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Ratings

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Research Update:

Japan Finance Organization for Municipalities Ratings Affirmed At 'A+/A-1'; Outlook Remains Stable

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Overview

- Japan Finance Organization for Municipalities (JFM) continues to benefit from improving credit quality of Japanese local and regional governments, consistent growth of its capitalization, and adequate control of interest rate risk amid a rising interest rate environment in Japan.
- We also believe the likelihood of JFM receiving extraordinary support from the government of Japan in times of need is extremely high.
- We affirmed our 'A+' long-term and 'A-1' short-term issuer credit ratings on JFM. We have also raised the stand-alone credit profile for JFM to 'aa-' from 'a+', and capped the rating at the level of the sovereign.
- The stable outlook reflects that 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 Oct. 21, 2024, S&P Global Ratings affirmed its 'A+' long-term and 'A-1' short-term issuer credit ratings on Japan Finance Organization for Municipalities (JFM). The outlook is stable. We also raised our stand-alone credit profile (SACP) for JFM to 'aa-' from 'a+', reflecting the financial organization's continued build-up of capitalization.

Outlook

Our stable outlook on JFM reflects the stable 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 our stand-alone credit profile (SACP) for JFM to remain stable at 'aa-', reflecting its strong public policy role and sound capitalization, as well as its financial risk management over the next two years.

Downside scenario

We could lower our ratings on JFM if we take such actions on our ratings on Japan.

Although we consider it fairly unlikely, 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; and if we lower the SACP for the agency three notches to 'a-'.

Upside scenario

Conversely, we could raise our ratings on JFM if we raise our sovereign credit ratings on Japan.

Even if we revise upward the SACP for JFM, we see a low likelihood of raising our ratings on JFM as we believe its creditworthiness will be severely affected under a stress scenario in which the sovereign defaults.

Rationale

The rating affirmation reflects 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, and its liquidity coverage in our extremely stressed scenario.

We see an extremely high likelihood of JFM receiving government support in times 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 Program (LGBP).

We believe JFM's creditworthiness will be severely affected under a stress scenario in which the sovereign defaults. Therefore, we cap the rating on JFM with that on the sovereign credit rating of Japan (A+/Stable/A-1).

Sector risk profile: Sound quality of Japanese LRGs operating in a very predictable and well-balanced system

JFM predominantly lends to Japanese LRGs, with a very small portion lent to GREs with guarantees by the parent LRG. We assess the sector risk profile of JFM to be "2", reflecting our assessment of the very predictable and well-balanced public finance system in which Japanese LRGs operate.

Individual credit profile: Long record of strong and stable performance

We believe JFM will maintain its strong public policy role as a major provider of long-term (maturities of more than 10 years and up to 40 years), low-cost financing to Japanese LRGs, which is difficult for private banks to provide. We believe JFM also fulfills a function as a safety net for provision of lending to small and midsize LRGs. While it provides a low share of LRG funding--at about 16% on a five-year average basis--compared with global peers, we view its market position as stable because the Ministry of Internal Affairs and Communications (MIC) incorporates JFM's lending into the annual LGBP that MIC provides to LRGs. In the LGBP, JFM serves as the public funding provider alongside the central government's Fiscal Investment and Loan Program (FILP).

We think JFM's customer base will remain stable, reflecting Japanese LRGs being both borrowers and shareholders of JFM. Despite low profitability reflecting its policy role, we see sensitivity to price in JFM's business as manageable and high customer loyalty in its historical financing records, which together have produced stable revenues. In addition, it gets increasing contributions from the proceeds of municipally operated racing events, which it uses to reduce lending rates. We see no material concentration in its revenues, with it having well-diversified its lending exposures among Japanese LRGs.

One weakness we see in JFM's risk management compared with most global peers that match funding, is structural exposure to interest rate risk stemming from unhedged duration gaps in assets and liabilities. However, JFM takes steps to offset this weakness, including through its assets and liabilities policy and a reserve fund for interest rate volatility in its general account. Our management and governance assessment also reflects our view that JFM's management and governance is closely linked to the government. This is reflected, for example, in MIC's involvement in management of credit risk in JFM's lending activities, which occurs in credit applications and special monitoring procedures if an LRG experiences financial difficulties.

We think credit risk in JFM's lending business will remain low. This is thanks to our expectation that the growth of the domestic economy will increase LRGs' revenues as well as vertical transfers to the LRG sector from the central government. We also believe the domestic LRG sector's indebtedness will gradually improve under a stable institutional structure despite the central government's mounting fiscal deficits and debt burden. However, LRGs' still-high gross debt compared with global peers partly weighs on our assessment of risk in the sector.

We believe JFM's strong capitalization will continue over the next two to three years. Accumulation of retained earnings in its general account has consistently improved its risk-adjusted capital (RAC) ratios. As of March 31, 2024, RAC ratios for JFM were 22.9%, and 15.7% adjusted for single-borrower concentration. We expect continuous moderate growth of Japan's economy over the next two to three years to help repair LRGs' finances, which worsened temporarily during the pandemic. Therefore, declines in debts of LRGs are likely to resume a moderate pace on positive fiscal balances, as was the case prior the pandemic.

