Asian Bond Markets Research Mission

— Research Report —

Proposals towards the Reform of Systems and Infrastructure
for the Further Development of Bond and Capital Markets in Japan

February 2003

Corporate Finance and Treasury Association of Japan (CFTA)
Japan Capital Markets Association (JCMA)

Shigehito Inukai	(Secretary-General, JCMA)
	(Mitsubishi Corporation & NIRA)
Junichiro Ando	(Hitachi Capital Corporation)
Takashi Kato	(Secretariat, CFTA and JCMA)
Mamoru Fujimoto	(TradeWin Co., Ltd.)[1]

This report written in Japanese is also available from the following web site.
http://www.enkt.org/katudou/pdf/asiahon.pdf

[1] Mr. Fujimoto accompanied this research mission as an agent and contracted consultant.

Executive Summary

Position of current research

As part of their efforts to promote the development of capital markets in Japan, the Corporate Finance and Treasury Association of Japan (CFTA) and the Japan Capital Markets Association (JCMA) have conducted research[2] into the bond markets of leading Asian countries, which in recent years have received little attention from market participants in Japan.

In light of the current lack of comprehensive information on regulations and infrastructure in leading Asian countries which are in the process of market reconstruction following the Asian financial crisis, one objective of this research is to clarify areas in which Japan's capital markets are deficient in comparison to those of other Asian countries from the perspective of enabling the nation to play a key role in the Asian region. Furthermore, utilizing also the results of research conducted previously, this research mission has the ultimate objective of formulating recommendations to aid in the development of world-class capital markets.

Bond market development in four Asian countries

The research mission[3] conducted interviews with 48 market participants at 18 separate organizations, including regulatory authorities and securities clearing organizations, in South Korea, Hong Kong, Malaysia, and Singapore. These interviews provided a near-complete understanding of the status of the bond markets and securities settlement systems in these countries.

Although South Korea's market is relatively large, bond markets (including government bonds) in the three other countries are small in comparison to Japan's. Nevertheless, corporate bond markets in all the countries surveyed are either comparable or larger than government bond markets, and have grown rapidly over the past several years.

The rapid growth of these bond markets can be attributed to a variety of factors. First, faced with non-functioning banks due to the Asian financial crisis and the temporary prospect of a collapse in bank-guaranteed bond issues and loan markets, government authorities placed emphasized the development of bond markets, and in a short period of time established a variety of bond-related regulations and institutions intended to facilitate the issuance and circulation of government bonds. These trends were especially pronounced in South Korea. Moreover, the governments of Hong Kong, Malaysia, and Singapore were pressed to develop healthy local currency denominated bond markets as an investment target for public pension funds and other institutional investors, and made this an important national goal. Interest rates have declined as a result of deflation in these countries, and slumping stock markets in recent years have created a greater need for more stable investment products. This has led to the growing importance of domestic bond markets. Above all else, the drive of top leadership and youthful staff members enabled the government authorities in these countries to plan and implement securities market reforms in an extremely short period of time.

---

[2] Please refer P.52-P.55 to the specific questionnaire / Meeting Agenda for this mission.

[3] The mission was conducted from 13th to 17th of January 2003.

Overview of bond markets in each country

An overview of the status of regulatory systems and infrastructure in the four countries surveyed is provided below.

1) South Korea

Within a very short period, South Korea has independently implemented regulatory and infrastructural reform of its extremely advanced stock and bond markets. These reforms were carried out under the strong leadership of the Financial Supervisory Service, the agency responsible for securities supervision. The bond settlement cycle in South Korea is normally T+0, but due to the increase in delivery versus payment (DVP) ratios, there are plans to change the cycle to T+1.

2) Hong Kong

The domestic stock market in Hong Kong has reached its limit, and there is little prospect for major expansion. As a result, the Hong Kong Monetary Authority is steadily developing a securities settlement system based on a vision of playing a central role in Asia similar to that of London's financial district and the Euroclear securities settlement facilities in Brussels.

3) Malaysia

Malaysia developed its comprehensive and ambitious Capital Market Master Plan in 2001 under the leadership of the Securities Commission, the country's securities supervisory agency. Phase I of the implementation of the plan is currently underway. Having first created a broad vision based on advanced regulatory systems and infrastructure in Europe, the US, and elsewhere, Malaysia is developing its markets in a careful and logical manner in order to avoid any missteps.

4) Singapore

Singapore is gradually easing currency control and other regulations imposed during the financial crisis and is moving to deregulate bond markets. At the same time, a new settlement system has been introduced and Central Depository (Pte) Limited, the sole central securities depository and part of the Singapore Exchange Limited, is developing and operating a number of systems. Singapore has an especially strong rivalry with Hong Kong, and is seeking to gain a superior footing in that competition.

Status of bond issuing regulatory and settlement systems

This research mission focused on the status of bond issuing regulatory and settlement systems, and revealed the following broad commonalities among the four countries.

1) Bond issuing regulatory systems

Bonds in the countries surveyed are basically positioned as a "professional" rather than "retail" product. As a result, registration and disclosure requirements when bonds are issued are determined on a case-by-case basis and details are not subject to examination and approval procedures. Bond issuers and arrangers determine the information required and prepare registration and disclosure materials. They tend to use methods that ensure there are no omissions in details. Consequently, the burden of filing when issuing bonds in these countries seems low compared to Japan. Moreover, these countries do not have special exemption provisions for certain product types and additional requirements are imposed only as needed for asset-backed securities (ABS) and other securitization products. Regulatory systems are therefore extremely simple. The range of "professional" investors—this category corresponds to qualified investors in Japan—includes wealthy individuals, and the scope of prospectus preparation exemptions is extremely broad compared to Japan. Moreover, the determination of qualifications is made independently by banks, securities firms, and other such institutions based on laws and regulations (no prior notification is required). We were impressed by the clear advantage of this system in terms of practicality.

2) Bond settlement systems

All the countries surveyed utilize DVP systems that operate on a real time gross settlement (RTGS) basis using funds from the central banks as bond settlement systems. These systems are capable of handling government bonds as well as corporate bonds; these countries have thus already implemented the settlement mechanisms that are currently being debated in Japan.

Although issuing volume is low compared to Japan, these countries have uniform settlement mechanisms for bonds and ABS, and sufficient consideration should be given to this point when improving settlement systems in Japan. Moreover, these systems were developed, expanded, and put into operation in the short span of one to two years (the mission did not conduct detailed research on this matter). We believe further exchange of information on the development, operation, and cost of these settlement systems would be valuable.

Conclusion

In conclusion, the mission’s survey left the impression that progress in reforming regulatory systems and infrastructure for debt and equity capital markets in these Asian countries has far outpaced reform in Japan. Compared with current conditions in Japan, including base infrastructure and related tax systems, these countries have already achieved a quite enviable position.

In Japan, the reform of securities settlement systems has been under debate for quite some time, but has as yet not been actually implemented. There is a sense of crisis concerning the possibility of being completely excluded from global markets. What Japan now requires is determination to be displayed by supervisory authorities, central banks and central securities depositories, which collectively make up the national infrastructure. There is, perhaps, little time still available to attempt to reach agreement on formats – it is time for bold decisions by a strong leadership. It is important for Japan to humbly reflect on its current circumstances and to be prepared to learn from Asia.

I Introduction

1. Research objectives

The Corporate Finance and Treasury Association of Japan (CFTA) and the Japan Capital Markets Association (JCMA) have made constructive recommendations[4] from the standpoint of experienced market professionals on the development of a legal system for electronic commercial paper and electronic bonds and on the development of infrastructure and the market environment. In light of the objectives of the financial "big bang," it is important that Japan's capital markets develop world-class market infrastructure and assume a central role, in particular in Asia. This basic agenda remains unchanged. On the basis of this perspective, the JCMA has assessed the current status of Japan's infrastructure with reference to a concept of the ideal status of capital markets. With a particular focus on debt markets, the JCMA has addressed the questions of what is specifically lacking compared to Europe, the US, and Asia in terms of a legal framework, settlement systems, and business practices, and what priorities and formats are required to develop desirable capital market systems in Japan. The JCMA approaches these questions with an awareness of the important responsibility that it bears in making recommendations from the standpoint of market professionals and issuers with expertise and practical experience in major markets of various countries.

The focus on these issues led to the dispatch of a mission two years ago to research securities settlement systems in Europe. The final report[5] of this research caused a stir among market participants, and partly for this reason, the current mission set out to conduct research into the bond markets of leading Asian countries, which have received little attention from market participants in Japan in recent years. The mission sought to clarify deficiencies in Japan's capital markets and offer recommendations for developing world-class capital markets.

Preliminary research revealed a lack of comprehensive and up-to-date information concerning Asian bond markets at financial and research institutions in Japan. The current mission was fortunate to receive considerable understanding and support from the individuals interviewed, and was therefore able to gain a near-complete understanding of the status of debt capital markets and securities settlement systems in leading Asian countries.

[4] http://www.lookjapan.com/JV/02MarEF.htm
http://www.enkt.org/katudou/index.html

[5] The full report written in Japanese is available from http://www.enkt.org/katudou/02_01.html and http://www.enkt.org/katudou/02_02.html.

Organizations visited

Given its research objectives, the mission visited securities supervisory authorities responsible for promoting market development and providing the relevant legal framework, settlement organizations in charge of administering settlement systems, and financial institutions that provide issuing services as market intermediaries. Specifically, the mission visited the following institutions.[6]

Securities Supervisory Authorities

Korea:	Financial Supervisory Service (FSS[7])
Hong Kong:	Hong Kong Monetary Authority (HKMA[8])
Malaysia:	Securities Commission (SC[9])
Singapore:	Monetary Authority of Singapore (MAS)

Settlement Organizations

Korea:	Korea Stock Exchange (KSE)
Hong Kong:	Hong Kong Monetary Authority (HKMA[10])
	Hong Kong Exchange & Clearing Limited (HKEx)
Singapore:	Singapore Exchange Limited (SGX)

Financial Institutions

Korea:	J.P. Morgan Securities (Far East) Limited
	J.P. Morgan Chase Bank
Hong Kong:	Hong Kong and Shanghai Banking Corporation (HSBC)
	Tokyo Mitsubishi International (HK) Limited
	Daiwa Securities SMBC Hong Kong Limited
Malaysia:	J.P. Morgan Chase Bank Berhad

Other

Korea:	Korea Institute of Finance (Private research institution)
Hong Kong:	ORIX Asia Limited (Business corporation)
Malaysia:	Rating Agency Malaysia Berhad (Rating agency)
	Adnan Sundra & Low (Law office)
Singapore:	Institute of Southeast Asian Studies (Government institution)

[6] See “Supplementary Reference 1. List of Organizations Visited” for more details concerning the organizations the mission visited. (Please refer the material written in Japanese. http://www.enkt.org/katudou/pdf/asiaten.pdf)
[7] The FSS is a special public corporation established in April 1999 with the merger of four financial supervisory agencies. The FSS acts on behalf of two government agencies, the Financial Supervisory Committee (FSC) and the Securities and Futures Commission (SFC).
[8] Supervisory organizations in Hong Kong include the Securities & Futures Commission (SFC) in addition to the HKMA.
[9] The Securities Commission also collects information on the RENTAS settlement system operated by Bank Negara Malaysia, the country’s central bank.
[10] The HKMA, in addition to serving as a supervisory agency, is also responsible for operating the CMU bond settlement system.

The organizations visited by the mission were sent questionnaires[11] in advance and interviews were conducted on the basis of these questionnaires. All the organizations reviewed the questionnaires before the interviews, and more than half prepared materials appropriate to the purpose of the visit. This helped facilitate efficient meetings and information gathering.

2. Organization of this report

This report begins with a factual discussion based on the results of the research mission (Chapters II-IV). This is followed by recommendations on what this research can teach us about how Japan should proceed with reform in the future (Chapter V).

Chapter II, "Current Status of Asian Bond Markets," begins with a discussion of trends in the size of bond markets in the four countries visited over the past several years, and the background to these trends. This is followed by an explanation of measures taken in each country to promote the development of bond markets, and a comparison with the current status of bond markets in Japan.

Chapter III, "Legal Framework for Bond Issuance," discusses the procedures and regulations in each country for issuing bonds in addition to the regulations and taxation system for bond investors. It then highlights differences in bond issuing regulations in Japan.

Chapter IV, "Bond Settlement Systems," discusses the current status of bond settlement systems and efforts being made towards reform in each country. It then highlights certain differences in Japan's pursuit of settlement system reform.

Chapter V, "Recommendations for Regulatory and Infrastructural Reform in Japan," provides a discussion based on Chapters III and IV of the measures required for the future development of the bond and commercial paper markets in Japan with respect to the legal framework of bond issuance and bond settlement systems.

11 See "Supplementary Reference 2. Agenda" for more information regarding the questionnaires.

II Current Status of Asian Bond Markets

Chapter II: Key points

a. Trends in market size
This section looks at the size (outstanding balance) of bond markets as a source of corporate financing in Asian countries compared to equity markets (aggregate market value) and bank financing (bank loans outstanding). It also breaks down bond markets to look at the size (outstanding balance and amount of issues) of public and corporate bond markets. Of particular interest is the extent to which corporate bond markets are expanding.

b. Composition of market participants
This section examines the composition of bond issuers and investors. It also looks at the proportion of foreign bond issuers and foreign investors in these bond markets.

c. Efforts towards market development
This section explores whether government authorities in each country have adopted or plan to adopt measures to expand corporate bond markets.

1. South Korea

a. Market size

South Korea's bond market was the largest among those of the Asian countries visited by this mission. The outstanding balance of bond issues exceeded 500 trillion won (approximately ¥52 trillion), surpassing the aggregate market value of the stock market by a wide margin (Figure 1). The bond market is expected to equal South Korea's GDP in 2002.

