Financial Markets Strategy Team
Second Report
“Toward an Open Country with Financial Strength”

June 12, 2008

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~ Toward an Open Country with Financial Strength~

Introduction

The subprime mortgage problem that has caused unprecedented turmoil in the global financial markets since last summer has yet to be overcome. The Financial Markets Strategy Team, an advisory group established by the Minister for Financial Services, Yoshimi Watanabe, conducted intensive discussions on this issue during the two months since its establishment. The results of these discussions were published in the First Report on November 30, 2007. That report not only analyzed the causes of the subprime mortgage problem, but also identified issues for individual parties involved in the securitization process, and put forward recommendations for measures to address those issues.

Based on this First Report, the Financial Services Agency (FSA) made active contribution to discussions at international forums, including the Financial Stability Forum (FSF) and the International Organization of Securities Commissions (IOSCO). As a result, the Team's views were broadly shared with international organizations and foreign policy authorities on a number of issues, and the FSA's recommendations were reflected in the measures proposed by those organizations, as described later.

Meanwhile, the subprime mortgage problem has become even more serious and widespread. Although the current situation of the financial markets is not extremely unstable, a careful watch needs to be kept on future developments. In this Second Report, we followed up on the situation of the subprime mortgage problem that has become more widespread and deepened since the publication of the First Report. We tried to identify and assess the measures and policy response taken to date, and pointed out issues to which Japan should pay due attention with regard to future developments in the global financial markets.

I. Growing problem in global securitization market

When the First Report by the Financial Markets Strategy Team was published on November 30, 2007, financial institutions in Europe and the United States started to raise capital in response to the disclosure of their massive losses, while the securitization market began to deteriorate again after a temporary calm following the outbreak of the turmoil in summer 2007. Since December 2007, the subprime mortgage problem has basically become even more serious and widespread, subsiding only temporarily.

Specifically, from the beginning of December 2007, major financial institutions in Europe and the U.S. started to make writedowns by placing structured investment vehicles (SIVs) onto their balance sheets, while the managerial problems "monoline" insurers, who provided guarantees for securitized products, came to the surface (see Note).

Note: Since the business model of monoline insurers is based on guarantee of the timely repayment of the principal and interest of public bonds, there is a concern that the deterioration of their businesses could affect local government finances with the increased costs of funding public bonds. Credit-rating agencies have required monoline insurers to increase their capital in order to maintain their credit ratings. While responses have been made by monoline insurers, the pressure of downgrading by credit rating agencies still remains.

In addition, tightened conditions in the money markets, in which banks secure funds maturing past December 31, mounted unusually.

Since January 2008, a number of indicators have started to show the weaknesses of the U.S. real economy. Not only have the indicators related to the U.S. housing market deteriorated across the board, but also employment indicators have worsened.[1] In

[1] *Real economy*:
The consumer confidence index (seasonally-adjusted, the year 1985 = 100) by Conference-Board (CB), which has been on a downward trend since last year, shows a further decline since the beginning of 2008 (January: 87.3, February: 76.4, March: 65.9, April: 62.8, and May: 57.2). The Non-Manufacturing Business Activity Index by the Institute for Supply Management (ISM) in January 2008 was 44.6, which dropped considerably below 50, the turning point for economic recession and expansion. Subsequently, the ISM business indices both for manufacturing and non-manufacturing fell below 50 in February and March. While the ISM index for non-manufacturing rose over 50 in April and May, the index for manufacturing remained below 50.

addition, a concern over the credit crunch has surfaced, as the Senior Loan Officer Opinion Survey (D.I.), conducted by the Federal Reserve Board (FRB), reported that more banks in the U.S. indicated that their lending standards have "tightened considerably."

Regarding the securitization market, losses expanded on a wide range of securitized products. Specifically, as de-leveraging have accelerated and attempts to put assets with a risk of valuation losses off balance sheet have started, the prices of securitized products for related mortgages, commercial equity mortgages, and credit-card loans, as well as those of leveraged loans and mortgage bonds guaranteed by government sponsored enterprises (GSEs), have declined. As a result, major banks in the U.S. had to post massive first quarter losses in 2008, as they did in the fourth quarter of 2007.[2] In addition, the total of losses linked to subprime mortgages estimated by all financial institutions also increased.

Note: In Europe, too, massive losses and capital increases were already disclosed by major banks and other financial institutions in the fourth quarter of 2007 and the first quarter of 2008, even though concerns over further losses on securitized products still remain.

The move for de-leveraging in February through March 2008 led to a further decline in the prices of securitized products and to a need for additional margin calls, which in return accelerated further de-leveraging. This spiral exposed shortages of collateral and liquidity at securities companies and hedge funds. In reflection of these situations, tensions in the U.S. financial and capital markets heightened considerably. One hedge

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Housing:
New privately-owned housing starts (annualized rate month-over-month, seasonally-adjusted) in March 2008 dropped considerably by 13.8 percent. Although it increased by 8.2 percent in April, the appreciation rate of home purchase prices (annualized rate month-over-month, seasonally-adjusted) decreased by 6.92 percent in the first quarter of 2008 (published at the end of May 2008), and the rate of decrease has grown since the third quarter of 2007 when the rate first dropped by 1.88 percent. New home sales declined from about 600 thousand in January 2008 to about 530 thousand in April. While existing home sales temporarily rose from about 4.9 million in January 2008 to about 5 million in February, it dropped again to about 4.9 million in March and April.
Employment:
The unemployment rate (except for military personnel, seasonally-adjusted) was 4.9 percent in January 2008, which decreased to 4.8 percent in February, but increased again to 5.1 percent in March. The rate in April was 5.0 percent and 5.5 percent in May.In addition, the non-agricultural unemployment rate (seasonally-adjusted) declined continuously from January to May 2008 (decreased by about 324 thousand in total).

[2] See page 18 for the closing accounts of financial institutions in Japan for the fiscal year 2007.

fund, Carlyle Capital Corp., for instance, went bankrupt in March, and subsequent concerns about counterparty risk triggered a rapid deterioration in the cash management of Bear Stearns Companies Inc., due to the company's funding structure which relied heavily on securities finance. Eventually, this problem developed into the company's management crisis.[3]

Since April, the tension in the markets for securitized and other products has become relatively stable. A careful watch, however, should still be kept on the situation of the financial and capital markets in Europe and the U.S., because the spread margin of securitized products remains at the same level as in January 2008, interests rates still remain at a high level in the short-term financial markets, the sluggish housing market is continuing in the U.S., and bankruptcies of smaller financial institutions have been reported.

