

Section 2 Government Bonds (JGBs)

Being the core of government debt associated with financing government activities such as JGBs, Financing Bills, borrowings and Government-Guaranteed Debts, JGBs are regarded as credit risk-free financial instruments and play a central role in the bond market.

1 Primary Market for Government Bonds

(1) Legal Framework of JGBs

JGBs can be divided into two main categories: general bonds, and Fiscal Investment and Loan Program bonds (FILP bonds). While the government mainly relies on tax revenue to redeem general bonds, the redemption and the interest payments on FILP bonds are covered through the recovery of loans to FILP agencies. However, both general bonds and FILP bonds are JGBs and are the same financial instruments.

| | | | |
|---|---------------|------------------------------|--------------------|
| JGBs | General bonds | New Financial Resource bonds | Construction bonds |
| | | Refunding bonds | |
| Fiscal Investment and Loan Program bonds (FILP bonds) | | | |

Note: In addition to general bonds and FILP bonds, JGBs consist of subsidy bonds, subscription/contribution bonds and bonds converted from the debts of various entities including the Japan Expressway Holding and Debt Repayment Agency bonds.

A General Bonds

General bonds consist of new financial resource bonds (construction bonds and special deficit-financing bonds) and refunding bonds.

a Construction Bonds

Article 4(1) of the Public Finance Act prescribes that annual government expenditure has to be covered in principle by annual government revenue generated from other than government bonds or borrowings. But as an exception, a proviso of the Article allows the government to raise money through bond issuance or borrowings for the purpose of public works, capital subscription or lending. Bonds governed by this proviso of Article 4(1) are called "construction bonds".

The Article prescribes that the government can issue construction bonds within the amount approved by the Diet, and the ceiling amount is provided under the general provisions of the general account budget. When intending to get approval for this ceiling amount, the government is obliged to submit to the Diet a redemption plan that shows the redemption amount, the redemption method and the redemption dates for each fiscal year for a reference.

b Special Deficit-financing Bonds

When estimating a shortage of government revenue despite the issuance of construction bonds, the government can issue government bonds based on special act to raise money for the purpose of other than public works and the like. Given their nature, these bonds are called "special deficit-financing bonds".

As is the case with construction bonds, the government can issue special deficit-financing bonds within the amount approved by the Diet and the ceiling amount is provided under the general provisions of general account budget. The government is also required to submit a redemption plan to the Diet for reference.

Special deficit-financing bond issuance must be made on exceptional cases. Therefore, the government has to minimize the issue amount as much as possible within the amount approved by the Diet, while taking into account the state of tax and other revenues. In this context, it is allowed to issue special deficit-financing bonds even during the accounting adjustment term. Specifically, the government is allowed to issue special deficit-financing bonds until the end of June in the next fiscal year, in order to adjust issue amount of special deficit-financing bonds until the end of May in the next fiscal year: the deadline for collecting the tax revenue for the fiscal year.

The revenue from their issuance is reported as the government revenue of the General Account.

c Refunding Bonds

Refunding bonds are the JGBs issued through the Special Account of Government Debt Consolidation Fund (GDCF) to raise funds to redeem matured JGBs. Revenues from refunding bonds are directly posted to the fund.

