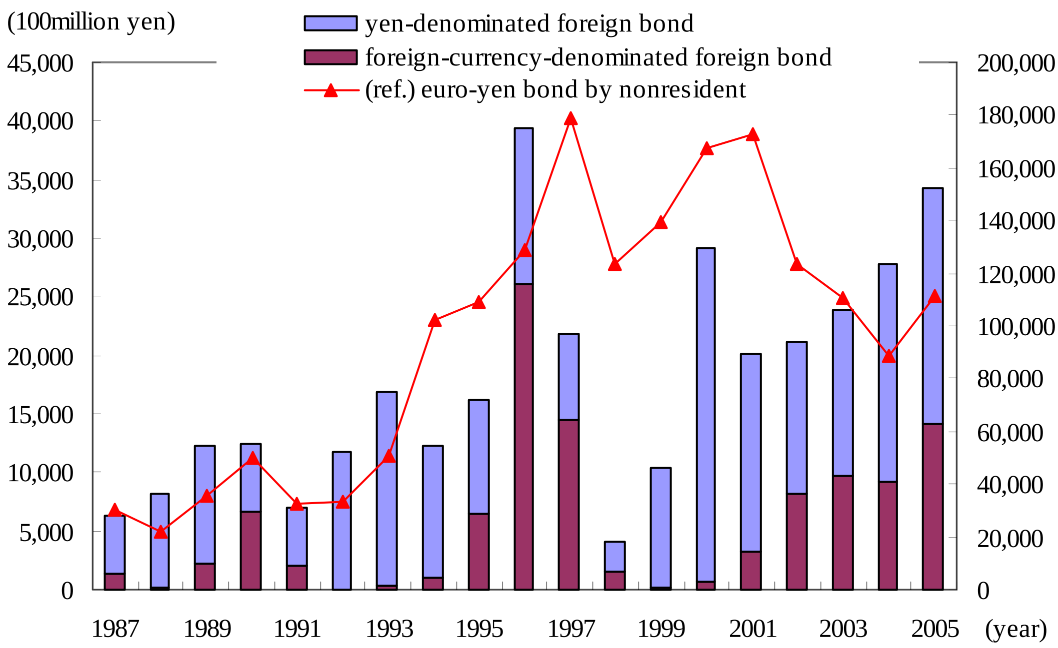
Chapter 2: Creating a more Active Tokyo Financial Market

This chapter will review the infrastructure issues of the current Tokyo bond market from the perspective of the nonresident issuers and nonresident investors.

1. Environment for the Nonresident Issuers

There are two possible categories of nonresident issuers: sovereign (governments or government agencies) and foreign corporations. The following discussion is mainly on corporate issuers but also refer to sovereign issuers. What issuers require to a market is the environment where they can raise the fund flexibly. There used to be numbers of inadequacy pointed out in the Tokyo Samurai Bond market, when compared to the euro markets, mainly to the London market. But its reputation has been rising in recent years as a market where large scale funds can be raised for M&A and capital increase.

Figure 1: Bond issuance and offerings in Japan by nonresidents



Compiled from data of Ministry of Finance Japan

To issue a bond in Tokyo bond market, there are two methods, Securities Registration Statement (SRS) and the Hakkou-Touroku (Shelf).

