



# FSA Newsletter March 2006



Yoshitaka Sakurada (Senior Vice Minister for Economic & Fiscal Policy and Financial Services) making an address at the meeting of Directors of Local Financial Bureaus (January 25)



Kaoru Yosano (Minister of State for Economic & Fiscal Policy and Financial Services) making an address at the Informal Round Table on Operations of Stock Exchange (February 6)

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## [Topics]

### **Launch of Informal Round Table on Operations of Stock Exchanges**

As the securities market is crucial infrastructure for economic activities, stock exchanges (i.e., market operators) are required to ensure smooth and stable operations of the market. As problems have been arising since last year, including a series of system failures, efforts are being made to restore confidence primarily by related institutions including stock exchanges.

In order to support such efforts, the Informal Round Table on Operations of Stock Exchanges (the Financial Services Minister's private consulting group headed by Yutaka Narita, Principal Advisor of Dentsu Inc.) held its first and second meetings on Monday February 6, 2006 and Friday February 17, 2006, respectively, to conduct studies and give advice from the viewpoint of experts with a global perspective.

At the second meeting, members agreed that it would be important for the Round Table to issue public messages promptly with respect to pressing matters such as system improvements and therefore, published a report titled "Summary of 1<sup>st</sup> Preliminary draft discussion paper on issues on building better operation systems of Stock Exchanges" on Thursday February 23.

In the months ahead, the Round Table will discuss a wide range of subjects—not only how systems should be improved but also what form stock exchanges should take—and will announce its opinions to the public whenever the preferred policy directions have been determined.

### **Framework (Terms of Reference) of the High-Level Dialogue between the Financial Services Agency and the U.S. Securities and Exchange Commission**

1. Amid the increase of cross-border financial transactions, the Financial Services Agency of Japan (FSA) acknowledges that it is extremely important to build a cooperative relationship with the Securities and Exchange Commission of the United States (SEC), which oversees the world's largest securities market. From this point of view, the FSA has been making efforts to maintain a good relationship with the SEC in the past.
2. The FSA and the SEC decided to have a regular high-level bilateral dialogue on securities markets ("Dialogue") in May 2005, then the first Dialogue was held in Tokyo in June 2005.
3. On January 27, the FSA and the SEC established and agreed on the framework ("Terms of Reference") which sets forth the objectives, timing, venue, participants and agenda of the Dialogue, with the aim of regularizing the Dialogue.
4. In accordance with the Terms of Reference, the FSA and the SEC will have regular meetings between senior staff and high-level officials of the FSA and the SEC counterparts, to exchange views on issues of common interest pertaining to the securities markets in both countries and to promote cooperation in addressing such issues. Discussion items for 2006 are expected to include: accounting and auditing standards; corporate governance and internal controls; approaches to securities companies, self-regulated entities, etc.; cross-border cooperation and information sharing on enforcement matters; and approaches to facilitating technological progress in securities markets.

\* For more information, please refer to ["The framework \(Terms of Reference\) of the High-Level Dialogue between Financial Services Agency and the US Securities and Exchange Commission" \(January 30, 2006\)"](#) in the ["Press Releases"](#) section of FSA's website.

## EU-Japan High Level Meeting on Financial Issues

1. On 18 January 2006, the EU-Japan High Level Meeting on Financial Issues was held at the headquarters of the European Commission in Brussels, the capital of Belgium. The meeting is a regular international conference, which has been held once a year since 1985, in order for senior administrative officials of the fiscal and monetary authorities of Japan and the European Union (EU)—namely, the Japanese Ministry of Finance (MOF) and the Financial Services Agency (FSA) and the Directorate General for Economic and Financial Affairs (DG ECFIN) and the Directorate General for Internal Market and Services (DG MARKT) of the European Commission—to exchange opinions on the macroeconomic climate and major issues relating to the respective financial sectors in Japan and the EU. This meeting was attended by Mr. Hiroshi Watanabe, Vice-Minister of Finance for International Affairs, MOF, Mr. Toru Shikibu, Deputy Commissioner for International Affairs, FSA and their related staff, and by Mr. Klaus Regling, Director General of DG ECFIN, Mr. Alexander Schaub, Director General of DG MARKT and their related staff.
2. In this meeting, the morning session started with discussions between MOF and DG ECFIN on the macroeconomic climate and fiscal and monetary policies in Japan and the EU. This was followed by a joint session with the participation of MOF, FSA, DG ECFIN and DG MARKT which involved discussions on the influence of China's economic performance on the Japanese and EU economies, the stability of the Chinese financial sector, and EU's assessment on the equivalence of the Japanese accounting standard with the International Accounting Standard (IAS). In the afternoon session, FSA and DG MARKT exchanged opinions on the developments in Japan and EU's financial sectors in recent years. The Meeting was productive in that opinions were actively exchanged throughout the day between MOF, FSA and the European Commission. The following is a summary of discussions on FSA-related matters.
3. With respect to the assessment on equivalence between accounting standards, in January 2005, as part of measures to consolidate the EU capital markets, the European Commission introduced a new rule that obliges local companies whose securities are listed on stock exchanges within the EU region to disclose IAS-compliant financial statements. Furthermore, the European Commission is going to apply the rule that obliges non-EU companies listed on the stock exchanges within EU region to disclose financial statements which comply with IAS or other accounting standards equivalent to IAS. Accordingly, with the aim of applying such obligations to foreign companies from January 2007 onwards, the European Commission has been assessing Japanese, American and Canadian accounting standards as to whether they are equivalent to IAS, and has been working toward reaching its conclusion. If in the end the European Commission concludes that the Japanese accounting standard is not equivalent to IAS, Japanese companies, which are currently listed on stock exchanges within EU region, will not be allowed to disclose information to EU investors by publishing financial statements based on the Japanese accounting standard; they will have to disclose information based on IAS or other accounting standards equivalent to IAS, which will be a significant burden on them. In this context, the FSA has stressed that Japanese accounting standard should be deemed equivalent to IAS because the Japanese accounting standard is already consistent with IAS and has excellent quality through the experience of "the Accounting Big Bang" in the late 1990s. In this meeting, Mr. Watanabe stated his concern that EU's uncertain direction to the conclusion of the assessment is increasing uncertainty of future funding of Japanese companies in the EU capital market. In response, the European Commission underlined the importance of ensuring effective equivalence between accounting standards through their convergence, and expressed its view that this problem could surely be resolved in the future by maintaining a close relationship between Japan and EU. Both Japan and EU share a consensus that it was important that the Accounting Standard Board of Japan (ASBJ), which established the Japanese accounting standard, and the International Accounting Standard Board (IASB), which established IAS, have to make progress on collaborative activities towards convergence of the Japanese accounting standard and IAS, including their ongoing joint project.

4. With respect to developments of the Japanese financial sector, the FSA explained that the non-performing loans problem of major banks—which had been a crucial issue—was resolved and international confidence in the Japanese financial system has been restored and introduced various measures for responding to the diversification of financial services and consumer needs and the recent further globalization of the financial sector, according to the Program for Further Financial Reform. The European Commission praised the rapid progress of Japanese financial system reform. As the European Commission showed its interest in how the review of the bank agent system would have an influence on the business of foreign financial institutions operating in Japan, the FSA explained the merits of the reform for both consumers and financial institutions.  
The FSA also introduced the basic concept of the draft of the Investment Services Law (provisional name) and the efforts for its legislation. Based on its experience of efforts to consolidate the EU financial markets, the European Commission asked questions about reflecting the opinions of market players in the legislative process. In response, the FSA explained that it had been working towards its legislation by taking account of the opinions of market players in foreign countries, including the EU, as well as those in Japan. The European Commission praised the FSA's efforts to create a new legal framework, which regulates various types of businesses and services in the Japanese financial sector in a cross-sectoral, comprehensive manner, because of being consistent with the trend of financial liberalization and globalization.
5. On the other hand, in regards to development in the EU financial sector, the European Commission introduced the *White Paper on Financial Services Policy*, which was announced at the end of last year as a comprehensive plan for consolidation of financial markets within the EU region in the next five years, and the priority issues to be tackled in the future based on this plan. The European Commission announced the White Paper—a plan to further consolidate the financial markets within the EU region—following the previous comprehensive policy program, the Financial Services Action Plan (FSAP). The FSA and the European Commission actively discussed the influence of the Clearing and Settlement Services Directive, which aims at unifying the clearing and settlement systems within EU borders, upon financial markets outside the EU region, in light of the provision of the White Paper, which requires the European Commission to take account of the influence of various future measures upon third countries.  
Moreover, the European Commission presented the Markets in Financial Instruments Directive (MiFID), which is aimed at consolidating the EU capital markets (such as entry restriction on investment service businesses (the passport system), investor protection rules, promotion of competition among market participants) and future activity to execute MiFID. The FSA and the European Commission exchanged opinions on the obligations imposed on investment service providers by comparing the Japanese system with the EU system.
6. After the meeting, the joint press release, outlining the meeting, was published.  
The next EU-Japan High Level Meeting on Financial Issues is scheduled to take place in Tokyo. (The date is yet to be decided.)

\* For more information, please refer to [“EU-Japan High Level Meeting on Financial Issues” \(January 19, 2006\)](#) in the [“Press Release”](#) of FSA website.

### **Amendment to the Information Sharing Arrangement with the US Securities and Exchange Commission and the US Commodity Futures Trading Commission**

1. As an increasing number of financial transactions are taking place across national borders, including those involving securities and financial derivatives, there is a growing need for overseas regulatory authorities to have the ability to share information smoothly with each other in order to oversee and supervise markets properly.

2. For this purpose, the Financial Services Agency (FSA) has already established an information exchange arrangement with the United States, Australia, Hong Kong, etc. (so-called “Japan-U.S. Memorandum of Understanding on information-exchange concerning Securities sector”). However, the existing arrangement covers securities derivatives but not financial derivatives.
3. On the other hand, the Commodity Futures Trading Commission of the United States (CFTC), which oversees financial derivatives in the United States, had requested information exchange on financial derivatives as well whenever necessary; with this in mind, the existing Statement of Intent (“SOI”) concerning Cooperation, Consultation and the Exchange of Information concluded among the FSA, the CFTC and the Securities and Exchange Commission of the United States (SEC) was amended on January 16, 2006, in order to include financial derivatives within its scope.
4. The document to amend the said SOI was signed when CFTC Chairman, Mr. Reuben Jeffery III, visited FSA Commissioner, Mr. Hirofumi Gomi, on the aforementioned date. In the meeting, the two exchanged their opinions on the importance of investor protection in relation to financial futures instruments, etc., and agreed that their cooperative relationship will become even more significant for that purpose.