JFM's asset quality is unlikely to deteriorate rapidly. It has not suffered any losses in its loan portfolio since its establishment and maintains prudent underwriting standards. On the other hand, JFM takes risk on interest rates by allowing unhedged duration gaps on assets and liabilities. This is because it provides mostly fixed-rate, long-term loans up to 40 years while raising funds mainly through issuance of 10-year fixed-rate bonds. As a result, higher interest rates in Japan and widening spreads between JFM's bonds and Japanese government bonds may negatively affect JFM's finances and its accumulation of retained earnings.

JFM has a policy of keeping duration mismatches to within two years. Also, as of March 2024, it set aside ¥2.2 trillion in a reserve fund in its general account and about ¥700 billion in its management account as a buffer against interest rate risk. These reserves sufficiently cover risk of loss, in our view, because they amount to about 10x JFM's potential loss from movement of market values assuming a 100 basis-point rise in interest rates. We believe the likelihood of interest rate risk affecting capitalization is low since we do not incorporate these reserves into our measurement of capital in the calculation of its RAC ratios.

We believe JFM will maintain strong name recognition in its respective markets. JFM has access to diversified funding instruments in a deep capital market with a diversified investor base in Japan. It periodically issues bonds in global markets, including green bonds to finance sewerage projects.

On the other hand, the ratio of its liquidity coverage over one year is below 1.0x, in our extreme stress scenario, which assumes a loss of funding access. This is relatively low compared with international peers. However, we consider JFM capable of managing its liquidity in such a case because we believe it has some financial flexibility, given the government also contributes to LGBP funding allocations to LRGs. Part of JFM's 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.

Extraordinary support: Likelihood of extraordinary support from the government of Japan is extremely high.

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 such as water supply and sewerage. On the other hand, replicability of JFM's financing by private financial institutions constrains the importance of 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.

In addition, JFM's management account funding comes from the government's FILP, and the government guarantees a portion of JFM's total funding. 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.

Japan Finance Organization for Municipalities--Selected indicators

	--Fiscal year*--				
(Bil ¥)	**2023**	**2022**	**2021**	**2020**	**2019**
Business position					
Total assets	24,164	24,556	24,835	24,858	24,347
Customer loans (gross)	23,074	23,300	23,551	23,144	23,400
Growth in loans (%)	(1.0)	(1.1)	1.8	(1.1)	(0.4)
Net interest revenues	81	92	103	116	128
Noninterest expenses	4	4	3	3	3
Capital and risk position					
Total liabilities	23,738	24,162	24,467	24,517	24,023
Total adjusted capital	441	406	371	339	312

Japan Finance Organization for Municipalities--Selected indicators (cont.)

	--Fiscal year*--				
(Bil ¥)	2023	2022	2021	2020	2019
Assets/capital (x)	54.8	60.4	66.9	73.3	78.1
RAC ratio before diversification (%)	22.9	20.8	18.7	16.4	16.2
RAC ratio after diversification (%)	15.7	12.1	10.7	10.0	9.6
Gross nonperforming assets/gross loans (%)	0.0	0.0	0.0	0.0	0.0
Funding and liquidity					
Liquidity ratio with loan disbursement (one year) (x)	0.5	0.7	0.6	0.6	0.6
Liquidity ratio without loan disbursement (one year) (x)	1.2	1.0	1.2	1.2	1.1
Funding ratio (one year) (x)	1.4	1.2	1.4	1.4	1.3

*Fiscal years end March 31 of the following year. RAC--Risk-adjusted capital.

Ratings Score Snapshot

Issuer credit rating	A+/Stable/A-1
Sector risk profile	Strong
Individual credit profile:	
Business position	Strong
Management & governance	Adequate
Capital adequacy	Very Strong
Funding & liquidity	Adequate
Anchor	aa-
Overriding factors and caps	0
Holistic analysis	0
Stand-alone credit profile	aa-
Extraordinary support	0

Related Criteria

- Methodology For Rating Non-U.S. Public-Sector Funding Agencies, July 26, 2024
- Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- Risk-Adjusted Capital Framework Methodology, April 30, 2024
- Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- Principles Of Credit Ratings, Feb. 16, 2011

- Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015

Related Research

- Institutional Framework Assessment: Japanese Prefectures And Cities' Recoveries Rely On National Support, July 30, 2024
- Research Update: Japan 'A+/A-1' Ratings Affirmed; Outlook Stable, March 28, 2024

Ratings List

Ratings Affirmed	
Japan Finance Organization for Municipalities	
Issuer Credit Rating	A+/Stable/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.spglobal.com/ratings for further information. Complete ratings information is available to RatingsDirect subscribers at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.spglobal.com/ratings.