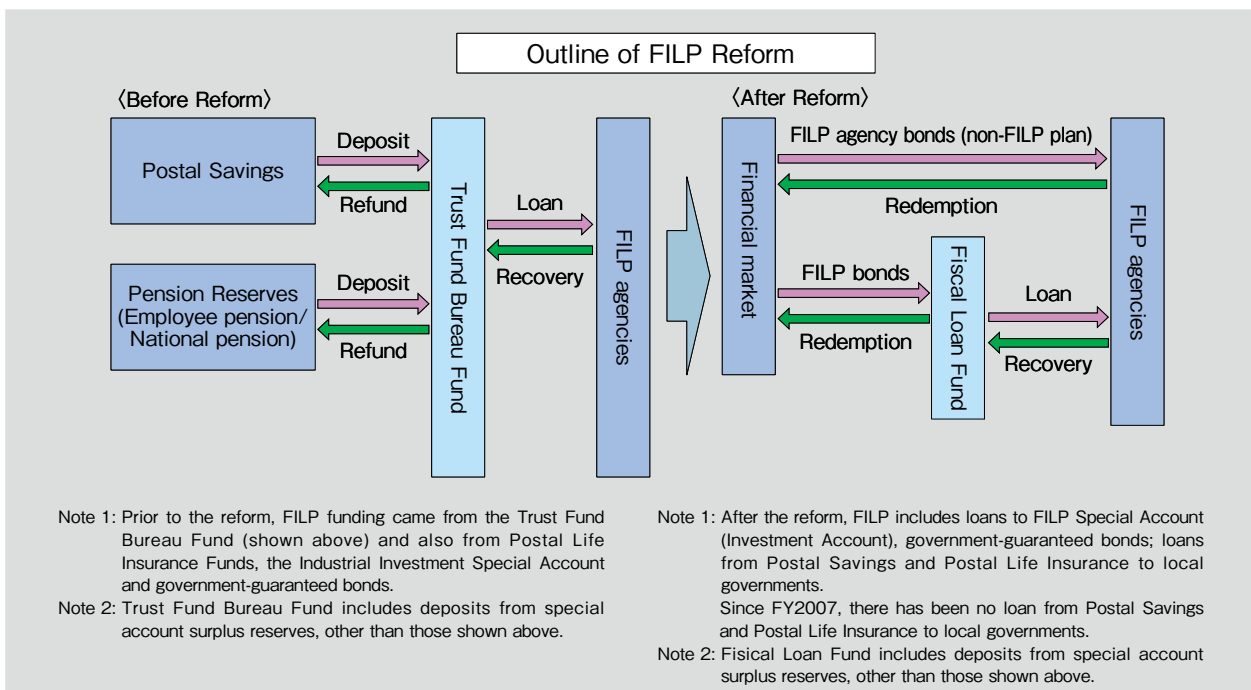
In the issuance of refunding bonds, the government is not required to seek Diet approval for the maximum issuance amount. This is because, unlike in the case of new financial resource bonds such as construction bonds and special deficit-financing bonds, issuing refunding bonds does not lead to an increase in the total amount of outstanding debt.

In addition, in order to mitigate the impact of a redemption rush and to enable flexible issuance in response to financial conditions, the government is also allowed to front-load the issuance of refunding bonds. However, this front-loading must be made within the maximum issuance amount stipulated in the special provisions of the special account budget.

B Fiscal Investment and Loan Program Bonds (FILP Bonds)

Along with the 2001 reform of the FILP (Fiscal Investment and Loan Program), the government started issuance of the Fiscal Investment and Loan Program Bonds (so-called FILP bonds) to raise funds for the investment of the Fiscal Loan Fund. As with other types of government bonds, this security is issued against the credit of the government, and its maximum issuance amount requires Diet approval (Article 62(2) of the Act on Special Accounts). Revenues from the FILP bond issuance are allotted to the annual revenue for the Special Account for the Fiscal Investment and Loan Program (FILP Special Account).

However, the FILP bonds are different from construction bonds and special deficit-financing bonds on one account. While future taxes will be used to redeem construction bonds and special deficit-financing bonds, the redemption and the interest payments on the FILP bonds are covered through the recovery of Fiscal Loan Fund loans to incorporated administrative agencies, etc. Therefore, when publishing outstanding debts, FILP bonds are treated differently from General bonds. Also in the System of National Accounts (SNA), which is the global standard of economic indicators, FILP bonds are not classified as debts of the general government.



C Other JGBs

In addition to general bonds and FILP bonds, JGBs include the following.

a Subsidy Bonds

Subsidy bonds are the government securities issued in place of provision of cash. Accordingly, issuance of subsidy bonds does not generate revenues.

Subsidy bonds are currently issued to the bereaved families of the war dead or those who suffered physical or spiritual damage in World War II and those who were repatriated after the war, in lieu of the condolence money and other compensations in cash.

In the context of leveling fiscal spending, redemption of these bonds is made over a period of several years on an installment payment basis.