\* For more information, please refer to [“Signing of the amendment to the Information Sharing Arrangement with the US Securities and Exchange Commission and US Commodity Futures Trading Commission” \(January 16, 2006\)](#) in the [“Press Releases”](#) section of FSA’s website.

### **Publication of Insurance Buyers' Guides**

The Insurance Buyer’s Guides produced by the Japan Institute of Life Insurance (JILI) and the General Insurance Association of Japan (GIAJ) were released to the public on their websites on January 23, 2006. For the purpose of enlightening consumers, the Guides summarize basic matters that should be considered when a consumer buys an insurance product, etc. in an easy-to-understand format. The Guides are posted on the Financial Services Agency’s website as well to make it common knowledge, in order to protect users and improve user convenience.

The Life Insurance Buyer’s Guide explains:

- (1) Tips for signing an insurance policy (basic approach to signing a life insurance policy);
- (2) How to select life insurance products (steps, tips for determining necessary coverage, mechanism of life insurance products, etc.);
- (3) How to review coverage and points to consider (changeover system, add-on policies and special terms added to policy in the middle of the policy term, policy switching, etc.); and
- (4) Points to consider when signing a life insurance policy (application for insurance policy, coverage commencement date, duty of disclosure, cases in which insurance money and other benefits are not receivable, cooling-off system, etc.).

The Non-life Insurance Buyer’s Guide explains:

- (1) Types of non-life insurance (explanation by broadly dividing insurance into home insurance (fire insurance, earthquake insurance), automobile insurance (compulsory automobile liability insurance, voluntary automobile insurance) and personal insurance (personal accident insurance, medical insurance, etc.);
- (2) Points to consider when signing a non-life insurance policy with respect to each type;
- (3) General points to consider when signing a non-life insurance policy (insurance solicitor’s authority, coverage commencement date, need to be given an explanation of important matters, need to confirm coverage, need to confirm insurance certificate, etc.); and
- (4) Other matters that should be understood (cooling-off system, etc.).



The report titled “Interim Summary of Issues: How Information Should be Supplied When Selling and Soliciting Insurance Products” compiled by the Study Team on Insurance Product Sales and Solicitation of the Financial Services Agency (FSA) in July 2005 recommends that: (1) information be provided by insurance companies to customers in an appropriate manner; and (2) consumer enlightenment activities are important.

The Guide addresses these recommendations together with the partial amendment (draft) of the Comprehensive Guidelines for Supervision of Insurance Companies relating to “policy overview” and “warning information” which were released to the public and subjected to public comments recently. The FSA hopes that the two will complement each other to develop an appropriate environment in which consumers can purchase insurance products that meet their own needs.

(Note 1) The Study Team on Insurance Product Sales and Solicitation (headed by Professor Shuya Nomura at the Faculty of Law of Chuo University) conducts studies to tackle problems which have been pointed out in the insurance sector, namely, (1) there are still a large number of complaints about sales and solicitation, and (2) product features have become difficult for consumers to understand due to increasingly diversified and complicated insurance products.

(Note 2) The partial amendment (draft) of the Comprehensive Guidelines for Supervision of Insurance Companies divides important matters that should be explained during sales and solicitation for insurance policies into two categories, namely, “policy overview” (information required by customers to understand the nature of an insurance product) and “warning information” (information that customers should be made aware of by insurance companies), and clearly defines the framework of matters that should be stated in the two categories and how they should be written.

### Status of Non-Performing Loans (as of End of September 2005)

On January 20, 2006 the Financial Services Agency (FSA) released to the public the status of non-performing loans as it stood as of the end of September 2005.

A brief explanation of the status of non-performing loans as of the end of September 2005 is given as follows:

The non-performing loan balance of all banks (on the basis of loans subject to disclosure under the Financial Reconstruction Law) totaled 15.9 trillion yen as of the end of September 2005, a drop of 2.0 trillion yen from 17.9 trillion yen recorded in the period ending March 2005.

In terms of non-performing loan ratio, the figures calculated for major banks, regional banks, and all banks dropped in comparison to the figures recorded for the periods ending September 2004 and March 2005, respectively, each marking a record low since data on loans subject to disclosure under the Financial Reconstruction Law began to be released to the public (*i.e.*, since the end of March 1999).

(Note) Non-performing loan ratio (= non-performing loans (loans subject to disclosure under the Financial Reconstruction Law) / total credit balance)

	Sep.04		March.05		Sep.05
Major banks:	4.7%	→	2.9%	→	2.4%
Regional banks:	6.3%	→	5.5%	→	5.2%
All banks:	5.3%	→	4.0%	→	3.5%

In particular, the NPL ratio of major banks decreased by 0.5 percentage points to 2.4%, from 2.9% as at March 2005 when the objective of halving the NPL ratio under the “Program for Financial Revival” (October 2002) was successfully achieved.

(Note) Objective of halving their non-performing loan ratio: to lower, by fiscal year 2004 (the period

ending March 2005), the non-performing loan ratio of major banks to approximately half the level recorded for the period ending March 2002 (8.4%).

Non-performing loan ratios of regional banks have also been dropping steadily as a whole, as they are making progress in efforts to enhance region-based relationship banking functions.

We will continue to be committed to taking all possible steps in the supervision of financial institutions in the future, lest a non-performing loan problem should reemerge and hobble the Japanese economy.

For convenience regarding statistical data, we released one in which past data was put in time series as best as possible, including one that has been released up to now.

For further details, please visit the FSA's website and go to either "End - September, 2005 (released on January 20, 2006)" under ["Status of Non-Performing Loans,"](#) or ["The Status of Non Performing Loans as of end-September 2005 \(January 20, 2006\) "](#) under ["Press releases."](#)

### **Request of Efforts to Ensure Appropriateness of Financial Institutions in their Transactions**

When a financial institution makes various requests to a client, the client may meet such requests even if it goes against his/her will because of the fear that it might influence future lending decisions, etc. As financial institutions are prone to cause problems under the Anti-Monopoly Law as a result of exploiting their dominant positions, it is extremely important for financial institutions to build a proper system amid the diversification of financial instruments and services, to ensure confidence in financial institutions.

Under these circumstances, there was a regrettable incident recently, in which a financial institution was issued a recommendation decision by the Fair Trade Commission of Japan (JFTC) on the grounds of violating provisions of the Anti-Monopoly Law relating to the exploitation of dominant position when selling financial instruments.

With this in mind, on January 5, 2006, the Financial Services Agency (FSA) requested deposit-handling financial institutions in general to look into the following, including their respective systems, to fully ensure the appropriateness of financial transactions and the sale of financial instruments and services, etc., so that problems under the Anti-Monopoly Law would not arise as a result of exploiting their dominant positions:

1. Whether or not the appropriateness of transactions, etc. is ensured, bearing in mind that a financial institution is prone to be in an influential position with respect to the client through loans, etc.; and
2. In particular, whether or not inquiries and complaints received by the financial institution in relation to loans, etc. are analyzed and examined and improvements are made in response to them in a speedy and sufficient manner, in view of 1. above.

In the event of any problems, financial institutions are required to take proper action by rectifying the situation.

The FSA will respond to the situation as necessary in the normal course of inspection and supervision, on the premise that each financial institution has made such efforts.

### **Progress of "the Action Program to Promote Further Enhancement of Region-based Relationship Banking Functions (FY2005-06)" in the First Half of FY2005**

Based on the "Action Program to Promote Further Enhancement of Region-based Relationship Banking Functions (FY2005-06)" announced in March 2005 (hereinafter referred to as "Action Program"), regional financial institutions (RFIs) have formulated and announced their respective Relationship Banking Promotion Plans (hereinafter referred to as "Promotion Plans") and are making efforts accordingly.

Following the RFIs' announcement of the progress of their respective Promotion Plans in the first half of FY2005 (April to September), the Financial Services Agency (FSA) compiled and released on January 31 a

summary report on the achievements made by the RFIs during the first half of FY2005, an evaluation of their efforts, and future challenges. The outline of the report is as follows.

**(Reference) Number of RFIs concerned: 585 institutions (as of September 30, 2005)**

65 regional banks (including Saitama Resona Bank), 48 regional banks II	}
297 credit associations, 175 credit unions	

**1. Achievements made by RFIs**

The following is a summary of the major trends with respect to the achievements made by RFIs in business revitalization and facilitation of small and medium-sized enterprises (SMEs) financing in the first half of FY2005.

**(1) Strengthening Functions to Support Creation and Opening of New Businesses**

There is a large increase in financing by loan products aimed at supporting startups. Investments in company promotion funds are also increasing. To be specific, a number of RFIs are striving to acquire expertise and enhance screening systems by cooperating with outside institutions in the fields with growth prospects, such as agriculture, medical care and welfare, while some RFIs provide support to venture companies spun off from universities.

**(Reference) Cumulative Total from FY2003 to First Half of FY2005 (same below)**

- Financing by loan products aimed at supporting startups: 7,500 cases, ¥68.7 billion  
(4,700 cases, ¥42.9 billion)
- Investments in company promotion funds: ¥36.8 billion  
(¥24.7 billion)

\* Figures in parentheses correspond to the cumulative total in the Intensive Improvement Period (FY2003-FY2004) (same below)

**(2) Strengthening Functions of Management Consultation and Support for Client Companies**

RFIs are making proactive efforts in promoting business-matching, for example by holding business networking meetings, resulting in an increasing number of deals being signed. Such efforts include hosting business networking meetings jointly with other RFIs in the region, and providing information through utilization of their overseas branches to support overseas businesses of local companies.

RFIs are also proactive in their attempt to upgrade “need attention” loans to the “normal” category, as exemplified by the increasing variation of measures to assist management improvement. Under such circumstances, at regional banks (regional banks and regional banks II), about ten percent of debtors which were given assistance for management improvement in the first half of FY2005 (excluding those classified as “normal”), or approximately 2,800 of such debtors, saw improvement in their respective business conditions and debtor classifications.

