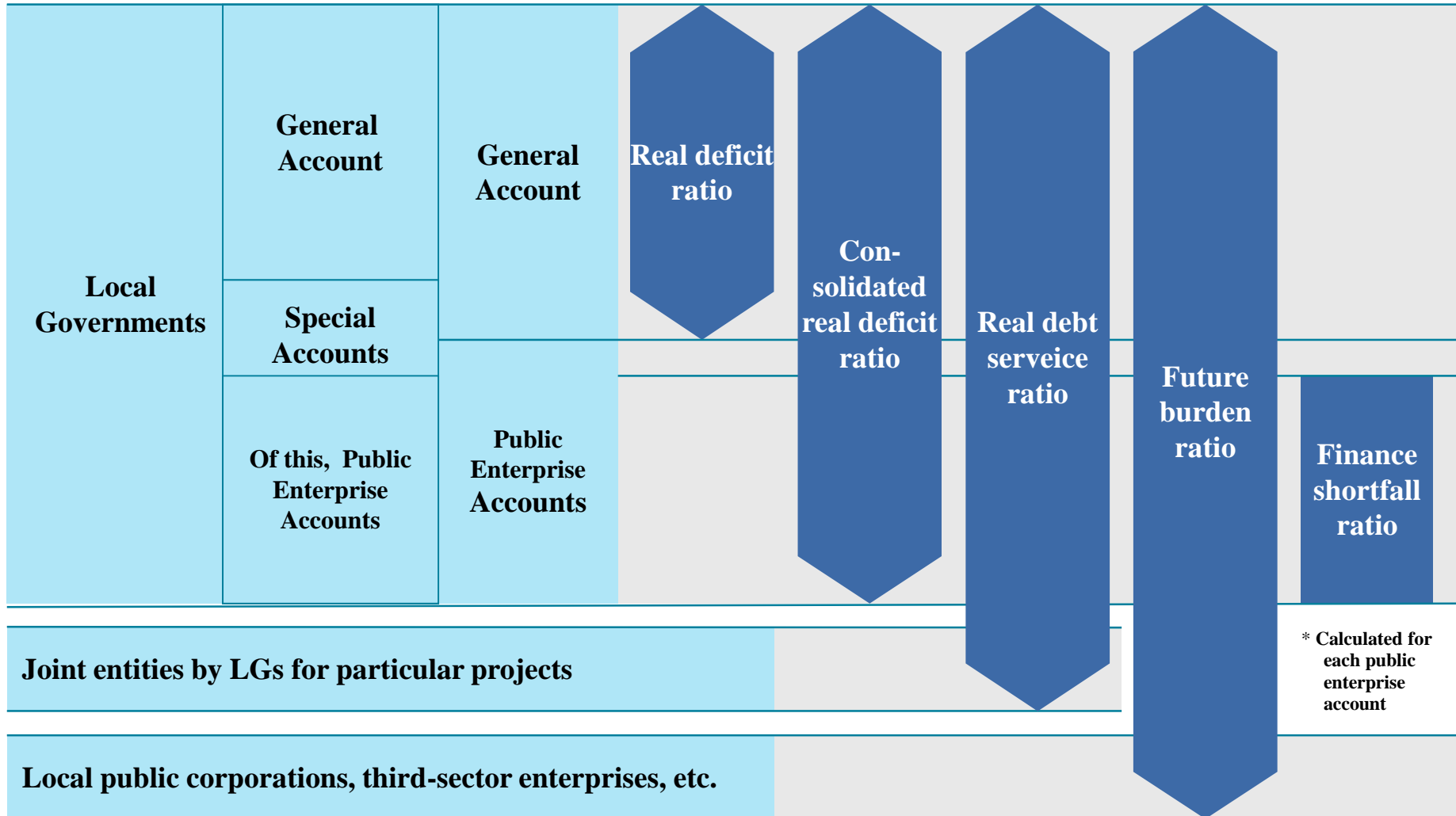
4. Future burden ratio	Prefectures and government-ordinance-designated cities :	400%
	Municipalities :	350%

Management disciplines standard

5. Finance shortfall ratio (for each public enterprise)	20%
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MIC Scope of financial indicators in the Law



Revision of consultation system for the issuance of LGB

◆ Notification system for the issuance of LGB was introduced from FY2012 by revising the part of consultation system in order to enhance the independence and autonomy of LGs.

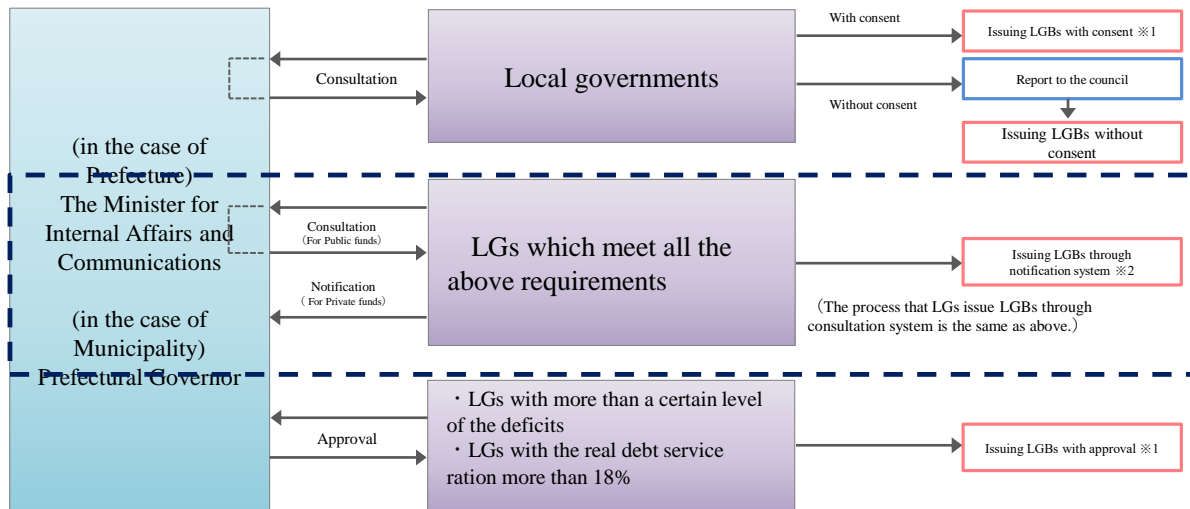
1. LGs that aren't required to consult in issuing LGBs

LGs that meet the following requirements can issue LGBs* without consulting with the Minister for Internal Affairs and Communications or the prefectural governor. *Only LGs financing from the private sector

- ① Real debt service ratio is less than 18%.
- ② Real deficit is 0.
- ③ Consolidated real deficit ratio is 0.
- ④ Future burden ratio is less than 400% (prefectures and government-ordinance-designated cities) or 350% (municipalities).

2. Local Allocation Tax System

Debt payments of LGBs which LGs notified and is to be approved if they consult with the Minister for Internal Affairs and Communications or the prefectural governors are included in Local Allocation Tax System.



Note: 1. LGBs with consent(or approval) are allocated public funds and debt payments of LGBs with consent(or approval) are included in Local Allocation Tax System.
2. Debt payments of LGBs which LGs notified and is to be approved if they consult with the Minister for Internal Affairs and Communications or the prefectural governor are included in Local Allocation Tax System.

- **Japan Local Government Bond Association**

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