

II. The issues on functions of financial markets and the Bank's initiatives

With a view to improving the functions and efficiency of financial markets in Japan, the Bank conducts various market research, and based on the results, takes initiatives to facilitate the market infrastructure. The three major issues that the Bank has been working on up to fiscal 2006 are as follows.

1. Short-term money markets

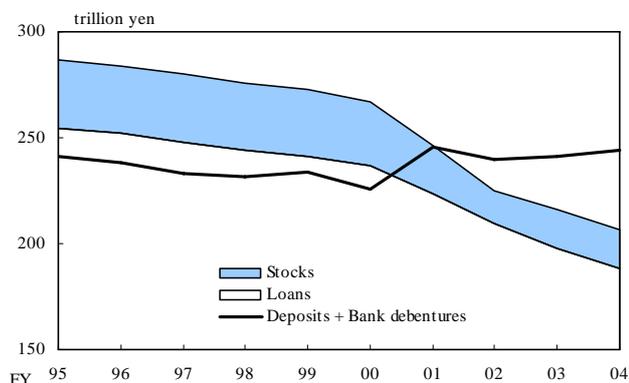
As stated in part I, during the second half of 2005, activities were affected by expectations as to when the Bank would exit from the quantitative easing policy and how fast it would raise the policy rate thereafter. Depending on the economic situations and financial developments in the coming months, the behaviors of market participants could change further, affecting transaction patterns and interest rates formulation in short-term money markets.

Meanwhile, transactions in the call market have fallen drastically during the quantitative easing policy, which has lasted nearly 5 years (Chart 6). This is because lenders have less incentive to lend when interest rates are zero, while there has been less demand from the markets for funds due to ample liquidity supplied by the Bank. In addition to the diminished scale of the markets, various structural changes have occurred in the environment affecting short-term money markets. The major changes are as follows.

First, the lenders and borrowers have changed. Major banks used to have more loans than deposits on their balance sheets and so were the primary borrowers in short-term money markets. On the other hand, other financial institutions such as regional banks, Keito-es (central financing organizations for financial cooperatives such as small/medium-sized businesses), investment trusts, and life insurance companies used to be lenders. However, major banks now raise far less funds, whereas securities companies and foreign banks have increased their fund-raising.

Several possible reasons for this change are as follows. Due to the decrease in loans, major banks now carry more deposits than loans on their balance sheets (Chart 62). Meanwhile, securities companies are currently active in stock trading and corporate finance business such as underwriting convertible bonds and thus cannot fully suffice the financing needs by repo transactions which have traditionally been their major funding tool (Chart 63). Foreign banks also have become more dependent on fund-raising in the call market, because they find fewer opportunities to raise funds in yen at a negative interest rate in the foreign exchange swap market, as the creditworthiness of Japanese banks has improved.

Chart 62 Balance of loans and deposits of major banks

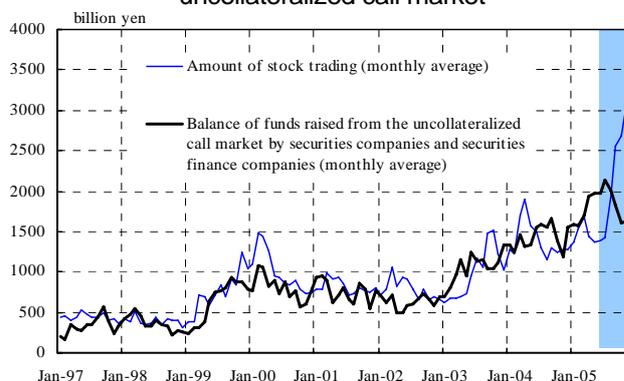


Notes: 1. The figures of loans, stocks, deposits, and bank debentures are on a domestic-operation basis.

2. "Major banks" include City banks, Shinsei bank, and Aozora bank.

Source: Bank of Japan

Chart 63 Stock trading and fund-raising from the uncollateralized call market



Note: Amount of stock trading is the aggregated amount of those in the First and Second sections and Mothers (since Dec. 99) of the Tokyo Stock Exchange.

Source: Tokyo Stock Exchange, Bank of Japan

Second, major banks have become much larger through mergers and the number of major market participants has decreased.

Third, the settlement system in Japan has developed substantially. The newly introduced systems include Real-time Gross Settlement of fund transfers between current accounts with the Bank and the transfer of Japanese Government Securities in 2001, a cross-border payment system for multiple currencies in 2002 (establishment of CLS bank), and a book-entry system for corporate securities and other non-JGB bonds which enabled transactions on a delivery-versus-payment basis in 2006. These have reduced settlement risks, but have also increased the demand for intraday liquidity and/or liquidity to be raised later in the afternoon.