Also, given the nature of these bonds that the recipients of redemption money are limited, subsidy bonds are offered as name bonds, and in principle their transfer and attachment are prohibited.

b Subscription/contribution bonds

Subscription/contribution bonds¹ are kinds of subsidy bonds, and are issued to pay the subscription or contribution in whole or in part to international institutions, in lieu of the amount to be paid in the currency. Thus, these securities are non-interest bearing, nontransferable, and payable on demand — whenever the institution concerned needs the currency and requests for encashment, the cash should be paid to the institution.

Currently, we have a total of 17 outstanding issues of subscription or contribution bonds issued to 12 institutions, including the IMF. As prescribed in the articles of agreement for each institution, using government bonds to make a payment to an international institution is permitted only when the institution concerned does not require the currency for the time being for the conduct of its operations.

Domestically, the Accession Measures Act for each international institution provides a legal base for the issuance of these subscription/contribution bonds.

c Government bonds converted from the Japan Expressway Holding and Debt Repayment Agency Bonds

Pursuant to the Act on State's Special Financial Measures on Road Construction and Improvement Projects, the general account inherited on two occasions -March 2, 2009 and March 24, 2009- The Japan Expressway Holding and Debt Repayment Agency Bonds totaling approximately 827 billion yen and converted them into government bonds.

(2) Types of JGBs

Government bonds are the securities issued by the central government. The central government pays the bondholders interests on the securities and repays the principal amount (i.e., redemption). Interest is payable on a semiannual basis and the principal amount is redeemed at maturity.

The JGBs currently issued can be classified into six categories: short-term (6-month and 1-year)²; medium-term (2-year and 5-year bonds); long-term (10-year bonds); super long-term (15-year floating-rate, 20-year, 30-year and 40-year bonds); JGBs for retail investors (5-year and 10-year); and inflation-indexed bonds (10-year).

The short-term JGBs are all discount bonds, meaning that they are issued at the price lower than the face value. No interest payments are made, but at maturity the principal amounts are redeemed at face value.

On the other hand, all medium-, long-, super long-term bonds (except for the 15-year floating-rate bonds) and JGBs for retail investors (5-year) are the bonds with fixed-rate coupons. With fixed-rate coupon-bearing bonds, the interest calculated by the coupon rate determined at the time of issuance is paid on a semiannual basis until the security matures and the principal is redeemed at face value.

1. While the difference between subscription bonds and contribution bonds is not so clear, usually the former is issued when Japan becomes a shareholder of international institution and acquires the shareholder's rights (eg. voting right), and the latter is issued to contribute to the replenishment of a special fund (ie. financial resources for interest-free, long-term lending) established within the international institution.
2. Short-term bonds were issued under the name of Treasury Bills (TB) until Jan. 2009, but are now integrated with the Financial Bills (FB) and issued as unified bills called Treasury Discount Bills (T-Bills) since Feb. 2009. (Please refer to column 4 "Issuance of Treasury Discount Bills".)

The 15-year floating-rate bonds and the JGBs for retail investors (10-year) feature their coupon rate that varies according to certain rules.

The inflation-indexed bonds is a security of which the principal amount is linked to the consumer price index (CPI). Thus, although their coupon-rate is fixed, the interest payment also fluctuates.

In the past, there used to be some other types of JGBs. But after the August 1988 issue of 3-year fixed-rate bonds, the September 2000 issue of 5-year discount bonds, the February 2001 issue of 4-year fixed-rate bonds, the March 2001 issue of 6-year fixed-rate bonds, and the November 2002 issue of 3-year discount bonds, these bonds have never been issued.