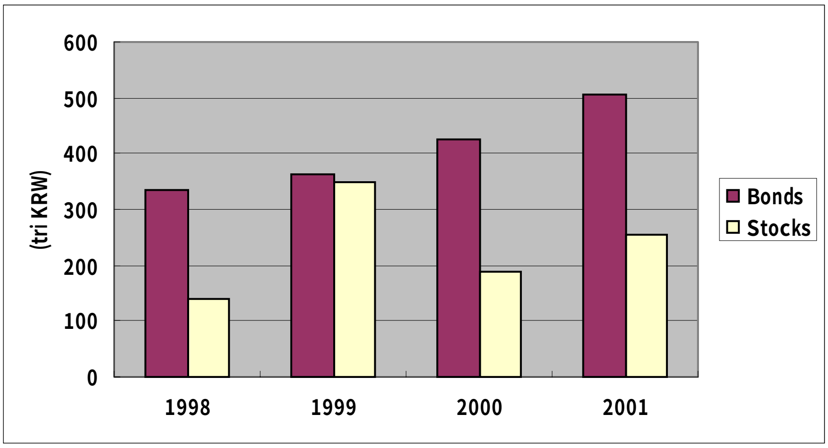

Figure 1. Size of South Korea's financial markets (Source: KSE)

The outstanding balance of corporate bond issues totaled 140 trillion won (approximately ¥14.6 trillion) as of end-November 2002, accounting for roughly 25% of the total bond market (Figure 2). The lack of an increase in outstanding corporate bonds compared to public bonds has the strong appearance of a "flight to quality" in the wake of the financial crisis, and is likely the result of a situation in which only companies with high creditworthiness are able to issue bonds. (Issues by companies with a AAA rating accounted for an extremely high 48.8% of corporate bond issues in 2001).

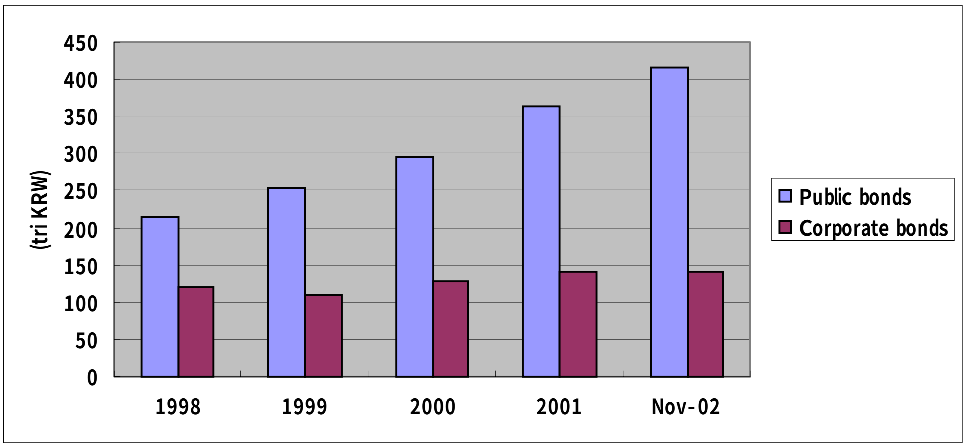

Figure 2. Outstanding balances by bond type (Source: KSE, JPMorgan)

On an issue amount basis, a total of 47.5 trillion won (approximately ¥4.9 trillion) of corporate bonds were issued in 2002 (Jan-Nov), accounting for approximately 20% of the total amount of bond issues

(Figure 3). Until the year preceding the financial crisis, corporate bonds accounted for nearly 70% of bond issues, but this figure fell instantly to 10%. This decline can be attributed to a sharp increase in the issuance of Monetary Stabilization Bonds (MSB) by the central bank for the purpose of monetary adjustment as a result of the financial crisis. However, the outstanding balance of MSBs is expected to decline owing to the stabilization of financial conditions in South Korea and to the government's adoption of a low interest rate policy.

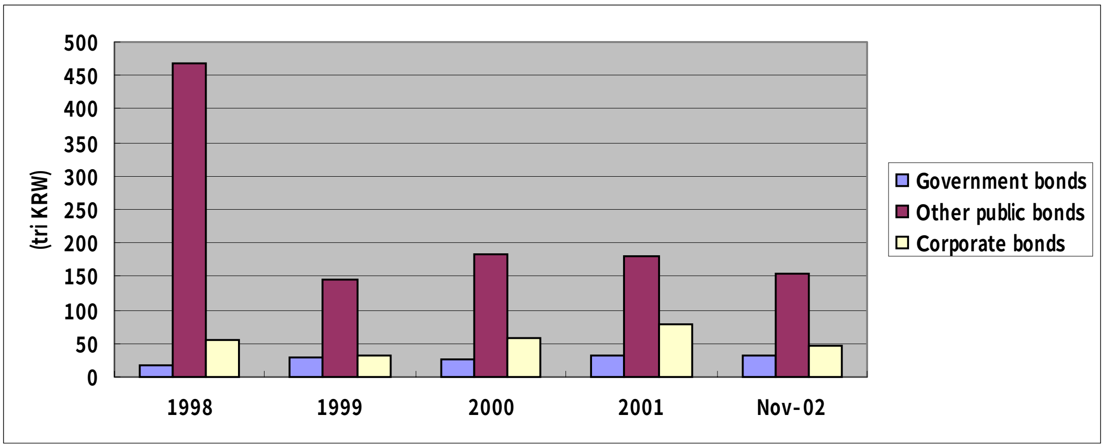

Figure 3. Issue amount by bond type (Source: KSE, JPMorgan)

Liquidity in the bond market is not especially high owing to a basic tendency among investors to "buy and hold." However, liquidity is gradually increasing due to the introduction of a primary dealer system for government bonds in 1999 and an inter-dealer trading system for public bonds at the Korea Stock Exchange (KSE) (Figure 4). Furthermore, in order to increase bond liquidity, in order to increase bond liquidity, the Financial Supervisory Service (FSS), has adopted mark-to-market requirements for public issues and has abolished tax withholding for repo and bond lending transactions.

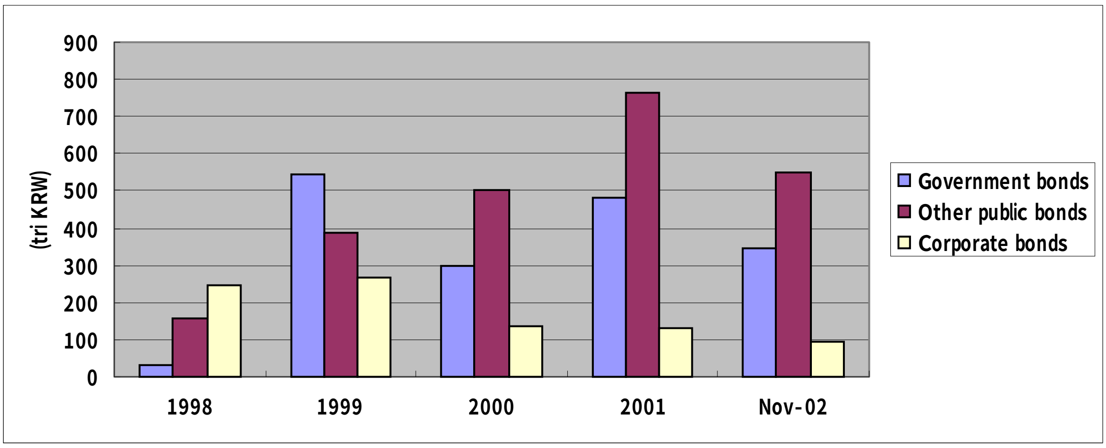

Figure 4. Trading volume by bond type (Source: KSE, JPMorgan)

b. Composition of market participants

The vast majority of issuers and investors are domestic companies. The proportion of foreign issuers and investors represents only a few percentage points. A breakdown of investors in the bond market shows banks to be the largest investors, but the proportion of investment trusts and pension funds has increased significantly in recent years (Figure 5).

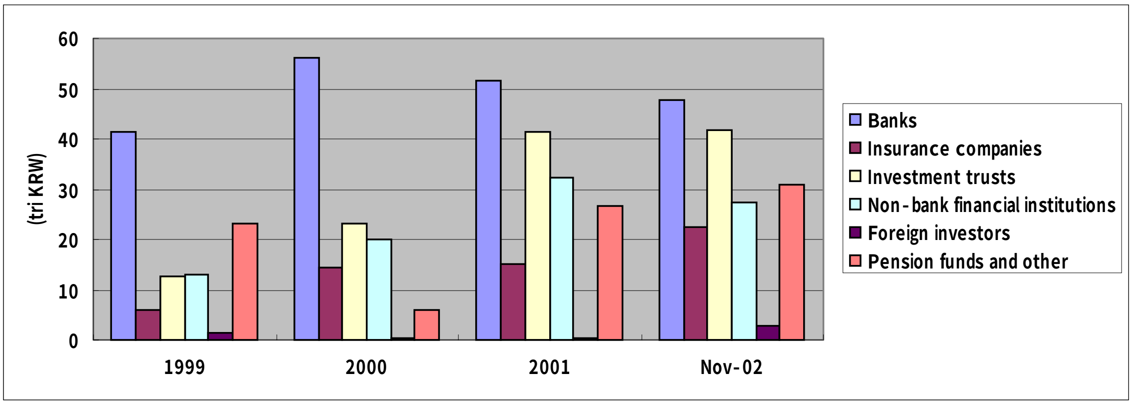

Figure 5. Investment balances by investor (Source: JPMorgan)

c. Efforts towards market development

South Korea, under the leadership of the FSS, has taken the following steps to expand the bond market:

1) Opened markets to foreign investors
2) Reformed the government bond market (Introduced primary dealers and reopenings to create fungibility)
3) Enhanced risk awareness (Mark-to-market requirements and development of the Korea Securities Dealers Association (KSDA) yield matrix)
4) Introduced a bond futures market (Three-year bond futures have the fifth highest trading volume in the world)
5) Introduced securitization products (Developed systems for collateralized bond obligations (CBO), collateralized loan obligations (CLO), and asset-backed commercial paper (ABCP))
6) Established an exchange repo market

These measures have enabled the majority of institutional problems to be solved in the past several years.

Current plans for major institutional changes include the proposed change of the bond settlement cycle from T+0 to T+1 (scheduled to begin in June 2003). With the current T+0 settlement, the DVP settlement ratio is low at around 40%, due to matching among investment banks and investment trust companies being too late for the cutoff time, among other reasons. The settlement cycle for normal bond trading will therefore be changed to T+1 in an effort to quickly increase the DVP ratio.

2. Hong Kong

1. <u>Market size</u>

Hong Kong's bond market is still developing. With an outstanding balance of HK$526 billion (approximately ¥8.3 trillion) as of end-2002, it pales by comparison to a stock market valued at HK$3.6 trillion and bank loans outstanding of HK$1.8 trillion (Figure 6). Apart from a few major corporations, companies tend to prefer bank loans, which have low financing costs. On the bank side, there is little resistance to increasing loan receivables due to the extremely low ratio of non-performing loans in Hong Kong. Consequently, there have been no signs to date of a shift from indirect to direct markets.

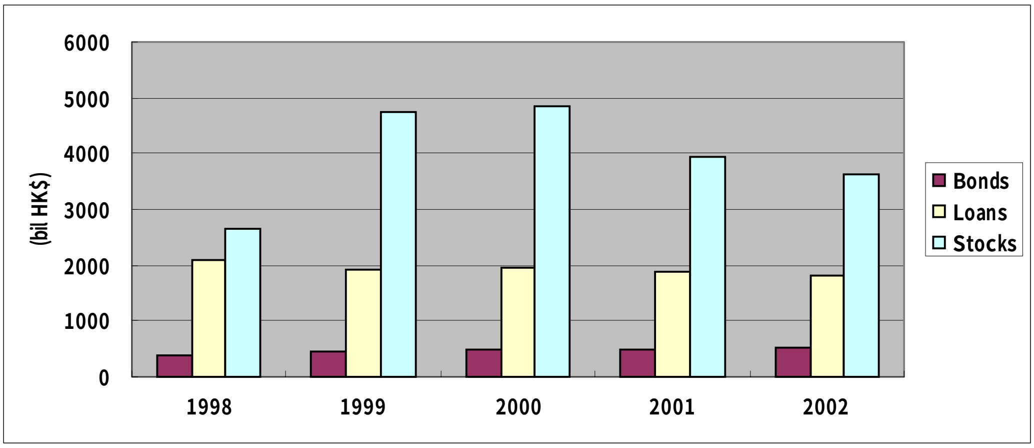

Figure 6. Size of Hong Kong's financial markets (Source: HKMA)

Corporate bonds account for approximately 80% of total bonds outstanding (Figure 7). In Hong Kong, Exchange Fund Bills and Notes (EFB&N) issued based on Hong Kong's foreign exchange reserves are positioned on an equal basis to government bonds. However, Hong Kong has historically been financially healthy and the government has not needed to actively issue these bonds as a means to raise funds. Consequently, the outstanding balance is currently not very high. (Although the situation is similar in Singapore, its government issues bonds on a regular basis in order to provide benchmarks for bond markets, rather than out of financial necessity.)

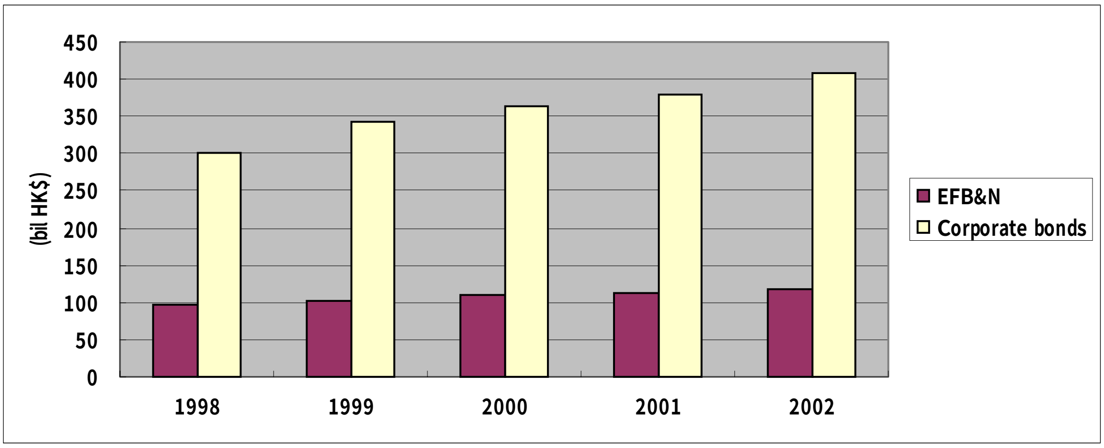

Figure 7. Outstanding balances by bond type (Source: HKMA)

Nevertheless, in response to growing demand in recent years for Hong Kong dollar denominated bonds from institutional investors, notably the Mandatory Provident Fund (MFP; a public pension fund), bond issues by the Hong Kong government and government-affiliated institutions have increased, and public bonds have surpassed corporate bonds on an issue amount basis (Figure 8). Interest rates are currently at historic lows in Hong Kong and banks are aggressively expanding their loan portfolios. This means the financing needs of companies are largely satisfied by bank loans, and as a result, the amount of corporate bonds outstanding is showing little growth.