Table 1: comparison of the two methods of issuance

	SRS	Shelf
outline	The issuer must submit a securities registration statement (SRS) to the prime minister on offering or selling securities. However, it is not necessary to file a statement “if a disclosure has already been made about the securities”, “if the intended buyers are qualified institutional investors (professional private placement)” and “if the total issue amount or issue price is less than 100 million yen”. When a statement is filed, it instantly becomes available to the public, and the issuer who is offering or selling the bonds can immediately begin soliciting investors. However, actual sales cannot be made until the statement become effective.	Issuance companies that meet certain criteria can place securities on sale by filing supplement documents, which states only the terms of issue, without filing the offerings or secondary offerings of the said securities if they had filed a shelf registration statement on the planned offerings and secondary offerings of securities within a certain period of time with the Minister of Finance primarily.
Required documents	SRS and attachments (documents that are deemed necessary and appropriate in the cabinet ordinance for public interest or investor protection such as legal opinion and contract) A copy of the contract with signatures after the issuance conditions are determined. When an issuer whose securities are listed in a securities exchange submits a SRS, the issuer must send a copy of the statement to the exchange. When an issuer of over-the-counter stocks submits a SRS, the issuer must supply a copy to the National Association of Securities Dealers.	Shelf registration statement with attachments, Supplement and attachments.
Conditions	Samurai bonds are divided into sovereign bonds and corporate bonds. Both needs to meet the disclosure requirements of the Securities and Exchange Law. International organizations in which Japan is represented are exempt from filing this document. Disclosure format: Issuers of sovereign bonds must prepare the securities registration statement in accordance with “the Cabinet ordinance regarding the disclosure of the details of the issuer of foreign bonds, etc.” (foreign bond ordinance) Issuers of corporate bonds must prepare the securities registration statement in accordance with “the Cabinet ordinance regarding the disclosure of the details of the corporation” in the same way as domestic corporations. Language use for disclosure: Japanese	The issuer must meet the following two criteria: <1> continuous discloser The issuer must have submitted a financial report continuously at least for a year. <2> public information In addition to <1>, the issuer must meet at least one of the following four criteria. • Market value at the time of primary filing is 25 billion yen or more. • Market value beyond 10 billion yen or more and stock trading value beyond 10 billion yen. • The issuer has two or more credit rating equivalent to or better than A-by designated credit rating institutions. • The issuer is a company that can issue general mortgage bonds.
Credit ratings/listing	Optional. However, if the issuer has no credit ratings, it should be noted that “credit rating not obtained” in the notification statement.	
Applied law	Japanese laws	
procedures	The issuer submits a SRS. If an amendment is submitted to increase or decrease the issuance amount depending on the margin of change in the issuance amount, it would take two to four days until the amendment become effective.	The issuer set up a shelf for a scheduled amount and period (maximum period is 2 years). File the Supplement at each time of new issuance.(Supplement: documents that provide the information on conditions that were previously unknown. Major items of information are issue amount, term, issuance/redemption date, issue amount and rate.)
Time before launch	Statement will become effective after "15 days have passed" after the day it was submitted. Public holidays are included in the 15 days but the holidays at the beginning and the end of a year could be treated differently. (This is laid down as the period to inform investors from the view of investor protection. With the introduction of the EDINET, information is posted within 30 minutes to two hours after it is submitted.)	Registration become effective after “seven days have passed” since filing.
Market risk	If offering cannot be made on the day the conditions are determined, market risk of one to two days will arise until the day of offering.	In theory, it is possible to conclude all procedures on the day the primary filing becomes effective by submitting the Supplement.
Recent reforms		“Widening the qualification conditions of the users of Hakkou-Touroku” was enacted in January 2003. This allowed the non-listed, non-registered foreign corporations which previously were not allowed to employ the system to do so in the same way as the domestic non-listed, non-registered companies.

compiled by IIMA based on interviews with market participants

(1) Issuance by SRS

<1> Outline of the issuance procedures

On issuing a Samurai bond, the issuer must prepare and file a SRS to the Kanto Local Financial Bureau. The issuer must also disclose required information in accordance with the Securities and Exchange Law, but international organizations in which Japan is represented are exempt from this rule.

The documents for disclosure must be in compliance with "The Cabinet ordinance regarding the disclosure of the details of the issuer of foreign bonds, etc." (foreign bond ordinance) for sovereign issuers and "The Cabinet ordinance regarding the disclosure of the information on the issuing corporation, etc" (ordinance on disclosure) for foreign corporate issuers just as for Japanese corporations. When the SRS is prepared, the statement and attachments (documents that are deemed necessary and appropriate in the cabinet ordinance for public interest or investor protection such as legal opinion and contract) must be filed. Fifteen days after the filing of the documents, the registered statement would be effective. When an issuer whose stocks are listed in the Stock Exchange files a SRS, the issuer should send a copy of the statement to the Stock Exchange. When an issuer of over-the-counter stocks files a statement, the issuer should send a copy to the National Association of Securities Dealers.

