

Japan Finance Organization for Municipalities

3-minute guide to investment in JFM bonds

- Joint funding organization owned by nationwide local public bodies, but MIC also involved
- All borrowers are local public bodies and bad loans at zero
- Risk under control regarding interest rate fluctuation caused by difference between avg. period of procurement and that of loan provision
- Law stipulates that local public bodies cover necessary expenses at time of JFM's liquidation
- Investment diversified across Japan and not characterized by specific regions
- Unlike jointly issued local gov't bonds, JFM issues bonds in various durations besides 10-year ones

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Joint funding organization owned by nationwide local public bodies, but MIC also involved

Japan Finance Organization for Municipalities (JFM) is a company that raises funds mainly via bond issuance and provides loans to local public bodies. JFM is helpful to such bodies, serving as a fundraising route other than the bond market or private-sector financial institutions. Before JFM was established in August 2008, it was a FILP agency funded by the government (Japan Finance Corporation for Municipal Enterprises). However, as the government stopped funding due to reform of policy-based finance by the Koizumi administration, JFM became a joint funding organization for local governments, owned by all local public bodies. That being said, the Ministry of Internal Affairs and Communications (MIC) continues to hold jurisdiction over the Japan Finance Organization for Municipalities Law (JFM Law), which stipulates various rules. There are thus many staff on loan from the ministry.

All borrowers are local public bodies and bad loans at zero

The first point in terms of credit valuation is the fact that all borrowers are local public bodies. As they secure fiscal soundness under the current local finance system, they have no actual cases of bankruptcy (although Yubari City, Hokkaido, placed under MIC's control, it continues to repay debt). Accordingly, bad loans at JFM are at zero.

Risk under control regarding interest rate fluctuation caused by difference between avg. period of procurement and that of loan provision

As the period of fund procurement and that of loan provision differs, JFM faces the risk of interest rate fluctuation—incurring losses due to rate fluctuation. However, JFM has set a target of constraining the difference between the average period of procurement and that of loan provision within two years. As of end-FY17, the difference was cut to 1.15 years. In addition, JFM has prepared reserves in case of interest rate fluctuations. At end-FY17, the reserve balance stood at ¥3.0tn vs. outstanding loans of ¥23.7tn. Looking at profit/loss levels, we found that JFM has been in the black to date. It has not yet faced a situation where reserves are used to make up for losses.

Law stipulates that local public bodies cover necessary expenses at time of JFM's liquidation

Moreover, the JFM Law stipulates that local public bodies cover the entire amount of necessary expenses when JFM is unable to complete debt payment at the time of its liquidation. Among FILP agencies, there is no case that a method of cost burdens in the remote chance is stipulated by the law. This is JFM's own scheme to protect investors.

Investment diversified across Japan and not characterized by specific regions

Purchases of JFM bonds are similar to indirect purchases of local government bonds. While investment in local government bonds means risk-taking on specific local public bodies, that in JFM bonds virtually enables diversified investment across Japan as JFM provides loans to all 47 prefectures, all 20 ordinance-designated cities, and most of the 1,715 cities, wards, towns, and villages (of total 1,721). In addition, as JFM is an "all-Japan" joint funding organization, owned by all local public bodies, investment is not characterized by specific regions. For example, investors in the Tohoku region do not have to worry about why they buy local government bonds in the Kyushu region.

Unlike jointly issued local gov't bonds, JFM issues bonds in various durations besides 10-year ones

Investment in jointly issued local government bonds (publicly offered in market) also enables diversified investment across 36 local public bodies, and it is not characterized by specific regions either. However, the duration of jointly issued local government bonds is only 10 years, while JFM provides various investment durations with 5-year, 20-year, and 30-year bonds, in addition to 10-year bonds. In terms of the annual issuance amount as well, JFM offers many investment opportunities, as witnessed by its FY18 domestic bond issuance plan of Y600bn, higher than the figure in the Tokyo Metropolitan Government. These are the attractions of investment in JFM bonds.

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In order to ensure the fairness and transparency in the markets, Credit Rating Agencies became subject to the Credit Rating Agencies' registration system based on the Financial Instruments and Exchange Act. In accordance with this Act, in soliciting customers, Financial Instruments Business Operators, etc. shall not use the credit ratings provided by unregistered Credit Rating Agencies without informing customers of the fact that those Credit Rating Agencies are not registered, and shall also inform customers of the significance and limitations of credit ratings, etc.

■ The Significance of Registration

Registered Credit Rating Agencies are subject to the following regulations:

- 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.
- 4) Duty to disclose information (preparation and publication of rating policies, etc. and public disclosure of explanatory documents).

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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")

The name and registration number of the Registered Credit Rating Agency in the group: S&P Global Ratings Japan Inc. (FSA commissioner (Rating) No.5)

How to acquire information related to an outline of the rating policies and methods adopted by the person who determines Credit Ratings

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>)

Assumptions, Significance and Limitations of Credit Ratings

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]

The Name of the Credit Rating Agencies Group, etc

The name of the Credit Rating Agencies group: Moody's Investors Service ("MIS")

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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The information is posted under "Unregistered Rating explanation" in the section on "The use of Ratings of Unregistered Agencies" on the website of Moody's Japan K.K. (The website can be viewed after clicking on "Credit Rating Business" on the Japanese version of Moody's website (https://www.moody.com/pages/default_ja.aspx))

Assumptions, Significance and Limitations of Credit Ratings

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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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Assumptions, Significance and Limitations of Credit Ratings

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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.

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Chief of Kanto Local Finance Bureau (Kin-sho) No.108
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The Financial Futures Association of Japan
Japan Investment Advisers Association
Type II Financial Instruments Firms Association