Daiwa Securities

Why are municipal bonds able to avoid defaults?—Part 2

Dramatic improvement in fiscal condition, even in Yubari City, which has a very large amount of debt caused by inappropriate accounting practices

- Although Yubari City's debt had swollen to a very high level, beyond what would normally be assumed under the current local finance system, it continues to redeem its debt as debt reduction/exemption is not allowed
- After completion of a reconstruction program, Yubari City's fiscal condition is expected to improve dramatically
- The adoption of a reconstruction program is generally regarded as equivalent to getting a red card, but it is rather positive in terms of creditworthiness

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Introducing the case of Yubari City

In our 4 July report titled *Why are municipal bonds able to avoid defaults?—Reasons behind municipal bonds being safeguarded but not guaranteed (JCRE431)*, we explained the scheme that prevents defaults on municipal bonds. As we touched on the case of Yubari City (in Hokkaido) in that report, this time we will cover the details of the case.

Yubari City is not defaulting on its debt

First, we would like to point out once again that Yubari City is not defaulting on its debt; rather, it has adopted a program for fiscal reconstruction under the supervision of the Ministry of Internal Affairs and Communications (MIC). The city continues to properly redeem its debt.

Three viewpoints on Yubari City

This time around, we would like to mention that (1) Yubari City incurred a very large amount of debt, beyond what would normally be assumed in the current local government finance system, due to inappropriate accounting treatment, (2) despite such a situation, the MIC does not allow Yubari City to apply for debt reduction/exemption; rather, the city must continue to repay its debt, and (3) at 21 years, the period covered under the reconstruction plan is extraordinary long given that the debt is unexpectedly large, but the city's fiscal condition is expected to improve dramatically after the completion of the plan, as shown by the reduction in the future debt ratio from 1,164.0% to 34.6%.

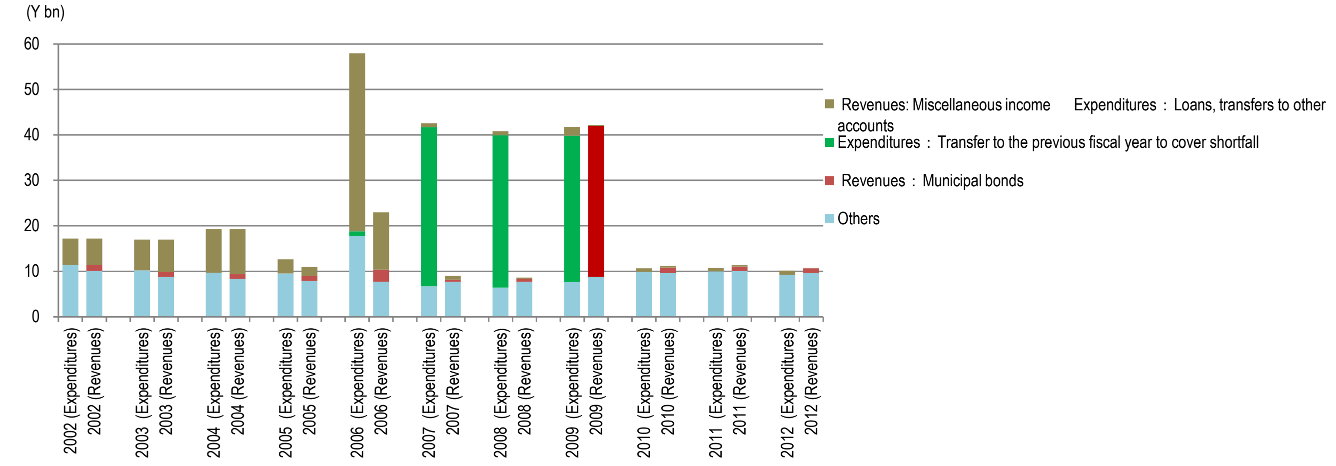
Yubari City incurred a revenue deficit due to failure to activate the sightseeing industry

Regarding the aforementioned first specialty of Yubari City, the city was once known for its coal mines, but it lost its main industry due to mine closures. Although the city tried to find new life with the sightseeing industry, it failed to become a major tourist spot in Hokkaido, leading to business deterioration at local hotels and ski resorts, which were operated by semi-public entities. Yubari City provided financial support for the tourism sector, but it was unable to recoup the money and incurred a very large revenue deficit. At that point, the city should have received MIC supervision.