<2> points

Although issuance by filing a SRS was not structured to provide flexibility in fund raising, there are numbers of regulations that inhibit flexibility and efficiency.

First, items that are listed in the statement regarding the offering or secondary offering (securities information) that can be omitted according to the Securities and Exchange Law are limited to a few items such as issue amount and interest rate (others are underwriter, managing company, registration organization, place of principal and interest payment and down payment for application and so on) by the Cabinet ordinance. It is difficult to change the offering date after the statement is submitted and no changes in term or securities information (such as attachment of a special clause) are accepted.

Second, if an amendment is filed, it would take time until it will become effective. Sometimes it is difficult to expect how long it takes to be effective. If there is a change in the issue amount, it would take two to four days until the notification become effective and how long it takes depend on the margin of change. The issue amount may change depending on the movement of market environment. Since the effective date of the statement varies according to the margin of change, it would affect the offering date and could be an obstacle for a flexible issuance. In case "information on the issuer" is amended, the days required for amendment to become effective varies (in most cases it takes four days but it could take more days according to the item amended) and this becomes a significant obstacle when the offering is made internationally in various markets.

In addition, it is also pointed out that preparing SRS documents requires more paperwork and costs than that of Shelf.

(2) Issuance by Hakkou-Touroku (Shelf)

In Europe and the United States, shelf registration is used widely as a most time-efficient method of bond issuance. This method is handy when the market environment is volatile. Japan followed this example and created the “Hakkou-Touroku” (Shelf) in 1988.

The advantages of issuance by Shelf compared to filing the SRS is that the method allows issuance at any time just by submitting Supplement provided that Shelf is set up for a scheduled amount and period. It also has the advantage of being able to shorten the period required to issue by 8 days compared to issuance by SRS[1].

In case of companies that are listed in the securities exchange (or over-the-counter), they can utilize this system to issue bonds if they meet the following two criteria by submitting the statement and attachments.

<1> continuous disclosure

The issuer must have submitted a financial report continuously for at least a year.

<2> public information

In addition to <1> the issuer must meet at least one of the following four criteria.

- Market value at the time of primary filing is 25 billion yen or more.
- Market value and stock trading value of the annual basis for past three years from the primary filing date is 10 billion yen or more.
- The issuer has two or more credit rating equivalent to or better than A- by designated rating agencies.
- The issuer is a company that can issue general mortgage bonds (Companies that come under the category are electricity companies, NTT, etc. Normal corporate entities do not apply)

Regarding the <2> public information criteria, initially there was a proviso that said that “the non-listed domestic companies could be eligible of primary filing by meeting the credit rating standard” but it was not applied to non-listed nonresident issuers. However, in the Cabinet ordinance reform of January 2003, the words “domestic companies” were deleted from the text. This enabled non-listed foreign companies to use the Shelf as long as it acquired the required credit ratings, in the same way that non-listed, non-over-the-counter domestic companies do. This increased the number of issuers that can take advantage of this method.

As a result of the various system reforms, the conditions for issuing Samurai bonds were improved to about the same standard as those for euro-yen bonds. There is still a disparity between the two issuances in the required fixed costs such as the lawyers’ fees for producing contracts and other documents required for issuance. This means that euro-yen bonds are preferred to Samurai bonds except for large scale issuances by issuers who can lower the per unit issuance cost.

(3) Types of bonds

The corporate bond registration system is a system unique to Japan and said to have been an unfamiliar system for foreign investors. But this system would make a shift to paperless. Following are the 3 types of bonds and the difference in the system depending on those types.

<1>Physical bonds

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[1] In the case of issuance by Shelf, the issuer can launch a bond on the day when the issuer submits Supplement, provided that 8 calendar days have passed since the issuer had submitted the shelf registration statement.

Actual certificates which are issued unlike recorded bonds or book-entry transfer bonds.