Fourth, financial institutions have become more conscious of counterparty risk following the crises in the financial system after the mid-1990s.

All these structural changes may have significant effects on the functions of short-term money markets. Due to ample liquidity resulting in a much higher reserve balance than required, the effects have not surfaced so far. It should be recognized, however, that there are many issues to be addressed in order to improve the functions of short-term money markets. For instance, in light of changes in lenders and borrowers as well as increasing awareness of counterparty risk by financial institutions, it would be important for borrowers to secure and confirm credit lines from lenders. It would also be necessary to activate risk-free, collateralized fund transactions. Furthermore, given the changes in the payment and settlement systems, the intraday call market would become more important.

Market participants are taking their own initiatives by discussing necessary measures to ensure smooth market transactions at working groups such as The Study Group for Activation of Short-term Money Markets. The Bank will continue to discuss with market participants issues such as how the behavior of market participants would change with respect to funding operations and management of interest rate risk, how those behavioral changes, along with the structural changes stated above, would affect the functions of short-term money markets. The Bank also seeks joint efforts with market participants to identify further challenges to be addressed in order to attain improved market functioning.

2. Credit markets

Since the late 1990s, the Bank, along with market participants, has taken various measures to facilitate corporate financing and to support the development of credit markets such as the corporate bonds market, the CP market and the asset-backed securities (ABS) market (Chart 64). During the period from 2002 to 2003, when the intermediary function of Japanese financial institutions was not sufficient, the Bank relaxed eligibility standards for asset-backed CPs (ABCPs) as collateral and instrument for repo operations. The Bank also introduced outright purchase operations of ABSs and ABCPs as temporary measures until March 2006, with a view to supporting the ABS and ABCP markets that were judged still in their infancy.

Chart 64 Measures taken by the Bank concerning credit markets

Date of implementation	Measures concerning market operations and collateral for the Bank's credit	Date of implementation	Other measures
Nov 1998	Expansion of the size of CP repo operations	Jan 1999	Release of statistics on credit derivatives
	Establishment of a temporary lending facility to support firms' financing activities (temporary measure)	Dec 2003	Release of statistics on loans syndicated and loans transferred
Feb 1999	Establishment of outright purchase operations of bills collateralized by corporate debt obligations	Nov 2003 - Apr 2004	Workshop on securitization
Oct 1999	Acceptance of ABS as eligible collateral	May 2004	Release of survey on the securitization market
Feb 2002	Acceptance of ABCP as eligible collateral and eligible CP for CP repo operations	Jan 2005	Release of amount outstanding figures of loans syndicated
Jan 2003	Relaxation of standards for ABCP as eligible collateral and eligible CP for CP repo operations (temporary measure)		
July 2003	Establishment of outright purchase of ABS and ABCP (temporary measure)		
Nov 2003	Acceptance of syndicated loans as eligible collateral		

Since then, the ABS market has developed steadily as investors have gained recognition of the product and have diversified. Accordingly, the purpose of these temporary measures to support the ABS market is considered to be largely accomplished. In addition, the environment surrounding corporate financing has improved substantially since these measures were implemented. The Bank therefore announced December 2005 that it would terminate the temporary measures at the end of March 2006, as scheduled.

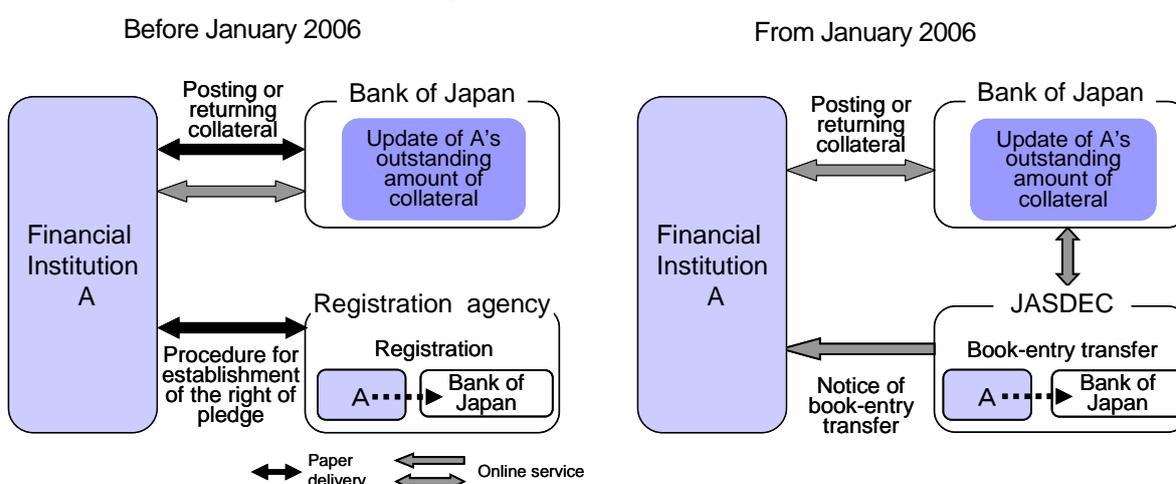
The Bank continues to consider that the development of new credit channels, such as ABS, syndicated loans and credit derivatives remains to be critical to improve the efficiency and stability of the whole credit markets. The Bank also considers that securing multiple credit channels is one of the key lessons to be learned from the experiences in the 1990s, when corporate financing that had been almost exclusively dependent on the banking sector was severely constrained by the non-performing loans problem. As for these new credit markets, the development of secondary markets, as well as improvement in disclosure and build-up of market data, remains as major issues.