Note: Up to the present date, the largest estimate for the total losses in relation to subprime mortgages in the financial markets is 945 billion dollars, estimated by the International Monetary Fund (IMF). (Please note that the scope of financial products covered in this estimate is not necessarily the same as in the estimates from other international organizations.) Remarks on the subprime-related losses made since the beginning of 2008 were as follows:

January 17, 2008	U.S. Federal Reserve Board Chairman Ben Bernanke said that the subprime-related losses were estimated at 100 billion dollars so far, but it could grow further to several times that figure, if the repayment rates and the number of foreclosures rose as well.
February 12, 2008	German Finance Minister Peer Steinbrück explained his belief that the losses linked to subprime mortgages could reach 400 billion dollars. (From a report in the Financial Times issued on February 12)
March 3, 2008	U.S. Treasury Assistant Secretary for International Affairs Clay Lowery said that the total subprime-related losses released by financial institutions around the world exceeded 200 billion dollars.
March 17, 2008	Director of the IMF's Western Hemisphere Department Anoop Singh said that the world financial system might face, altogether, a total of 800 billion dollars of losses across all banks, insurance companies, hedge funds and pension funds.
April 8, 2008	The IMF estimated in its Global Financial Stability Report that the total losses linked to subprime mortgages to be posted by banks, insurance companies, hedge funds and other financial institutions could reach up to about 945 billion dollars. (The losses in the banking sector may reach 440-510 billion dollars.)
April 15, 2008	The Organisation for Economic Co-operation and Development estimated the total subprime-related losses at 352-422 billion dollars.

[3] JPMorgan agreed to buy Bear Stearns Companies Inc. as a bailout, with financing from the Federal Reserve Bank of New York.

II. Approaches to resolving the subprime mortgage problem

1. Approaches taken by the policy authorities of individual countries

As a result of the prevalence of such issues as described above, the policy authorities of individual countries have taken various measures accordingly.

(1) United States

Since the end of 2007, the U.S. government has announced and implemented a series of measures such as providing relief to borrowers, an economic stimulus package, and measures for stabilizing financial markets (liquidity provisioning).

(i) Providing relief to borrowers

On December 6, 2007, the U.S. government announced a policy for providing relief to subprime mortgage borrowers, a step taken by an organization called "HOPE NOW" which is an alliance between counselors, servicers, investors, and other mortgage market participants. This is a program to provide relief to borrowers who are forced to pay back loans at a higher interest rate following a rate reset[4], which includes relief measures such as the refinancing an existing loan into a new private mortgages and freezing their current interest rate for five years and, out of the 1.8 million borrowers for whom mortgage rates will be reset from this year onward, 1.2 million (excluding those who are delinquent borrowers) are expected to be eligible for this program (see Note 1).

In addition, the U.S. announced on April 9 the upper limit of the mortgage guarantee by the Federal Housing Administration (FHA) would be raised further (see Note 2).

Note 1: Provision of relief to borrowers, including these relief measures, are under way on the part

[4] In many of the subprime mortgage products, it is often the case that the rate is low and fixed for the initial two years and is shifted to an adjustable rate from the third year onward. The rate will be reset for many mortgage borrowers from the beginning of 2008 onward, and there was a concern that cases of debt delinquency might increase.

of the parties concerned in the private sector and, from January onward, measures such as refinancing and the freezing of loans have been applied to more than 400,000 subprime mortgage borrowers.

Note 2:The existing FHA loan program (FHASecure) was also made applicable to delinquent borrowers and enabled them to refinance into long-term fixed rate mortgages. In addition, it was decided that the scope of application of FHASecure should be expanded and that, among borrowers of adjustable rate mortgages, loan guarantees of up to 97 percent of loan-to-value (LTV) should be provided for those who were delinquent on loans for two consecutive months and of up to 90 percent of LTV for those who were delinquent on loans for three consecutive months. As a result, from September 2007 onward, approximately 200,000 mortgages were shifted to an FHA-insured mortgage.

(ii) Economic stimulus package

In consideration of the impact of the subprime mortgage problem on consumer spending and the housing market, President Bush announced on January 18 an economic-stimulus package centering on a tax cut to a total amount of 150 billion dollars (a 100 billion dollar tax cut with rebate and a 50 billion dollar tax cut for capital investments) and the raising the upper limit of mortgages guaranteed or purchased by the FHA or GSEs[5], and bills including there measures were passed on February 13. According to this bill, tax was refunded as from April this year, up to 600 dollars for an individual or 1,200 dollars for a couple, and with an additional amount of 300 dollars for each child.

(iii) Measures for stabilizing financial markets

(Expansion of the means of liquidity provisioning)

Since the summer of 2007 when the subprime mortgage problem surfaced, massive liquidity provisioning was made by central banks in order to cope with the liquidity

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[5] In Congress, housing-related bills including the expansion of the mortgage guarantee by the FHA and the reform of the GSE oversight system were approved by the House of Representatives and are now also being examined by the Senate, and they are expected to pass by the end of July.

problem, which occurred mainly in the ABCP (Asset Backed Commercial Paper) market. Since then, from the standpoint of ensuring the stability of the money markets in Europe amid an awareness of the need for funding beyond the year-end, the FRB and central banks in Europe adopted on December 12, 2007, measures such as the effective use of swaps to facilitate the provision of dollar funds in European markets and the introduction of the Term Auction Facility to provide relatively long-term funds.

In addition, after the turn of the year, facing a situation where the function of the mortgage market described below had weakened and some securities companies had had liquidity problems as described above, a series of successive measures were adopted to provide liquidity for the purpose of stabilizing the financial markets, such as the Term Securities Lending Facility (TSLF) that provides Treasury bonds with mortgage-backed securities as collateral, and the Primary Dealer Credit Facility that provides Fed funds directly to primary dealers.

On May 2, facing a situation where interest rates still remained at a high level in the money markets, the central banks of individual countries announced additional measures to provide liquidity, such as expanding the scale of the currency swap agreement and expanding the scale of the TSLF.

Furthermore, when Bear Stearns was bailed out in March, the Federal Reserve Bank of New York took a bold step by providing 29 billion dollars to the company that took over the non-performing assets of Bear Stearns. This can be said to be a *de facto* use of public funds, thereby strengthening the approaches to ensuring the stability of the financial system.

(Liquidity provisioning in the mortgage market)

The securitization market plays an important role in the financial intermediation channel in the U.S. financial markets. However, after the subprime mortgage problem occurred, the function of this securitization market has been substantially weakened.

Under these circumstances, successive measures were taken to expand the purchase of securitized products by GSEs (such as Fannie Mae and Freddie Mac) in view of the declining liquidity of mortgage debts, a typical product in this securitization market (see Note).

Note: Measures to expand the purchase of securitized products by GSEs

Dec. 2007	Fannie Mae and Freddie Mac increased their capital to strengthen their financial foundations.
Feb. 13, 2008	The upper limit of a mortgage which can be purchased by GSEs was raised from 417,000 dollars to 729,750 dollars for mortgages borrowed for a certain period (refer to (ii) above).
Mar. 1, 2008	The upper limit of the total amount of assets purchased by GSEs was eliminated, thereby promoting liquidity provision to the market.
Mar. 19, 2008	The Office of Federal Housing Enterprise Oversight and GSEs jointly announced an initiative to provide liquidity amounting to a maximum of 200 billion dollars to the MBS (mortgage-backed securities) market by easing their respective capital regulation (1.3 times capital as required by the law → 1.2 times) (and as a result, it will be possible to purchase and provide guarantees for securities amounting to 20 billion yen this year).
Mar. 24, 2008	It was announced that the upper limit of MBSs purchased by the Federal Home Loan Bank would be raised from 300 percent to 600 percent of its capital amount for a period of two years, with liquidity amounting to 100 billion dollars to be provided for the housing market.