**(Reference)**

- Deals signed as a result of business matching: 22,600 cases (16,600 cases)
- Ratio of upgraded debtors to those receiving assistance for management improvement (excluding those classified as “normal”): 10.1% [Note 1]  
(10.2%) [Note 2]

[Note 1] Results of the first half of FY2005

[Note 2] Average during FY2003-FY2004 (on a semiannual basis)

**(3) Proactive Efforts for Business Revitalization**

RFIs continue to make progress in developing systems to facilitate business revitalization, and the number of debtors formulating revitalization plans with the assistance from SME Revitalization Support Councils is steadily increasing. Moreover, achievements are being made with the utilization of corporate reconstruction funds. Specific examples utilizing such measures include collective revitalization of a spa resort as a whole, and turnaround of a construction business.

**(Reference)**



- Debtors having formulated revitalization plans with the assistance from SME Revitalization Support Councils: 716 cases, ¥743 billion (503 cases, ¥572.7 billion)
- Investments in corporate reconstruction funds: ¥34.4 billion (¥27.7 billion)
- Debt-to-debt swaps: 89 cases, ¥40.2 billion (64 cases, ¥33.7 billion)

#### (4) Promoting Loans without Excessive Reliance on Collateral and Guarantee

Both the number of cases and monetary amount of loans which do not excessively rely on collateral and guarantee are increasing as a result of proactive promotion efforts, including through the expansion of loan products utilizing financial covenants and business loans using credit scoring models.

The number of loans secured by chattel and claims against third parties are also increasing, including those utilizing chattel registration system, which show that efforts to diversify SME financing methods are steadily yielding results.

#### (Reference)

- Loans utilizing financial covenants: 8,300 cases, ¥225.2 billion (5,700 cases, ¥129.4 billion)
- Loans using credit scoring models: 443,000 cases ¥4.1 trillion (327,000 cases, ¥2.9 trillion)
- Loans secured by chattel and receivables: 40,500 cases, ¥380 billion (29,000 cases, ¥283.9 billion)

## 2. Evaluation of RFIs' Efforts and Future Challenges

### (1) Views on RFIs' Efforts by RFIs and Users

While a large part of both RFIs and users show positive and constructive assessment on RFIs' efforts in general, some point out, as shown below, that not enough solid accomplishments have been made and that RFIs' efforts are insufficient.

- RFIs' views: Not enough solid accomplishments have been made with regard to proactive efforts for business revitalization and efforts to upgrade "need attention" loans to the "normal" category.
- Users' views: Not enough personnel have expertise and business judgment abilities required in business revitalization and management guidance. The situation remains unchanged in that RFIs are still dependent on collateral and guarantee.

### (2) Evaluation of RFIs' Efforts and Future Challenges

Considering the above, the evaluation of RFIs' efforts and future challenges are as follows.

- RFIs continue to proactively make efforts to strengthen functions of management consultations and support for client companies such as business matching, as well as efforts to promote loans without excessive reliance on collateral and guarantee aimed at facilitating SME financing. Their efforts to support creation and opening of businesses are also making steady progress.
- On the other hand, although RFIs are developing systems and enhancing efforts in the field of business revitalization, it may take some time for them to yield results in concrete terms.

In any case, the Promotion Plans were formulated and announced only recently—at the end of August 2005. RFIs will need to continue making efforts to enhance region-based relationship banking functions into the future.

## Consultation Requests Received by Counseling Office for Financial Services Users

### 1. Background

On July 19, 2005, the Financial Services Agency (FSA) launched consultation services with the opening of the Counseling Office for Financial Services Users (hereinafter referred to as “Counseling Office”) assigned to serve as a one-stop center to handle users’ inquiries, consultation requests, opinions, etc. on financial services, etc. (hereinafter referred to as “consultation requests, etc.”), with the aim of improving the user convenience of financial services and putting the received information to effective use in financial administration.

The number of consultation requests received by the Counseling Office from users, the gist of major consultation cases and other such information are released to the public on a quarterly basis. The consultation requests, etc. received, their characteristics and other related information for the quarter commencing October 1, 2005 and ending December 31, 2005 are as follows.

### 2. Outline of Public Release

- (1) We received a total of 9,392 consultation requests, etc. between October 1, 2005 and December 31, 2005. The average number of consultation requests, etc. received per day was 159, an increase from 126 per day received in the previous period from July 19, 2005 to September 30, 2005. The increase is deemed to be attributable to many consultation requests, etc. received from users partly due to administrative action taken against financial institutions, in addition to the impact of enhancements to the framework to deal with consultation requests, etc. by increasing consultation staff from 10 to 15 members.
- (2) By subject, the number of consultation requests, etc. related to depositing, financing, etc. totaled 2,283 (24%), insurance products etc. totaled 3,198 (34%), investment products, etc. totaled 2,974 (32%), cash loans, etc. totaled 813 (9%) and financial administration in general and other issues totaled 124 (1%).
- (3) The following characteristics, etc. were identified with respect to each subject area.
  - a. Depositing, financing, etc.: With respect to financing services, we received consultation requests, etc. concerning the execution and repayment of loans. With respect to depositing services, we received consultation requests, etc. on the system of explanation to be provided when a deposit is made, handling of counterfeit/stolen cash cards, the identification procedures, etc.
  - b. Insurance products, etc.: We received consultation requests, etc. concerning insurance payments, insurance companies’ responses to insurance claims, etc.
  - c. Investment products, etc.: We received consultation requests, etc. relating to foreign exchange margin trading businesses, problems in securities companies’ computer systems, brokers of unlisted shares, how to use Electronic Disclosure for Investors’ NETwork (EDINET), etc.
  - d. Cash loans, etc.: We received consultation requests, etc. relating to inquiries about the existence and reliability of moneylender registration and improper conduct.
- (4) Consultation requests, etc. received by the Counseling Office included information that would be useful for inspection and supervision purposes (see Note). For the purpose of protecting users in general and improving user convenience, we make use of such valuable information in financial administration, when conducting verification as part of inspection, conducting interviews for supervision, issuing reporting orders and taking administrative action with respect to the financial institution concerned.

(Note) Examples of useful information for inspection and supervision purposes:

- a. Information on credit crunch and oppressive debt collection;
- b. Information on sale of financial products to a borrower by a financial institution exploiting its dominant position;
- c. Information on improper conduct by salespersons, etc. of an insurance company (such as abetting non-disclosure, paying insurance premiums on behalf of the policyholder, producing a contract without authorization and borrowing someone else’s name);
- d. Information on improper conduct by foreign exchange margin trading businesses (such as making unsolicited calls to general customers, making assertive judgments, trading without authorization, and delaying refund of balance, etc.); and

- e. Information on dealings with securities companies over the Internet.

### 3. Approach to Future Actions

The Counseling Office was established as part of measures designed to *enhance the framework for providing information and dealing with consultation requests, etc. in order to protect users* under the Program for Further Financial Reform. The FSA will continue to run the Counseling Office in an appropriate fashion, including summarizing and publishing the number of consultation requests, etc. received and the gist of major consultation cases on a quarterly basis, in order to realize the ideal financial system pursued under the Program for Further Financial Reform, that is, *a financial system with high user satisfaction*.

## Results on “Small- and Medium-Sized Enterprise Financing Monitoring” Conducted in November 2005

“Small- and Medium-Sized Enterprise (SME) Financing Monitoring” is performed on a quarterly basis by employees of the Local Finance Bureaus and Offices with the cooperation of the Japan Chamber of Commerce and Industry (JCCI), etc. for the purpose of accurately identifying the actual status, etc. of SME financing from the viewpoint of SMEs in the respective regions, as part of efforts to facilitate SME financing.

The Financial Services Agency (FSA) recently summarized and published the following results of SME Financing Monitoring conducted in November 2005.

### 1. Subjects of Monitoring

We conducted interviews with a total of 438 individuals (from 173 organizations) in 47 prefectures nationwide who are involved in management consulting in such organizations as JCCI, Central Federation of Societies of Commerce and Industry, Societies of Commerce and Industry, National Federation of Small Business Associations, Federations of Chambers of Commerce and Industry and Small and Medium Entrepreneurs Associations.

Organization	Number of Interviewees (Number of Organizations)
JCCI	203 (80)
Central Federation of Societies of Commerce and Industry	114 (26)
Societies of Commerce and Industry	69 (51)
National Federation of Small Business Associations	49 (14)
Small and Medium Entrepreneurs Associations	3 (2)
Total	438 (173)

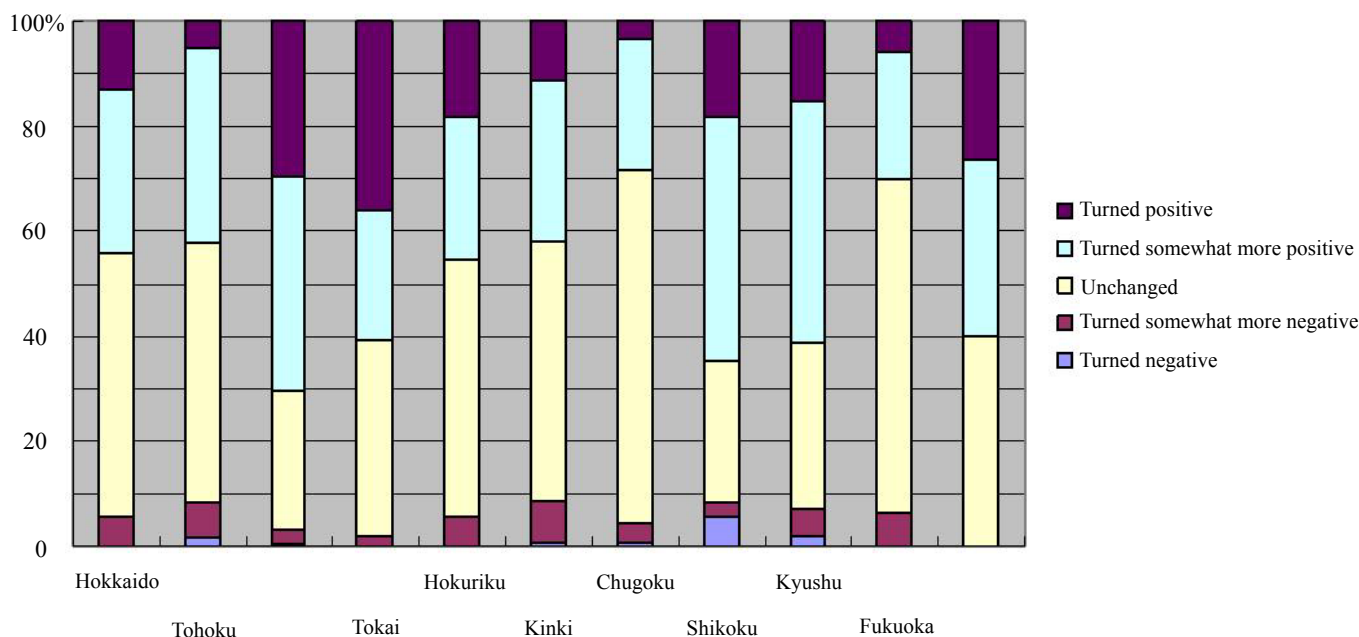
(Note) As SME Financing Monitoring is not a fixed-point survey in which the survey is conducted with the same interviewees every time, the number and identity of interviewees may vary between surveys.