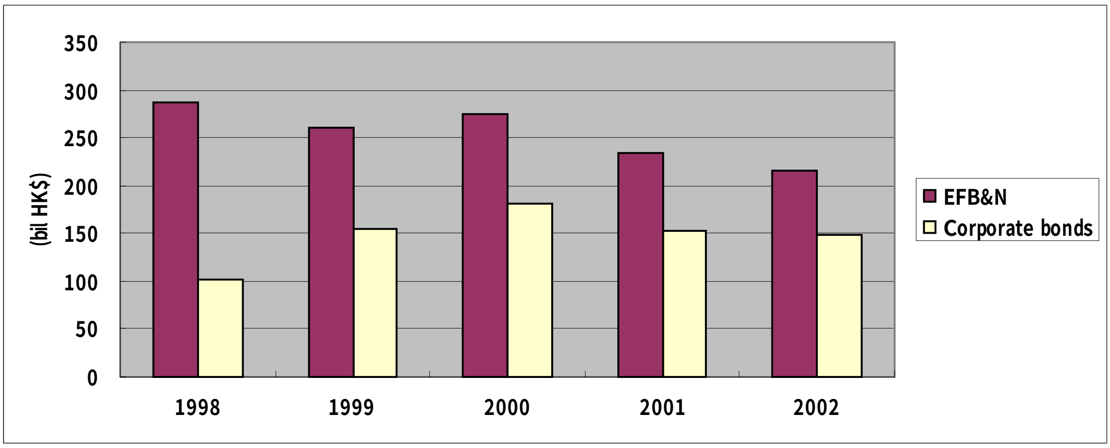

Figure 8. Issue amount by bond type (Source: HKMA)

b. <u>Composition of market participants</u>

Banks are the largest issuers of corporate bonds in Hong Kong. Among general business enterprises, only a few major corporations conduct issues. Banks are the largest issuers because the 20% BIS risk weighting of bank bonds is low compared to general corporate bonds, making bank bonds the preferred choice of financial institutions, which represent the largest investors.

The Hong Kong and Shanghai Banking Corporation enjoys the dominant position among the financial institutions underwriting Hong Kong dollar bonds, with an approximately 25% share on a new issue amount basis. (The Standard Chartered Bank ranks second, with an approximately 10% share.) Hong Kong financial institutions are essentially universal banks, and because there is no separation between banking and securities, companies basically consult with the same financial institution regardless of whether they seek to raise funds through loans or bonds.

However, there is little overall demand on the part of companies for raising Hong Kong dollar denominated funds. Due in part to sharp declines in real estate values, major projects in Hong Kong which require Hong Kong dollars fall mostly in areas such as highway and subway construction, which are undertaken primarily by public institutions.

c. <u>Efforts towards market development</u>

The Hong Kong Monetary Authority (HKMA) considers the development of a Hong Kong dollar denominated bond market for individual investors to be a priority policy issue. It is promoting bond issues by government-affiliated financial institutions such as the Hong Kong Mortgage Corporation. This position was prompted by the recent slump in the stock market (despite a strong preference for equity investment in Hong Kong, a growing number of investors are seeking stability owing to the decline in the stock market). The HKMA believes it is important to provide individual investors with new investment products other than stocks and deposits.

As part of efforts to further develop bond markets, the HKMA has decided to list all EFB&Ns on the Hong Kong Exchanges and Clearing Limited and has lowered the minimum trading unit.

3. Malaysia

a. Market size

Malaysia's bond market has grown since the financial crisis in 1997 to reach 292.6 billion ringgit (approximately ¥9.3 trillion) as of end-2002 (Figure 9). This growth can be attributed to the financial crisis prompting banks to restrict lines of credit in order to avoid the risk of non-performing loans, and to a shift by general business enterprises from financing through loans to bond issues due to the switch to collateral-backed loans, among other reasons. Other contributing factors include the near impossibility of raising foreign currency funds as a result of foreign exchange regulations prompted by the financial crisis, and a growing preference among investors for government bonds as a more profitable investment than loans and stocks.

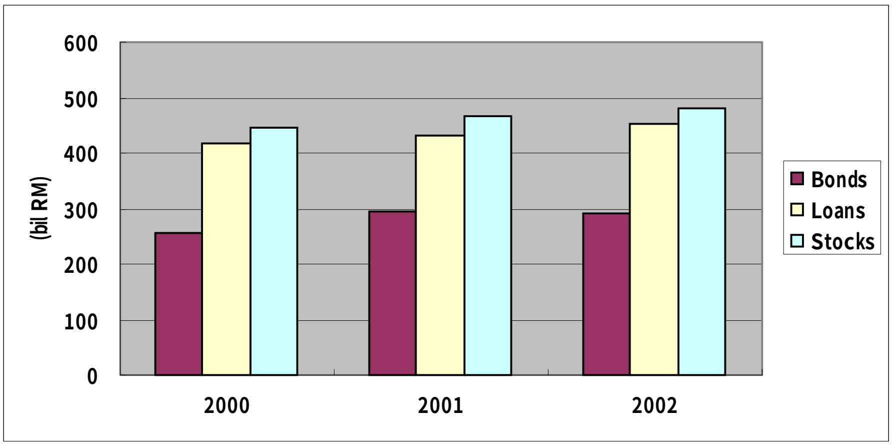

Figure 9. Size of Malaysia's financial markets (Source: Bank Negara Malaysia)

A breakdown of bonds outstanding shows that although corporate bonds accounted for over 50% as of end-2002, the ratio of government bonds is gradually increasing (Figure 10). This can be attributed to an increase in the government's procurement of funds in order to stimulate the economy following the financial crisis, and to bond issues to raise funds by government-affiliated agencies such as Danaharta, Danamodal, and Khazanah, which are involved in disposing of non-performing loans and industrial revitalization.

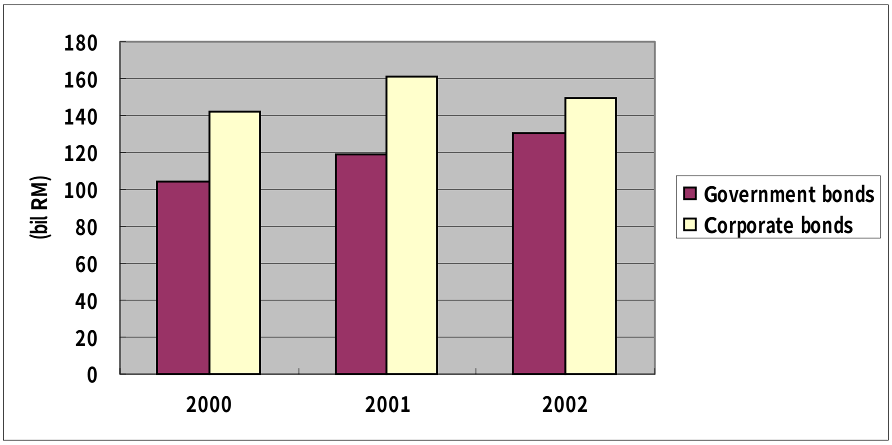

Figure 10. Outstanding balances by bond type (Source: Bank Negara Malaysia)

However, with a decline in the issue amount of government bonds in 2002 (Figure 11), the outstanding balance of government bonds is likely to stop increasing. Malaysia does not have a fiscal deficit, and now that it has dealt with the financial crisis, it has little need to raise funds for fiscal purposes. Nevertheless, given the importance of establishing a yield curve and improving liquidity in secondary markets, it plans to issue bonds on an ongoing basis in order to help develop bond markets.

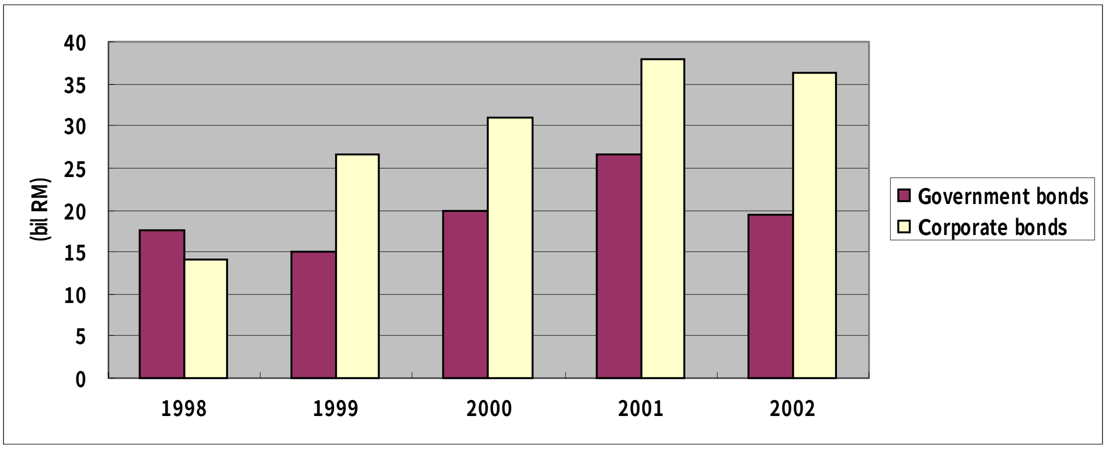

Figure 11. Issue amount by bond type (Source: Bank Negara Malaysia)

Secondary bond markets are relatively advanced, and the liquidity of government bonds in particular is increasing rapidly (Figure 12). This is due to the introduction of a primary dealer system for government bonds requiring primary dealers to trade in certain secondary markets. In addition, the availability of the latest price information for all bonds with the launch of the Bond Information and Dissemination System (BIDS) in 2000 has probably made a particular contribution to improving the liquidity of corporate bonds.

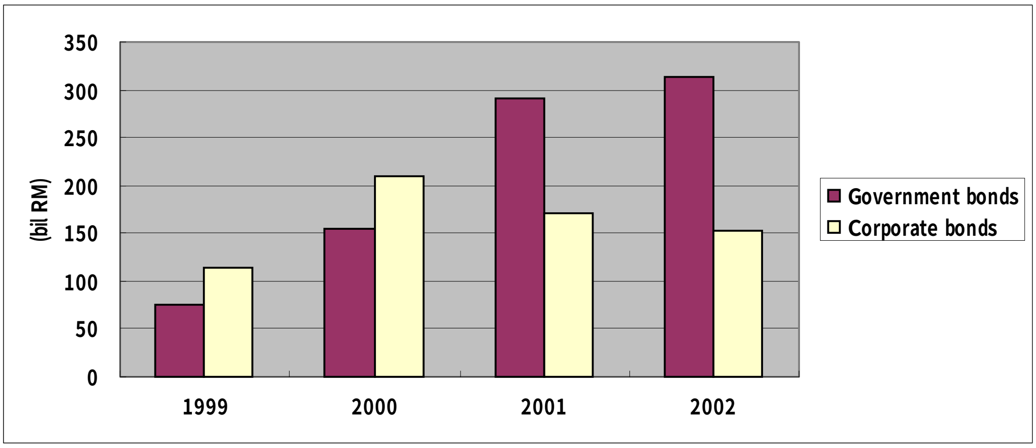

Figure 12. Trading volume by bond type (Source: Bank Negara Malaysia)

b. Composition of market participants

Almost all bond issuers are business enterprises (including non-banks). Due to foreign exchange regulations, there are virtually no issues by non-residents or foreign currency denominated issues. (Government agencies and certain major corporations such as Petronas raise funds in overseas markets). The issue format is generally a “bought deal” or private placement to professional investors. This is because the issuing procedures (preparing a prospectus, etc.) for general public offerings are complicated, and retail issues are quite rare as bonds are normally products for professional investors.

The largest investor in bond markets is the Employee Provident Fund, a public pension fund. This giant institutional investor holds 60% of government bond issues. The next largest investors are banks and insurance companies. Overall, public and financial institutions hold an extremely high 90% of government bonds and 80% of corporate bonds. Investment by social insurance funds is expected to steadily increase in the future, a factor which will cause a corresponding increase in the amount of bond issues.

c. Efforts towards market development

The Securities Commission has taken over the securities supervisory duties of Bank Negara Malaysia. After becoming the sole securities supervisory agency, it issued new guidelines on corporate bond issues in July 2000 and new guidelines on ABS issues in 2001. Alongside these efforts, the Securities Commission strengthened market infrastructure by launching the BIDS bond information system in October 1997 and the RENTAS RTGS-DVP settlement system in 1999.

Moreover, the Securities Commission announced the Capital Market Master Plan in April 2001 as a strategic plan for overall capital markets. This ten-year plan was recently launched; Phase I, which is currently being implemented, focuses on measures to “strengthen the domestic market.”

4. Singapore

a. Market size

Singapore's bond market has more than doubled in size over the past five years to reach S$141.1 billion (approximately ¥9.8 trillion) as of end-2002 (Figure 13).

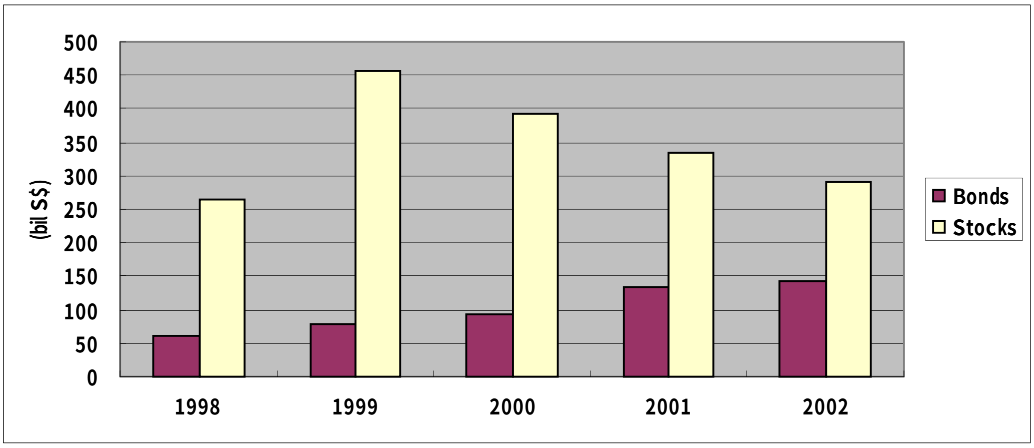

Figure 13. Size of Singapore's financial markets (Source: MAS for bonds, SGX for stocks)

In Singapore, as in other Asian countries, the shift away from excessive dependence on bank loans toward direct markets has become an important issue since the financial crisis. Government authorities have focused on developing domestic bond markets and both government and corporate bonds have expanded steadily (Figure 14).