<2> Registered bonds

Registered bonds are bonds whose holders are recorded at the registration institution (Bank of Japan for government bonds, private banks for others) in accordance with the book-entry system, instead of issuing physical bonds. The holders of bonds hold a "statement of registration" (registering the security name, face value, reference numbers, etc.) instead of the physical bonds, and the registration institution notifies the interest payment and redemption to the holders. On selling the bond, the settlement is made by changing the registered name from the transferor to the transferee (registration of transfer).

The current registration system for bonds, etc. is to be abolished on the date specified by a government ordinance to be issued by January 5, 2008. Then, all bonds should be issues as book-entry transfer bonds or physical bonds. As for the registered bonds and physical bonds that have already been issued, those that will be redeemed by the end of 2007 need not be transferred, but the others should be transferred to the book-entry transfer system by the end of 2007 to keep them eligible of special tax preference.

Until now, most of the corporate bonds issued by domestic business corporations were issued as registered bonds, and all nonresident issuances are the same.

<3> Book-entry transfer bonds

This is a system where information such as records on transactions are managed in the transfer account book (kept at the Bank of Japan for government bonds and Japan Securities Depository Center for corporate bonds and others) on the computer instead of issuing certificates in accordance with the "Transfer of Corporate Debt Securities Law". Transfer of ownership rights of book-entry transfer bonds are conducted in a completely paperless method (electronic means) through a transfer between accounts and investors cannot request the issuance of actual certificates. This enables the issuers to decrease the cost of issuance because it is needless to issue physical bonds, including sample and reserve certificates, which was required under the registration system for corporate bonds[2] and others.

It is said that the need to confirm whether the bond holder is subject to tax payment or not is the obstacle to promote utilizing book-entry transfer bonds. This subject will be mentioned on later in the taxation part of this chapter.

2. Environment for the Nonresident Investors

(1) Developing the Market Environment

<1> Investment diversification

For nonresident investors who manage global bond portfolio, the most basic way to manage their assets is "diversified investment", which aims to diversify issuer risks and improve yields. For these

[2] Currently, since there are registered bonds that were issued in the past still exists in the market, book-entry transfer and registered bonds exist in parallel. But by January 2008, the systems will be unified into the Book-Entry Transfer system for "corporate bonds". (Some of the issued bonds would be redeemed and the others should be transferred into book-entry transfer bonds in order to maintain the same preferential tax treatment.)

nonresident investors, it is important the market has a developed infrastructure that enables “diversified investment”. The yen bond market is not highly regarded by nonresident investors because tax exemption scheme is applied only to Japanese government bonds (JGBs).

Diversification of investment to products other than US Treasury started in 1997-98 in the United States when the agency bond market began to expand. After a wide range of investors started to adopt the Lehman Brothers Index, it became quite notable that investors started to diverse their investment from investing only to sovereign and government agency bonds but also to private company mortgage bonds. The needs for bonds such as ABS and mortgage bonds are quite high, to such extent that the central banks, whose investment is on the conservative side, started to invest in the United States mortgage bonds. It is also said that some investors are even considering investing in RMBS of the Japanese Government Housing Loan Corporation.

<2> Credit products

Credit products issued by non-government issuers play an important role as investment tools.

Reflecting the demand for credit products that aim to meet the need for investment diversification and higher return, credit spread is tightening around the world. It is said that increasing oil money due to higher oil prices are also flowing in the credit products market

<3> Beginning of investment

(a) Japanese Government bond (JGB) transaction

To start JGB investment, a nonresident should either open a direct custody account at a domestic financial institution, which is a participant of the JGB book-entry system, or open a custody account at a financial institution which is a global custodian, then open a custody account at a domestic financial institution through the global custodian.

JGB transactions by nonresidents are currently exempt from withholding tax as long as they meet certain criteria. But it often happens that it takes a considerable time to open accounts and going through the procedure of being eligible of tax exemption, due to confirming whether the entity is subject to taxation or not.

(b) Transaction of corporate bonds and others

In the case of central banks, government agencies and international institutions, which are exempt from withholding tax:

About 10% of the foreign reserves in Asian economies are yen denominated. Since the interest rate for JGBs are very low at the moment, there are high potential needs for investing in corporate bonds and others with higher interest rates. Although many central banks and government agencies have custody accounts at the Bank of Japan, corporate bonds and others cannot be settled at the Bank of Japan. So they have to open custody accounts at private financial institutions, but arise of cost and credit risks become the issue then. As a result, some central banks have difficulty in opening the accounts.