### 2. Overview of Interview Results

#### (1) Overview of interview results: “Lending trend in SME financing over the most recent three months”

##### [By Region]

While the results varied between regions, the majority of interviewees answered “Turned positive” or “Turned somewhat more positive” in the Kanto, Tokai, Shikoku, Kyushu and Okinawa regions. Those who responded “Turned negative” or “Turned somewhat more negative” accounted for less than 10% in all regions. Judging from these figures alone, facilitation of SME financing appears to be progressing.



**[By Type of Financial Institution]**

Trend over Most Recent 3 Months	Major Banks		Regional Banks, Second-tier Regional Banks		Shinkin Banks, Credit Unions		Government-affiliated Financial Institutions		Total	
1. Turned positive	21	9.5%	43	10.8%	65	16.9%	95	23.0%	224	15.8%
2. Turned somewhat more positive	44	19.9%	143	36.0%	129	33.5%	152	36.8%	468	33.1%
3. Unchanged	144	65.2%	180	45.3%	173	44.9%	145	35.1%	642	45.3%
4. Turned somewhat more negative	10	4.5%	26	6.5%	14	3.6%	20	4.8%	70	4.9%
5. Turned negative	2	0.9%	5	1.3%	4	1.0%	1	0.2%	12	0.8%
Total	221	100.0%	397	100.0%	385	100.0%	413	100.0%	1416	100.0%

(Note 1) SME Financing Monitoring is not a fixed-point survey in which the survey is conducted with the same interviewees every time.

(Note 2) The table above shows the breakdown of valid responses and does NOT include non-responses and unclear responses. For this reason, the number of interviewees is not consistent with the total number of responses.

**- Reasons given by respondents who selected “4. Turned somewhat more negative” or “5. Turned negative” in the table above**

Reasons given for Answer 4 or 5 above	Major Banks		Regional Banks, Second-tier Regional Banks		Shinkin Banks, Credit Unions		Government-affiliated Financial Institutions		Total	
Refusal of new loan requests	6	30.0%	12	30.0%	5	18.5%	12	48.0%	35	31.3%
Collateral & guarantee	2	10.0%	15	37.5%	11	40.7%	3	12.0%	31	27.7%
Interest rates	1	5.0%	0	0.0%	1	3.7%	0	0.0%	2	1.8%
Lending terms	5	25.0%	4	10.0%	4	14.8%	3	12.0%	16	14.3%
Loan assessment procedures	4	20.0%	5	12.5%	4	14.8%	5	20.0%	18	16.1%
Other	2	10.0%	4	10.0%	2	7.4%	2	8.0%	10	8.9%
Total	20	100.0%	40	100.0%	27	100.0%	25	100.0%	112	100.0%

(Note) As a single interviewee may give multiple answers, the total number of answers 4 and 5 above (82) is not consistent with the total number of the responses in the table above (112).

**(2) Overview of interview results: “Actual status, etc. of SME financing in the respective regions from the viewpoint of SMEs”**

Interviews were conducted on the following eight topics regarding the actual status, etc. of SME financing in the respective regions from the viewpoint of SMEs:

**[Interview Topics]**

- (a) Stance to lending
- (b) Collateral and guarantee
- (c) Management guidance and business startup or revival assistance
- (d) System of providing explanation when lending
- (e) Quality and ability of financial institutions
- (f) Period of loan assessment
- (g) Interest rates
- (h) Other

Main comments received with respect to each topic are as follows:

**(a) Comments on actual status of stance to lending**

- Financial institutions’ stance to lending is positive. (Hokkaido, Tohoku, Kanto, Tokai, Hokuriku, Kinki, Chugoku, Shikoku, Kyushu, Fukuoka and Okinawa)
- Can acknowledge their stance to actively tap new borrowers when approached by financial institutions and head office staff who had never approached before. (Kanto and Hokuriku)
- There are hardly any reports on credit crunch and oppressive debt collection. (Hokkaido, Tohoku, Tokai, Hokuriku, Kinki, Shikoku and Kyushu)
- There is a tendency among financial institutions to cherry-pick companies, and their stance to lending is becoming increasingly polarized. (Hokkaido, Tohoku, Chugoku, Shikoku and Fukuoka)
- While an increasing number of products have “sales points” based on unsecured loans, unguaranteed loans and speedy loan approval assessment, lenders are in a dominant position (as exemplified by the diversification of risks by interest-rate top ups and assessment based on scoring system) and the borrowers’ satisfaction is far from fully reflected. (Kinki)

**(b) Comments on actual status of collateral and guarantee**

- There is a wider choice of products due to the increasing number of unsecured, unguaranteed loan products, etc. (Hokkaido, Tohoku, Tokai, Kinki, Chugoku, Shikoku, Kyushu, Fukuoka and Okinawa)
- Financial institutions’ stance is becoming less collateral-oriented. (Hokuriku and Kinki)
- Focus is shifting from collateral to cash flow. (Fukuoka)
- The response of financial institutions is changing, as exemplified by cases in which loans were executed in the patent-pending stage of intellectual property and cases in which the company’s technological capabilities were taken into account. (Hokkaido)
- Loans guaranteed by credit guarantee corporations are given priority. (Hokuriku, Kinki and Chugoku)
- Financial institutions’ stance to lending remains dependent on collateral and guarantees. (Hokkaido, Tohoku, Tokai, Hokuriku, Kinki, Chugoku, Shikoku, Kyushu, Fukuoka and Okinawa)
- Although the lineup of unsecured and unguaranteed loan products is being enhanced, financial institutions’ stance to focus on collateral and guarantee remains unchanged, as exemplified by strict assessments. (Hokkaido, Tohoku and Kinki)

**(c) Comments on actual status of management guidance and business startup or revival assistance**

- Financial institutions have started to actively make efforts in management guidance, including establishing management consulting divisions. (Hokkaido, Tohoku, Tokai and Kinki)
- The fact that financial institutions are giving business-matching opportunities to companies is appreciated, including cross-industrial social events and inspection tours. (Tohoku, Kanto, Hokuriku, Kyushu, Fukuoka and Okinawa)
- There is a need to improve the support framework, including developing an organization to support business startups and cooperating with certified tax accountants’ associations, Chambers of

Commerce and Industry, Societies of Commerce and Industry, etc. (Hokkaido and Kyushu)

- Financial institutions are just haphazardly recommending borrowings in the interest of their own profits, and are not providing guidance with a view to nurture companies. (Tohoku, Hokuriku, Chugoku, Shikoku, Kyushu and Fukuoka)
- Although loan facilities for startups have been enhanced, there is a need to improve loan facilities to meet the demand for funds three to five years after the inauguration of business, when more funds are needed. (Kinki)

**(d) Comments on system of providing explanation when lending**

- Financial institutions have improved their system of providing an explanation, and even in cases where loan applications are refused, they carefully provide a sufficient explanation and are getting better at dealing with complaints. (Hokkaido, Tohoku, Kinki, Chugoku, Shikoku, Kyushu, Fukuoka and Okinawa)
- Efforts in relationship banking are proving effective, as more customers are saying that they have been given a careful, in-depth explanation recently. (Tokai, Hokuriku and Chugoku)
- Financial institutions' responses are poor in some cases in that the explanation varies between staff and there is no explanation provided on the progress status when the assessment takes a long period of time. (Tokai, Kinki, Hokuriku and Fukuoka)
- Financial institutions should conduct more training schemes, etc. as their ability to provide an explanation of loan facilities, etc. remains poor. (Shikoku)
- There were cases in which an approved loan application was suddenly overturned and rejected, resulting in cash flows problems. (Chugoku)

**(e) Comments on actual status of quality and ability of financial institutions**

- There is an increasing number of staff who can see the future potential of companies, without assessing companies based solely on their sales. (Tohoku and Hokuriku)
- Financial institutions appear to have improved their discerning eyes, as there is an increasing number of personnel with specialized knowledge. (Hokkaido, Tohoku, Tokai, Hokuriku, Kinki, Kyushu and Okinawa)
- The quality, ability, etc. of the branch manager and staff vary between individuals, which affects lending decisions in some cases. (Tohoku, Kanto, Kinki, Hokuriku, Tokai, Chugoku and Kyushu)
- Financial institutions are making progress in introducing a scoring system, but they are lagging behind in qualitative assessment. (Kanto and Fukuoka)

**(f) Comments on period of loan assessment**

- The assessment period is becoming shorter overall, resulting in speedy responses. (Hokkaido, Tohoku, Tokai, Hokuriku, Kinki, Chugoku, Shikoku, Kyushu, Fukuoka and Okinawa)
- There is a trend towards shorter assessment periods, possibly due to the development of unsecured, unguaranteed loan products. (Chugoku)
- Assessment is becoming more time-consuming due to the increasing number of cases in which the head office is involved. (Tohoku and Kyushu)

**(g) Comments on actual status of interest rates**

- Interest rates are being set properly according to the management circumstances of the company, and there have been no reports of interest rates being set unfairly. (Hokkaido, Kinki, Kyushu and Okinawa)
- There is a declining trend in interest rates, possibly due to fierce competition among financial institutions. (Tohoku, Tokai and Kyushu)
- Interest rates vary between companies depending on the credit rating based on the financial position of the company. (Hokkaido, Tohoku, Kanto, Hokuriku, Kinki, Chugoku, Shikoku and Fukuoka)

**(h) Other Comments**

- Companies want to tap new clients. While financial institutions are making SME business-matching efforts, referral of more small companies would be appreciated. (Fukuoka)



- Financial institutions should disclose debtor classifications to borrowers and show what kind of improvements need to be made in order to be classified in a superior grade. (Tohoku)
- An increasing number of companies are dealing with more than one financial institution, due to their experiences of credit crunch and other such problems in the past. (Hokuriku)

**(3) Overview of interview results: “Case examples showing the penetration of measures for facilitating SME financing”**

- In SME Financing Monitoring, a specific theme relating to inspection and supervision is set each time, and a survey is conducted accordingly with respect to cases showing the penetration of measures for facilitating SME financing.
- The theme for the latest Monitoring was the same as in the previous Monitoring as follows.