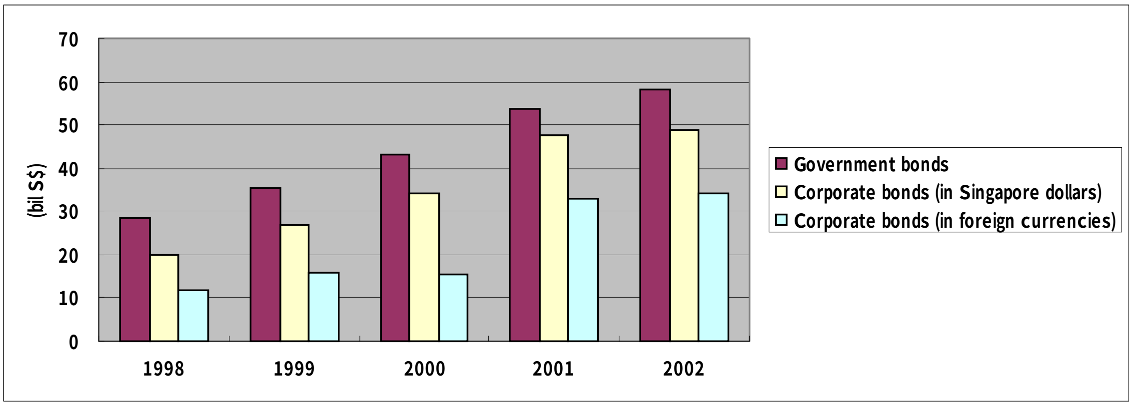

Figure 14. Outstanding balances by bond type (Source: MAS)

The outstanding balance of new issues has shown a gradual upward trend, in particular for government bonds (Figure 14). Commercial paper with maturities less than one year issued by non-residents account for over 50% of foreign currency denominated debt securities.

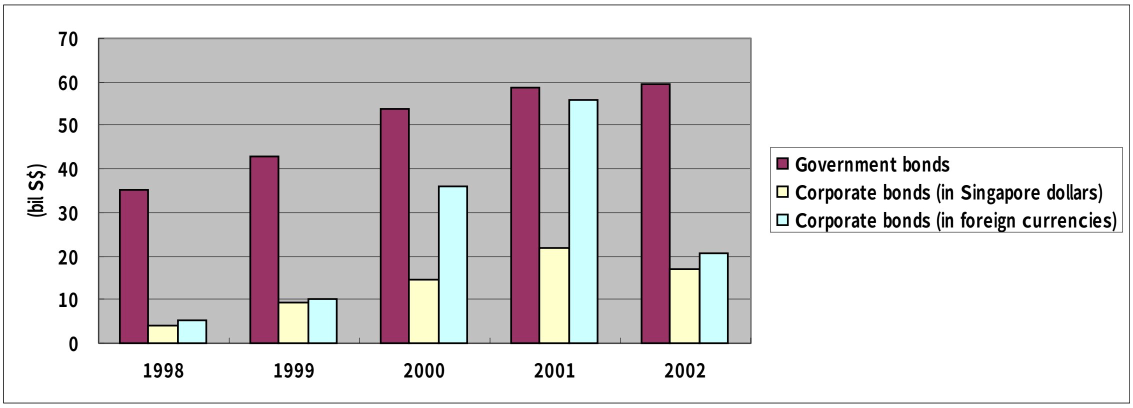

Figure 15. Issue amount by bond type (Source: MAS)

The increase in corporate bond issues can be attributed to participation of government-affiliated financial institutions (mortgage, etc.) in bond markets and to growing fund raising needs as a result of mergers and acquisitions by financial institutions and telecommunications companies.

b. Composition of market participants

A variety of entities issue Singapore dollar bonds, including general business enterprises, financial institutions, real estate companies, and government-affiliated organizations. The proportion of real estate companies was high until recently, but the amount of funds they raise has been declining in recent years. At the same time, issues by business enterprises, financial institutions, and government-affiliated organizations have been increasing. Moreover, with the easing of regulations for foreign companies, issues by US and European financial institutions and companies, Asian companies, and international financial institutions have been gradually increasing.

Domestic investors account for 99% of investors in Singapore dollar denominated bonds. By contrast, non-residents account for 92% of investors in foreign currency bonds. Banks are the largest investors in bond markets, accounting for over 40% of the total. Banks are followed by insurance companies and fund managers, with an approximately 25% share each. The proportion of non-residents is extremely low, at around 3%.

Almost all issues, whether denominated in Singapore dollars or foreign currencies, are by private placement (96% for Singapore dollar bonds and 99% for foreign currency bonds). Bonds are essentially a product for sophisticated investors.

c. Efforts towards market development

The Monetary Authority of Singapore (MAS) first developed a government bond market with a view to expanding overall bond markets. Specifically, MAS issued government bonds with multiple maturities in order to establish a 15-year benchmark yield, introduced a reopen system to increase the size of issue lots, and established a repo market. At the same time, to hasten the development of a corporate bond market, MAS eased regulations (abolished prior approval requirements, allowed unrated bond issues to qualified investors, etc.) in order to encourage successive bond issues by government-affiliated organizations and issues by foreign-owned companies.

The MAS has recently taken steps to establish hedge markets (bond and interest rate futures, swaps), set standards for repo transactions, and improve settlement systems, with a view to increasing liquidity in secondary markets.

5. Conclusion

a. Market size

Bond markets are expanding in each of the four countries visited by the survey. To varying degrees, this can be attributed to a wide range of measures implemented by government authorities for the purpose of developing the markets. In the background of these efforts is a decline in bank loans prompted by the financial crisis, slumping stock markets, and the growing importance of bonds as an investment target for public pension funds and other institutional investors.

Japan's bond market has also grown significantly in recent years (Figure 16), but this is almost entirely the result of rapid growth in the outstanding balance of government bonds, especially treasury bills (TB) and financing bills (FB). Corporate bonds outstanding have shown little growth (Figure 17). On an issue amount basis, corporate bonds account for an extremely low 3% of total bond issues (approximately 8% of private bond issues including bank bonds; Figure 18), in part reflecting a decline in corporate willingness to procure funds due to the deflationary environment.

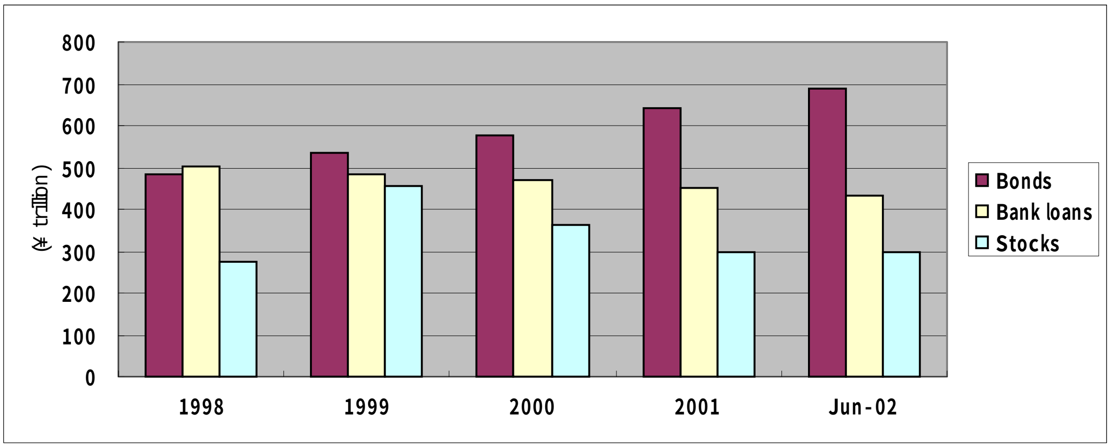

Figure 16. Size of Japan's financial markets (Source: BOJ, Monthly Statistics of Japan, TSE monthly statistics)

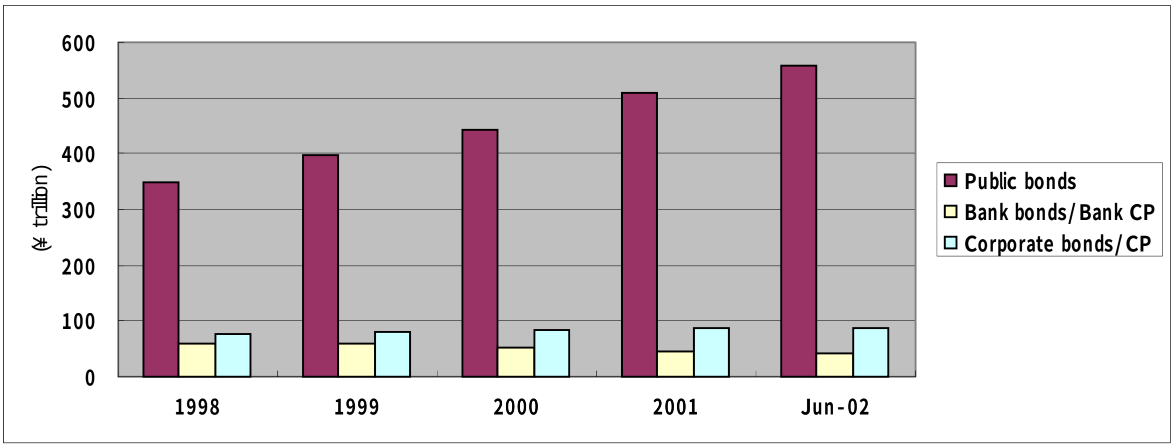

Figure 17. Outstanding balances by bond type (Source: BOJ, Monthly Statistics of Japan)

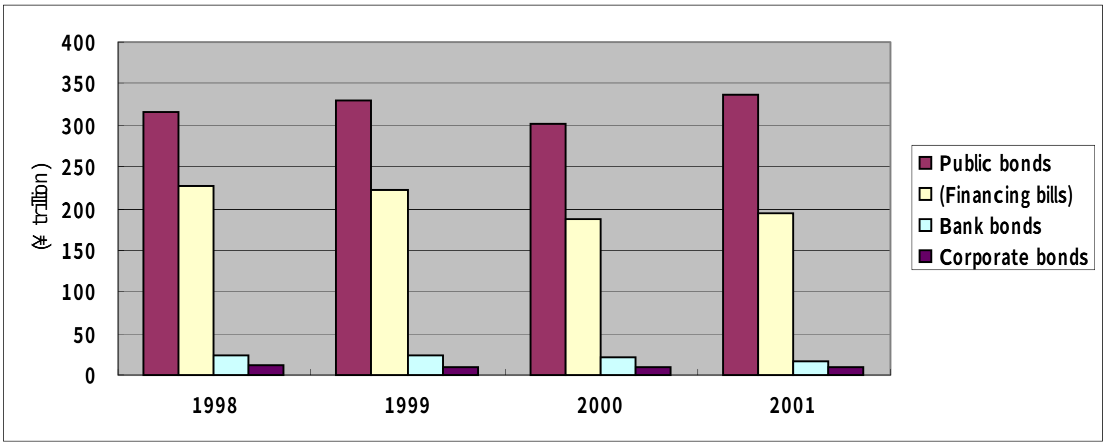

Figure 18. Issue amount by bond type (Source: BOJ, Monthly Statistics of Japan)

The ratio of corporate bonds to the overall bond market is lower in Japan than in any of the four Asian countries visited in the survey (Figures 19 and 20). (The difference is even more pronounced when bank bonds are excluded from corporate bonds).

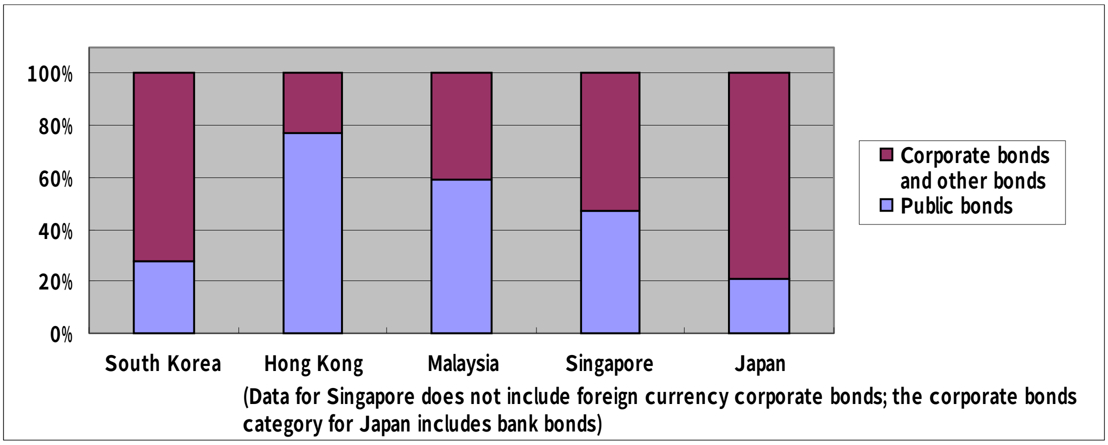

Figure 19. Proportion of corporate bonds to overall bond market (outstanding balance; end-2001)

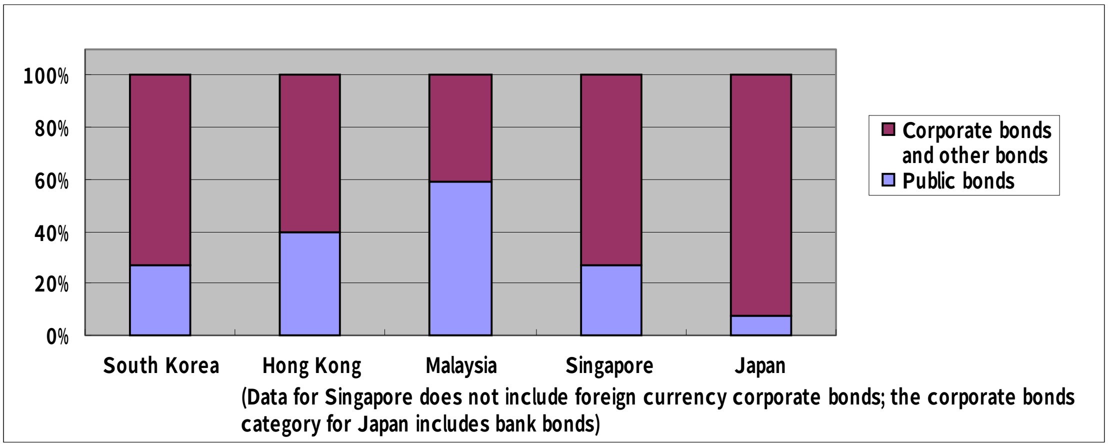

Figure 20. Proportion of corporate bonds to overall bond market (issue amount; 2001)

In Japan's bond market, government bonds account for 74% on an outstanding balance basis and have surpassed 91% on an issue amount basis. The market therefore appears to be a mature market with high liquidity. In reality, however, there is no balance in terms of issue valuations and the market lacks depth. We believe measures to develop the corporate bond market are particularly necessary to change this situation and create a bond market with true depth.

b. Composition of market participants

While the composition of bond issuers varies from country to country, bond investors in the four Asian countries surveyed are primarily financial institutions and public pension funds. Malaysia, followed by Singapore and Hong Kong, has seen significant growth in the outstanding balance of bond holdings by public pension funds. They are now (or are fast becoming) the largest investors in bond markets. Government authorities, aware of the importance of local currency bond markets as an investment target for public pension funds, are pursuing a variety of measures to help develop bond markets.