In the case of private, nonresident investors:

Since withholding tax is applied, most of the private nonresident investors refrain from investing in corporate bonds and others, that is to say, government guaranteed bonds, local government bonds and corporate bonds and so on.

<4> Bond holding

Since there is a blackout period for name transfer twice a year, about three weeks per each, it is necessary to construct a portfolio consistent with this restriction when holding registered bonds. However, such considerations will not be needed after the corporate bonds and others shift to the book-entry transfer system.

<5> Settlement

(a) Settlement of JGBs

In the settlement of JGBs (including TB/FBs)[3], the Bank of Japan Financial Network System (BOJ Net) is used both for funds and securities. Real time Gross Settlement was introduced in January 2001 and DVP settlement is applied on the BOJ Net.

(b) Settlement of corporate bonds and others

Since the book-entry transfer system for “corporate bonds” was launched on January 10, 2006 , book-entry transfer bonds are settled in the gross-gross DVP method at the Japan Securities Depository Center (JASDEC). The BOJ Net is used for fund settlement and the JASDEC for securities. Settlements are made by linking these two systems to manage account balances by recording the changes in the transfer account books held at JASDEC and the account management institutions.

(c) Utilizing Euroclear

Although Euroclear is a settlement system used by most of the nonresident institutional investors, yen bonds (JGBs, corporate bonds and others) cannot be settled through the system. One of the reasons for this is the issue regarding confirmation of the status of final investor, whether they are subject to withholding tax or not[4].

If yen bonds (JGBs, corporate bonds and others) could be settled at Euroclear, it would increase the opportunities for nonresidents to acquire funds since it enables agile investment as soon as the decision was made. Actually, there are some nonresident investors who would like to consider investing in yen bonds if all yen bonds could be settled at Euroclear.

(2) Tax Issues

<1> Current tax exemption scheme

According to the current taxation, interest on book-entry transfer JGBs are tax exempt for nonresident and foreign corporations. However, for other government bonds and corporate bonds, interest incurs a national withholding tax of 15% except for foreign governments, central banks and some international organizations[5].

There are two types of bonds in the secondary market for public and corporate bonds. One is the bond subject to withholding tax (taxable bonds) on interest and those that are not (non-taxable

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[3] Book-entry transfer system is not corresponding to inflation-indexed securities yet.

[4] Other problems include an extensive system adjustment by Euroclear for the investment horizon calculation, which is required by the Japanese corporate bond transfer settlement law.

[5] Withholding tax is exempt from interest received by domestic corporations with a capital of 100 million yen or more such as financial institutions, securities companies and public corporations.

bonds). Most transactions in the secondary market are in non-taxable bonds. This means that even among bonds with the same security name, taxable ones are less liquid than non-taxable ones[6], which makes it difficult for entities that are subject to withholding tax, to participate in the secondary market of public and corporate bonds.

There are some nonresidents who cannot enjoy the tax exemption, due to the status of the final investor. Such cases are seen in nonresidents who settle through global custodians. Especially in the case of investment companies which are mandated asset management from the third party.

(Reference) Transaction of taxable government and corporate bonds

Since taxable bonds incur withholding tax at the time of interest payment, calculating the accrued interest becomes complicated for financial institutions. And also, since non-taxable bonds are the major products traded in the secondary market, it tends to be difficult to find a buyer for taxable bonds. Sometimes it cannot be sold. Consequently, the taxable bonds holders tend to hold them until the day of interest payment (name transfer date) and holding costs and repo-costs accrue. When securities companies buy taxable bonds, there are practices to offer a price after deducting such costs. As a result, the price of taxable bonds would be lower than that of non-taxable ones.