Degree of SMEs’ awareness of the Supplementary Issue to the Financial Inspection Manual [for Small- and Medium-Sized Enterprise Financing] (revised version)

**[Main Comments Received]**

- SMEs do recognize the Supplementary Issue to the Financial Inspection Manual itself but have little interest in the details.
- Some SMEs which are conscious of medium/long-term cash flows and management plans are aware of the content of the Supplementary Issue to the Financial Inspection Manual, but it is still not widely accepted among many SMEs.
- The Supplementary Issue to the Financial Inspection Manual is spreading, albeit at a slow pace, through leaflets placed on the counter, individual management guidance, group consultation sessions, etc.
- The Supplementary Issue to the Financial Inspection Manual should be made common knowledge by holding lectures and by placing an advertisement in newspapers.

**3. How the “SME Financing Monitoring” Results Are Utilized**

**(1) Interviews**

We conducted interviews with individual financial institutions in regards to their action policies, systems, etc. by making effective use of the information on those financial institutions obtained from SME Financing Monitoring.

**(2) Requests at Discussion Meetings (Utilized by FSA)**

We present cases acquired from SME Financing Monitoring at monthly discussion meetings held between top officials of the FSA and representatives of business associations and on other occasions. More specifically, we request participants to: further facilitate the supply of funds to sound SMEs, including loans focusing on cash flows from business activities without excessively relying on collateral and guarantees; provide a sufficient explanation that could gain customers’ understanding and convince them, in consideration of the past business relationship and the customers’ knowledge, experience and asset positions; make the Supplementary Issue to the Financial Inspection Manual common knowledge; and so on.

**(3) Utilization at Conference for Regional Financing Facilitation (Utilized by Local Finance Bureaus, etc.)**

On various occasions including the semiannual Conference for Regional Financing Facilitation in each prefecture (consisting of financial authorities, small- and medium-sized and regional financial institutions and relevant business associations) and meetings between top officials of Local Finance Bureaus and representatives of financial institutions, we urge participants to develop a system to provide an explanation to customers and enhance consultation and complaint-handling functions, and request them to make efforts to facilitate SME financing.

## [From the Office of International Affairs]

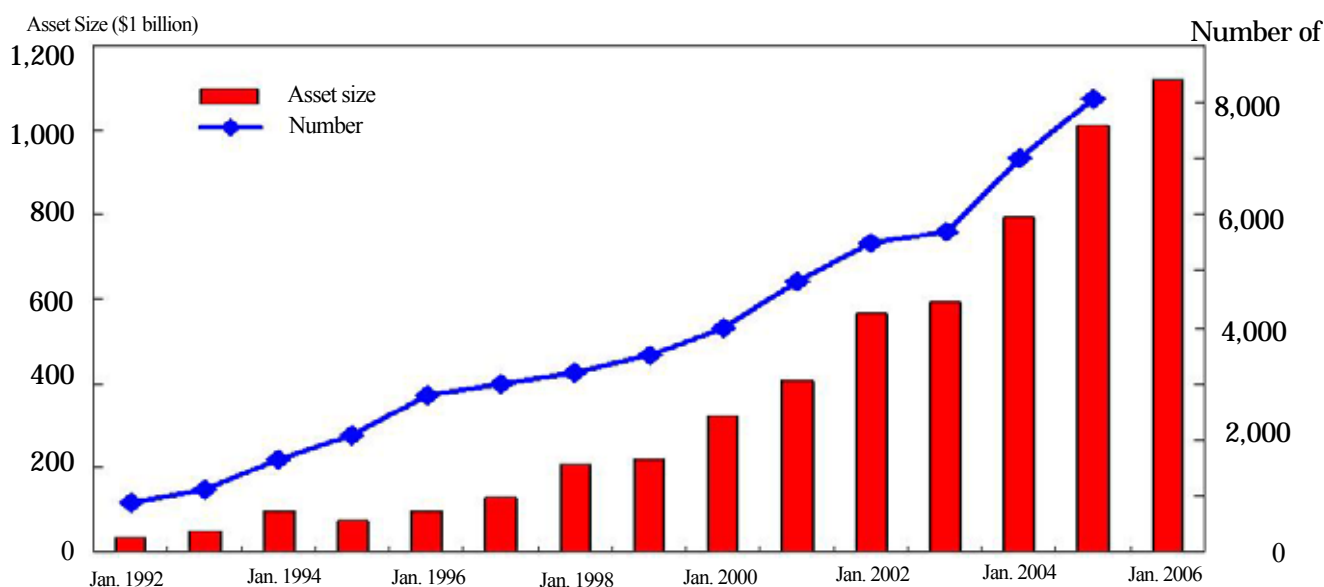
### Current State of Hedge Funds in Japan

In 2005, the Financial Services Agency (FSA) conducted a fact-finding survey on hedge funds in Japan and published the findings in a report titled “Summary of Hedge Fund Survey Results and the Discussion Points” on December 13, 2005 (the English version was released on December 22, 2005)<sup>1</sup>. The Survey was the first fact-finding survey ever conducted on Japan’s hedge fund market, and many responses were received both at home and abroad. The following is an overview of the Survey results. Please note that all opinions stated hereunder are the writer’s personal opinions.

#### Global Market Size for Hedge Funds exceeds \$1 Trillion

The hedge fund market has been growing dramatically in recent years. According to the survey conducted by an American hedge fund research company, the size of hedge fund market—which was worth US\$324 billion in early 2000—exceeded US\$1 trillion for the first time by early January 2005, and is still growing (refer to Figure 1).

Figure 1: Number and Asset Size of Hedge Funds



(Source: Hennessee Group LLC. Data on the number of funds in Jan. 2006 is yet to be obtained.)

Under these circumstances, regulatory authorities are paying more attention to hedge funds. In particular, as it is said that cross-border activities of hedge funds have become more vigorous, there is growing recognition that further cooperation among regulatory authorities is needed to monitor and regulate their activities. Accordingly, many regulatory authorities are making proposals and taking measures with respect to hedge funds, including the International Organization of Securities Commissions (IOSCO), which consists of securities regulators of the world. In Japan, the study of issues of hedge funds is declared as one of the concrete efforts to be made under the *Program for Further Financial Reform - Japan's Challenge: Moving toward a Financial Services Nation* formulated and announced in December 2004. We have also participated actively in discussions at international conferences, including those of IOSCO.

#### What are Hedge Funds?

It is extremely difficult to define hedge funds. There is no clear definition, not only in Japan but also in any other countries and international organizations. For example, according to the IOSCO report<sup>2</sup> published in February

<sup>1</sup> For more information, please refer to FSA's website.

<sup>2</sup> *Regulatory and Investor Protection Issues Arising from the Participation by Retail Investors in (Funds-of) Hedge Funds*

2003, hedge funds have “at least some of the following characteristics: (1) borrowing and leverage restrictions, which are typically included in collective investment scheme (CIS) regulations, are not applied, and many (but not all) hedge funds use high levels of leverage; (2) significant performance fees (often in the form of a percentage of profits) are paid to the manager in addition to an annual management fee; (3) often significant ‘own’ funds are invested by manager; (4) derivatives are used, often for speculative purposes, and there is an ability to short sell securities; and (5) more diverse risks or complex underlying products are involved.” However, it also states that it is “extremely difficult to arrive at a legally sound description for the purposes of laws and statutes.”

Nevertheless, in some IOSCO member countries, funds that have some of the following characteristics are considered as hedge funds: (1) use of short-selling and leverage; (2) subscription through private placement; (3) investment in various types of assets; and (4) diverse investment strategies. In addition, charge of performance fees is also considered one of characteristics unique to hedge funds.

In consideration of the above, we defined hedge funds as the funds (including funds of hedge funds (FOF)) with the following three components in this Survey for the purpose of identifying the actual state of hedge funds in Japan as broadly as possible: (1) use of leverage; (2) charge of performance fee; and (3) use of hedge fund investment strategies. Considering that the number of publicly offered investment trusts with hedge fund strategies aimed at general (individual) investors established and sold has been increasing recently, we decided to cover both publicly offered funds and privately placed funds in this survey. (In this Survey, the interpretation of the definition of hedge funds was left to the respondents (financial institutions). As the interpretation might vary between the respondents, it should be noted that such variation might have affected the Survey results.)

### Overview of Survey

In this Survey, the FSA sent a questionnaire to 1,251 financial institutions (“surveyed companies”) under its jurisdiction (deposit-taking financial institutions, insurance companies, securities companies, investment trust management companies, investment advisors, etc.) and requested them to respond on a voluntary basis. Specifically, three types of questionnaires to identify the actual state of hedge funds from three angles, namely, from the respective viewpoints of arrangement/management of hedge funds, distribution of hedge funds and investment in hedge funds (**refer to Table 1**). We also interviewed more than ten companies that were relatively large as hedge fund arranger/distributor/investor.