The proportion of bond issues and investments by non-residents is extremely low in the bond markets of these countries, with the exception of foreign currency bonds. There are two major reasons for this fact. The first is restrictions on the cross border flow of funds as a result of foreign exchange regulations imposed after the financial crisis. The second is low demand for fund raising and investment by non-residents in Asian countries.

c. Efforts towards market development

Government authorities in these four countries have taken the following steps to promote the development of bond markets:

1) Establishing benchmarks by developing primary and secondary markets for government bonds and government agency bonds (and also developing interest derivative markets as needed)
2) Developing an issuing and taxation environment that offers incentives to corporate bond issuers and investors
3) Developing bond settlement systems (RTGS-DVP settlement systems)

Government authorities sought through these measures to achieve balanced growth in public and corporate bond markets, and we were impressed by the development of various regulatory systems and infrastructure in such a short period of time. Looking at the present situation in Japan, although item 1) above, the establishment of benchmarks, is almost completed, Japan lags behind the surveyed countries in the second two items. We believe these issues require immediate attention.

To date, Japan has adopted a variety of measures to promote the market, primarily targeting government bonds. As noted earlier, however, we believe that it will be extremely important to develop regulatory systems and infrastructure for non-government bonds in a short space of time in order to create a bond market with depth and genuine significance.

III Legal Framework for Bond Issuance

Chapter III: Key points

a. Bond issuing regulatory systems
This section looks at the regulatory systems relating to bond issuing procedures and bond issuing applications in the surveyed countries. It also examines disclosure exemption provisions based on issue format (public or private offering) or product type, and requirements for corporate bond issues (e.g. rating acquisition).

It then discusses the time period required to gain approval for corporate bond issues and looks at any provisions, such as the issue suspension period in Japan, that create problems for issuing bonds in a flexible manner. It concludes by examining whether the countries discussed have a shelf registration system for issuing bonds on an ongoing basis.

b. Investor regulations
This section looks at regulations that impose restrictions on investors when investing in corporate bonds, and how the surveyed countries regulate what are known as “qualified institutional investors” in Japan.

c. Bond taxation
This section addresses taxes on bond investments, and in particular how these countries handle interest tax withholding, which has become an issue in Japan.

d. Future direction of reforms
This section explores current issues in fostering bond markets and plans for future reforms concerned with issuing and holding bonds.

1. South Korea

a. Bond issuing regulatory system

The primary feature of bond issuing practices in South Korea is that all procedures including filing are performed via a web-based system. The entire process is paperless. Filing with the Financial Supervisory Committee (FSC), which is the securities supervisory agency, can be broadly separated into the following three steps:

1) Issue registration
2) Filing (Securities report and preliminary prospectus)
3) Issue results report

Initial issue registration is performed prior to selecting a lead manager, and prescribed items are filed with the FSC via the web-based system. Filing entails the submission of documents detailed in the prescribed items (draft prospectus, etc.) via the web-based system. After filing, the bond issue is announced and subscription and sales activities can begin on the day the filing enters into force (10 days after filing for non-guaranteed bonds). The details of these activities are reported to the Korean Securities Depository (KSD) and an issue results report is filed with the FSC via the web-based system. These procedures are followed for all bonds.

Publicly issued bonds are required to be rated by a minimum of two rating organizations. Privately placed bonds are not subject to this requirement and the question of rating is left to the discretion of the issuer. Aside from this, there are no exemption rules for private offerings. Moreover, there are no special provisions containing exemption rules for specific products such as commercial paper programs.

The bond issue approval period is now seven days, shortened from the pre-financial crisis period of fourteen days. There are no special provisions for an issue suspension period, and this matter is left to the discretion of the issuer. Although a shelf registration system is in place, only credit card companies and other non-banks actually use the system.

b. Investor regulations

South Korea has no special regulations governing investment grades (bonds rated BBB and higher are considered “investment grade,” but there is no system to regulate investment in “non-investment grade” bonds). For trust banks, however, all bond holdings are required to be marked-to-market. This provision was introduced in conjunction with a mark-to-market requirement for all publicly issued bonds as a measure to increase bond liquidity and protect investors. In response, there are currently three bond valuation companies that are independent from financial institutions and which announce market values for public and corporate bonds.

c. Bond taxation

Tax on bond interest is withheld at a rate of 15% for residents and 27.5% for non-residents. However, non-residents that are residents of a country with which South Korea has concluded a tax treaty may qualify for a reduction of or exemption from withholding tax.

In either case, the KSD is required to withhold tax for all bonds deposited at the KSD, and it pays interest to each participant on the basis of their account information. For bonds not deposited at the KSD, the paying party is required to withhold tax, but because nearly 99% of all bonds issued in South Korea are deposited at the KSD, the KSD withholds and pays almost all interest tax to the national government.

Corporate capital gains are subject to aggregate taxation, with profits up to 100 million won subject to income tax of 10% and profits over 100 million won to income tax of 27%.

d. Future direction of reforms

Since its founding, the Financial Supervisory Service (FSS) has developed a variety of securities systems, including web-based systems for issuing bonds. In addition to the items already mentioned, a standard contract between an issuing body, underwriter, and trustee has been developed under the direction of the FSS.

Due to the prompt development of appropriate systems for new products such as ABS, outstanding issues grew ten-fold in just one year from the first issuance in 1999. At the present time, structured bonds have grown to account for over 50% of total issues in the bond market.

Given the above, the FSS believes that its reforms with respect to issuing bonds are generally complete. We predict that the FSS will focus future reform efforts on measures to enhance settlement safety and bond liquidity.

2. Hong Kong

a. Bond issuing regulatory system

Prior approval of the Hong Kong Monetary Authority (HKMA) is not required when issuing bonds in Hong Kong. Therefore, there is no minimum required number of days for bond issues. (Private offerings can theoretically be issued the same day.) However, although prior approval is not required, there are guidelines for issuing procedures. In general, it takes about a week and a half to issue privately placed bonds and about three weeks for publicly issued bonds. The Securities and Futures Commission (SFC), which determines the guidelines, has shown its willingness to simplify and lighten the procedural burden at the request of market participants.

The bond market is fundamentally a professional market, and as such, almost all issues are privately placed. Public issues are extremely limited owing to a lack of issue flexibility due to the requirement of preparing a prospectus and to the fact that there is essentially no demand for raising funds from individuals. Moreover, although a listing examination is required for listing on an exchange, because issuers are not seeking bond liquidity, virtually no corporate bonds are listed (government agency bonds are the exception).

With regard to disclosure documents, because Hong Kong’s legal system is based on the English system of common law, issuers generally consult with a law firm and prepare documents to “satisfy the needs of market participants.” Consequently, government authorities do not provide individual guidance on issue disclosure.

A rating is not required for issuing bonds in Hong Kong, and in actuality there are few companies that have acquired a rating. Additionally, there is no shelf registration system, and the concept of an issue suspension period does not exist.

b. Investor regulations

Hong Kong has no system for designating qualified institutional investors, but the SFC does determine a code of conduct for professional investors, and the term “professional investor” is defined in this code. The qualification of investors is therefore determined by each financial institution on the basis of this code of conduct.

Hong Kong has no investment regulations for non-residents. Hong Kong is fundamentally an open market, and there are no trading regulations for products denominated in either Hong Kong dollars or other currencies.

c. Bond taxation

Individuals are not taxed on either capital gains or interest. For corporations, treatment varies as follows depending on the type of bond.

1) Exchange Fund Bills and Notes and similar government bonds and international organization bonds are not taxed.
2) Government agency bonds and corporate bonds that meet certain conditions are taxed at a rate of 8% (50% reduced rate).
3) Other bonds are taxed at 16%.

d. Future direction of reform

As touched on above, the HKMA’s current focus is on developing a retail bond market. The SFC has simplified procedures for publicly issued bonds with a view to easing requirements, in order to encourage the development of a retail bond market.

Potential obstacles to developing a retail bond market include: (1) the high cost for companies of issuing bonds through public offering compared to borrowing from banks; and (2) the cost to individual investors from bond custody fees, etc. We believe the high cost for companies can be solved by easing requirements for issuing procedures, and the cost to investors by growth in the retail bond market to a certain size.

3. Malaysia

a. Bond issuing regulatory system

From July 2000, all bonds issued in Malaysia, with the exception of bonds issued or guaranteed by the government, have required approval by the Securities Commission based on the Guidelines on the Offering of Private Debt Securities. Bonds previously needed the approval of the Kuala Lumpur Stock Exchange (KLSE), Foreign Investment Committee, and the central bank, but now only the approval of the Securities Commission is required.[12]

The preparation of the abovementioned Guidelines substantially reduced the regulatory requirements for issuing bonds. For general bond issues, the following three documents are submitted to the Securities Commission.

1) Issuer and Advisor Declaration
2) Term Sheet
3) Information Memorandum

The details of the Issuer and Advisor Declaration and Term Sheet are determined by the Guidelines, and approval by the Securities Commission is based solely on the details contained in these two documents. The Information Memorandum is only registered with the Securities Commission, and the details are not individually examined. The Declaration represents an oath by the issuer and advisor that disclosure will be fair and in accordance with the Guidelines. The Term Sheet encompasses the essential 28 items required for issuing bonds. The Information Memorandum is prepared solely as disclosure material (abbreviated prospectus) for market participants. Normally, the advisor prepares a Due Diligence Report concerning documents relating to the issue, and this is generally submitted with the Issuer and Advisor Declaration.

Issuing bonds generally requires the preparation of a prospectus, but this requirement does not apply when bonds are issued to so-called sophisticated investors (banks, professional investors, government agencies, and other specially designated investors), and an Information Memorandum is prepared instead. In reality, over 90% of all bonds are issued to sophisticated investors.

Malaysia has no disclosure exemption provisions depending on the type of product issued, but additional guidelines were prepared for ABS. With respect to product specific regulations, redemption term regulations were prepared for commercial paper and medium-term notes (maximum of seven years). The Guidelines also contain many provisions for Islamic bonds based on Islamic law.

The Guidelines stipulate the approval period for bond issues as within 14 days for ordinary bonds and within 28 days for ABS. There are no provisions for a bond suspension period and issue-related documents cannot be amended following approval (notification concerning post-issue changes is not required). Malaysia has developed a shelf registration system, but because it is relatively new, there are few examples of its use at the present time.

The acquisition of a rating is normally required when issuing bonds, but there is no minimum rating requirement. However, appropriate risk information must be disclosed for bonds that are below investment grade (BBB). Almost all bonds actually issued are rated AA or higher.

b. Investor regulations

With regard to investor-related regulations, there are investment restrictions for government agencies (including public pension funds) and for insurance companies (these can only invest in bonds rated BBB or higher).

---

[12] As an exception, bonds issued by foreign corporations require prior approval from the Controller of Foreign Exchange due to foreign exchange regulations. In reality, however, bond issues by foreign corporations are extremely rare.

For non-residents, there are no regulations for securities, but there are regulations in foreign exchange laws (the approval of government authorities is required to exchange ringgits and foreign currencies). As a result, the ratio of foreign investors holding bonds is less than 5%.

New bond issues (including commercial paper and medium-term notes) must be registered with the Fully Automated System for Tendering (FAST), a bidding system operated by the central bank.[13]

c. Bond taxation

Malaysia does not tax capital gains. Moreover, interest is tax-free for residents and tax is withheld at a rate of 15% for non-residents. Residents other than individuals were previously taxed, but this requirement was eased in an effort to encourage bond investment.

d. Future direction of reform

The basic regulatory system for issuing bonds is already in place, but there are plans to make modifications on an ongoing basis in order to promote further market development. Specific measures under consideration include an easing in the tax requirements for ABS and the abolition of interest tax for non-residents to encourage investment by foreigners.

There are plans to move forward with reform of securities markets based on the Capital Market Master Plan.

[13]This system is not always used for bidding on new issues, but as a means to disclose issue information to investors.

4. Singapore

a. Bond issuing regulatory system

In Singapore, because of the requirement to prepare a prospectus for publicly issued[14] corporate bonds, the majority of bonds are privately placed with sophisticated investors, who are not subject to disclosure with a prospectus. Exemption provisions for disclosure depend solely on whether or not the investor is a sophisticated investor. There are no provisions for exemption from disclosure for specific products. There are several additional entry items for ABS and other securitization products.

With regard to the details of a prospectus or Information Memorandum in the case of private placement, although there is a checklist, there is no template or model for entry items. These documents are therefore prepared on the basis of the idea of "covering the information required by investors." The review by the Monetary Authority of Singapore (MAS) is basically only a check to ensure that the checklist items are included. The level of detail is left to the issuer and arranger. Consequently, the format of disclosure documents is different for each arranger.

