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Research Update:

Japan Finance Organization For Municipalities 'A+' Ratings Affirmed After Criteria Revision; Off UCO; Outlook Positive

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Research Update:

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Overview

- We have completed our review of the ratings on Japan Finance Organization for Municipalities (JFM), a Japan-based public sector funding agency that lends to Japanese local and regional governments, following the release of our "Public-Sector Funding Agencies: Methodology And Assumptions" criteria.
- We had placed the ratings on the agency Under Criteria Observation (UCO) on May 22, 2018, in conjunction with the criteria's release.
- After our review, we are affirming our 'A+' long-term and 'A-1' short-term issuer credit ratings on JFM and are upgrading the stand-alone credit profile for JFM to 'a+' from 'a'. We are also removing the ratings from UCO.
- The positive outlook reflects the positive outlook on our long-term sovereign credit rating on Japan and no expected change in our assessment of the likelihood of extraordinary support for JFM over the next two years.

Rating Action

On Aug. 6, 2018, S&P Global Ratings affirmed its 'A+' long-term and 'A-1' short-term issuer credit ratings on Japan Finance Organization for Municipalities (JFM). We upgraded our stand-alone credit profile (SACP) for JFM to 'a+' from 'a'. We also removed the ratings from Under Criteria Observation (UCO), where we placed them May 22, 2018. The outlook is positive.

Outlook

The positive outlook reflects the positive outlook on our long-term sovereign credit rating on Japan and our view that the likelihood of JFM receiving extraordinary government support if needed is unlikely to change in the next two years. In addition, we expect the SACP for JFM to remain stable at 'a+', reflecting its strong public policy role; sound capitalization under its capital policy, including accumulation of net earnings; and financial risk management over the next two years.

We could upgrade JFM if we raise our sovereign ratings on Japan. Conversely, we could lower the ratings or revise downward the outlook on JFM if we lower our ratings or revise downward the outlook on Japan. We may also consider lowering our ratings on JFM if, in our view, its policy role becomes less important or its link with the central government weakens. We could also downgrade JFM in the event that we lower the SACP for the agency to ' a-', which we consider fairly unlikely for now.

Even if we revise upward the SACP for JFM because of factors including strengthening capitalization through accumulation of net earnings, we see a low likelihood of upgrading our long-term rating on JFM as long as we maintain the current sovereign ratings on Japan.

Rationale

The ratings reflect our view of JFM's strong public policy role and its stable market position as a provider of financing to local and regional governments (LRGs) in Japan. Also supporting our ratings are low risk in Japan's LRG sector, owing to a favorable institutional framework and strong economic resilience, strengthening capitalization through accumulation of net earnings, JFM's financial management of risk related to volatility in interest rates, and its adequate liquidity. Counterbalancing factors include a lower market share of LRG funding than global peers, taking interest rate risk because of unhedged duration mismatches between assets and liabilities, and its liquidity coverage in our extremely stressed scenario.

We see an extremely high likelihood of JFM receiving government support in a time of need. This is because JFM plays a very important role as the primary long-term funding provider with competitive prices to LRGs in Japan and its lending comprises an integral part of the central government's support for LRGs under the Local Government Borrowing Programme (LGBP).

Enterprise Risk Profile: Strong public policy mandate and low sector risk in LRGs in Japan

- JFM has a strong public policy mandate as a major lending institution for LRGs in Japan.
- Risk in Japan's LRG sector is low, reflecting its favorable institutional framework, solid economic resilience, and healthy financial system, while LRGs' gross debts are easing but remain high.
- Adequate risk management offsets unhedged interest rate risk arising from duration mismatches.

JFM plays a strong public policy role as a major long-term provider of low-cost financing to Japanese LRGs, in our view. JFM acts as a safety net for provision of lending to small and midsize LRGs. While it has a low market share of around 15% of LRG funding compared with global peers, we view its market position as stable because its lending is incorporated into the LGBP that the Ministry of Internal Affairs and Communications (MIC) provides to

LRGs. In the LGBP, JFM serves as the public funding provider together with the government's Fiscal Investment and Loan Program (FILP). Furthermore, JFM is the primary provider of long-term loan funding (over 10 years).

We view JFM's customer base as stable, reflecting customers that are all LRGs in Japan and JFM shareholders. We see limited sensitivity to price in JFM's business and see high customer loyalty in its historical financing records, which has produced stable revenues despite declining profitability. We see no material concentration in its revenues, because it has achieved well-diversified lending exposures among Japanese LRGs.

We view as a weakness in JFM's risk management the interest rate risk stemming from unhedged duration gaps in its assets and liabilities, compared with most global peers, who match funding to minimize such risks. However, its risk management, including a ¥2.2 trillion reserve fund in its general account and asset and liability management (ALM) monitoring such as maintaining duration mismatches to within two years, offsets the weakness. Our assessment also reflects our view that JFM's management and governance has close links to the government. This is reflected, for example, in management of credit risk in JFM's lending activities, which involves MIC in credit applications and special monitoring procedures if an LRG experiences financial difficulties.

We view credit risk in doing business in Japan's LRGs sector as low. This reflects our view that the institutional framework for Japanese LRGs is stable and predictable, which we base on its record of a stable structure and improving credit metrics for the LRG sector despite the central government's mounting fiscal deficits and debt burden. In addition, Japan's economic resilience is strong, for which we revised up our assessment in April 2018, and Japanese banking system has a robust systemwide funding structure and prudent regulatory monitoring, while intensive rate competition threatens the stability of the banking system. However, LRGs' improving but still-high gross debt compared with global peers partly weighs on our assessment of risk in the sector.