**Table 1: Survey Items, etc.**

Category	Subject	Item
I. Hedge fund arranger/manager	Hedge funds established by surveyed companies during the five-year survey period between April 1, 2000 and March 31, 2005 (including hedge funds established by an overseas affiliate of a surveyed company that is involved in the management, distribution, etc. of such hedge funds)	Name of fund, form of subscription, investment strategy, name of management company, country of establishment, terms of fund, and amount of assets under management
II. Hedge funds distributor	Hedge funds sold by surveyed companies during the five-year survey period between April 1, 2000 and March 31, 2005	Name of fund, form of subscription, investment strategy, name of management company, country of establishment, terms of fund, date of sale, amount of sale, and buyer
III. Hedge funds investor	Hedge funds held by surveyed companies or their consolidated subsidiaries as of March 31, 2005	Name of fund, form of subscription, investment strategy, name of management company, country of establishment, terms of fund, date of purchase, amount of purchase, and seller

## Characteristics of Hedge Fund Market in Japan

In the Survey, questionnaires were sent to 1,251 financial institutions, of which 1,171 responded, as summarized in **Table 2**.

**Table 2: Summary of Survey Results**

	Number of surveyed companies which established/sold/invested in hedge funds	Amount of Establishment/Sale/Investment
Establishment of hedge funds	57 companies	Approx. ¥2.5 trillion
(including those established outside Japan)		40%
Sale of hedge funds	91 companies	Approx. ¥5.9 trillion
(including those established outside Japan )		61%
Investment in hedge funds	310 companies	Approx. ¥6.1 trillion

(Note) “Establishment of hedge funds” shows the number of financial institutions that established hedge funds and the amount of hedge funds established between April 1, 2000 and March 31, 2005, while “Sale of hedge funds” shows the number of financial institutions that sold hedge funds and the amount of hedge funds sold during the same period. “Investment in hedge funds” indicates the number of financial institutions that held hedge funds and the amount of hedge funds held as of March 31, 2005.

The survey results show that about 60% of approx. ¥5.9 trillion worth of hedge funds sold by financial institutions in Japan was established outside Japan. As hedge funds sold to financial institutions accounted for about 50% of approx. ¥5.9 trillion worth of hedge funds (**refer to Table 2**), a considerable portion of approx. 6.1 trillion worth of hedge funds held by financial institutions may be deemed to have been established outside Japan. The increase in the amount of hedge funds sold to individual investors is also outstanding.

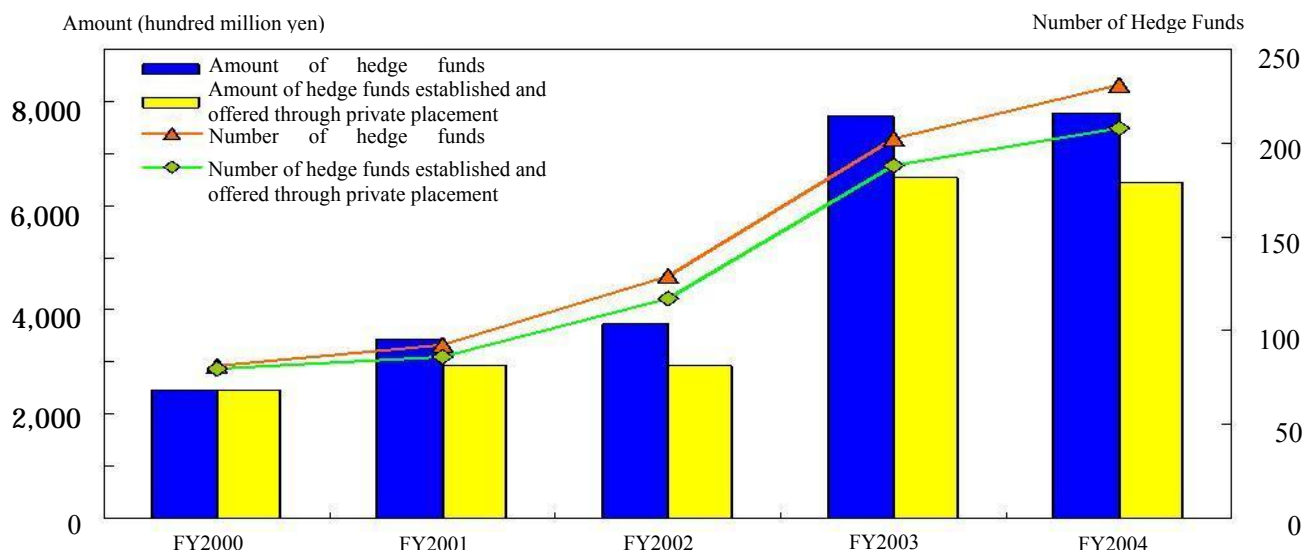
Accordingly, it is fair to say that the hedge fund market in Japan is largely characterized by funds established overseas that are imported into Japan, and the increasing acceptance of hedge funds among individual investors.

While the amount of hedge funds held by financial institutions amounted to approx. ¥6.1 trillion, about 50% of the cumulative total amount of hedge funds sold over the past five years (¥5.9 trillion) was sold to non-financial institutions. Accordingly, the hedge fund market in Japan is estimated to be worth almost ¥10 trillion.

### **Amount of established hedge funds approach ¥1 trillion: Those established outside Japan account for approx. 40%**

Hedge funds established substantially increased both in number and in amount in fiscal 2003, approaching ¥1 trillion in amount (**refer to Figure 2**). By country of establishment, hedge funds established in Japan accounted for 60% in amount, while those established in foreign countries such as the Cayman Islands and Ireland accounted for the remaining 40%. These countries were chosen because of lower establishment costs, etc. compared to Japan. Hedge funds offered through private placement accounted for more than 80% of all hedge funds in amount.

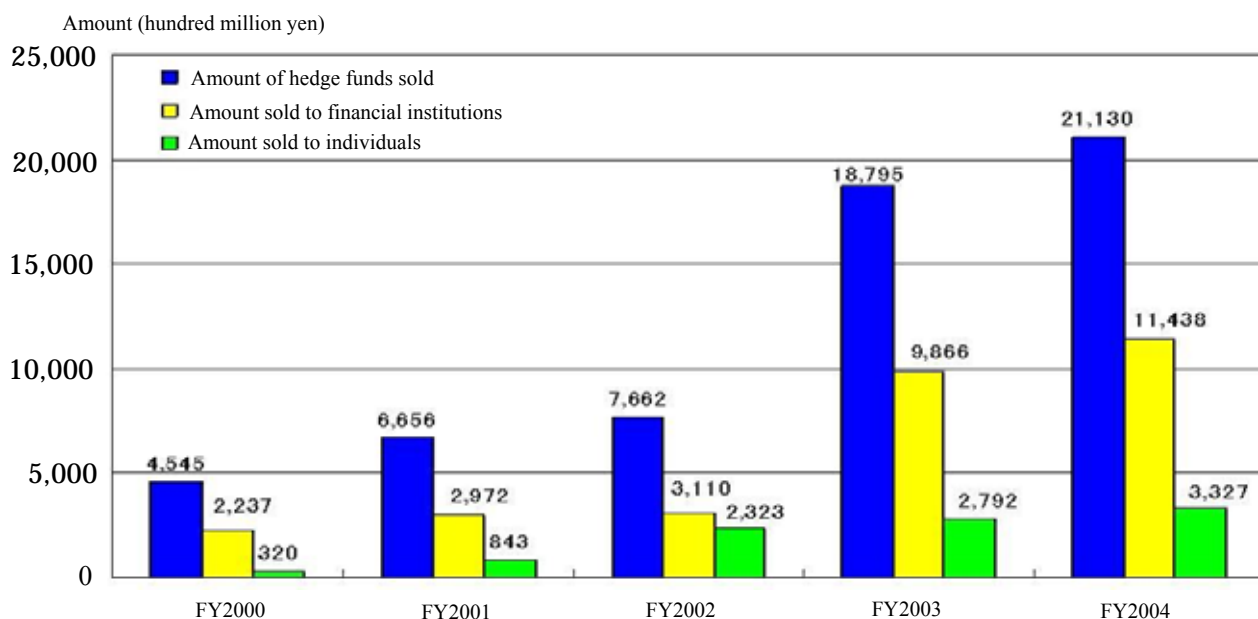
**Figure 2: Number and Amount of Hedge Funds Established**



### Acceptance of Hedge Funds by Individual Investors

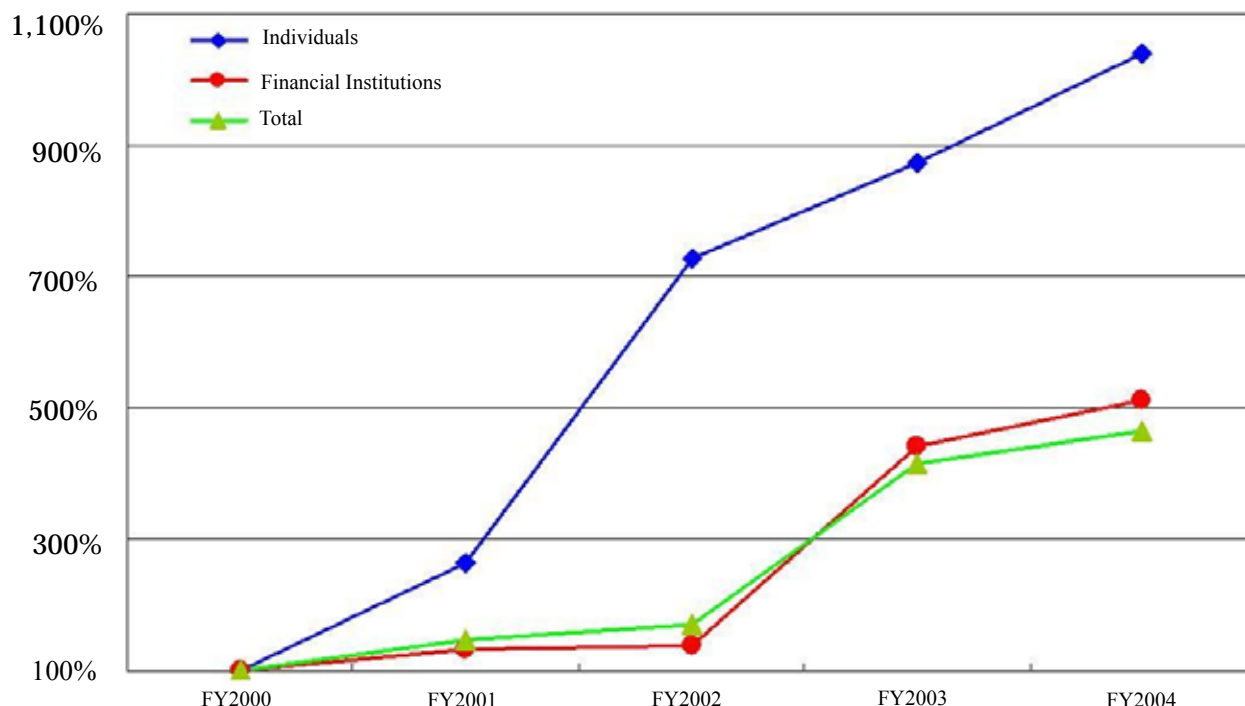
The amount of hedge funds sold has been dramatically increasing since 2003, as in the case of the amount of hedge funds established (refer to Figure 3).