The Bank will continue to closely monitor the development of the credit markets by exchanging views with market participants and search for new tasks to be tackled. For the time being, it will take the following measures.

(i) Facilitating utilization of corporate securities as collateral for the Bank's credit

In January 2006, along with the introduction of the book-entry system for corporate securities and other non-JGB bonds by the Japan Securities Depository Center Inc. (JASDEC), the Bank started to provide an online service to post or return corporate securities, other non-JGB bonds and dematerialized CPs as collateral for the Bank's credit to financial institutions. While it took around one week to deliver those securities by paper-based processing before the introduction of the book-entry system, the online service now enables one-day delivery of collateral (Chart 65). The Bank has also speeded up the process of selecting corporate securities as eligible collateral among newly issued securities by increasing the frequency of selection from monthly to weekly.

Chart 65 Online service to deliver corporate securities as collateral



(ii) Simplifying the procedure for accepting loans on deeds as collateral

The Bank will reduce the number of documents and simplify the procedure for accepting loans on deeds including syndicated loans as collateral, thereby reducing the burden on financial institutions and making it easier to use loans on deeds as collateral (Chart 66).

Chart 66 Examples of simplification of the procedure

Before simplification	After simplification
A financial institution must submit evidence that there do not exist any precedent registrations of assignment of, or pledge on, a loan on a deed to be accepted as collateral every time it delivers collateral to the Bank.	A financial institution does not need to submit the evidence on condition that there are appropriate internal controls on the operation of loans on deeds.
The Bank may exercise a security right on a loan and collect proceeds directly from a borrower, even in case of a syndicated loan.	If the loan accepted as collateral is a syndicated loan, the Bank shall assume the status of lender and shall collect proceeds from a loan by assignment or repayment via the agent of the syndicated loan.

(iii) Improving the efficiency of internal credit ratings

Internal credit ratings are conducted by the Bank to assess the creditworthiness of corporations which are obligors of corporate debt obligations as a precondition to accept corporate debt obligations as eligible collateral. While the Bank uses market information, including ratings by rating agencies, in conducting internal credit ratings, it will consider wider use of ratings by agencies and other information more effectively in order to conduct internal credit ratings more efficiently and promptly.

3. Market Level Business Continuity Plan (BCP)

The 9.11 terrorist attacks in 2001 drove market participants and related parties strongly to recognize that it is essential to develop market-level business continuity plan (market level BCP) for maintaining market functioning in case of disaster. Indeed, it is now a widely shared notion that BCP is an integral part of market infrastructures that retains minimal market functioning in times of disaster. In Japan, market level BCP has been gradually developing mainly through the efforts of market participants.

At the time of an earthquake or terrorist attack, the operational ability of each financial institution would be undermined, and thus market transactions and settlements would tend to be restrained. However, market participants would still need minimum market transactions such as funding and position closing even when a disaster strikes. A contagious situation when financial institutions remain unable to execute minimal transactions over an extended period of time would be counterproductive as heightened uncertainties and anxiety could adversely affect price-formation mechanism. Not only is the BCP in the interest of each market participant but also contributes to maintaining the stability of financial markets and the economy as a whole.

It is essential that each financial institution develops its own BCP. In terms of market level BCP, preparations and actions should be made to secure networks which connect the BCP of each financial institution in order to continue market transactions.