The flow of MAS procedures is application receipt, prospectus review, filing, and registration. The entire process from application to registration takes from 14 to 21 days.

Singapore does have a shelf registration system, but the effective period is a maximum of six months. In other words, ongoing bond issues require that an application be filed at least once every six months. Moreover, in the event of "significant changes" in registration details during the effective period, a supplement must be filed in each case. The determination of "significant changes" is left to the discretion of the issuer, and as a rule a notification is issued when a change is judged important for investors. A system for an issue suspension period regardless of whether or not a supplement is filed has not been established. Should an issuer determine that an important matter should be made known to investors, it is considered best for the issuer to independently suspend the issue.

It is not necessary to acquire a rating for a bond issue, but only sophisticated investors are able to purchase unrated bonds (this has not become a significant constraint).

b. Investor regulations

Singapore has no particular regulations concerning investors. Investment targets are essentially determined independently. However, public funds such as the Central Provident Fund determine an institutional investment grade rating.

Sophisticated investors exempt from disclosure regulations are defined as wealthy individuals with assets of over S$1 million or annual incomes of over S$200,000, and corporations with net assets of over S$5 million.

c. Bond taxation

Singapore does not have a capital gains tax (Tax on income from bonds is treated as ordinary income tax). Interest on qualifying debt securities is taxed at a reduced rate of 10% for corporations, while non-residents are not taxed. Qualifying debt securities include all bonds managed by an Approved Bond Intermediary[15] in Singapore.

d. Future direction of reform

Ongoing deregulation efforts are expected in order to encourage the further development of the corporate bond market. Authorities are considering abolishing the guidelines that govern the Information Memorandum required when applying for a bond issue. (We believe the final goal is for bond issues

[14] While there is no clear legal definition of "public issue," in actual practice, public issues are viewed as those not placed with sophisticated investors but rather on the retail market. There are plans to clarify this point in the future.

[15] There were a total of 27 financial institutions with Approved Bond Intermediary status as of end-2001.

based entirely on voluntary disclosure.) Authorities are also planning to ease any remaining regulations for transferring Singapore dollar funds out of the country.[16]

[16] Singapore dollar funds raised by issuing bonds or other instruments must be exchanged for a foreign currency in order to transfer these funds out of the country.

5. Conclusion

a. Bond issuing regulatory systems

There is one major difference in the requirements for bond issue applications between South Korea and the other three countries surveyed. South Korea does not have any special exemption provisions for disclosure requirements and instead all application procedures are performed online. By contrast, the other three countries effectively have prospectus disclosure exemption provisions for almost all bonds. In either case, however, the provisions do not prevent efficient issuing.

In South Korea, performing all application procedures online via a web-based system results in a decided difference in terms of issue efficiency compared to the paper-laden requirements in Japan. (A web-based system standardizes and simplifies disclosure, which essentially eliminates the major problem of preparing documents, even in the absence of exemption provisions.)

In the other three countries, almost all bonds are issued to professional investors, thereby exempting the bonds from prospectus requirements and making application documents extremely simple. Moreover, details of information memorandums accompanying applications are checked only to see whether they conform to guidelines prepared by government authorities. There is no particular guidance on the level of detail. (Issuers and arrangers are basically responsible for providing the information required by investors.)

There is one further major difference between Japan and the countries surveyed in terms of disclosure requirements. This is the concept of an issue suspension period. The countries we visited do not have such provisions. Although supplemental filing may be required for any "significant changes" in disclosure information, as this is not, per se, related to the advisability of the issue, these countries share a common stance that issuers should determine whether or not to suspend an issue in the event of significant changes. This stance is underpinned by a basic belief that the decision on whether to suspend an issue should be based on the personal responsibility of issuers under the supervision of the market (investors) rather than being left to government authorities.

b. Investor regulations

Hong Kong, Malaysia, and Singapore have disclosure exemption provisions for "professional investors," but due to the broad scope of application and the fact that there is no requirement for individual approval by government authorities, these provisions do not provide a major constraint. Although Japan also has disclosure exemption provisions for private placement with small groups and professional investors, because the actual scope of application is narrow and approval is required, there is a major difference in terms of usability.

The countries we visited do not have exemption disclosure provisions for specific products as Japan does, and their bond issuing systems have the advantage of being extremely simple.

c. Bond taxation

The greatest impediment to bond liquidity in Japan is the "taxable / non-taxable" issue, which does not exist in the four Asian countries surveyed. This issue is the same regardless of whether or not interest tax is withheld. (Although it took some time, we were able to convey some idea of the problems associated with tax withholding in Japan to the individuals we interviewed; they had no idea that Japan's tax system was so complicated.)

With regard to interest tax, Hong Kong, Malaysia, and Singapore are establishing tax-free or reduced tax incentives under certain conditions with a view to developing bond markets. Moreover, even when tax is withheld, in the case of a central securities depository making interest payments, it is the central securities depository that withholds tax, resulting in virtually no administrative burden on financial institutions. We believe that if Japan implemented a simple system similar to those in operation in these

Asian countries, it would be able to significantly reduce the cost (commissions, etc.) to both issuers and investors associated with principal and interest payments.

d. Future direction of reform

The development of bond issuing regulatory systems has been essentially completed in the countries discussed in this report, and they are now considering how to simplify and ease disclosure requirements to promote further market development.

Malaysia is considering tax-free measures for non-residents, but there are no other plans for major changes to interest tax. This means that basic tax measures have also been completed.

The framework for issuing bonds in Japan is more complicated than in these countries, and we believe it is necessary to simplify this system to encourage market development, to ease requirements to broaden the scope of investors, and to fundamentally reform the tax withholding system.

IV Bond Settlement Systems

Chapter IV key points

a. Bond settlement systems
This section discusses the status of bond dematerialization and immobilization as well as book-entry systems and delivery-versus-payment (DVP) systems for bond settlement. Bond settlement cycles are also covered.

b. DVP settlement systems
This section looks at whether the four Asian countries have central bank fund settlement systems and related bond DVP settlement systems (funds and securities are delivered at the same time). If these systems have been established, we examine what kind of DVP settlement method is used.

c. Future direction of settlement system reform
This section looks at current settlement system issues and future plans for settlement system reform.

1. South Korea

a. Bond settlement system

South Korea has not implemented full dematerialization in terms of the legal system, but the immobilization rate for bonds is extremely high at 92.6% (dematerialization rate of 86.2%). All securities are deposited at the Korean Securities Depository (KSD) and ownership is transferred through book-entry transfer at the KSD. (Bonds are not required to be deposited at the KSD. However, bonds not deposited at the KSD cannot be traded. Settlement with physical certificates is extremely rare.)

Bond settlement systems are different for exchange transactions and over-the-counter (OTC) transactions. Exchange transactions use multilateral netting settlement via the clearing system of the Korea Stock Exchange (KSE), while OTC transactions use gross settlement at the KSD. The following discussion assumes OTC transactions, which account for 96% of total transactions.

Bond settlement at the KSD is either RTGS DVP settlement using BOK-Wire, the fund settlement network of South Korea’s central bank, the Bank of Korea, or free settlement. The settlement cycle can range from T+0 to T+14 based on an agreement between the transacting parties, but T+0 settlement is currently the norm. (Exchange transactions are certain to use a T+0 settlement cycle.)

In the case of DVP settlement, because there is currently no settlement matching mechanism, transacting parties, after confirming transaction details, must send a settlement order to the KSD and BOK by the 5pm deadline of BOK-Wire. (After that, free settlement is possible until the KSD deadline.)

b. DVP settlement system

South Korea’s DVP settlement system is shown in Figure 21. The party delivering the securities (seller) sends an order to the KSD and the party delivering funds (buyer) sends an order to the BOK. The KSD reserves the seller’s securities balance according to the DVP settlement order and sends a fund transfer order to the BOK. BOK-Wire is used for transferring funds based on the fund transfer order from the buyer and KSD. Funds are transferred from the buyer to a KSD account and then transferred from the KSD to the seller’s account. The KSD, after receiving a fund transfer completion notification, transfers the securities to the buyer’s account. All transfers are on a RTGS basis, but for convenience, the KSD acts as a central counterparty and settlement is performed via a KSD account.

Development of this DVP settlement system began in the fall of 1998, mainly at the request of overseas investors. The system was completed in November 1999 and all settlement was transferred to this system in December.

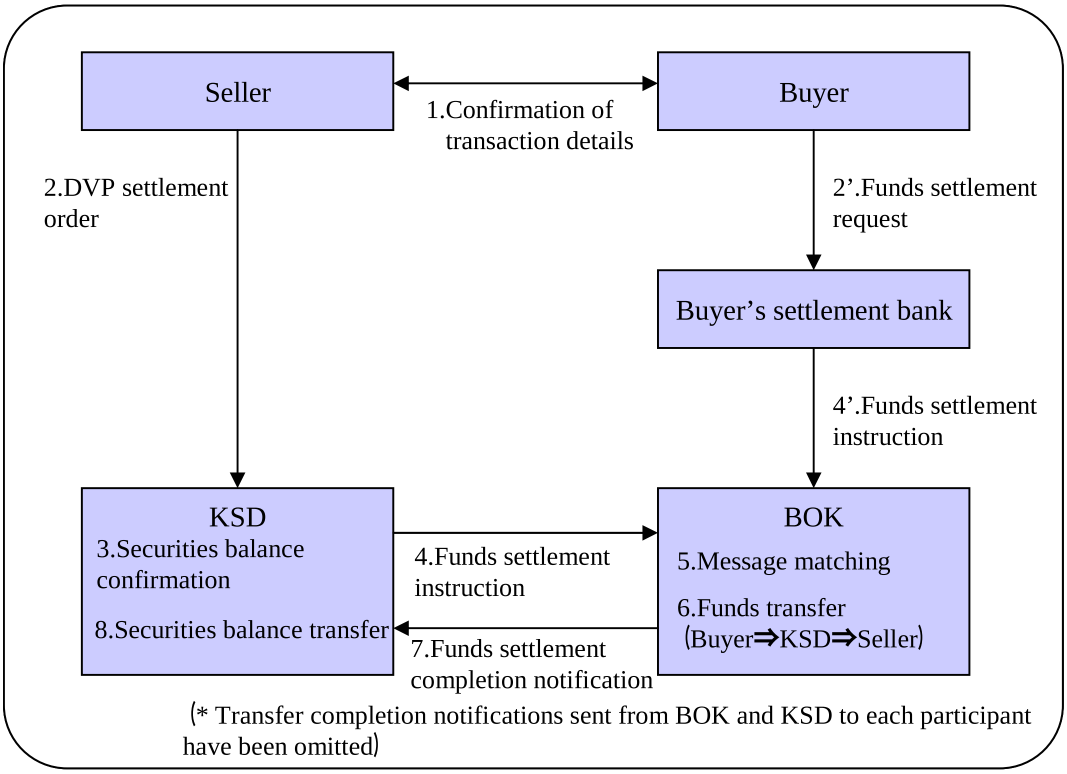

Figure 21. South Korea's DVP settlement system

c. Future direction of settlement system reform

As noted earlier, T+0 settlement is standard in South Korea. This makes it difficult for investment trusts and other institutional investors with extremely high trading volumes to finish confirmation of all trades between the market closing time of 3pm and the BOK-Wire deadline of 5pm. As a result, they generally choose free settlement to avoid increasing the administrative burden (including cancellations, corrections, etc.) that results from choosing DVP settlement. The DVP settlement ratio using the DVP system introduced in 1999 has therefore peaked at just under 50%. The Financial Supervisory Service (FSS), in an effort to reduce settlement risk in this global process, has decided to switch settlement cycles from T+0, which is a main reason for the low DVP settlement ratio, to T+1 settlement. Use of T+1 settlement is scheduled to begin on June 1, 2003. The FSS expects this change to boost the DVP settlement ratio to 99% by mid-2003.

Concerning future improvement in the settlement system, in order to simplify fund liquidity management for securities settlement on BOK-Wire, there are plans to introduce a new system to manage fund transfers in securities settlement.

Additionally, as part of infrastructure development to help raise settlement efficiency, the introduction of an electronic trading system and establishment of a clearing organization is under consideration.

2. Hong Kong

a. Bond settlement system

Approximately 60% of all Hong Kong dollar denominated bonds issued in Hong Kong, amounting to HK$300 billion, are deposited and dematerialized at the Central Moneymarket Unit [17] (CMU) administered by the Hong Kong Monetary Authority (HKMA). The remaining 40% are deposited at either Euroclear or Clearstream. Bonds deposited overseas at international central securities depositories are essentially handled as non-resident bonds similar to euro bonds, and for this reason, they are not traded or settled in Hong Kong.

Bond settlement systems are different for exchange transactions and OTC transactions. Exchange transactions use multilateral netting settlement via the Central Clearing and Settlement System (CCASS) operated by the Hong Kong Exchanges and Clearing (HKEx), while OTC transactions use gross settlement at the CMU. When settling through CCASS, HKEx acts as a central counterparty for end-of-day DVP settlement using a CMU account where the bonds are deposited. Bond trading on an exchange is limited to small lots, and in reality, there are virtually no transactions. Therefore, the following is a discussion of OTC transactions.

In gross settlement at the CMU, settlement orders sent prior to 11am are settled the same day, and orders sent between 11am and 3pm (CMU cutoff time) are settled the following day. The settlement cycle is T+2 as a market rule rather than settlement system regulation. The CMU system is also capable of T+0 settlement.

RTGS DVP settlement of Hong Kong dollar bonds is performed by the CMU in cooperation with the RTGS funds settlement system of the HKMA. Nearly all transactions currently use DVP settlement. Moreover, a DVP settlement system for US dollar bonds has been operating since 2000, and there are plans to launch a DVP settlement system for euro bonds in 2003. With foreign currency DVP settlement, because the HKMA handles only Honk Kong dollar funds, accounts at Hongkong and Shanghai Banking Corporation are used for US dollar funds and at Standard Chartered Bank for euro funds. The RTGS funds settlement system is operated entirely by Hong Kong Clearing Bank.