Revenue deficit was papered over using improper accounting treatment

However, Yubari City papered over the revenue deficit using an improper accounting treatment between the general account and the special account via the use of temporary borrowings. Chart 1 shows revenue and expenditure trends in Yubari City. The city has extraordinarily high weightings for miscellaneous income on the revenue side as well as for loans and amounts transferred to other accounts on the expenditure side compared to other local government bodies, indicating that the city conducted inappropriate accounting practices. This treatment was conducted from FY92 to FY05. In FY06, the city finally reached a dead end and its swollen cumulative revenue deficit surfaced. Although Yubari City continued to book revenue deficits in FY07 and FY08, it finally received MIC supervision in FY09 and was allowed to issue special bonds whose redemption period is set within the range of its fiscal reconstruction program. The issuance enabled the city to cover the revenue deficit. Since FY10, the balance between revenues and expenditures has been normalized.

Chart 1: Revenue/Expenditure Results at Yubari City

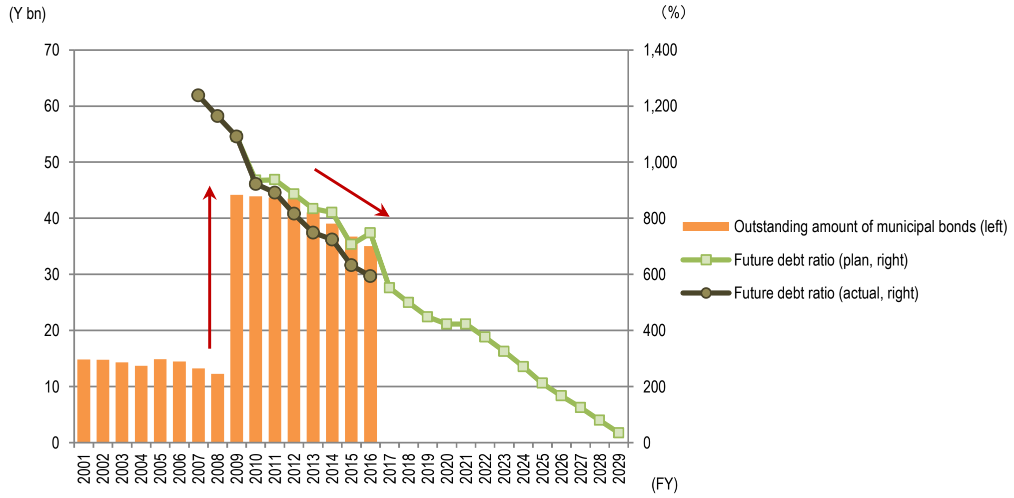


Source: MIC; compiled by Daiwa Securities.

Yubari City is under fiscal reconstruction, incurring extraordinary debt under the current system

The bars in Chart 2 show the outstanding amount of municipal bonds issued by Yubari City. When the city papered over its revenue deficit via temporary borrowings, the amount was roughly flat (e.g., Y12.2bn in FY08). However, as the revenue deficit was covered in FY09 via the issuance of the aforementioned special bonds, the outstanding amount of municipal bonds posted a 3.6-fold leap to Y44.2bn. The lines in Chart 2 indicate Yubari City's future debt ratio (actual) and the figures under the reconstruction plan. When the revenue deficit surfaced in FY07, the ratio was extraordinarily high at 1,237.6%. If the city had received MIC supervision earlier without resorting to improper accounting practices, the figure would not have worsened to that level. In short, Yubari City's fiscal reconstruction originated from a quite extraordinary situation.

Chart 2: Outstanding Amount of Municipal Bonds and Future Debt Ratio in Yubari City



Source: MIC; compiled by Daiwa Securities.