**Figure 3: Amount of Hedge Funds Sold**



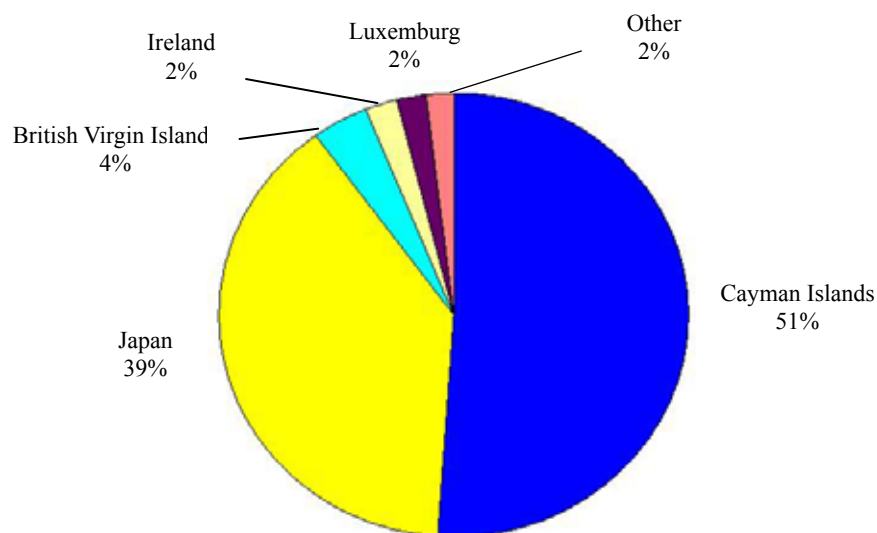
By buyer, financial institutions have accounted for about 50% of all buyers on average over the past five years. What is noteworthy here is that the amount of hedge funds sold to individual investors has increased dramatically: more than tenfold over the past five years (refer to Figure 4). This characteristic is extremely interesting for those engaged in discussions on how to deal with hedge funds in light of investor protection.

**Figure 4: Growth in Amount of Hedge Funds Sold**



As for the breakdown of sales of hedge funds by country of establishment, approx. 40% of all hedge funds sold in Japan during the survey period were established in Japan, while the remaining 60% were established in foreign countries (refer to Figure 5). Furthermore, 56% of hedge funds sold by domestic securities companies and 84% of hedge funds sold by foreign securities companies were established outside Japan. Accordingly, it is fair to say that funds established outside Japan are being imported and sold in Japan.

**Figure 5: Sales of Hedge Funds by Country of Establishment**



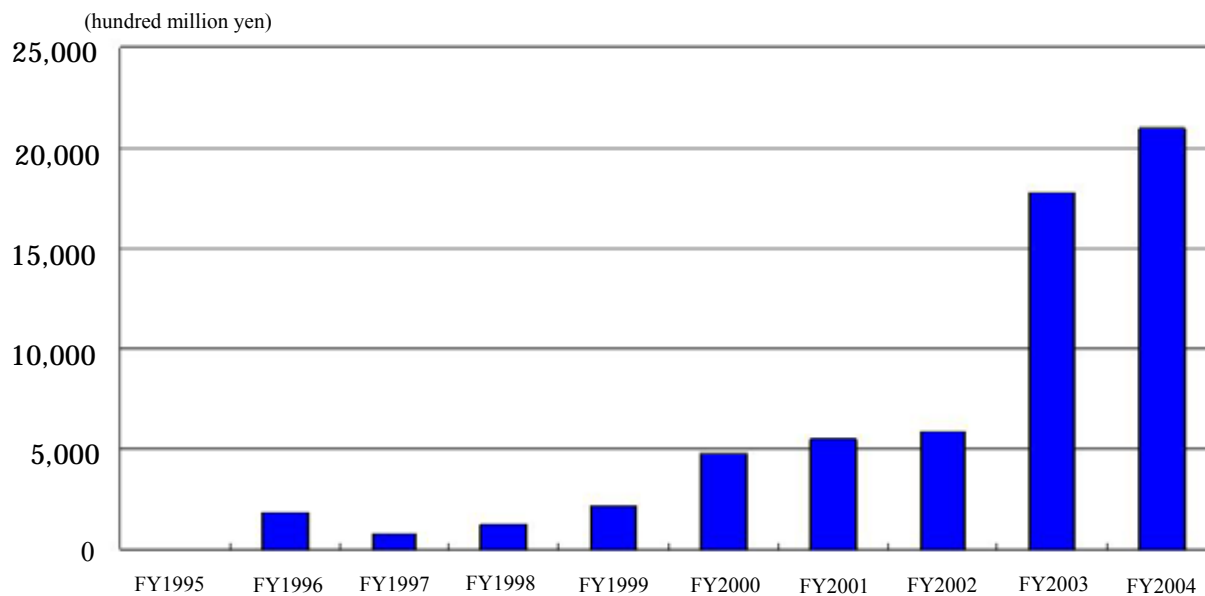
This provides a significant hint on how the FSA should deal with hedge funds. In other words, there will be difficulties involved in directly overseeing the hedge funds or hedge fund arrangers/managers themselves. Also, it will be indispensable to work with foreign authorities to accurately identify their activities to the extent needed. On the other hand, it will be necessary to oversee how risks are managed by financial institutions.



### Diversification of Hedge Funds

As of March 31, 2005, a quarter of all surveyed companies (310 companies) held hedge funds worth about ¥6.1 trillion. Their holdings substantially increased especially in fiscal 2003 (refer to Figure 6). This substantial increase in the amount of hedge funds established is considered to be attributable to financial institution's growing needs to invest in hedge funds.

**Figure 6: (Reference) Annual Trends in Amount Invested in Hedge Funds**



The increase in investment in hedge funds is considered to be attributable to the drive to seek absolute returns by building a portfolio resistant to the impact to market fluctuations that has limited correlation with conventional investment products such as stocks and bonds, in response to persistently low interest rates and the sagging stock market.

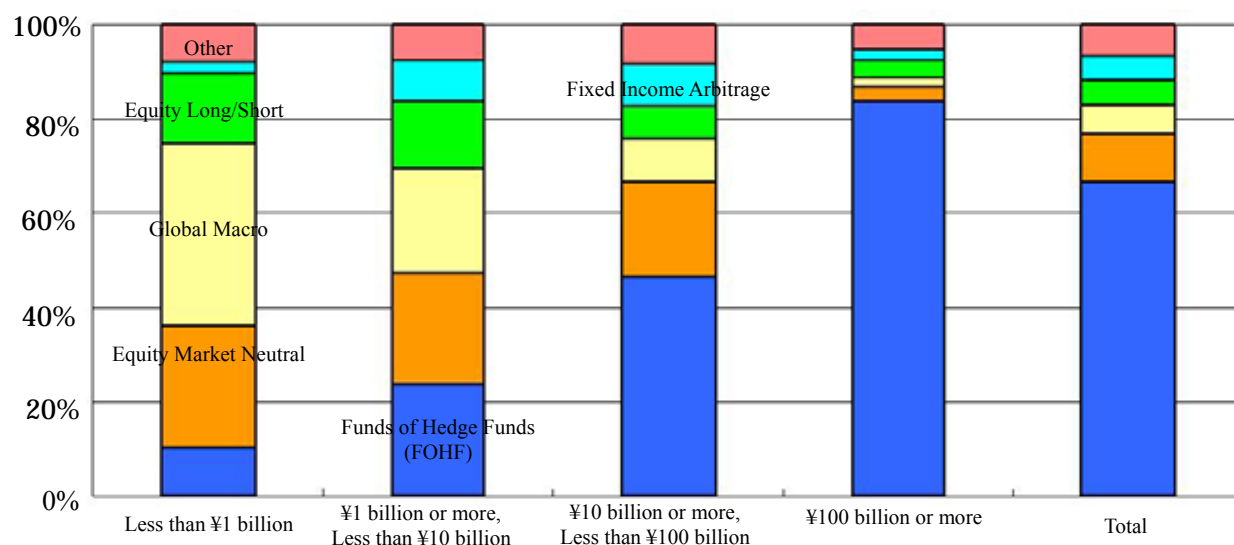
Hedge funds have generally been regarded as high-risk, high-return investment products in the past. However, FSA's survey has revealed that many surveyed companies actually recognized them as middle-risk (middle-return) investment products due to the single-digit risk profile (standard deviation) of hedge funds compared to, for example, the +10% risk profile of TOPIX.

This is an interesting aspect. Put differently, it may be fair to say that hedge funds—which used to offer products with high returns (i.e., high risks) by utilizing excessive leverage back in the day as did the Long Term Capital Management (LTCM)—gradually started providing products aimed at generating stable returns in addition to them. Some analyses point out that such trends are due to hedge funds investors shifting from wealthy individuals to institutional investors seeking stable returns. Nonetheless, the actual status of risks of hedge funds needs to be identified in greater detail, and it is premature to conclude that “hedge funds = middle risks” at this point.

### Risks of Investing in Hedge Funds

**Figure 7** shows the investment balance by hedge fund investment strategy (refer to Table 3). While Funds of Hedge Funds (FOHF) account for 67% of the total, the percentage of FOHF with respect to investment balance is positively correlated with the amount of investment. While further fact-finding is required to analyze the factors behind this, the findings of this Survey suggest that there is a possibility that investors who invest smaller amounts in hedge funds are investing in funds with higher risks, considering that FOHF is generally aimed at diversifying risks compared to single funds.