| Maturity | Short-term | Medium-term | Long-term | Super long-term |
|---|---|---|---|--|
| | 6-months, 1-year | 2-year, 5-year | 10-year | 15-year floating-rate*1 |
| Type of issue | Discount bonds | | Coupon-bearing bonds | |
| Min. face value unit | 10,000,000 yen | 50,000 yen | 50,000 yen | 100,000 yen |
| Issuance method | Public offering /BOJ switch | Public offering/ OTC sales (making offerings and accepting subscriptions) | Public offering/ OTC sales (making offerings and accepting subscriptions) | Public offering |
| Auction method | Price-competitive auction/ Conventional-style auction | Price-competitive auction/ Conventional-style auction | Price-competitive auction/ Conventional-style auction | Price-competitive auction/ Conventional-style auction |
| Non-price Competitive Auction | Non-price Competitive Auction I | Non-Competitive Auction/ Non-price Competitive Auction I / Non-price Competitive Auction II | Non-Competitive Auction/ Non-price Competitive Auction I / Non-price Competitive Auction II | Non-price Competitive Auction I / Non-price Competitive Auction II |
| Transfer | Restricted*2 | Not restricted | Not restricted | Not restricted |
| frequency of issue (FY2009 Apr. Revision) | 1-year Treasury Discount Bills: Monthly 6-month Treasury Discount Bills: Total of 0.9 tri. yen | Monthly each | Monthly | Yearly*4 |

| Maturity | Super-long term | | | JGBs for retail investors | Inflation-Indexed bonds |
|---|--|--|--|--|--|
| | 20-year | 30-year | 40-year | 10-year floating rate, 5-year fixed-rate | 10-year |
| Type of issue | Coupon-bearing bonds | | | | |
| Min. face value unit | 50,000 yen | 50,000 yen | 50,000 yen | 10,000 yen | 100,000 yen |
| Issuance method | Public offering | Public offering | Public offering | OTC sales (making offerings and accepting subscriptions) | Public offering |
| Auction method | Price-competitive auction/ Conventional-style auction | Price-competitive auction/ Conventional-style auction | Yield-competitive auction/ Dutch-style auction | - | Yield-competitive auction/ Dutch-style auction |
| Non-price Competitive Auction | Non-price Competitive Auction I / Non-price Competitive Auction II | Non-price Competitive Auction I / Non-price Competitive Auction II | Non-price Competitive Auction II | - | Non-price Competitive Auction II |
| Transfer | Not restricted | Not restricted | Not restricted | Restricted*2 | Restricted*2 |
| frequency of issue (FY2009 Apr. Revision) | Monthly | Bimonthly*3 | Quarterly*3 | All quarterly | Yearly*4 |

*1 The reference rate for 15-year floating-rate bonds is linked to the interest rate on 10-year fixed-rate bonds (the interest rate on 10-year fixed-rate bonds minus α) and is subject to change every six months, but the spread α is determined on the auction date and remains unchanged to maturity.

*2 Short-term bonds are transferable only to corporations (including certain trustees); JGBs for retail investors are transferable only to retail investors; and Inflation-Indexed bonds are transferable only to qualified corporations.

*3 The June and August issues of and the December and February issues of the 30-year bonds will in principle be reopenings of the April and October issues, respectively.

The July, November and January issues of the 40-year bonds will in principle be reopenings of the May issues.

*4 The Issuance could be called off, taking in the market conditions.

(3) JGB Market Special Participants Scheme

The so-called "primary dealer" system had been in place in major Western countries as a scheme to promote stable financing as well as to maintain and improve debt market liquidity. Given that large scale JGB issuance is expected to continue, a new scheme based on the primary dealer system was also introduced in Japan in October 2004. Under the scheme — the "JGB Market Special Participants" Scheme — the Ministry grants special entitlements to certain auction participants when they carry out responsibilities essential to debt management policies. The following is an outline of the scheme:

< Basic Outline of the JGB Market Special Participants Scheme >

A Purpose

In order to promote stable financing and to maintain and improve liquidity on the JGB market, the Ministry of Finance make corporation with "JGB Market Special Participants" who are key role players in the JGB market and participate in planning and operating JGB management policies with special entitlements and responsibilities.

B Responsibilities of Special Participants

- a Bidding responsibility: In every auction, the Special Participants shall bid for an adequate amount (at least 3% of the planned issue amount) at reasonable prices.
- b Purchasing responsibility: The Special Participants shall purchase and underwrite at least a specified share of the planned total issue amount (1% in principle) in each of the super long-term, long-term, medium-term and short-term zones in auctions for the preceding two quarters.
- c Responsibility on the secondary market: The Special Participants shall provide sufficient liquidity to the JGB secondary market.
- d Information sharing: The Special Participants shall provide information on JGB markets and related transactions to the Ministry of Finance.