(iv) Further discussions on how to ensure the stability of financial markets

In order to ensure the stability of the financial markets more fundamentally, it is important that financial institutions have an adequate amount of capital. Regarding the injection of public funds in a similar way to what took place in Japan, there are strong negative opinions in the U.S. from a moral hazard viewpoint. While some experts actively argue for injection of public funds[6], the U.S. government took the stance of

[6] Remarks by major leading figures

Remarks by John Lipsky, First Deputy Managing Director of the IMF, at a lecture on March 12:

"In order to protect the financial system, we should have various options in place, including the possibility of using public funds."

Remarks by Robert Rubin, former Secretary of the Treasury, at a lecture on March 14:

"We are already at the stage of examining whether public funds should be used (in the mortgage sector) in order that low-income homeowners will not lose their homes."

Remarks by Lawrence Summers, former Secretary of the Treasury, at a lecture on March 14:

"Regardless of whatever market intermediaries hope for, there has been an urgent necessity for encouraging the private sector to take voluntary measures, including prompt disclosure and disposal of losses by private financial institutions and strengthening of their capital where necessary. Under these circumstances, U.S. financial institutions disclosed a total loss of approximately 20 trillion yen up to the first quarter of 2008 and announced that they would increase their capital by approximately 12 trillion yen (including additional capital increases)[7].

(2) Europe and other countries

In Europe, also, there are cases where public intervention in financial institutions has been implemented by governments. The United Kingdom announced on February 17 the temporary nationalization of Northern Rock due to the failure of a relief program for the bank. Germany announced on February 8 that the state (Land) government would provide guarantees for a company which was set up specifically to separate non-performing assets from West LB, a major state bank. In addition, it was announced on February 13 that the federal government would inject capital via the KfW Bankengruppe into Deutsche Industriebank (IKB) which slid into financial difficulties in the summer of 2007.

Further, based on liquidity provisioning measures agreed upon by five central banks in December 2007 and March 2008, the European Central Bank (ECB) and the Swiss National Bank provided dollars to the money markets according to the currency swap agreements with the FRB[8]. On April 21, in consideration of the existing conditions in the financial markets, the Bank of England announced and implemented a special liquidity scheme (50 billion pounds in total) to swap government bonds for asset backed

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capital increase, no matter by what means, public or private."

Remarks by Alan Greenspan, former FRB Chairman, at an interview with the press on April 8:
"Public funds should be used to resolve the housing crisis."

[7] The move to disclose losses and increase capital has continued since the second quarter of 2008 as well, and it has been announced that, currently, worldwide financial institutions, including those in Japan, have suffered a total loss of more than 30 trillion yen related to subprime mortgages and have increased capital by approximately 20 trillion yen.

[8] Regarding policy interest rates, while the ECB continued to leave policy interest rates unchanged even after the subprime mortgage problem surfaced, the Bank of England lowered interest rates, three times in total, from December 2007 onward.

securities, such as MBS held by banks.

In addition, on February 27, the European Commission adopted a report that incorporated proposals such as a request to financial institutions for prompt disclosure of losses, and indicated the position the European Union (EU) would take at international discussions. Further, the EU Council of Financial Ministers approved on March 14 a process chart of crisis response measures for financial stability, such as strengthened procedures for financial services regulation and supervision and the strengthened function of the deposit insurance systems.

(Reference) Discussions on the supervisory framework in individual countries

Drawing a lesson from the turmoil in the financial markets triggered by the current subprime mortgage problem, some countries recently started discussions on the issue of revising the framework for financial supervision.

(i) United States

In the U.S., the Blueprint for a Modernized Financial Regulatory Structure was released on March 31, 2008. In the Blueprint, policy targets were proposed for the short, intermediate, and long term, respectively, aiming for an overhaul of the regulatory system.

As recommendations for the short term, the Blueprint put forward the following recommendations: (a) modernization of the President's Working Group on Financial Markets such as the broadening of its focus; (b) creation of a federal Mortgage Origination Commission; and (c) standardization of lending practices by non-deposit-taking financial institutions in line with the Federal Reserve regulations and the need for examination and supervision.

As recommendations for the intermediate term, it presented the abolition of the thrift institution system, the rationalization of the direct federal supervision of state-chartered banks, oversight of the payment and settlement systems, and reforms of regulation of insurance, securities and futures industries.

On that basis, as recommendations for the long term, it indicated the direction to take to reorganize current regulation by business category, such as banking, insurance, securities and futures, into (a) a market stability regulator (FRB), (b) a prudential regulator (assuming the roles of the current Office of the Comptroller of the Currency, the Office of Thrift Supervision, etc.), and (c) a business conduct regulator (assuming the roles of the current Commodity Futures Trading Commission, the Securities and Exchange Commission (SEC), etc.)

(ii) United Kingdom

In the U.K., the Financial Services Authority (UKFSA) conducted an internal audit regarding problems in the supervision of Northern Rock which led to a situation as serious as a bank run for the first time since the 19th century. Following the result of the audit, the UKFSA indicated a strengthening of supervision.

Based on comments arising from the internal audit, such as the lack of sufficient supervision of Northern Rock, inadequate employee resources, and the insufficient utilization of risk information in supervision activities, the UKFSA decided to take measures regarding the supervision of "high-impact firms" in particular, such as establishing a group of experts to conduct regular reviews, increasing the number of employees, expanding the involvement of high level staff, and attaching importance to liquidity.

(iii) Germany

Drawing on the lessons from the subprime mortgage problem, the German authorities announced a change to the supervisory authority over banks on February 6. Specifically, it was indicated that the supervisory authority would be clarified in such a way that, in the future, the Deutshe Bundesbank, which has frequent contact with many of the financial institutions located in Frankfurt, will conduct day-to-day supervision, including examination, while the Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht, BaFin) will exercise the regulatory authority stipulated by law.

2. Discussions by international organizations on remedies for the subprime mortgage problem

In order to stabilize the financial markets, international organizations have been holding intensive discussions, mainly on measures for preventing the recurrence of the turmoil in the financial markets, as individual countries have taken the approaches as described in 1 above[9].

(1) Financial Stability Forum (FSF)

[9] In the U.S., too, regarding the measures to prevent the recurrence of market turmoil following the subprime mortgage problem, recommendations were also put forward at the meeting of the President's Working Group on Financial Markets on March 13. They included issues such as reform of the mortgage-borrowing process, reform of the rating process for structured credit products, reinforcement of risk management of international financial institutions, and promotion of prudential regulation.

At the meeting of the Group of Seven Finance Ministers and Central Bank Governors (G7) held in the fall of 2007, the FSF was requested to analyze the causes of the market turmoil this time and to put forward recommendations on policy response. The FSF presented an interim report to the G7 meeting held in Tokyo in February this year and a formal report (Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience) to the G7 meeting in Washington held on April 11. In this report, the FSF made many recommendations in the following five major categories: i) strengthening prudential oversight of capital, liquidity and risk management; ii) enhancing transparency and valuation; iii) changing the role and uses of credit ratings; iv) strengthening the authorities' responsiveness to risks; and v) putting in place robust arrangements for dealing with stresses in the financial system.