<2> Procedures for applying the non-taxable system for JGBs

To be eligible for tax exemption on interest arising from book-entry transfer JGBs, the “Application Form for Withholding Tax Exemption” must be submitted to the Director of the Nihombashi Tax Office. In the case of opening a transfer account with a domestic JGB Book-entry System participant (sub-custodians like domestic financial institutions or securities companies, which are the account management institutions of JGBs), the application should be submitted through the participant and the Bank of Japan. In the case of opening an account with a Qualified Foreign Intermediary (QFI), the application should be submitted through the QFI, its upper-positioned participants in Japan and the Bank of Japan. Although procedural requirement for interest tax exemption for nonresident holders of JGB was streamlined with the FY2005 tax reform, it is still pointed out that it is still complicated[7].

The Law Concerning Book-Entry Transfer of Corporate Bonds, Etc. (the Law) requires the “account management institutions” to keep the “Transfer Account-Book”, and in the case of global custodians, who are foreign indirect participants, they are obliged to keep a ledger of all participants even when there are multiple indirect lower-positioned participants. This rule is said to exist to enable comparing them to the account books kept at the Bank of Japan. However, the Bank of Japan reviews all indirect participants at the time when they apply as the Foreign Intermediate Participants (FIP)[8] and the necessity of asking the global custodians to keep the account-books of all participants

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6 Sale price of taxable bonds are also lower than non-taxable bonds, because liquidity premium and tax and so on are deducted from the non-taxable bond price.

7 When the applicant first intends to be exempt from taxation, the entity should submit the “Application Form for Withholding Tax Exemption”. If there is a change in name or address after the application has been submitted, a “Application Form for Amendment” should be submitted at least one day preceding the date of the first interest payment after the change has been effected. It is necessary to submit the “Statement of the Holding Period” at least one day preceding the interest payment date of the book-entry transfer JGB, but the statement may be prepared and submitted by the JGB Book-entry System participant in Japan or the QFI which has received the Application Form for Withholding Tax Exemption. .

8 This is a qualification status that the Bank of Japan created in April 2001, for foreign financial institutions etc., such as a global custodian. In cases that transactions proceed in the order as, the Bank of Japan – direct depository –

seems to be low.

There are other procedural requirements that should be streamlined: administrative procedures to receive preferential tax treatment on dividends received by nonresidents based on tax agreements, authorization procedure for a QFI[9], procedure for nonresident individuals and foreign corporations to be eligible for tax exemption on interest arising from book-entry transfer JGBs (coupon-bearing bonds) and procedures for being certificated as FIPs. It is also important to facilitate the judgment whether an entity is a non-taxable entity or not and to make the application form required for tax exemption unified.

<3> Tax exemption scheme for JGBs (treatment of foreign investment trusts)

"According to the tax exemption scheme on interest of coupon-bearing JGBs held by nonresident individuals or foreign corporations, the interest paid to foreign investment trusts that the offer for subscription of beneficiary certificates for the establishment of the foreign investment trust is made outside Japan (and has not been made in Japan), will be the subject of tax exemption scheme provided that the trusts fulfill certain requirements."

In order to clarify whether the foreign investment trust comes under the category of "foreign investment trusts which come into the category of securities investment trust", it is sometimes necessary to consult with the Nihombashi Tax Office or the National Tax Agency (division in charge of withholding tax) by handing over a prospectus with an establishment document attached (in Japanese). The concrete standard for qualification is listed as "eligible foreign securities trusts", in the "expansion of the special tax treatment on interest on coupon-bearing JGBs[10]", which is a part of tax reform related to coupon-bearing JGBs. The entity is eligible if <a> the foreign investment trust is (i) a securities investment trust or (ii) a public or corporate bond management investment trust (as prescribed in the Japanese tax laws), <b> the offering of the beneficiary certificate related to the establishment of the foreign investment trust is made outside Japan, in addition, the prospectus for the foreign investment trust and other documents similar thereto contain statements to the effect that the solicitation for the subscription is equivalent to solicitation made pursuant to the same provisions, and <c> the offer for subscription of beneficiary certificates for the establishment of the foreign investment trust has not been made in Japan. However, these descriptions do not provide clear standards for entities without corporate status that is ineligible for this exemption.