**Figure 7: Amount of Investment by Hedge Fund Strategy**



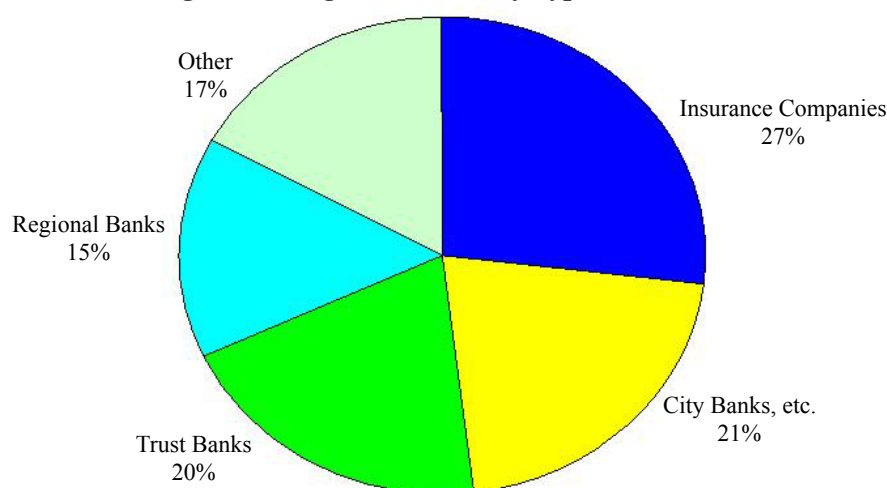
**Table 3: List of Hedge Fund Strategies**

Strategy	Description
Global Macro	A strategy that seeks to generate returns regardless of market trends with the aggressive use of spot trades, futures and derivatives transactions, by finding investment opportunities in market anomalies, inconsistencies and trends in all global markets for foreign exchange, interest rates, shares, commodities, etc.
Equity Market Neutral	A strategy that seeks absolute returns by hedging against the risks of market downturn so that the portfolio outperforms the market index, while taking a long position in individual shares in the core portfolio.
Equity Long/Short	A strategy that combines taking a long position in individual shares that are expected to rise in price and taking a short position in shares that are expected to fall in price.
Fixed Income Arbitrage	A strategy that involves taking a short position in over-priced bonds and a long position in under-priced bonds. One of the relative-value strategies that seeks to generate returns in the process of temporary price anomalies being narrowed until a rational price is reached.

(Source: The FSA (based on “Pursuit of  $\alpha$ : New Asset Management Strategies” (Kinzai Institute for Financial Affairs), “Introduction to Alternative Investments” (Toyo Keizai Inc.)

As for the breakdown of hedge funds held by each type of business, regional banks and cooperative financial institutions accounted for approximately 20% of the total in terms of balance (**refer to Figure 8**). Although it is not necessary clear from the Survey findings, hedge funds may have been one of the preferred investment vehicles for surplus funds in which high returns appear to be promising, amid the continual fall in the deposit-loan ratio.

**Figure 8: Hedge Funds held by Type of Business**



Hedge fund investors need to understand the risks unique to hedge funds.

Firstly, it is generally difficult for investors to grasp the portfolio of hedge funds in detail. This is because the detailed disclosure of investment strategies, subjects of investment, etc. might lead to a loss of profit-making opportunities for the fund manager. The same applies to the valuation of net asset value; there might be risks not found in conventional investment products, such as those relating to the appropriateness of the valuation method, and objective verification of the valuation.

It is also necessary to note that hedge funds are extremely illiquid. In general, it is deemed to be extremely difficult to sell hedge funds to a third party, and many of them set a lock-up period during which withdrawals will incur penalties. It is also said that in many cases, it takes a relatively long period of time to get the investments actually converted into cash after giving a notice of withdrawal.

Financial institutions must improve their respective risk management systems by giving due consideration to the following. Specifically, it is vital that financial institutions establish investment policies and investment rules that can deal with investments in hedge funds as well. As a matter of course, it is also necessary for financial institutions to have sufficient understanding of the nature of the investment products to the greatest extent possible. Moreover, if a financial institution measures the risks of hedge funds based on an internal model (Value-at-Risk (VAR), etc.), it is necessary to take the aforementioned risk factors into account when building a model. It is particularly important to carry out sufficient stress testing. In addition, if a financial institution extends loans to hedge funds, counterparty risks exist. When executing a loan for them, financial institutions need to fully identify the actual status of the counterparty.

### **Treatment under Basel II**

The following is a review of the situation in Japan regarding Basel II, the new capital adequacy framework. In the draft released for public comment by the FSA on December 28, 2005, as a general rule, a financial institution taking a standard approach is required to calculate risk assets of a hedge fund by firstly identifying the portfolio of the fund's assets and then calculating the total amount of credit-risk assets in the portfolio.

On the other hand, a financial institution that takes an Internal Rating-Based Approach (IBA) may assume that the amount of credit-risk assets is equal to:

- (1) If the underlying individual assets are known, the total amount of those credit-risk assets; or
- (2) In the case of (1), if more than half of the total amount of the underlying assets is exposed to shares, etc., the amount of hedge funds held multiplied by the risk weight to exposure of shares, etc.

Otherwise, it may assume that the amount of credit-risk assets of the hedge funds held is equal to:

- (3) If the credit-risk assets of hedge funds held cannot be calculated directly and if (1) and (2) are inapplicable but the investment criteria for the underlying assets are known, the amount of credit-risk assets assuming a portfolio in which risk assets are maximized according to the said asset investment criteria.

Further, if (1) through (3) are inapplicable,

- (4) The financial institution may calculate the amount of credit-risk assets based on an internal model approach, provided that certain requirements are met (e.g., the hedge fund is valued at fair market value on a regular basis); and
- (5) The amount of credit-risk assets may be deemed to be equal to the amount of hedge funds held multiplied by 400% in cases where there is a high possibility that the weighted-average of risk weight of individual assets will be below 400%, or 1,250% in other cases.

As shown above, hedge fund holdings are treated in a more risk-sensitive manner under Basel II. Therefore, due consideration must be given to these aspects when investing in hedge funds.

### **Future Approach**

Hedge fund regulations in different countries can broadly be divided into two types: (1) regulations which require the person who deals in hedge funds to be registered with the authorities; and (2) regulations that require the hedge funds themselves to be registered with the authorities if they are sold to general investors. Examples of the former regulations are found in the U.S.A., U.K., Hong Kong and Japan, while the latter is found in Germany.

As explained above, difficulties will be involved in directly regulating and overseeing the funds themselves. Therefore, the most rational thing to do under the current circumstances is: to monitor what kind of hedge

funds financial institutions are investing in and how they are managing the risks, and if they are extending loans to hedge funds, etc., how they are managing those risks; and to enable the sharing of necessary information on hedge funds involved in cross-border activities with precision, by further enhancing cooperation with foreign authorities. In conjunction with this, we will conduct studies as necessary to look into how investors should be protected in consideration of the extent to which hedge funds are accepted by individual investors, while keeping a close eye on international discussions.

## **[Hot Picks from the Financial World]**

\* We deliver the hottest information of the times in this section, selected from among questions and answers given at the Minister's press conferences etc. If you wish to find out more, we invite you to visit the "[Press Conferences](#)" section of Financial Services Agency's website.

**Q. Do you think the authority given to Japan's SESC is extremely wide ranging? Supposing that its authority will be reviewed in the future, which specific aspects of it could be considered for review?**

- A. An organization is no good if it is just written on a piece of paper. It needs to have some history and build up expertise and human resources. I think it is impossible to create a perfect organization overnight in practice. Take a close look at the handout, as it shows that the authority to establish regulations and to take administrative action rests with the Financial Services Agency (FSA). It is formally an extension of the discussions dating back to around 1991 and 1992, that there should be some kind of firewall between the body in charge of surveillance and the body in charge of taking action. I think the current organization is good, and the SESC has effectively functioned in practice with respect to the latest (Livedoor) incident.

(from [the press conference following a cabinet meeting on Tuesday, January 31, 2006](#))

**Q. The current procedures for administrative action involve the SESC making a recommendation and the FSA taking action. Some people are demanding that the SESC be given the right to take administrative action as well. The existing framework probably has its pros and cons—what is your view on this?**

- A. The system is based on the idea that it is not desirable for the coach and the umpire to be the same, so even if the administrative body that recommends administrative action and the administrative body that actually takes administrative action are different organizations, there are no obstacles whatsoever. The FSA will never leave a case unaddressed by omission if there is a recommendation by the SESC, so I think the existing system is sufficient at this point.

(from [the press conference following a cabinet meeting on Monday, February 6, 2006](#))

**Q. The other day, the first payment order has been issued since the launch of the civil penalty system. What is your evaluation of the first payment order, and your view on what the civil penalty system should be like in the future?**

- A. There are two ways of taking action, criminal and administrative. The civil penalty system is a speedy and effective means of taking action more flexibly. Also, as I just said, the civil penalty system is based on administrative action, so it is distinguished by a certain degree of speediness and flexibility.

(from [the press conference following a cabinet meeting on Friday, February 10, 2006](#))

**Q. A round-table meeting is to be held by experts over the issues on the stock exchanges today. Can you please describe the purpose of the meeting?**

- A. Needless to say, the role fulfilled by the Tokyo Stock Exchange (TSE) is extremely important for the Japanese economy and for foreign investors. This makes the TSE vital infrastructure not only for the Japanese economy but also for the international financial market. It therefore goes without saying that the reliability of the TSE's system and various rules of the TSE must be world-class. The meeting to be held by experts on these issues today is not aimed at scolding the TSE. Rather it

has two objectives; the first is to make the TSE carefully listen to what has been discussed on the TSE, and the second objective is to give social support to reforms envisaged by the TSE itself.  
(from [the press conference following a cabinet meeting on Monday, February 6, 2006](#))

**Q. A Mizuho Bank employee was arrested for stealing massive volumes of personal information. What is your view on this incident?**

- A. Important information on customers was leaked outside. Even worse, the leak involved a company acting as a front for a crime syndicate according to reports by the press. It was an extremely shocking incident indeed. How it happened remains unknown as the case is still under investigation, but in any case, not only Mizuho Bank but also other banks must make a commitment to manage information so as to ensure the reliability and trustworthiness of financial institutions.  
In any case, there is a lesson to be learnt from this problem by the FSA.  
(from [the press conference following a cabinet meeting on Friday, February 10, 2006](#))