Minutes of the Meeting of JGB Market Special Participants
(76th Round)

- Date: Monday, June 25, 2018 (4:00 p.m. to 4:50 p.m.)
- Place: Special Conference Room 3, Ministry of Finance
- Gist of the Proceedings

1. Issuance amount of Inflation-Indexed Bonds in the July–September 2018 quarter

▸ The Financial Bureau gave the following explanation about the issuance amount of Inflation-Indexed Bonds in the July–September 2018 quarter:

・As regards Inflation-Indexed Bonds the JGB Issuance Plan for FY2018 says on page 3 that "the debt management office flexibly adjust issuance amounts taking into consideration opinions exchanged with JGB market participants, the market environment and investment demands" for making four issuances in the year by the per-issuance amount of ¥400 billion. Therefore, today we would like to hear your opinions about the issuance amounts in the July - September 2018 quarter.

・For the April–June quarter, as shown on page 4, we conducted the auction for the issuance amount of ¥400 billion in May and Buy-back Auctions in the amount of ¥20 billion in April and June. Page 5 shows that the May auctions continued to successfully end, as seen for example by the bid-to-cover ratio of 4.01, the highest since issuance was resumed. While we saw some wavering of the bid-to-cover ratio with regard to Buy-back Auctions and the Bank of Japan (BOJ)'s Outright Purchase of JGBs, the results were generally stable and conformed to market yields as shown on page 6.

The secondary market has continued to be stable over the past months with the BEI around 0.5% as shown on page 7.

・In such circumstances, we asked for your opinions beforehand and found that many of you are concerned about the continuing limited expansion of the investor base for Inflation-Indexed Bonds, therefore being of the opinion that the debt management office should desirably maintain for the July - September quarter the

current issuance amounts of Inflation-Indexed Bonds and of Buy-back Auctions.

・In view of such a situation, as shown on page 8, we are considering issuing Inflation-Indexed Bonds in the July - September quarter in the amount of ¥400 billion and carrying out Buy-back Auctions in the amount of ¥20 billion in the even-numbered month of August, in the same amount as the April - June quarter.

・The development of the market for Inflation-Indexed Bonds, is an important issue related to the Debt Management Policy. Therefore, we would like to hear your opinions, on the direction of our policy related to the issuance amounts in the July - September quarter, the auction schedule at equal intervals, etc.

▸ Summarized below are the views and opinions expressed by the attendees:

・We agree to the proposal. Even with the significant shakeups that have occurred in the external environment since April, BEI is steadily transitioning by about 55–60 bps and the results of BOJ's Outright Purchase of JGBs have also been comparatively stable. Since we are not currently experiencing any oversupply or excess demand, we request to maintain the current issuance amount.

・We agree to the proposal. While the February auctions were held during a time of market confusion and thus produced somewhat sluggish results, the auctions in May had a more substantive outcome. Although it would be premature to increase the issuance amount, we believe that maintaining the current amount is the correct approach in terms of further market development. We request to continue holding a single ¥20-billion Buy-back Auctions in each even-numbered month.

・We have no objection to the proposal. Looking over the medium term, the demand-supply balance is perfectly balanced. If the market's liquidity improved and its number of participants increased, we request to raise the issuance amount, but that is not currently the case. On the other hand, we don't want the issuance amount to decrease because that would create doubt as to the debt management office's commitment to Inflation-Indexed Bonds. Buy-back Auctions could conceivably be held every month; but since supply and demand are balanced, there won't be any problems sticking with the ¥20 billion in the even-numbered months.

・There is no problem with an issuance amount of ¥400 billion per auction. Ever since the May auctions and their strong results, however, our company has witnessed a single-minded drive among foreign investors to sell, with sales inquiries coming in almost daily. Although prices are holding, we get the impression that the demand-supply balance has deteriorated considerably. We would therefore rather have ¥20 billion of Buy-back Auctions every month rather than every other month because doing so will even out the demand-supply balance.

2. Liquidity Enhancement Auctions for the July–September 2018 quarter

▸ The Financial Bureau provided the following explanation regarding the Liquidity Enhancement Auctions for the July–September 2018 quarter:

・As shown on page 10, the FY2018 JGB Issuance Plan states the following about the Liquidity Enhancement Auctions:
(1)While the operating assumption is that the total annual issuance amount will be ¥12.6 trillion (¥2.4 trillion for the 1 - 5 - remaining - year zone, ¥7.2 trillion for the 5 - 15.5 - remaining -year zone, and ¥3.0 trillion for the 15.5 - 39 - remaining - year zone),
(2)ultimately, “based on discussions with market participants, the issuance amount for each zone would be adjusted flexibly manner in response to the market environment and investment demands”.
Accordingly, we request you to discuss the issuance amount for each zone in the July–September quarter.