In the U.S. and U.K., various initiatives have been taken to secure networks in the event of a disaster (Chart 67). Prominent features are threefold. First, human networks have been developed among related parties in order to convey and share accurate information. Also, since usual communication tools such as telephones may not function well during a disaster, alternative methods should be kept in place. They are mobile terminals and websites in the case of the U.S. and the BCP-designated website in the U.K. case. Second, procedures for recommendations on modifications of transaction practices have been explicitly established by market committees and associations. Third, market-wide exercises simulating a disaster have been conducted in the U.S. and U.K. These exercises are useful for building up cooperation among related parties and to explore the issues regarding market level BCP.

These ongoing initiatives in the U.S. and U.K. provide useful insights in establishing market level BCP in Japan. For example, different practices in terms of trading hours, settlement dates and settlement hours may have to be adopted in times of disaster. List of contingency action plans and procedural arrangement should be in place to ensure prompt and appropriate decisions.

Chart 67 Development of market level BCP in the U.K. and U.S.

	U.K.	U.S.
Before 2000	1987: Market close due to hurricane 1990s: Activation of IRA terrorist activities (1993: The Bishopsgate Bomb) -2000: Y2K problems	1993: Bombings at the World Trade Center -2000: Y2K problems
2001		September: 9/11 attacks
2002	April: Launch of the Financial Sector Continuity website by tripartite financial authorities (FSA, BOE, and HM Treasury)	
2003	February: Release of the HM Treasury Green Paper on “The Financial System and Major Operation Disruption” -- A Task Force was established to examine the need for a legislative response to deal with the threat of major operational disruption in the U.K. financial system. June: First Financial Sector Market-Wide Exercise (coordinated by FSA and a financial institution) August: Power outage in London December: Final Report by the Task Force -- It concluded that new legislative powers would not be helpful to deal with the threat of major operational disruption.	August: Power outage in the Northeast
2004	November: Second Financial Sector Market-Wide Exercise (coordinated by tripartite authorities)	May: Market-Wide Exercise coordinated by SIA (Securities Industry Association) and TBMA (The Bond Market Association) August: Revelation of terrorist threats against financial institutions in Northeast by The Department of Homeland Security
2005	July: Terrorist attack in London November: Third Financial Sector Market-Wide Exercise (coordinated by tripartite authorities)	October: Market-wide connectivity test in securities markets December: New York City Transit Strike

In Japan, progress is being made to develop market level BCP. The efforts so far have been marketwise. In the call market, the Study Group for Activation of Short-term Money Market and JBA (Japanese Bankers Association) have collaborated to build the BCP-designated website (which is expected to be launched in April). In the foreign exchange market, Tokyo Foreign Exchange Market Committee has discussed the development of market level BCP. The Committee and the Bank co-organized “Seminar on market level BCP in foreign exchange markets” in January 2006. Also, the Committee is exploring the introduction of a BCP-designated website, whose function is similar to that of the call market. In securities markets, the Japan Securities Dealers Association set up a Working Group for market level BCP in securities markets in September 2005 and started discussions.

The Bank has participated in the discussions among the related parties to exchange views on specific contents of market level BCP with market participants (Chart 68). The Bank intends to continue contributing to the further development of market level BCP by supporting the related parties’ initiatives such as identifying issues to be addressed, facilitating cooperation between markets, and assisting the building and operation of BCP-designated websites.

Chart 68 Major conferences regarding market level BCP organized by market participants and other related parties (which the Bank joined)

Market	Conference	Period
Short-term money markets	JBA's conference regarding market level BCP in short-term money markets for its members	April 2005
	Conference regarding market level BCP in short-term money markets for non JBA members co-organized by JBA and the Study Group for Activation of Short-term Money Markets	October 2005
Foreign exchange markets	Tokyo Foreign Exchange Market Committee	September 2005
	"Seminar on market level BCP in foreign exchange markets" co-organized by Tokyo Foreign Exchange Market Committee and the Bank of Japan	January 2006
Securities market	"Working Group for market level BCP in securities markets" organized by Japan Securities Dealers Association	October 2005
Settlement institutions	"Payment System Forum" organized by Payment and Settlement Systems Department, Bank of Japan	December 2005

In addition to the major issues that the Bank is now working on as stated above, there are other challenges that are considered essential for better market functioning. For instance, as mentioned in part 1, various operational problems related to market transactions erupted in the stock market. Meanwhile, there has been a dramatic change in the stock market with Nikkei at highest levels in five years accompanied by record high turnover, which is perhaps a consequence of entries of more investors including retail investors into the market. The Bank considers it necessary to constantly monitor and check whether the current market infrastructure such as the computer systems of stock exchanges and financial institutions, the trading rules and the ways of operating the stock market can adequately cope with those ongoing changes.