Based on this report, at the April G7 meeting, the members identified in order of priority measures which should be taken within 100 days (such as disclosure of the information that determine losses at an early stage and the reinforcement of risk management, including through the use of stress testing) and those which should be taken by the end of 2008. In addition, the FSF was requested to actively monitor the implementation of the measures incorporated in the report.

(Reference)
[Measures which should be taken within 100 days]

(Measures which financial institutions should take)

- Full and prompt disclosure of their risk exposures, write-downs, and fair value estimates for complex and illiquid instruments. Robust risk disclosures consistent with leading disclosure practices as set out in the FSF report (in their upcoming mid-year reporting).
- Strengthening of risk management practices, supported by supervisors' oversight, including rigorous stress testing. Strengthening of capital positions as needed.

(Measures which accounting standard -setters such as the International Accounting Standards Board should take)

- Initiate urgent action to improve the accounting and disclosure standards for off-balance-sheet business entities and enhance its guidance on fair value accounting, particularly on valuing financial instruments. When the market is in periods of stress.

(International organizations)

- The Basel Committee on Banking Supervision should issue revised liquidity risk management guidelines. The International Organization of Securities Commissions should revise the code of conduct for credit rating agencies (CRAs).

[Measures which should be taken by the end of 2008]

(i) Strengthened prudential oversight of capital, liquidity, and risk management

Individual countries need timely implementation of the Basel II capital framework.

The Basel Committee on Banking Supervision should raise capital requirements for complex structured credit instruments and off-balance sheet vehicles, require additional stress testing, and enhance their monitoring.

(ii) Strengthened valuation standards for financial products and enhanced transparency

The Basel Committee on Banking Supervision should issue further guidance to enhance the supervisory assessment of bank's valuation processes to strengthen disclosures for off-balance-sheet entities, securitization exposures, and liquidity commitments

(iii) Changing the role and uses of credit ratings

Investors: Improve their due diligence in the use of credit ratings.

CRAs: Address the potential for conflicts of interest, clearly differentiate the credit ratings for structured products from that for ordinary bonds, improve their disclosure of the rating methodologies, and take effective actions to assess the quality of the information provided by originators, arrangers, and issuers of structured products.

(iv) Strengthening the authorities' responsiveness to risks

The supervisory authorities and central banks should Further strengthen cooperation and exchange of information, including the assessment of financial stability risks. An international group of supervisory authorities should be established.

Market authorities should act cooperatively and swiftly to investigate and punish fraud, market abuse, and manipulation.

(v) Responses to deal with stress in the financial system

Central banks should be able to provide liquidity effectively when the financial system is under stress.

The authorities of individual countries should re-examine the framework needed to cope with financially weakening banks, domestically and internationally, and strengthen the framework where necessary. A small group should be established to address specific issues related to cross-border crisis management planning (the first meeting should be held by the end of 2008).

(2) International Organization of Securities Commissions (IOSCO)

In order to analyze the role played by CRAs in structured finance markets, the IOSCO set up the task force on CRAs in the spring of 2007 and, since then, it has conducted discussions viewing subprime mortgage turmoil. As a result of such discussions, the IOSCO published a report, “The Role of Credit Rating Agencies in

Structured Finance Markets—Final Report" on May 28 at the IOSCO annual meeting in Paris.

The report analyzed the role that CRAs play in structured finance markets, in the quality and integrity of the rating process, CRA independence and avoidance of conflicts of interest, and CRA responsibilities to the investing public and issuers, etc. Also, based on this analysis, the Code of Conduct Fundamentals for CRAs[10]was revised from the viewpoint of avoiding the conflicts of interest and enhancing the transparency, etc. regarding credit ratings for structured finance products[11].

(3) International Monetary Fund (IMF)

The IMF released the latest edition of its Global Financial Stability Report on April 8. As described above, this report estimated the losses suffered by financial institutions worldwide, but it also put forward some policy recommendations. In addition to strengthened disclosure and the need to raise capital, the report also referred to the fact that the IMF had made suggestions to the authorities of individual countries that they might wish to prepare contingency plans for dealing with large stocks of non-performing assets in the case that the disposition of non-performing assets by financial institutions has a serious impact on the real economy, and that it pointed out the problem of the acceleration of forced sales as a result of applying fair value accounting in periods of market turmoil would need to be examined.

3. Approaches taken by parties concerned in the private sector

The subprime mortgage problem can be said to have resulted from the manifestation

[10] The IOSCO Code of Conduct Fundamentals is a code which a CRA is expected to voluntarily adopt and complies with , and/or to explain and disclose the reasons when failing do so.

[11] The IOSCO also set up the "Task Force on the Subprime Crisis" in November 2007. A wide range of issues related to the subprime crisis were discussed, such as the enhancement of transparency by issuers of securitized products and investor due diligence, and the final report was released on May 29 this year. This report summarized the issues to be tackled and responses to be made by the IOSCO in the future.

of the problems faced by various parties concerned in the securitization market. In the First Report, too, we pointed out that there were many issues with which parties concerned in the private sector should deal. The major approaches taken by parties concerned in the private sector to date are described as follows:

(1) CRAs

From the viewpoint of ensuring independence and avoiding conflicts of interest, CRAs are implementing or considering measures such as re-examining their internal organization such as the establishment of a checking organ and clarifying the conduct prohibited by internal rules. In addition, from the viewpoint of strengthening the quality of credit ratings, they implemented measures such as a third party's review and strengthening the ongoing monitoring of the credit ratings. Further, from the viewpoint of enhancing transparency, they implemented measures such as improving external access to the rating methodologies and strengthening communication with market participants[12].

On the other hand, regarding the approaches to issues other than credit risk, such as liquidity risk, they have been considering tentative approaches in response to market needs while maintaining the basic stance that credit rating is after all a means by which to determine the credit risk.

[12] In addition, there are movements in the European and the U.S. authorities regarding CRAs such as the following:
In the U.S., Mr. Christopher Cox, Chairman of the SEC, stated on April 22 that the SEC was considering revising the regulations for CRAs with regard to the following areas,:

- Accountability(ensuring the comparability among CRAs about rating performance, prohibiting the provision of consulting services to the issuers of securities they rate, etc.)
- Transparency (disclosing information on underlying assets, and enhancing the disclosure about how CRAs determine their rating for structured products)
- Competition (enhancing disclosure of rating performance, enhancing competition by promoting greater due diligence by market participants, and expanding access to information on underlying assets)

Also, on May 19, as requested by the European Commission, the Committee of European Securities Regulators (CESR) released the "CESR's Second Report to the European Commission on the compliance of credit rating agencies with the IOSCO Code and the role of credit rating agencies in structured finance" As a response to the current issues, this report recommended, as an immediate step, to form a body to develop international standards for CRAs and to monitor the compliance of CRAs to those standard.

Note: In this context, the way CRAs should function and the reliability of credit ratings were further called into question as some CRAs were found to have made mistakes, in their credit ratings for CPDO (constant proportion debt obligation), a complex financial product, due to computer error.