C Entitlements of Special Participants

- a Participation in the Meeting of JGB Market Special Participants: The Special Participants can take part in the meeting, held as a rule on a quarterly basis, in order to exchange opinions with the Ministry on debt management policies.
- b Participation in buy-back auctions: The Special Participants can take part in buy-back auctions.
- c Separation and integration of STRIPS bonds: The Special Participants can apply for the separation and integration of STRIPS.
- d Participation in Non-price Competitive Auctions: The Special Participants can take part in Non-price Competitive Auction I (held concurrently with normal competitive auctions) and Non-price Competitive Auction II (held after normal competitive auctions). These auctions enable Special Participants to obtain bonds at the weighed average accepted price at a competitive price auction, up to a purchasing limit preset for each Participant on the basis of past accepted price (Non-price Competitive Auction I) and past subscriptions (Non-price Competitive Auction II).
- e Participation in Auctions for Enhanced-Liquidity: The Special Participants can take part in Auctions for Enhanced-liquidity that are designed to maintain and improve liquidity on the JGB market.
- f Preferential Participation in Interest Rate Swap Transactions: The Special Participants can be preferential counterparties for the interest rate swap transactions implemented by the Ministry.

D History of Introduction of Systems

- October 2004: JGB Market Special Participants system was introduced (Special Participants were designated. Meeting of Special Participants started. The Non-price Competitive Auction II was launched.).
- April 2005: The Non-price Competitive Auction I was launched.
- January 2006: Interest rate swap transactions started.
- March 2006: The government bond syndicate underwriting system was abolished.
- April 2006: Auction for Enhanced-liquidity was launched.

(4) Methods of Issuance

Methods of issuing JGBs are basically divided into three: offerings for the market, offerings for retail investors, and offerings for the public sector.

A Offering for the market

JGBs are principally issued in public offering on market-based issue terms.

a Price/yield-competitive auction

Price/yield-competitive auction is a method in which each auction participant submits a bidding price (or yield) and bidding amount in response to the issue terms (e.g., issue amount, maturity, coupon rate) presented by the Ministry, and the issue price and amount will then be determined based on the bids.

In this type of auction, the issuing authority starts selling first to the highest price bidder in descending order (or to the lowest yield bidder in ascending order) till the cumulative total reaches the planned issue amount.

In Japan, the auction method varies by type of security. One is the conventional method by which each winning bidder purchases the security at his bidding price; and the other is the Dutch-style method by which all winning bidders pay the same lowest price of their biddings regardless of their original bid³.

In order to increase government bond liquidity, the Ministry also started implementing the immediate reopening rule effective from March 2001 issues. When a new issue is offered by the Ministry of Finance, both its coupon rate and principal/interest payment dates may occasionally correspond to those of a specific issue outstanding. In such a case, the Ministry of Finance reopens the outstanding issue additionally. And then, as soon as it comes into the market, the reopened issue is immediately dealt as the outstanding issue based on the immediate reopening rule. Also, under the new rule, a reopened issue will generate accrued interest⁴.

Furthermore, in April 2006, Auctions for Enhanced-liquidity, in which the outstanding issues with scarce liquidity are additionally reopened, were introduced to maintain and enhance the liquidity of the secondary market.

b Non-competitive auction

Besides competitive auction, 2-year, 5-year and 10-year bonds are also issued through noncompetitive auction. This approach is to take into account small and medium market participants who tend to submit a smaller bid than their larger counterparts. Biddings for non-competitive auction are offered at the same time as for the price-competitive auction, and the price offered equals to the weighted average accepted price of the price-competitive auction. One can bid for either the price competitive auction or for the non-price competitive auction.