[17] The CMU launched a settlement system for government bonds in 1990 and began handling corporate bonds and other debt securities in 1994.

b. DVP settlement system

Hong Kong's DVP settlement system is shown in Figure 22. The CMU, upon receiving a matching transaction, locks the securities balance and sends a payment order to the funds settlement system. The funds settlement system, after receiving payment approval from the payer's settlement bank and settling the funds, sends a securities release order to the CMU. The CMU transfers the securities and releases the balance lock.

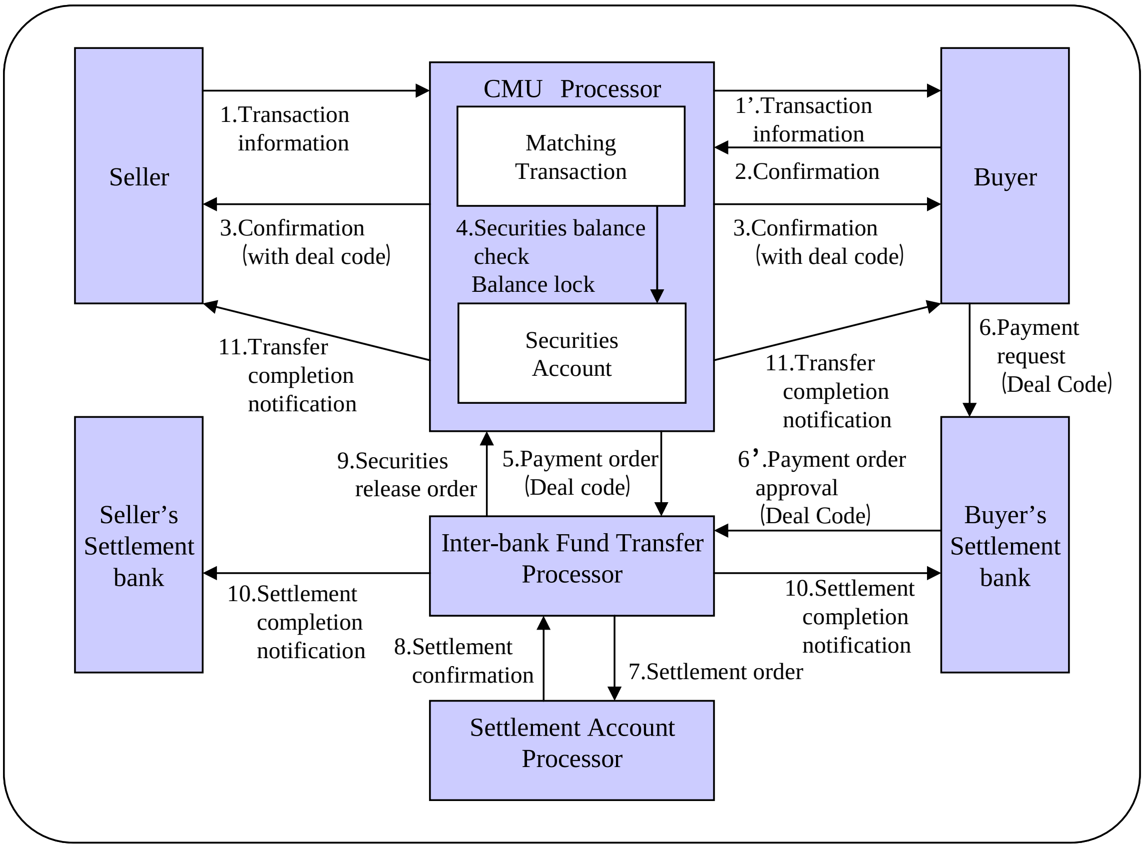

Figure 22. Hong Kong's DVP settlement system

The CMU has established an intraday repo and overnight repo system as a means of providing fund liquidity throughout the day for DVP. Additionally, it established a system that allows market maker participants to hold temporary short securities positions throughout the day.

Aside from the DVP settlement system described above, the CMU also provides securities lending services, principal and interest payment services, and other custody services.

c. Future direction of settlement system reform

The HKMA positions the CMU as the regional settlement hub of the Asia Pacific region and has formed partnerships with several central securities depositories. Specifically, the HKMA already has working partnerships with the Korean Securities Depository (South Korea) and AustraClear (Australia and New Zealand), and plans to launch a partnership with the China Government Securities Depository Trust & Clearing (CDC), China's central securities depository for government bonds, in the first half of 2003. Moreover, through mutual partnerships with Euroclear and Clearstream, the HKMA aims to function as a hub between the euro market and Asia Pacific market.

As noted earlier, funds settlement in Hong Kong dollars, US dollars, and euros are all possible, thus providing the capability for DVP settlement among these currencies. This gives the HKMA the ability to complete cross-border settlement within Asia of bonds issued in Asia and purchased by investors in Asia. (Because nearly all such cross-border transactions are currently settled through Euroclear or Clearstream, administrative efficiency is extremely low, due partly to the time difference.)

In the future, the HKMA aims to further expand bond markets in the Asia Pacific region by offering a seamless process from trade execution to settlement by linking settlement systems to electronic trading systems.

3. Malaysia

a. Bond settlement system

Malaysia has established guidelines for bond settlement using the Real Time Electronic Transfer of Funds and Securities (RENTAS) system operated by the central bank. However, because commercial paper and medium-term notes are settled by delivering the physical security, they do not use the RENTAS system for settlement. (We think this is because circulation is not the original purpose of commercial paper and medium-term notes.)

For corporate bonds, a global certificate must be deposited at the central bank by the day before the issue date. Since the launch of the RENTAS system in 1999, settlement has been through book-entry transfer at both the time of issue and while in circulation.

The RENTAS system can support either same-day settlement, ordinary settlement (T+2), and post-dated settlement (maximum of one month). Settlement cutoff times are 5:30pm for same-day settlement and 11am on the delivery date for the other two settlement options. (The RENTAS system operates from 8am to 6pm.[18])

b. DVP settlement system

Malaysia's DVP settlement system is shown in Figure 23. The RENTAS system does not perform transaction matching. Instead, the settlement agent delivering the securities (authorized depository institution) sends a settlement order to RENTAS on the basis of a settlement request following trade confirmation, and the settlement agent of the receiving party (payer of funds) approves the order. The approved settlement order initiates DVP settlement on the settlement date.

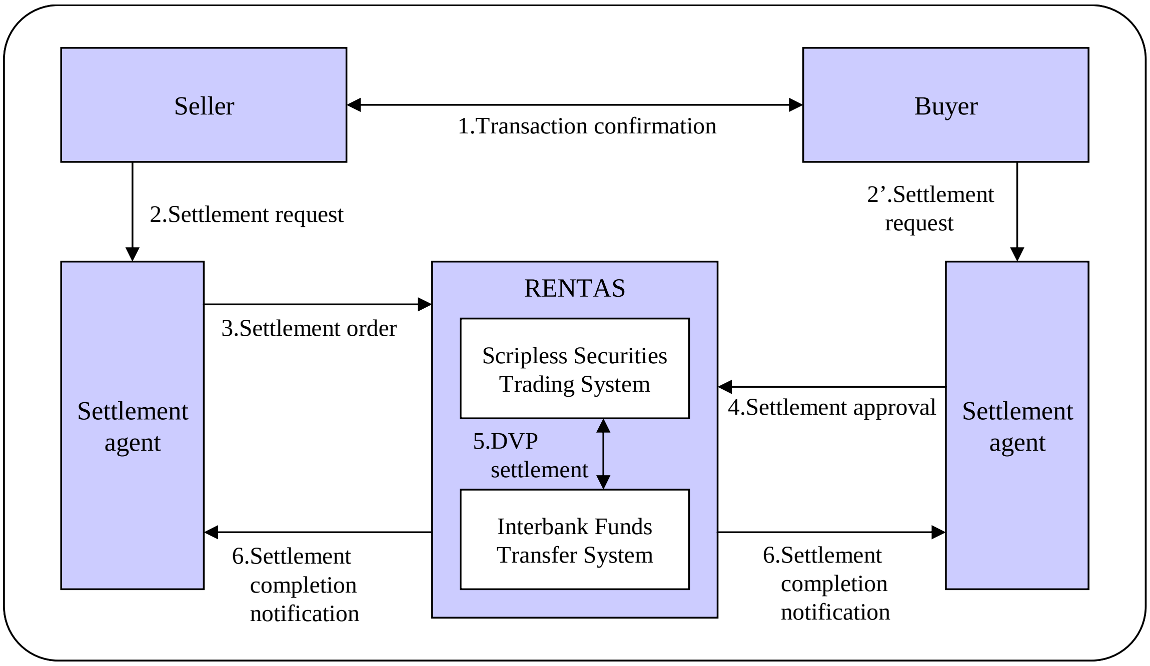

Figure 23. Malaysia's DVP settlement system

Settlement agents have collateral accounts in order to ensure intraday liquidity, and the central bank grants intraday credit based on a valuation of collateral securities (includes valuation haircut).

[18] Malaysian markets are also open on Saturday, and the RENTAS system operates from 8am to 1pm on Saturday.

c. Future direction of settlement system reform

Malaysia currently does not have any particular new plans for bond settlement systems now that the RENTAS system is up and running. Efforts to improve transparency in secondary markets are also generally complete as a result of launching the Bond Information and Dissemination System (BIDS) and the requirement to report information on all transactions.

4. Singapore

a. Bond settlement system

Bond settlement is different for government bonds and corporate bonds. Government bonds are settled by the MAS Electronic Payment System (MEPS) for Singapore Government Securities (SGS)[19], and corporate bonds are held in custody and settled by the Debt Securities Clearing and Settlement System (DCSS)[20] operated by the Central Depository (Pte) Limited (CDP), a subsidiary of the Singapore Exchange Limited (SGX). Bonds are essentially dematerialized. Government bonds are deposited at MAS and corporate bonds at SGX. Investor ownership is protected on the basis of trust law.

Corporate bonds are settled by the DCSS through DVP settlement in combination with MEPS-ITF, which is MAS's RTGS system, or through free settlement within DCSS. DVP settlement is only available for Singapore dollar bonds, but DCSS can also manage bonds denominated in US dollars and other currencies. Actually, Euroclear and Clearstream have opened accounts as depository agents at CDP, and CDP is now able to provide securities transfer and settlement in combination with these international central securities depositories.

Bonds are settled on a T+0 or T+1 basis. For T+0 settlement, the DCSS cutoff time is 2pm. (DCSS operates from 9am to 5:30pm.)

Nearly all bond transactions are OTC. Though an exception, listed corporate bonds traded on SGX use net settlement via the Equity system. (Even in this case, final securities settlement is performed through a DCSS account transfer.)

[19] MEPS-SGS is the custody and settlement system for government bonds. DVP settlement is performed in combination with MEPS-ITF, the fund RTGS settlement system. MEPS was launched in July 1998.

[20] DCSS was launched in December 1998 and linked with MEPS in 1999 to provide DVP settlement.

b. DVP settlement system

Singapore's bond DVP settlement system is shown in Figure 24. Orders placed with DCSS are continuously matched. Matched settlement orders are queued and DVP settlement is performed on an RTGS basis when the seller has a securities balance and the buyer a funds balance on the settlement date.

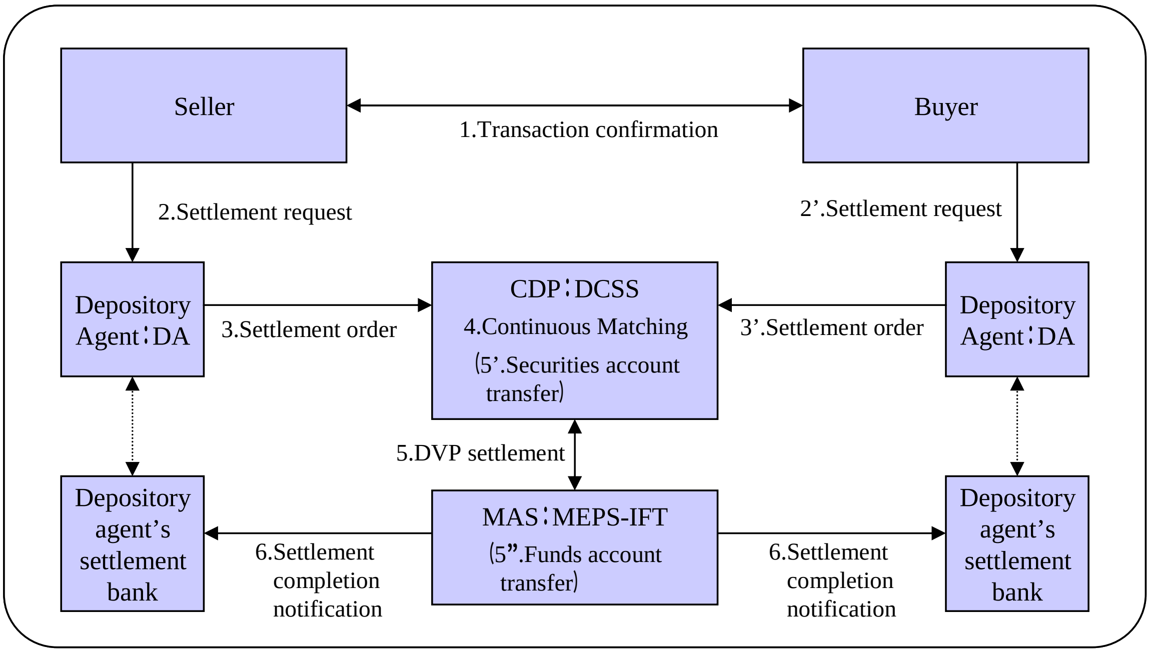

Figure 24. Singapore's DVP settlement system

CDP provides custody services in addition to securities settlement, and pays principal and interest for deposited securities. Specifically, principal and interest is received from the paying agent of the issuer, and then principal and interest is paid to the depository agent according to the depository agent's account balance.

c. Future direction of settlement system reform

Singapore has no particular plans for major settlement system reform going forward, but the CDP plans to make ongoing improvements based on a recognition of the importance of its system to market expansion and intermarket competition. To this end, the CDP has opted for an organization that can perform system development entirely in-house.