(2) Institute of International Finance (IIF)

In its interim report released on April 9, the IIF (see Note below) put forward their recommendations for developing best practice regarding risk management and information disclosure by major financial institutions as a lesson drawn from the turmoil in the current financial markets. The IIF is scheduled to release a final report by the end of June this year.

Note: The IIF is an international organization set up by private financial institutions in 1983, taking the opportunity of the debt crisis of the 1980s. It has more than 375 companies from more than 70 member countries as its members. Eleven financial institutions from Japan are IIF members.

4. Approaches taken in Japan

As described above, , the FSA has actively put forward recommendations based on the First Report at international discussions regarding the strengthening of the foundation for the OTD (originate-to-distribute) model, the importance of communication of information on the arrangement and sale of securitized products, and various issues on CRAs and accounting. Many of these recommendations have been reflected in the measures proposed by the international organizations.

Also, the FSA has been making efforts to disseminate information in a proactive manner, including prompt disclosure of the amount of subprime mortgage-related products held by Japan’s financial institutions, which was collected based on a unified standard.

Responding to the recommendations put forward in the First Report, the FSA and the parties concerned have taken the approaches described in the following. This Team expects further efforts to be made to push forward the approaches suggested in the First Report.

(1) Enhancing market analysis and reinforcing international cooperation with among supervisory authorities

The current crisis can be regarded as a 21st century-type crisis triggered by the markets. It is therefore important to utilize information from the market adequately for supervisory purposes. To this end, the FSA is scheduled to set up the Office for Supervisory Policy, Financial Market and Risk Analysis from the next program year starting July 2008, and the preparations are now under way. In the midst of a deepening link between domestic and international financial markets and an increasingly low barrier between businesses due to factors such as progress in conglomeration, it is important to make supervisory responses from a global and all-inclusive viewpoint.

Also, the FSA has increased the number of foreign authorities with which an MOU (Memorandum of Understanding) has been concluded, and has initiated or continued to hold periodical consultations with foreign authorities, with a view to strengthening cooperation with them. Meanwhile, the FSA and the Ministry of Finance have been engaged actively in the exchange of information with financial authorities in Europe and the U.S. with regard to the subprime mortgage problem. It is necessary to continue to make further efforts to reinforce such cooperation.

(2) Ensuring traceability

As one of the major contributing factors as to why the subprime mortgage problem spread, the Strategy Team, in the First Report, raised the issue of the so-called "risk proliferation uncertainty," i.e., as financial technologies such as securitization become widespread, it becomes difficult to identify the location and magnitude of risks because the risks pertaining to the underlying assets have been widely dispersed. Accordingly, the Team raised the question of whether there were problems with the arrangers and distributors of securitized products in their information collection and analysis, and their framework for communication and sales.

In addition, as a response in Japan, the First Report pointed out that the provision of necessary information in an appropriate manner by individual entities involved in the securitization process should be explored and, on that basis, it is hoped that effective measures for the establishment of a mechanism for ensuring traceability will be discussed among the parties concerned based on business practices in the private financial sector.

Following these recommendations, the FSA revised on April 2 its "Guidelines for Supervision of Financial Instruments Firms, etc.," which laid down important matters regarding the communication of information when financial instruments firms sell securitized products. The revised Guidelines for Supervision aim to encourage companies selling securitized products to acquire and provide information on the risks of original assets, and thereby to improve traceability. Also, responding to this revision of the Guidelines, the Japan Securities Dealers Association founded the "Working Group on Sales of Securitized Products" and started the consideration of voluntary rules on the communication of information and a uniform format for information disclosure regarding securitized products[13].

It is hoped that great progress will be achieved in improving the traceability of securitized products, and eventually in enhancing transparency and fairness of the securitized market in Japan, as these approaches are taken together by the authorities and self-regulatory organizations,.

(3) Improving the early warning system, etc.

As was seen when Bear Stearns's business conditions deteriorated, the liquidity conditions and financial soundness of a securities company or an investment bank may

[13] The FSF report in April 2008 referred to and welcomed this study.

deteriorate rapidly when the market environment is undergoing drastic changes. In Japan, the early warning system, which takes into consideration liquidity conditions and financial soundness with regard to deposit-taking financial institutions, has so far been used effectively and, in view of the recent conditions, an early warning system for financial instruments firms was introduced on April 2, whereby an alarm line is set regarding any sharp decline in the capital adequacy ratio or a drastic change in prices of stocks and bonds held, and a detailed hearing will be conducted when the situation falls below standard, thereby leading to adequate supervision.

(4) Presenting principles and exploring best practice

Development of voluntary rules and best practices by self-regulatory organizations will be effective with regard to disclosure related to securitized products. In this connection, the Japan Securities Dealers Association has held the “Working Group on Sales of Securitized Products” and discussed issues such as disclosure and risk measurement.

In addition, the fourteen Principles in the Financial Services Industry were announced on April 18, on which the FSA and financial service providers agreed to share, as part of the FSA’s efforts toward “better regulation.” These Principles also pointed out the importance of risk management and information provision. It is hoped that financial institutions and trade associations will continue their voluntary efforts to make improvements in this direction.

III. Future tasks

1. Lessons from Japan’s non-performing loan problem

From the 1990s onward, Japan addressed the problem of the non-performing loans that had weighed on its financial institutions. It took the country many years to resolve this problem, and Japan learned a variety of lessons during the process. The ongoing subprime mortgage problem differs from Japan’s non-performing loan problem in that it originated in the securitization market. Nonetheless, we believe that the lessons Japan has learned may be useful in a variety of ways, given that the two problems evolved in a similar fashion: starting with the bursting of a “bubble,” threatening the solvency of financial institutions, destabilizing the financial system and hurting the real economy.

(1) The first useful lesson is that prompt action is essential. Japan’s non-performing loan problem grew serious because a long period of time (seven to eight years) elapsed between the collapse of the economic bubble and the establishment of a full-fledged safety net underpinned by public funds.

The “jusen” housing loan companies, which had been set up primarily by banks, plunged into insolvency as their loans went sour, prompting the government to decide to use public funds to resolve the crisis. However, public opposition to the use of public funds grew on the grounds that the financial institutions involved were not held fully responsible for the crisis, among other reasons. This made it difficult to establish a full-fledged safety net.

As a result, it was not until 1998 that such a safety net, underpinned by public funds, was established. The losses related to the disposal of non-performing loans over the period between 1992 and 2004, when the non-performing loan problem finally subsided, amounted to as much as ¥96.4 trillion.

Based on this bitter lesson, Japan’s safety net has been substantially enhanced. From the viewpoint of ensuring the stability of the financial system, the financial authorities of countries around the world should constantly review the status of their national safety nets and promptly make any necessary improvements, while bearing in mind possible future developments related to the financial markets and financial systems.

(2) The second lesson is that the issue of solvency lies behind a liquidity crisis. In November 1997, the first postwar default occurred in the Japanese call market, which until then had been operated based on the assumption that a default would never occur. Prompted by this default, jitters over the issue of solvency grew, throwing the money markets into turmoil. As a result, three major banks and one major securities company failed.