・Page 11 shows that issuance for the April–June quarter went according to the JGB Issuance Plan; ¥400 billion was issued in May for the 1 - 5 - remaining - year zone, ¥600 billion was issued each month for the 5 - 15.5 - remaining - year zone, and ¥500 billion was issued in April and June for the 15.5 - 39 - remaining – year zone.

・Page 12 and after shows the results of the Liquidity Enhancement Auctions. Each zone exhibited stable results.

・When we heard opinions under these conditions about the Liquidity Enhancement Auctions for the July - September quarter from the JGB Market Special Participants

in advance, there were many opinions that maintaining the current issuance amount is appropriate.

・In view of such a situation, we have prepared our proposal for each zone's issuance amount during the July–September quarter (see page 15). We are considering issuing ¥400 billion in July and September for the 1 - 5 - remaining - year zone, ¥600 billion each month for the 5 - 15.5 - remaining - year zone, and ¥500 billion in August for the 15.5 - 39 - remaining – year zone.

It is also worth mentioning that the starting point for calculating a bond's term as listed in the note on page 15 will be slightly different than before due to the reduction in settlement time for issues of 2-Year Bonds, but the basic approach to the rules regarding bond selection remains unchanged.

・Based on today's discussion, we will decide the issuance amount for each zone of the Liquidity Enhancement Auctions in the July - September quarter, and so we would like to ask for opinions.

▸ Summarized below are the views and opinions expressed by the attendees:

・We agree to the proposal. Until now, we have requested that the issuance amount be increased for the 1 - 5 - remaining - year zone. However, recently some investors have stopped purchasing off-the-run issues of bonds in the 3 - 4 - remaining - year zone, and the chronic short-cover needs of securities companies in this sector have also waned; therefore, we request to maintain the status quo. The 15.5 - 39 - remaining - year zone is burdened by an issuance amount greater than the 40-Year Bonds auction, which made for somewhat weak results in the April auction. We thus find it difficult to increase the issuance amount for the 15.5 - 39 - remaining - year zone at this time. We just increased the issuance amount for Liquidity Enhancement Auctions in the April–June quarter (relative to the previous fiscal year), so revising it again now would be the second time in three months that such a change has been made. We request to maintain the current issuance amount to guarantee continuity.

・We agree to the proposal. The demand-supply balance has essentially been achieved with the current issuance amount. If we were to increase the issuance amount for the 1 -5 - remaining - year zone and decrease it for the 15.5 - 39 - remaining - year zone, we might flatten the yield curve and ultimately stymie

demand from investors. Furthermore, because bonds in the vicinity of the cheapest futures are quite scarce, maintaining an issuance amount of ¥600 billion per auction is appropriate for the 5 -15.5 - remaining - year zone.

・We agree to the proposal. Demand-supply condition for the 1 - 5 - remaining - year zone has been tight for quite some time, and we feel that there is some leeway for increasing the issuance amount to forestall that tightening. But based on the most recent demand-supply condition, we have no objections to maintaining an issuance amount of ¥400 billion per auction. The proposal for the 15.5 - 39 - remaining - year zone is a good one because increasing its issuance amount may give rise to concerns about the continued stability of bond issuance in that zone.

・We agree to the proposal. Decreasing the issuance amount for the 5 - 15.5 - remaining - year zone and increasing it for the 1 - 5 - remaining - year zone is conceivable, but we might as well monitor the situation for a while to see how the demand-supply condition fluctuate.

3. Latest JGB market situation and outlook for future

▸Summarized below are the views and opinions presented by the attendees：

・This April, the yields for 20-Year Bonds, 30-Year Bonds, and 40-Year Bonds hit their lowest levels since December 2016. We expect this as the result of some investors purchasing JGBs with longer maturities to ensure a certain level of interest rate revenue while keeping in mind the redemption of their JGBs with high coupons (0.4% for 5-Year Bonds and 1.8% for 10-Year Bonds) in June. And just like last fiscal year, investing in US bonds is difficult due to the rising funding costs of dollars, which has allowed JGBs to make somewhat of a comeback.