The maximum issue amount is 10% of the planned issue amount. Each participant, excluding the Shinkin Central Bank, the Shinkumi Federation Bank, the Rokinren Bank and the Norinchukin Bank, is permitted to bid up to 1 billion yen.

c Non-price competitive auction I & II

Non-price competitive auction I is an auction in which biddings are offered at the same time as for the price-competitive auction. The maximum issuance amount is set at 10 % of the total planned issue amount and the price offered is equal to the weighted average accepted price of the price-competitive auction. Only the JGB market special participants are eligible to bid in this auction. Each participant is allowed to bid up to the amount set based on the result of its successful bids during the preceding two quarters.

Non-price competitive auction II is an auction carried out after the competitive auction is finished. The price offered is equal to the weighted average accepted price in the price-competitive auction or lowest accepted price in Dutch-style yield-competitive auction. Only the JGB market special participants are eligible to bid in this auction. Each participant is allowed to bid up to the 15% of one's total successful biddings in the competitive auction and non-price competitive auction I.

B Methods of selling JGBs to retail investors

a JGBs for retail investors

JGBs for retail investors are sold by private financial institutions using an intermediary method. By this method, under commission from the government, financial institutions solicit subscriptions for JGBs for retail investors from, and sell JGBs to, retail investors.

b New over-the-counter (OTC) method for selling marketable JGBs

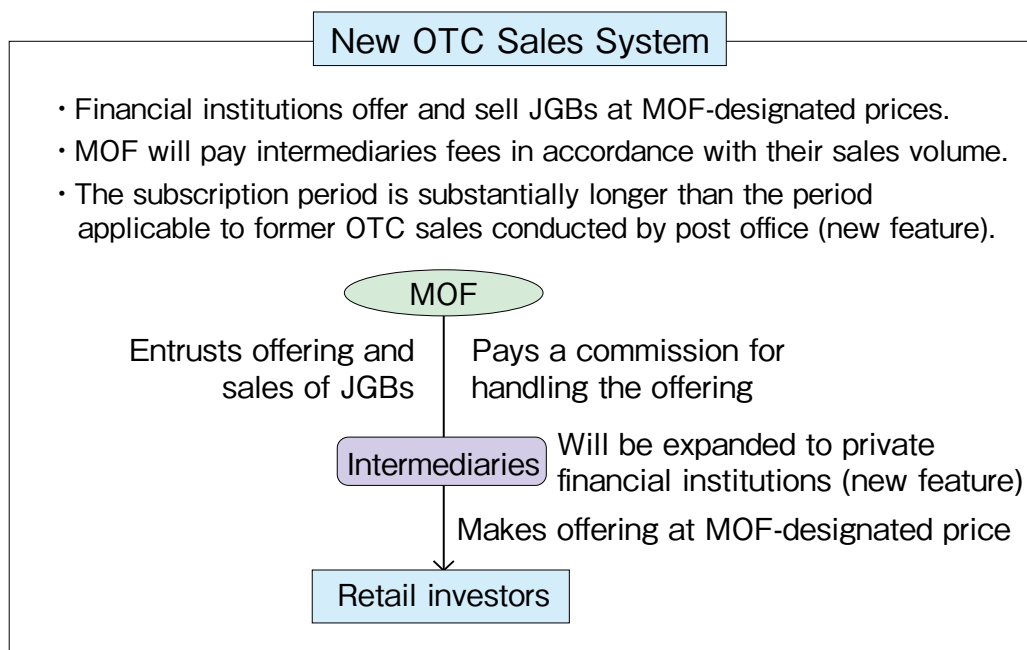
In addition to JGBs for retail investors, in October 2007 a new OTC sales system for marketable JGBs was introduced in order to increase retail investor purchase opportunities with regard to JGBs. With regard to this new OTC sales method, it allows private financial institutions to engage in subscription-based OTC sales of JGBs in a manner previously exclusive to post offices. This development allows retail investors to purchase JGBs via financial institutions with whom they are familiar, it also allows them to purchase JGBs in a manner that is essentially ongoing (as of April 1, 2009, 745 institutions are conducting subscription-based sales of JGBs). Note that JGBs covered by the new OTC sales method are 2-year, 5-year, and 10-year marketable bonds.