In this respect, it is important, first and foremost, that the senior managers of financial institutions proactively engage in efforts to enhance risk management and governance.

Given that liquidity risk has materialized at some financial institutions during the subprime mortgage problem, it is important not only that financial institutions enhance their risk management to a more advanced level, but also that the financial supervisory authorities precisely grasp the state of health of financial institutions, particularly when the market is under stress (stress testing).

(3) The third lesson is that a common yardstick is essential for the proper assessment of asset quality. From the viewpoint of ensuring the precision of financial institutions' calculation of their capital adequacy ratios, Japan established a framework of rules in 1998 concerning asset quality assessment, loan write-offs and loss provision, coinciding with the introduction of the prompt corrective action system, under which the authorities can issue an order to financial institutions that have failed to maintain an appropriate level of the capital adequacy ratio.

This has made it possible to precisely grasp the financial conditions of financial institutions on a comparable basis, to introduce market discipline based on information disclosure, and to enhance the effectiveness of inspections by the authorities.

In relation to the subprime mortgage problem, SIVs – which had previously been treated as an off-balance item – were in some cases moved back onto the balance sheet, leading to the booking of huge losses. As a result, the issue of whether to consolidate SIVs in financial statements has drawn strong interest. Furthermore, it has been pointed out that it is difficult to apply the fair value approach to securitized products in a situation in which market prices are hard to determine.

In order to maintain and enhance the market's confidence in financial reports, it is desirable that the bodies responsible for setting accounting standards and other parties concerned urgently conduct studies and deliberations on issues such as the consolidation of SIVs, appropriate valuation of financial instruments with insufficient liquidity and disclosure practices, while paying due consideration to the opinions of market players and regulatory authorities.

(4) The fourth lesson is that if a problem at a financial institution is detected and recognized at an early stage and the institution remains solvent, the government can deal with the problem through the injection of capital, which will probably reduce the financial burden on taxpayers in comparison with resolution procedures. In Japan, public funds totaling approximately ¥12.4 trillion were used for the injection of capital into troubled financial institutions. At this amount, approximately ¥8.8 trillion in face value has been collected, bringing profits of about ¥1.3 trillion to government coffers.

Meanwhile, regarding the total cost of resolution procedures, funds totaling ¥18.6 trillion, including deposit insurance benefits, were provided as grants in order to sort out the failed financial institutions. Of this amount, ¥10.4 trillion is set to be borne by taxpayers.

In light of its experiences of capital injection and resolution procedures, as well as the various arguments and opinions concerning issues such as moral hazard and management responsibility, Japan gives consideration to the need to prevent moral hazard while avoiding systemic risks under its prudence policy.

Note: Reflecting the abovementioned approach, in usual cases, Japan provides insurance for deposits totaling up to ¥10 million per depositor, as a way to protect small-lot depositors and prevent bank runs. However, extraordinary measures that go beyond the system of limited deposit protection are provided for in order to address cases where the failure of an individual bank could lead to the materialization of systemic risk [14]

Furthermore, if an LCFI (large and complex financial institution) fails or faces deterioration in the soundness of its operations, the global financial markets could be significantly destabilized, given the huge presence of such an institution in the markets, including the derivatives market. In light of this possibility, there is no doubt that it is important to act before the soundness of a financial institution substantially deteriorates (crisis prevention) and to manage crises properly. With this in mind, the authorities of each country should conscientiously strive to ensure the stability of the financial system.

2. Evaluation of policy measures taken up to now and future tasks

As the turmoil in the global financial markets has not yet subsided, Japan must keep a close watch on future developments.

The most important thing for ending the turmoil is that financial institutions make increased efforts to tackle it. In addition, the authorities responsible for supervising the financial markets and financial institutions should promptly implement appropriate measures as necessary. Since the subprime mortgage problem is a 21st century-type crisis in that it first emerged in the markets and produced a global impact, the supervisory authorities should further enhance cooperation with each other in

[14] In order to avoid moral hazard, two schemes are available as extraordinary measures, with one of them applying to (i) cases where the troubled financial institution maintains a positive net worth and the other to (ii) cases where it has fallen into negative net worth. In case (i), public funds are used to inject capital into the financial institution, while full deposit protection and provisional nationalization are used to deal with case (ii).

responding to the problem.

We basically appreciate the policy measures recommended by the FSF and IOSCO, as they are based on the same perspectives as the ones reflected in our First Report. The FSA should continue to actively engage in efforts to enhance risk management by Japanese financial institutions, with due consideration of the perspectives reflected in the reports issued by the FSF and others. The following are the points of attention in carrying out the recommended policy measures, as recognized by the Financial Markets Strategy Team:

(1) It is crucial that rigorous implementation of each recommended policy measure and follow-up, by the bodies and in line with the timetables as specified in the FSF report.

The FSA and other relevant Japanese authorities should get actively involved in discussions regarding the issues set aside by the FSF report for future recommendations.

There are also some recommendations which require private sector entities such as institutional and other investors need to take action.[15] The relevant investors (or, in some cases, the IIF and industry groups comprising private financial institutions) should promptly take appropriate action.

(2) In its First Report, the Financial Markets Strategy Team already pointed to the importance of detecting problems early and taking prompt action. From this viewpoint, the Team appreciates the FSF report's stance of putting emphasis on determining and disclosing losses early and of encouraging financial institutions heavily exposed to risks related to the current market conditions to adopt leading disclosure practices.

Meanwhile, the FSA have compiled and published data[16] on exposures of Japanese

[15] For example, the report refers to the establishment of best practices and a review of risk analysis concerning securitized products.

[16] In light of the losses incurred by domestic and foreign financial institutions as a result of the subprime mortgage problem, on June 6 the FSA started soliciting comments on proposed revisions to

deposit-taking financial institutions to subprime-related products, securitized products, etc. ahead of their foreign counterparts (see Notes 1-3 below). We hope that the authorities of other countries will follow the FSA's example.

In this respect, the IMF discusses problems[17] related to the existing fair value accounting in its Global Financial Stability Report. The Team is of the view that suspending the application of fair value accounting, for example, would not necessarily help to stabilize the market, as it would only postpone the booking of losses. We therefore believe that careful consideration is warranted regarding this kind of measures.

Note 1: Japanese financial institutions significantly expanded the scope of disclosure items on the occasion of announcing their financial results for the fiscal year ended in March 2008, following the issuance of the FSF report.

Note 2:The amounts of subprime mortgage-related products, etc. held by Japanese deposit-taking institutions as of the end of March 2008 are as follows:

	Book value	Valuation losses	Realized losses
Major banks, etc.	933 billion yen	-123 billion yen	-652 billion yen
Regional banks	54 billion yen	-1 billion yen	-46 billion yen
Cooperative financial institutions	32 billion yen	-1 billion yen	-28 billion yen
Total	1,019 billion yen	-125 billion yen	-725 billion yen

"Major banks, etc." include major banks [Mizuho Bank, Mizuho Corporate Bank, Mizuho Trust Bank, Bank of Tokyo-Mitsubishi UFJ, Mitsubishi UFJ Trust Bank, Sumitomo Mitsui Banking Corporation,

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the supervisory guidelines that take into consideration the points of attention in risk management identified through hearings with financial institutions and examination by international forums such as the FSF.