<4> Confirming the status of the holder (question of the taxation status)

Since the taxation differs by the status of the holder, whether the holder is subject to withholding tax or is eligible for tax exemption, there is a definition that determines the entity legally responsible for tax withholding, according to the types of bonds. In particular, the entity responsible for withholding tax is; the place of principle and interest payment for physical bonds the designated

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indirect depository – customer, then unless the foreign indirect depository acquires a FIP status, the associated foreign customers cannot be eligible for tax exemption.

[9] A QFI is a foreign financial institution, etc., such as a global custodian, which has been: (a) designated as the account management institution prescribed in the Law Concerning Book-Entry Transfer of Corporate Bonds, Etc.; and (b) approved by the Bank of Japan as a Foreign Indirect Participant (FIP) in the JGB Book-entry System, and approved by the District Director of the Nihombashi Tax Office as satisfying the requirements, including having a head office or main office in a counterparty country that has a tax treaty with the article on the exchange of information with Japan.

[10] The current system was originally implemented as "special treatment of tax on interest for a blanket registration of JGBs" in 1999 and has been reformed a number of times over the years.

place of payment for registration bonds, the issuer and issuing agent for the national tax and account management institution for the local tax for book-entry transfer bonds.

In the case of registered bonds, the designated place of payment confirmed the status of the final bond holder, by utilizing the bond holder information disclosed by the registration institution. But actually, it was difficult because of the confidentiality of the registration institution.

As for book-entry transfer bonds, it is understood that "It is taken that, interest payment information including whether the investor is subject to withholding national tax or not, must be provided to the issuer by the Securities Depository Center. The fee for this information is included in the new issue recording fee paid by the issuer to the Securities Depository Center through the issuance agent (although it is not written on the schedule of fees)."[11]

<5> Tax exemption scheme for corporate bonds

To diversify investment, institutional investors generally exclude products that are subject to tax. The fact that only JGBs are tax exempt and all other domestic bonds (excluding Samurai bonds) such as government guaranteed bonds, local government bonds, corporate bonds and coupon bank debentures, are subject to withholding tax. And this is an obstacle for nonresidents to invest in Tokyo Financial Market.

Hedge funds perform active arbitrage transactions among government bonds, stocks and corporate bonds in the European and American markets. But it is said that there are many funds that refrain from starting investment in Tokyo Financial Market due to the taxation issue. For the Tokyo Financial Market to be preferred by non-resident investors, not only JGBs but also, corporate bonds and others should be eligible for tax exemption.

Recently, there is a debate led by the Ministry of Internal Affairs and Communication to study the possibility of making local government bonds eligible for tax exemption. Tax exemption should be applied widely to corporate bonds and others including government guaranteed bonds, FILP Institution bonds, corporate bonds, coupon bank debenture. If only local government bonds would be eligible, and others remain ineligible, it would be confusing for the market participants. It will also make the nonresident investors concerned about the basic attitude of the policy makers regarding the internationalization of Tokyo Financial market.

(a) Benefits for issuers

If products eligible for tax exemption increase, it will contribute to achieve higher yield. It will also meet the potential needs of nonresident investors who aim for efficient diversification of investment products, which leads to the expansion of investors of the Tokyo Financial market. The diversified investors would lead to stable fund raising funds.

(b) Benefits for investors

- Diversification of portfolio and credit

Tax-exempt will lead to a significant diversification in investment products. The variation of investment products, to such as short-term bonds which are rarely liquid in euro yen bonds, and bond issues that have a wider spread than euro yen bonds (such as government guaranteed bonds) would

[11] Kigyou no Shikinchoutatsu no Enkatsuka ni Kansuru Kyougikai. (2005).

enable investors ideal portfolio and ALM management.