As with JGBs for retail investors, for the new OTC sales method, MOF has commissioned financial institutions to conduct subscriptions and sales of JGBs. MOF pays subscription handling charges to these institutions based on the value (volume) of subscriptions handled by them. Note that while these financial institutions are required to subscribe and sell JGBs at prices defined by MOF within a defined period, they are not required to purchase any unsold JGBs.

3. Except for Inflation-Indexed bonds and 40-years bonds, offered via Dutch-style yield-competitive auction, all the JGBs are offered via the conventional price competitive auction.

4. Six-month interest will be paid in full to bondholders at the first interest payment even when the bondholding period during the purchase to the first interest payment will amount to less than six months. To make the necessary adjustment, bondholders are required to pay accrued interest at the time of purchase (i.e., the interest for the period calculated by subtracting the actual bondholding period from six months).

< New OTC Sales System >



*Each financial institution is free to continue adopting Secondary Method (OTC sales of JGBs at mark-up prices upon principle purchase).

< Comparison of new over-the-counter (OTC) sales system and JGBs for retail Investors >

| | New OTC JGBs | | | JGBs for Retail Investors | |
|--|---|------------------------------------|-------------------------------------|--|---|
| | 2-year marketable fixed-rate bonds | 5-year marketable fixed-rate bonds | 10-year marketable fixed-rate bonds | 10-year floating-rate | 5-year fixed-rate |
| Issue frequency | Monthly (12 times a year) | | | Quarterly (4 times a year) | |
| Purchase units and purchase value limits | Minimum purchase of 50 thousand yen in 50 thousand yen units. Maximum value of 100 million yen per individual application | | | Minimum purchase of 10 thousand yen in 10 thousand yen units. No upper limit value. | |
| Sales price | Determined by MOF for each issue | | | 100 yen per 100 yen of face value | |
| Eligible purchasers | No restrictions (can also be purchased by corporate entities or condominium associations, etc.) | | | Retail investors only | |
| Interest type | Fixed-rate | | | Floating-rate | Fixed-rate |
| Redemption before maturity | Possible to sell at any time on the market (However, because the price at time of sale shall be the market price at that time, loss/profit shall occur on sale. Furthermore, there is no scheme for the government to buyback these bonds before maturity.) | | | Once one (1) year has elapsed since issue, redemption before maturity due to government buy-back shall be possible at any time. Face value + accrued interest - the two interest payments immediately preceding redemption (pre - tax) x 0.8 | Once two (2) years have elapsed since issue, redemption before maturity due to government Buy-back shall be possible at any time. Face value + accrued interest - the four interest payments immediately preceding redemption (pre - tax) x 0.8 |