[17] With regard to the desirable role to be played by the public sector in the short term, the IMF's Global Financial Stability Report states, "Some latitude in the strict application of fair value accounting during stressful events may need to be more formally recognized."
According to media reports, sources related to some private sector financial institutions have pointed out problems regarding fair value accounting.

Resona Bank, Chuo-Mitsui Trust Bank and Sumitomo Trust Bank], Norinchukin Bank, Shinsei Bank, Aozora Bank, Citibank, new types of banks, foreign trust banks, etc.
“Cooperative Financial Institutions” include Shinkin Banks including Shinkin Central Bank, Credit Cooperatives including The Shinkumi Federation Bank, Labor Banks including The Rokinren Bank, Prefectural Banking Federations of Agricultural Cooperatives and Prefectural Banking Federations of Fishery Cooperatives. This does not include Japan Agricultural Cooperatives, etc.

Note 3:The amounts of securitized products, etc. held by Japanese deposit-taking financial institutions, disclosed in line with leading disclosure practices recommended by the FSF report, are as follows:

	Book value	Valuation losses	Realized losses
Total	22,793 billion yen	-983 billion yen	-1,453 billion yen

(3) The FSF report recommends establishing international colleges of supervisors as a framework for cooperation among authorities in supervising internationally active banks. If such a college is to be established for the supervision of a financial institution with particularly large influence on Japan’s financial markets, it is desirable for the Japanese authorities to be involved in the college as much as possible.

The FSF report also recommends, regarding major cross-border financial institutions, that the supervisory authorities and central banks most involved establish a small group to address specific cross-border crisis management planning issues. In response to these recommendations, the Japanese authorities should actively involve themselves in relevant discussions in various aspects, based on the lessons Japan has learned from its efforts to stabilize the financial system.

(4) The FSF report points out that authorities need to “strengthen, where appropriate, arrangements (legal frameworks for resolution, deposit insurance, etc.) for dealing with weak banks, both nationally and cross-border.” In the past, there were some cases of a certain degree of public intervention in dealing with crises at individual banks. In the future, it may become necessary to consider strengthening the involvement of the public sector, depending on future developments.

The lessons Japan has learned will be useful for the establishment of safety nets designed to stabilize the financial system. It is also important for us to bear in mind that the subprime mortgage problem could have an extremely large impact on the global economy, given that its effects have spread widely throughout the U.S. and European financial markets, which are at the core of the global financial system.

(5) The IOSCO published a report that included revisions to the Code of Conduct Fundamentals for Credit Rating Agencies, with a view to restoring investor confidence in credit ratings. CRAs should promptly implement measures based on the revised Code of Conduct and fulfill their accountability obligations to investors properly.

3. Points of attention concerning the global financial markets from Japan's viewpoints

As we explained above, it is necessary to keep a close watch on the possible materialization of risks and policy measures taken in relation to the global financial market turmoil triggered by the subprime mortgage problem. At the same time, Japan should also watch various developments in the global markets with increased interest, from the perspective of how to make use of the markets to achieve economic growth.

(1) Strengthening the competitiveness of the financial and capital markets

In the global financial markets, a major shift in the flow of funds and a structural change in the international macro-economy may be occurring against the backdrop of surging crude oil and food prices. Japan must respond to such possible changes properly. As Japan is poor in natural resources and has a low food sufficiency rate, its economic structure will be highly vulnerable to these macroeconomic changes.[18] In addition, the country is saddled with structural problems such as the aging and shrinking population as well as a ballooning fiscal deficit, and faces competition

[18] The amount of funds that flowed out of Japan due to the deterioration in trade terms totaled ¥21 trillion in fiscal 2007, compared with ¥19 trillion in income earned by Japan from its net foreign assets, such as interest and dividend income (net receipts). Over the past four or five years, the trade terms for Japan have rapidly deteriorated, to the extent that they have almost wiped out the country's investment surplus, which represents the benefits of the current account surpluses accumulated since the end of first oil shock.

from the rapidly growing economies of China and India. If Japan is to remain a major global economic power in terms of per-capita GDP in a situation like this, it will need to make effective use of financial assets held by Japanese households worth ¥1,500 trillion, and strengthen the competitiveness of its financial and capital markets while continuing to manufacture products with high value added.

The financial sector globalization over the past decade has led to a decrease in the ratio of deposits to overall financial assets and a significant increase in the total stock market capitalization. The United States and Europe, for example, have attracted increased flows of foreign capital by opening their financial markets wider, and at the same time increased their own overseas investment, thereby revitalizing economic activities both at home and abroad and enhancing their profit-generating capabilities. This has led to an increase in the total capitalization of the U.S. and European stock markets, which in turn expanded the overall size of U.S. and European financial assets. [19]

The living standards for Japanese people will rise[20] if Japan establishes a flow of funds from savings to investment and expands the amount of financial assets held by households, by enhancing its financial sector and developing the Tokyo market into Asia’s leading financial center. It is also important to consider how Japan should create domestic demand and contribute to the Asian and global economy. From this viewpoint, Japan should implement promptly the measures[21] included in the Plan for Strengthening the Competitiveness of Japan’s Financial and Capital Markets and constantly review and revise regulations that could undermine market

[19] Over the past 10 years alone, the amount of global financial assets has increased by $90 trillion. This increase is six times the size of the total amount (¥1,500 trillion, or $15 trillion) of financial assets accumulated by Japanese households, mainly through savings, over the six decades since the end of World War II. Taking into account the time span as well as the amount of funds, we may say that the size of financial assets in the United States and Europe has grown 36 times as fast as the size of assets in Japan.

[20] It should be noted that direct finance accounted for most of the supply of industrial funds in Japan in the 1930s.

[21] The Bill for the Amendment of the Financial Instruments and Exchange Act, etc. was enacted on June 6, paving the way for the establishment of a market intended exclusively for professional investors, the diversification of exchange-traded funds, a review of the firewall regulations, an expansion of the scope of businesses for banks, etc. and the revision of the administrative civil monetary penalties system.

competitiveness, thereby making the Japanese economy more competitive.

(2) Sovereign Wealth Funds (SWFs)

The presence of SWFs in the global financial markets is growing. SWFs have provided about 30 percent of the additional capital (totaling around ¥20 trillion) received by U.S. and European financial institutions that incurred massive losses in relation to the subprime mortgage problem.

There is no clear, official definition of an SWF. However, we can identify notable features of an SWF, such as that (1) it is owned by a government, (2) it is comprised of assets denominated in foreign currencies, (3) it has a net asset value and (4) it can afford to invest in various assets, including risk assets, from a long-term perspective.

Although SWFs have existed for many years, mainly in oil-producing countries, their number and asset size have increased sharply in recent years, with the total amount of assets managed by SWFs estimated at between $2.5 trillion and $3.0 trillion (the exact amount is not clear due to the absence of information disclosure).

As developments related to SWFs have drawn international attention, the Financial Markets Strategy Team has been conducting research and analysis based on hearings with relevant parties.