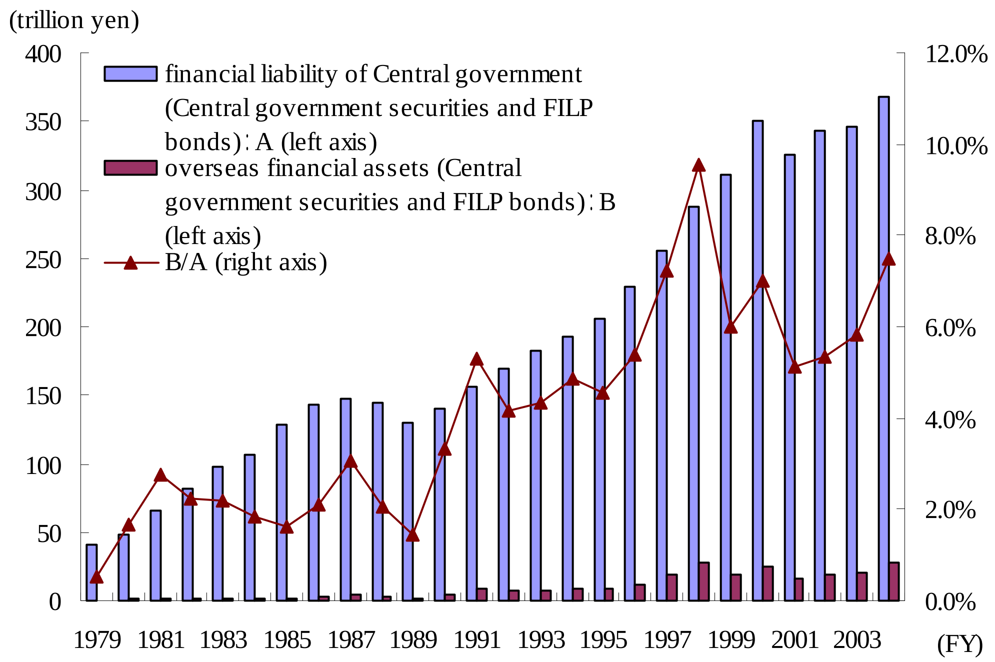
- The development of the derivatives market

Since the diversification enables ensuring the spread that reflects credit rating of the issuer, corporate bonds and others could be used for hedging the cash bonds of interest swaps and credit swaps.

It is difficult to give concrete figures of the increase in nonresident bond holders when tax exemption scheme were applied to corporate bonds and others. However, the increase in non-resident bond holders of JGBs could afford an instance of the figures.

Before and after 1999, when the tax exemption scheme was applied to JGBs, the holdings ratio increased from 3.5%, which was the average for the previous 20 years, to around 5%. (Figure 2). So, in the corporate bonds, we could expect the similar increase in the holding ratio.

Figure 2: Holdings of JGBs by nonresidents



(note) central government securities and FILP bonds held by Bank of Japan and the general government are deducted from financial liabilities of the central government

compiled from the FLOW of FUNDS data, Bank of Japan

Besides the increase in holdings ratio, the change in taxation treatment could lead to a more active secondary market for corporate bonds.

Transaction shares of foreigners in the JGB secondary market was at average 5-7% before the abolition of withholding tax in September 1999, but after the abolition, it increased to 15-20%. Recently, the figures sometimes go up to 30%. Foreign investors have come to create a large a group as major domestic investors, such as city banks, trust banks and life insurance companies. Judging from this development, nonresidents can be expected to become major players in the corporate bonds secondary market with the introduction of tax exemption scheme. This could lead to a significant increase in number of participants in the yen bond market, including JGBs, and stimulate the domestic yen bond market as a whole to become more active. And this would lead to the rise in position of the yen bond market, for the non-resident investors.

3. Conclusion

In order to make Tokyo bond market more active, it is important to make the yen bond market more attractive for nonresident issuers and nonresident investors. As has been discussed in this chapter, for issuers, the market environment equivalent to the euro yen bond in terms of costs should be prepared. Then it would lead to make the market attractive for institutional investors around the world to consider this market as one of the useful options for investment diversification. In concrete terms, <1> corporate bonds and others should be eligible for tax exemption in addition to JGBs and <2> the options for settlement system should be widened (for example, to begin yen bond settlement at Euroclear).

By taking these measures, the reputation of the Tokyo bond market should rise significantly from the viewpoint of nonresidents. Then increase of nonresident participants in both issuance and secondary markets could be expected, which will lead to the activated Tokyo financial market as a whole.