While interest rates for US bonds increased in April, interest rates for JGBs have remained largely unchanged under the yield curve control of the BOJ, and we expect that trend to continue into the future. Although we think that an immediate exit to the monetary policy would be difficult, we can imagine market participants investing in JGBs with longer maturities due to concerns that the long-term interest rate target of 0% will be raised.

・While the FRB continues to raise interest rates, the ECB has indicated that it will maintain its policy interest rate until around the summer of next year, which makes it hard for interest rates to increase on the European continent. With JGBs, there continues to be scant motivation as interest rates fluctuate within an extremely narrow range, with interest rates for 10-Year Bonds staying above 0.025%.

Under these circumstances, we can't help but recognize that the market function has declined. And the context for this is a market environment which simply lacks availability, as evidenced by things like each bond in the vicinity of the cheapest having an outstanding amount of less than ¥1 trillion due to Outright Purchase of JGBs. Moreover, the health of securities companies is deteriorating amidst poor post-auction performance and trading within the market has decreased substantially. There is the sense of an impending crisis that these conditions may continue.

If the market loses its function and its participants, there won't be anyone left to buy bonds in the event that something happens, and we are concerned that the market will be highly volatile in such a situation. We must give serious thought to how we can preserve the function of the market.

・If these conditions of extremely low volatility persist, the revenue of bond departments will decline and the balance-sheet funds allocated to them will also decrease. We are concerned that this state of "lows"—low interest rates, low volatility, and low earnings—will continue and cause us to lose the market depth we will need when interest rates do change, which is something we would like the debt management office to be cognizant of.

・We think that the focus is now on transactions that are reliant on the Outright Purchase of JGBs and are unrelated to the external environment, and that has led to the loss of the important fair-price function of the market. Furthermore, extending this period of low interest rates and low volatility that significantly diverge from the fundamentals has greatly dulled interest in buying and selling the scarcely profitable JGBs and has reduced the number of market participants.

While it may seem that a narrow bid-ask spread does not cause liquidity problems, in reality there aren't any transactions except those focusing on the current bond, and few options exist for buying or selling off-the-run bonds. We feel that these conditions are worsening day by day and that makes us worried about liquidity.

・The behavior of market participants has become uniform and there is no longer any variation in market forecasts. Right now, if we actively build a single position, we cannot unwind it easily, which we feel makes it difficult to hold excessively large positions. Primary dealers must be the ones providing liquidity within the JGB market, but there is a real danger that the function of market makers will decline throughout the entire industry if current developments continue.

・Decreasing volatility has caused price correction among bonds on the yield curve to occur only rarely, and trading by foreign hedge-fund investors and active pensions has also declined.

Even today, very few traders are buying and selling the current bond between traders. Due to this ongoing situation, profitability has declined and managers have had no choice but to reconsider the balance sheets, funds, and personnel allocated to bond departments. We feel that it has become difficult to maintain the functions of the market in future.

・The current issues have relatively good liquidity, and transactions involving it can take place freely; but we feel that the suitable size transactions of off-the-run bonds are impossible, which (along with their declining liquidity) makes them difficult.

Therefore, we feel that the market is extremely appreciative when off-the-run bonds are issued via Liquidity Enhancement Auctions.

・We find that the shortening of settlement cycle to T+1 for JGB market has gone smoothly, and we don't feel any inconvenience in terms of the execution of transactions. In the repo market, a spread has arisen between standard transactions and subsequent collateral allocation transactions, which is creating arbitrage opportunities. We feel that it has given the post-T+1 market its shape with the liquidity generated by that.

・We still hear some investors request transactions with a settlement time of T+2, therefore we can't say that the entire market has completely transitioned to the T+1 settlement. But if we set aside that small group, the transition to T+1 settlement has been trouble-free and the overall system is functioning quite well, including our company's back-office activities.

・Even though foreign investors were excluded from the transition to T+1

settlement this time, we occasionally hear some of them say that they would like transactions settled by T+1 as well.

・We think that the transition to T+1 settlement has gone smoothly and not encountered any major problems. The current challenge, however, is that the overall decline in market liquidity has caused T+1 transactions between traders to taper off even more after 3 p.m., a time period when T+1 repo transactions among investors had already decreased due to the high administrative workload. And as a securities company, we would be extremely grateful if the base of investors who participate in GC repo under subsequent collateral allocation method was expanded.

・When the JGB settlement cycle was shortened to T+1, liquidity in the repo market temporarily declined. That liquidity has largely been restored as of late, but we feel that the funding of securities companies continues to be a little tight.