From Japan's viewpoint, the various issues of interest related to SWFs include:

(i) What influence will SWFs have on the stability of the global financial markets and on the global economy, and what are the points of attention in this respect?

(ii) How should Japan deal with (existing) SWFs and what are the points of attention in this respect?

(iii) What is Japan's stance on the idea of establishing an SWF of its own?

(Regarding (i))

SWFs have drawn criticism for their alleged lack of transparency. In addition, concerns have been expressed that SWFs may be used as vehicles to pursue inappropriate macroeconomic policies, such as artificially keeping the value of currencies low, that their investment activities may destabilize the global financial markets, and that political motives may be reflected in their investments. Amid such concerns, the IMF is planning to draw up best practices for SWFs in areas such as organizational structure, risk management, transparency and accountability (a report is scheduled to be published in October this year).[22]

(Regarding (ii))

As we will explain in (3) below, we believe that it is an urgent task for Japan, as an "open country," to establish an attractive financial market that will draw both domestic and foreign funds, as it is confronted with the aging and shrinking population. From this perspective, it would basically be a welcome development if SWFs increased investments in Japan while acting in accordance with the principles and best practices mentioned in (i).[23]

Meanwhile, it is necessary to consider ways to enhance governance with regard to investment in Japan by entities backed by foreign capital, including SWFs, in order to ensure the fairness and transparency of the market. As the globalization of the securities market advances further, it is also important for the Japanese authorities to strengthen their relations with the market regulators of other countries, including the ones that own SWFs, through measures such as establishing an adequate framework for exchange of information.

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[22] On March 20, the United States reached agreement with the governments of Abu Dhabi and Singapore on policy principles for SWFs and countries receiving investments from SWFs.

[23] In response to a request from the G-7, the OECD has drawn up guidelines for countries receiving investments from SWFs. The guidelines point out that (i) SWFs should be treated fairly, as they bring benefits to both home and host countries, and that (ii) recipient countries should observe the principles of proportionality, transparency, predictability, etc. in the design and implementation of measures intended to address national security concerns. In a declaration adopted at the OECD Ministerial Council Meeting held on June 5, the ministers welcomed the benefits brought by SWFs to the economic development of both home and host countries and opposed the establishment of protectionist barriers against foreign investment.

(Regarding (iii))

Regarding the issue of whether Japan should establish an SWF of its own (irrespective of whether or not to describe or define the fund as an SWF), there are both supporters and opponents of such establishment. Supporters argue that government-held assets should be utilized as effectively as possible for the benefit of the people and that such a fund would help to inject vitality into Japan's financial markets. Meanwhile, opponents point out that the management of such a fund would involve various potential problems, such as the issue of accountability and the need to ensure safety and stability, given that the fund would have a public nature under whatever scheme. Therefore, it is essential that the parties concerned conduct in-depth discussions on this matter from a variety of perspectives, including how to efficiently manage national assets and how to strengthen the competitiveness of the financial and capital markets, as well as what the role of SWFs in the global financial markets is.

As debates on the idea of establishing a Japanese SWF is under way at various forums, it is important to keep a close watch on developments related to the existing foreign SWFs and international discussions concerning SWFs. Another point of attention is that, because of the growing institutionalization of the financial and capital markets, the asset management capabilities and systems of institutional investors have significant implications for the quality and performance of the markets. From this viewpoint, in order to allow people to receive the benefits of the management of national assets such as pension reserves, it is necessary to consider drastic reforms to achieve efficient management of pension assets, including abolishing the Government Pension Investment Fund and shifting to a personal account system.

(3) Promotion of foreign investment in Japan

In an effort to become a "country open to the world," Japan is striving hard to attract foreign investment and strengthen the competitiveness of its financial and capital markets. This effort will contribute significantly to the sustainable growth of the Japanese economy by injecting vitality into the economy and expanding employment opportunities, as the country grapples with problems such as the aging and shrinking population.

Meanwhile, with an increasing number of public corporations being privatized, there are growing calls for the need to introduce new regulation – given the public nature of such corporations' services and businesses – and, in some cases, the imposition of restrictions on foreign ownership is advocated as a regulatory measure.

It is argued that other countries, while observing the principle of equal treatment for domestic and foreign interests, also impose restrictions compatible with international rules on foreign investment in areas that may concern national security and public order. However, it is important to be careful to avoid creating the mistaken impression that Japan is not an "open country" when designing and implementing these restrictions. In the meantime, it has been pointed out that the effectiveness of restrictions on foreign investment is questionable, given that entities backed by domestic capital, as well as those backed by foreign capital, could undermine the public nature of their investment targets.

Our conclusion is that restrictions on foreign investment should be limited to a necessary minimum under the principle of equal treatment between domestic and foreign interests; while giving due consideration to the public nature of the services and business of the investment target, the restrictions need to be sufficiently consistent with Japan's broad goals of promoting foreign investment and of strengthening the competitiveness of its financial and capital markets,

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It is also important to ensure high degree of predictability regarding the enforcement of restrictions on foreign investment, since low predictability would make Japan less attractive as a market for investment.

Furthermore, it is essential that the government hold sufficient dialogue with market players, both domestic and foreign, as part of the process of deliberating on future reform of the framework for investment, in order to avoid surprising them with unexpected measures.

The Council on Economic and Fiscal Policy has recommended that comprehensive deliberations be conducted on restrictions on foreign investment within fiscal 2008.[24] It is extremely important that issues like this be addressed through deliberations that extend across the boundaries of ministries and agencies. It is also important for the FSA to actively involve itself in such deliberations and make clear to the outside world that Japan is open to foreign investment.[25]

Conclusion ~ Toward an open country with financial strength~

It is hard to predict how the global financial markets will evolve, including how far the impact of the subprime mortgage problem will spread. We therefore must monitor future developments closely and with an enhanced level of vigilance.

As described above, there are signs of a change in the fund flow structure as represented by increased investment in real assets, against the backdrop of factors such as the economic growth of emerging countries as well as reduced confidence in securitized products and other financial assets. Therefore, we must also keep a close watch on a possible major shift in the money flow.

Whereas U.S. and European financial institutions are expected to remain in a difficult situation for a while, it can be said that now is the time for Japanese financial institutions to "go on the offensive" by actively exercising their financial intermediary functions in the global financial markets, given the limited damage they suffered from the subprime mortgage problem.

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[24] "Economic Growth Strategy" by the Council on Economic and Fiscal Policy (June 10, 2008)

[25] The "Economic Growth Strategy" also recommended that the key points of the rules on M&As be sorted out and clarified by the summer of 2008.

In addition, Japan should accept foreign investments with open arms and take advantage of them in order to inject vitality into the Japanese economy. From this perspective, Japan should steadily implement the measures included in the Plan for Strengthening the Competitiveness of Japan's Financial and Capital Markets, and continue efforts to make the markets more attractive. With financial regulation entering a new phase, Japan should aim to become an "open country with financial strength," capable of competing with financial centers around the world in terms of talent, institutional infrastructure, the quality of financial services, the integrity of the market, financial supervision and other elements.

End