Debt reduction/exemption not allowed despite incurring unexpected amount of debt

As mentioned on the first page ([2]), the MIC has a stance of not allowing debt reductions/exemptions for local governments. As Yubari City's debt had swollen to a level beyond what would normally be assumed under the current local finance system, the city's fiscal reconstruction plan is set to last for 21 years, from FY09 to FY29. The term is more than double the length seen in a previous case—the town of Akaike in Fukuoka Prefecture—whose fiscal reconstruction was controlled by the MIC and 10 years were needed to complete the program. Under the current local finance system, debt reductions/exemptions are not allowed despite forfeiture of a local public body's autonomy for more than 20 years. This is the reason why municipal bonds are able to avoid defaults.

Local government's finance improves due to adoption of reconstruction program

Regarding the dramatic improvement mentioned on the first page ([3]), the future debt ratio at Yubari City is expected to decline over 21 years from 1,164.0% in FY09 to 34.6% in FY29. In addition, the actual debt ratio as of FY16, eight years after the start of the MIC's supervision, was lower than the planned figure. In other words, once a reconstruction program is adopted, fiscal conditions at local governments improve dramatically via major reorganization. Adoption of a reconstruction program is generally regarded as equivalent to getting a red card, but it is rather positive in terms of creditworthiness. Other than Yubari City, there are currently no local governments getting even a yellow card, much less a red card. Local finances are currently quite healthy. In addition, even if they were to worsen, local finances should be restored to a sound condition, meaning that there is no need to exclude any municipal bonds from the purchase list.

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1) Duty of good faith.
2) Establishment of control systems (fairness of the rating process, and prevention of conflicts of interest, etc.).
3) Prohibition of the ratings in cases where Credit Rating Agencies have a close relationship with the issuers of the financial instruments to be rated, etc.
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■ Credit Rating Agencies

[Standard & Poor's]

The Name of the Credit Rating Agencies group, etc

The name of the Credit Rating Agencies group: S&P Global Ratings ("Standard & Poor's")
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The information is posted under "Unregistered Rating Information" (http://www.standardandpoors.co.jp/unregistered) in the "Library and Regulations" section on the website of S&P Global Ratings Japan Inc. (http://www.standardandpoors.co.jp)

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Credit ratings assigned by Standard & Poor's are statements of opinion on the future credit quality of specific issuers or issues as of the date they are expressed and they are not indexes which show the probability of the occurrence of the failure to pay by the issuer or a specific debt and do not guarantee creditworthiness. Credit ratings are not a recommendation to purchase, sell or hold any securities, or a statement of market liquidity or prices in the secondary market of any issues.

Credit ratings may change depending on various factors, including issuers' performance, changes in external environment, performance of underlying assets, creditworthiness of counterparties and others. Standard & Poor's conducts rating analysis based on information it believes to be provided by the reliable source and assigns credit ratings only when it believes there is enough information in terms of quality and quantity to make a conclusion. However, Standard & Poor's does not perform an audit, due diligence or independent verification of any information it receives from the issuer or a third party, or guarantee its accuracy, completeness or timeliness of the results by using the information. Moreover, it needs to be noted that it may incur a potential risk due to the limitation of the historical data that are available for use depending on the rating.

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[Moody's]

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The name and registration number of the Registered Credit Rating Agency in the group: Moody's Japan K.K. (FSA commissioner (Rating) No.2)

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Based on the information received from issuers or from public sources, the credit risks of the issuers or obligations are assessed. MIS adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources MIS considers to be reliable. However, MIS is not an auditor and cannot in every instance independently verify or validate information received in the rating process.

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[Fitch]

The Name of the Credit Rating Agencies group, etc

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The name and registration number of the Registered Credit Rating Agency in the group: Fitch Ratings Japan Limited (FSA commissioner (Rating) No.7)

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May 2018

IMPORTANT

Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law

If you decide to enter into a business arrangement with our company based on the information described in this report, we ask you to pay close attention to the following items.

• In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction. In some cases, our company also may charge a maximum of ¥ 2 million (including tax) per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
• For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements**.
• There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
• There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
• Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

** The ratio of margin requirements etc. to the amount of the transaction cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with our company.

Corporate Name: Daiwa Securities Co. Ltd.
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Chief of Kanto Local Finance Bureau (Kin-sho) No.108
Memberships: Japan Securities Dealers Association
The Financial Futures Association of Japan
Japan Investment Advisers Association
Type II Financial Instruments Firms Association