Financial Risk Profile: Strong capitalization, sufficient cushion for interest rate risk volatility, and adequate liquidity

- Accumulation of net earnings in JFM's general account supports its strong capitalization.
- Reserve funds provide a sufficient buffer to cushion risk of loss from interest rate volatility.
- JFM benefits from healthy access to funding in Japan's deep and diversified capital market and maintains adequate liquidity.

We believe JFM's strong capitalization will continue over the next two years under its current capital policy. JFM's risk-adjusted capital (RAC) ratio was 13.6% as of March 31, 2018, and 8.2% if we make adjustments for single-borrower concentration. We expect its RAC ratios to continue to improve thanks to stable accumulation of net earnings in its general account, while loans outstanding will not grow significantly, in our view, because of progress collecting principal and interest on loans in its management account.

JFM has not suffered any losses in its loan portfolio since being established and maintains prudent underwriting standards. On the other hand, and in contrast with many of its international peers, JFM takes risk on interest rates by allowing unhedged duration gaps because it provides mostly fixed-rate, long-term loans up to 40 years while raising funds mainly through the issue of 10-year fixed rate bonds. However, JFM sets aside ¥2.2 trillion in a reserve fund in its general account as a buffer against interest rate risk, which sufficiently covers the risk of loss in our view.

JFM has access to diversified financial instruments in a deep and broad capital market with a diversified investor base in Japan, and it periodically issues bonds in global markets. Therefore, JFM has strong name recognition in its respective markets. On the other hand, the ratio of its liquidity coverage over one year is below 1.0x in our extreme stress scenario, assuming loss of funding access and various assumptions for scheduled loan disbursements. However, we consider JFM capable of managing its liquidity in such a case because we believe it has some flexibility to reduce loan disbursement, given the government shares LGBP funding allocations to LRGs with JFM. Part of its debt service being on government-guaranteed bonds in its management account also mitigates the pressure that bond redemptions put on its liquidity, in our view.

Extremely high likelihood of extraordinary support from the Japanese government

- We base our assessment of an extremely high likelihood of extraordinary support for JFM if needed on our view that JFM has a very important role for and integral link to the government of Japan.

We believe JFM plays a very important role as the primary public financial institution offering long-term, low-cost financing to Japan's LRGs so they can fund national policy targets--such as disaster-proof projects--and as a primary lender to the LRG sector for basic infrastructure-related funding. On the other hand, the replicability of JFM's financing by private financial institutions constrains its role.

Even if Japanese LRGs own JFM, we consider it has an integral link to the government of Japan. We base this on our view that JFM's lending constitutes an integral part of central government support for the LRG sector's financial system under the LGBP.

Moreover, JFM's management account funding comes from the government's FILP. The government guarantees funding supplied to JFM through FILP and still guaranteed about 36% of JFM's funding in fiscal 2017. Despite the central government's complete divestiture of its interest in JFM's predecessor at the end of September 2008, we believe JFM's link to the government remains intact.

Key Statistics

Japan Finance Organization for Municipalities--Selected Indicators					
	--Fiscal year*--				
(Bil ¥)	**2017**	**2016**	**2015**	**2014**	**2013**
Business position					
Total assets	24,756	24,786	24,643	24,524	24,101
Customer loans (gross)	23,768	23,720	23,665	23,438	23,083
Growth in loans (%)	0.2	0.2	1.0	1.5	1.8
Net interest revenues	155	164	174	183	194
Noninterest expenses	3	3	4	3	3
Capital and risk position					
Total liabilities	24,488	24,545	24,427	24,351	23,959
Total adjusted capital	261	235	206	176	146
Assets/capital (x)	94.9	105.7	119.4	139.2	165.0
RAC ratio before diversification (%)	13.6	N.A.	N.A.	N.A.	N.A.
RAC ratio after diversification (%)	8.2	N.A.	N.A.	N.A.	N.A.
Gross nonperforming assets/gross loans	0	0	0	0	0
Funding and liquidity					
Liquidity ratio with loan disbursement (one year)(x)	0.7	N.A.	N.A.	N.A.	N.A.
Liquidity ratio without loan disbursement (one year)(x)	1.2	N.A.	N.A.	N.A.	N.A.
Funding ratio (one year)(x)	1.4	N.A.	N.A.	N.A.	N.A.

*Fiscal year ended March 31 of the following year. RAC--Risk-adjusted capital. N.A.--Not available.

Ratings Score Snapshot

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Issuer Credit Rating                  A+/Positive/A-1

SACP                                  a+

Enterprise Risk Profile               Strong (2)
 PICRA                                Strong (2)
 Business Position                    Strong (2)
 Management & Governance              Adequate (3)
Financial Risk Profile                Adequate (3)
 Capital Adequacy                     Strong (2)
 Funding                              Neutral
 and Liquidity                        Adequate (3)

Support                               0
 GRE Support                          0
 Group Support                        0
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Additional Factors	0

Related Criteria

- Public-Sector Funding Agencies: Methodology And Assumptions, May 22, 2018
- Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Risk-Adjusted Capital Framework Methodology, July 20, 2017
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017

Related Research

- 10 Public-Sector Funding Agencies Placed Under Criteria Observation On Publication Of New Criteria, May 22, 2018
- Assumptions For Liquidity Gap Analysis Under "Public-Sector Funding Agencies: Methodology And Assumptions", May 22, 2018
- Credit FAQ: A Closer Look At The New Public-Sector Funding Agencies Criteria, May 22, 2018

Ratings List

Ratings Affirmed

Japan Finance Organization for Municipalities	
Issuer Credit Rating	A+/Positive/A-1
Japan Finance Organization for Municipalities	
Senior Secured	A+

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.

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