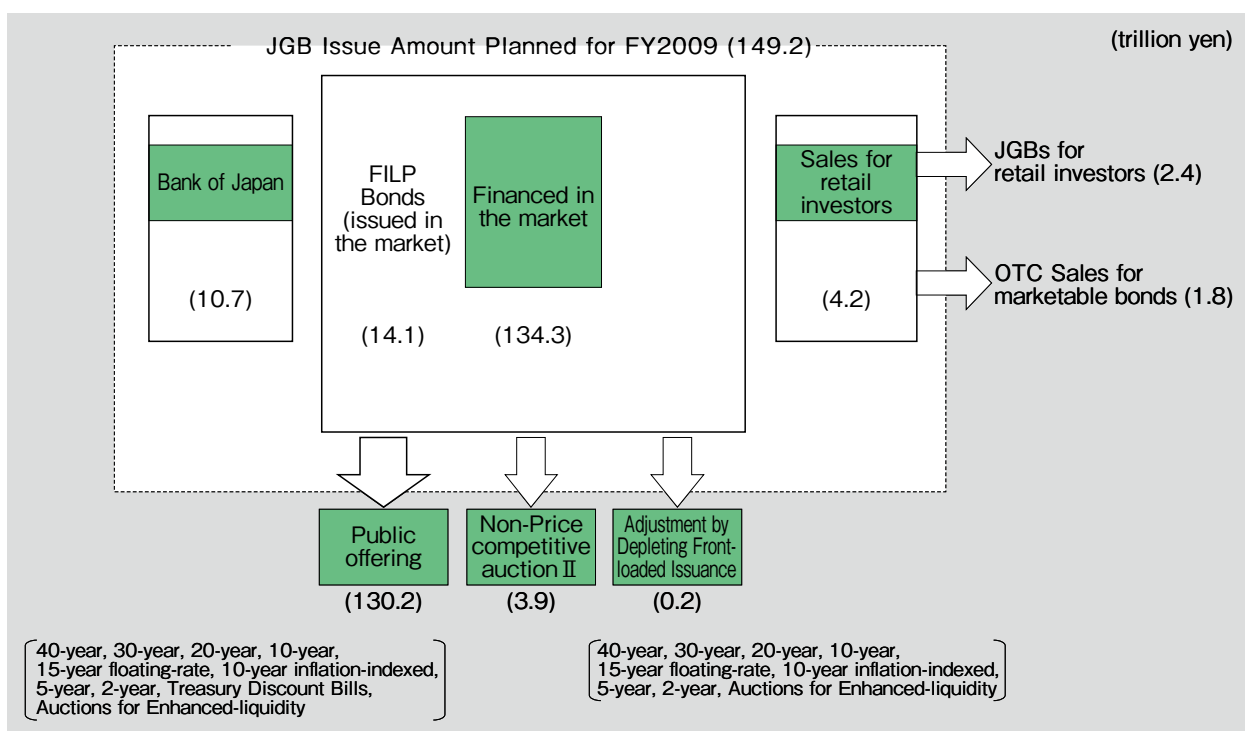
C Offering for the public sector (Bank of Japan Switch — Underwriting by the BOJ to roll over maturing bonds)

While Article 5 of the Public Finance Act prohibits the Bank of Japan from underwriting government bonds, a proviso to the Article allows the BOJ to extend credit to the government, up to an amount authorized by the Diet, in exceptional cases.

In practice, such cases are limited to underwriting of refunding bonds within the amount of JGBs that are held by the BOJ and have reached maturity (— often referred to as "switch underwriting" or "roll-over underwriting").

Through its market operations, the BOJ holds a large amount of government bonds. If the BOJ tried to have its JGB holdings redeemed in cash, the Ministry of Finance would be required to issue refunding bonds in the market to raise the fund needed for redemption. A massive issuance of refunding bonds in the market, however, could invite a fund shortage in the private sector, thus obliging the BOJ to provide the private sector with funds by purchasing a substantial amount of the refunding bonds from private sector. To avoid such roundaboutness, the BOJ is exceptionally allowed to underwrite only up to the amount necessary to roll over its maturing bonds.

< JGB Issue amount by method of issuance >



(5) Government Bond Administration

A Items the Bank of Japan handles

The Ministry of Finance entrusts the Bank of Japan with most of the government bond-related administrative tasks, such as issuance and redemption. Specifically, those administrative tasks include the following.

- Issuance-related: The BOJ accepts bids from bidders in auctions, notifies accepted bids, collects payments, issues the securities, and receives and handles revenues.
- Redemption/interest payment-related: The BOJ pays principal and interests on JGBs, and receives and handles funds to be used for redemption, and makes their disbursement.

The BOJ provides these government bond-related services through its head office and branches, and through agent financial institutions throughout the country.

B The Bank of Japan government bond network system

The Bank of Japan Financial Network System, commonly known as the BOJ-NET, is an online computer network system that connects the central bank and other financial institutions. The BOJ-NET has been developed to make administrative procedures / operations more efficient and paperless.

To be precise, the BOJ-NET consists of two systems: the BOJ-NET Funds Transfer System; and the BOJ-NET JGB Services.

The BOJ-NET JGB Services allow the following procedures to be completed online.

- Notification of offering (the BOJ to auction participants)
- Bidding (bidders to the BOJ)
- Report to the Ministry of Finance on total bidding
- Notification of accepted/allocated bids (the BOJ to bidders)
- Issue and payment (the BOJ to purchasers / purchasers to the BOJ)

C Auction procedures for public offering auction