5. Conclusion

a. Bond settlement system

The four countries visited have all established systems for transferring and settling government as well as corporate bonds, and the ratio of paperless settlement through immobilization or dematerialization is near 100%. These countries have also established DVP settlement systems using fund settlement accounts at central banks. Hong Kong has a DVP settlement ratio of nearly 100%, and South Korea will raise its ratio to 100% within this year. Based solely on this, the development of securities settlement systems in Japan certainly lags well behind these Asian countries. Given the significant difference between Japan and these Asian countries in the time required to develop this infrastructure, we feel a strong sense of crisis that Japan has fallen completely behind. In South Korea, development of a DVP settlement system took only one year, and development of a central bank clearing interface to accompany the KSE's introduction of wholesale government bond trading took only three months. Malaysia's RTGS DVP settlement system RENTAS was developed as part of regulatory and infrastructural reform prompted by the financial crisis in 1997. This system was brought online in 1999 for a development period of approximately two years.

b. DVP settlement system

Concerning DVP settlement methods, the four Asian countries have all adopted RTGS DVP settlement. As the exception,[21] only exchange transactions use multilateral netting settlement similar to stocks. Though settlement cycles vary depending on the country, they have all developed systems capable of handling same-day, next-day, or longer settlement periods. In Japan, we think one factor delaying infrastructure development is the extremely long time being taken to decide on the settlement method. However, global standards for bond settlement systems have already been determined, and Japan needs to move forward quickly and robustly with infrastructure development under the leadership of government authorities and central securities depositories.

c. Future direction of settlement system reform

The systems in Hong Kong and Singapore offer a good reference when considering the future development of a settlement system in Japan. Despite long-standing calls in Japan for the internationalization of the yen, without the development of proper infrastructure, Japan will likely proceed no further than mere discussion. In other words, for Japan to play a central role in the creation and expansion of Asian bond markets, it clearly must develop an infrastructure that is at least on par with Asian countries. Hong Kong's CMU system can already handle DVP settlement of US dollar bonds, and will become capable of handling DVP settlement of euro bonds this year. Moreover, Hong Kong's CMU and Singapore's DCSS have established mutual links with Euroclear and Clearstream, while CMU has developed mutual links with central securities depositories throughout the Asia Pacific region. If the aim is to have Japan's bond market be open to the world as a central market in the Asia Pacific region, then we must successfully link Japan's large market to these Asian markets after giving full consideration to these systems. The goal of expanding the overall Asian bond market can perhaps be achieved through such an approach.

[21] The four Asian countries do not have corporate bonds that are actively traded on exchanges like convertible bonds in Japan. Corporate bonds are traded almost exclusively OTC.

V Recommendations for Regulatory and Infrastructural Reform in Japan

Chapter V key points

1. Recommendations for bond issuing regulatory system reform

    a. Simplify issue application procedures and disclosure documents and switch to electronic application documents
    b. Expand scope of disclosure requirement exemptions and qualified investors
    c. Abolish issue suspension period regulations
    d. Revise interest tax withholding system
    e. Ease various reporting requirements for non-residents, etc.

2. Recommendations for bond settlement system reform

    a. Quick development of paperless corporate bond transfer system
    b. Design integrated, cross-product account management system
    c. Provide custody services to improve administrative efficiency
    d. Efforts to strengthen role as central Asian market

1. Recommendations for bond issuing regulatory system reform

a. Simplify issue application procedures and disclosure documents and switch to electronic application documents

There is no major difference between Japan and the four Asian countries in the time required from issue application to approval. However, these countries have simplified the disclosure documents required for application, and the burden of preparing issue application documents is perhaps lower than in Japan. Though this is related to disclosure requirement exemptions as discussed below, by making a clear distinction in disclosure documents in terms of a prospectus for retail investors and an information memorandum for professional investors, disclosure requirements can be greatly simplified by using an information memorandum when issuing corporate bonds. Moreover, as a medium to long-term measure, we think it may be possible to simplify application documents for individual issues by having all companies that raise funds in capital markets undertake regular disclosure via EDINET or other means. This would ultimately create equal investment opportunities for retail and professional investors by providing them with the same level of information. As a result, we believe this would eliminate the necessity of having two categories of disclosure rules.

Concerning the submission of issue application documents, introducing a web-based system like South Korea to enable the electronic submission of application documents would have the advantages of standardizing and simplifying documents as well as improving administrative efficiency for both issuers and supervisory authorities (ultimately reducing the amount of time until issue).

b. Expand scope of disclosure requirement exemptions and qualified investors

As noted above, the requirements for disclosure to professional investors (prospectus exemption) as stipulated in these Asian countries allow issuers to greatly simplify disclosure documents compared to disclosure to retail investors. In Japan, however, the legal scope of professional investors, known as "qualified institutional investors," is extremely narrow, and as a result, the actual number of exemptions received is limited. Therefore, in order to make exemption provisions more effective and encourage a greater number of bond issues, the scope of qualified institutional investors must be broadened. Specifically, we believe the scope should be expanded to include wealthy individuals that meet a certain minimum criteria in terms of financial assets or income, and the hurdle for corporations should also be lowered. Moreover, a current status notification is required of qualified institutional investors, but we think eliminating this necessity (requiring confirmation of bond seller) could possibly avoid making exemption procedures more complicated while broadening the investor base.

c. Abolish issue suspension period regulations

The issue suspension period is a major constraint, especially for commercial paper and other short-term securities issues, and we basically think it should be abolished. This requires a change in the current approach to issue disclosure. In other words, rather than uniform issue suspension based on regulations, an obligation of good faith (or contractual covenant) to investors should be placed on issuers and arrangers, and they should be given the discretion to decide whether or not to suspend an issue on the basis of protecting investors from being adversely affected.

We believe this should be implemented in conjunction with the expansion of disclosure requirement exemptions for professional investors mentioned above.

d. Revise interest tax withholding system

The "taxable / non-taxable" issue has already been debated, and there are plans to resolve this issue first with public bonds. The treatment of corporate bonds and other debt securities is still pending, but measures similar to those taken with public bonds will naturally follow. We anticipate prompt action.

In addition to current problem-solving efforts, as a forward-looking measure that would provide a major boost to the development of the corporate bond market, consideration should be given to either eliminating or reducing tax on interest. When looking at this issue, sufficient consideration must be given to the administrative burden of paying interest, and as such, we perhaps need to proceed in tandem with settlement system development, the topic of the next section.

Securities tax reform has recently become a hot topic in Japan. Though the tax rate on interest will be cut by 10% in the near-term, taking a longer-term perspective, a radical overhaul of the current interest tax withholding system is perhaps necessary. Moreover, we think the current inefficient procedures for paying principal and interest must be simplified by switching to a paperless system. We also think "transfer organizations" should provide principal and interest payment services with a view to sharply reducing principal and interest payment fees.

e. Ease various reporting requirements for non-residents, etc.

In the four countries visited, there are virtually no transactions by non-residents in South Korea and Malaysia, while trading by non-residents is extremely active, including foreign currency denominated bonds, in Hong Kong and Singapore. The unique reporting requirements for non-residents in Japan do not exist in these countries, with the exception of restrictions on transferring local currency out of the country in Malaysia and Singapore, who have established currency regulations based on foreign-exchange laws (approval of currency authorities is required to transfer currency out of the country).

Though we understand that government authorities need information to gauge market trends and consider international money flow policies, we also think rules that restrict non-resident trading (high costs), which will continue to increase in the future along with market globalization, should be eased to the extent possible.

2. Recommendations for bond settlement system reform

a. Quick development of paperless corporate bond transfer system

In Japan, there are plans to launch a transfer and settlement system for electronic commercial paper (short-term corporate bonds) this spring. Testing of this system is in the final stages. Historically speaking, this transfer and settlement system was implemented in an extremely short period of approximately one year. However, plans for a transfer and settlement system for electronic corporate bonds are still under development, and implementation is expected to take at least another two years. There is certainly a major difference with the four Asian countries in terms of speed.

Factors requiring time include the creation of a system to manage various types of bonds and the coordination of views to address the requirements of market participants with differing perspectives. However, given that these Asian countries have developed systems to manage various bonds, from ordinary corporate bonds to ABS, within a uniform framework, we think Japan is perhaps aiming for an overly sophisticated and complicated transfer and settlement system. In other words, the critical issue now is the quick launch of a transfer and settlement system for dematerialized securities rather than the creation of a system that satisfies all requirements. We need to check with related parties to see whether they have any issues concerning the priorities of infrastructure development.

As an analogy, Hong Kong and Singapore use IC card systems similar to the Suica system adopted by JR in Japan. In Hong Kong, IC cards are used for commuter passes and prepaid cards, and recyclable magnetic cards are used for regular tickets. In Singapore, IC cards are used for everything including tickets. There are clear differences in the complexity of ticket-taking systems. Singapore has the simplest system using only IC cards, followed by Hong Kong using both IC cards and magnetic cards. Japan, however, has a complicated, high cost system that handles various types of tickets and cards. When considering national infrastructure, one approach is to build systems like Suica that include existing old systems, but what is perhaps now truly needed, is complete standardization and construction of a ticket system similar to Singapore in a short period of time.

b. Design integrated, cross-product account management system

In South Korea and Singapore, government bonds and corporate bonds are managed through different systems. Japan is also planning to manage government bonds and all other bonds through different systems. An important point in designing these systems is creating common rules for both types of bonds for balance management and settlement of paperless securities. Without the ability to manage each type of bond within a single framework, there is risk of double investment by financial institutions and other participants. We believe this will be reflected back in the transaction costs of issuers and investors. (With Japan's current settlement system, financial institutions have developed separate systems because the BOJ-Net and JB Net account management systems are completely different.)

Japan achieved the dematerialization of government bonds ahead of other securities as a result of abolishing the BOJ transfer and settlement system in January this year. Because the transfer system for dematerialized government bonds is essentially based on the previous BOJ transfer and settlement system, account management methods and settlement rules are largely unchanged. Concerning the future development of a transfer and settlement system for electronic corporate bonds, adequate consideration must be given so that account management methods and settlement rules are basically the same as for government bonds (if possible, even simpler than the government bond system).

Additionally, it is essential that the account management methods and settlement rules for electronic commercial paper (short-term corporate bonds), which are the first private-sector securities to achieve dematerialization, be inclusive of the settlement system for electronic corporate bonds.

c. Provide custody services to improve administrative efficiency

Though touched on earlier in the discussion of regulatory systems, central securities depositories in the four Asian countries provide principal and interest payment support functions for deposited bonds, and depending on the institution, also withhold tax. From the perspective of lowering costs in overall bond markets, given that this is a function of national infrastructure, we believe the function should naturally be included in a new settlement system.

We therefore need to reform the tax system while developing a new settlement system, moving to simplify the tax system rather than retain the current tax withholding system.

d. Efforts to strengthen role as central Asian market

Hong Kong and Singapore have already concluded several cross-border partnerships. Both countries are extremely active in cross-border trade because they position their own market as the "hub market" in Asia. Both countries also have a large number of foreign currency denominated bond issues. In Japan, the Study Group for the Promotion of the Internationalization of the Yen issued a report titled "Promotion of the Internationalization of the Yen" in January. This report advocated "developing bond markets in Asia" and "establishing infrastructure in order to develop regional bond markets." Specifically, the report cited the "importance of moving forward with efforts to establish independent settlement systems in each country, shortening settlement periods, introducing DVP, and so forth." From this perspective, it is Japan that is lagging behind in Asia. The report further calls for "future cooperation among countries in forming settlement system partnerships within the region," indicating a path toward continuing efforts to develop independent settlement systems and form cross-border partnerships.

While we agree completely with the content of this report, with respect to Japan's current settlement system, there are several issues (first, the decision to create a new settlement system) that come before efforts to form partnerships with the four Asian countries the mission visited. From this perspective, when the report talks about "expecting countries within the region to provide mutual technical support from the standpoint of sharing their various experiences," we think that perhaps it is Japan that would benefit from receiving technical support from Asian countries.

Though we were unable to gain a complete view of these settlement systems during this mission, we think it is necessary for market participants in Japan to take a serious look at the current status of Japan's settlement system and adopt a humble, learner's attitude toward Asian countries. We believe the system already implemented to varying degrees in these Asian countries should be introduced in Japan. At the same time, serious consideration should be given to the idea of forming cross-border partnerships. Market participants in Japan need to realize that unless Japan quickly develops a system that surpasses the settlement systems in the Asian countries the mission visited, Japan will not be the central market in Asia. Reform efforts require a sense of urgency.

VI Afterword

Finance Minister Shiokawa and Prime Minister Mahathir held a meeting in Kuala Lumpur on January 11, the day before this research mission departed. Recognizing the importance of developing bond markets in the Asian region, they agreed that consideration of specific measures should be on the agenda of future ASEAN Plus Three meetings. This agreement was extremely timely, and in all four countries visited, people expressed their expectation for Japan to take the initiative in developing Asian bond markets. Or course, this was due largely to the “size” of Japan’s market, and they had little knowledge about the current status of Japan’s bond settlement system. Our ability to meet the expectations of Asian countries depends on a strong resolve to move forward quickly in reforming Japan’s securities settlement systems and developing infrastructure.

We felt a strong sense of “determination” when meeting with supervisory authorities and central securities depositories in these countries. In each instance, we witnessed junior staff members (as they would be viewed in Japan) in positions of responsibility strongly promoting reform. We believe Japan is most lacking in strong leadership and long-term commitment. In Japan, development of the regulatory system appears complete with the passage of the Corporate Bond Transfer Law. In reality, however, regulatory system reform has still not been implemented, and it is important to establish a long-term personnel system that can “carry reform through to the end.” In creating this system, we feel it is necessary to appoint younger market specialists with no vested interests who would be given the full support of government authorities.

More than enough time has been spent on forming “agreement” in Japan. Given that infrastructural reform is not proceeding smoothly, the time for “agreement” has already passed, and “determination” is now required.

The CFTA and JCMA have made recommendations for creating electronic commercial paper in a report on the “European settlement system research mission” two years ago, and recommendations for Japan’s first dematerialized securities settlement infrastructure in a report on the “electronic commercial paper grand design” last year. We believe it is necessary to look squarely at conditions in Asian countries and Japan in light of the results of this research mission, and to make ongoing and determined efforts to promote securities settlement system reform in Japan.

(End of the report)

Questionnaire / Meeting Agenda

for Asian Capital Market Research Mission

Focusing on "Debt Market Development" &

"Securities Settlement System Reform"

1. Purpose of the research

1-1. What's happening in Japan?

In Japan, major regulatory reforms on securities settlement systems are underway toward dematerialization and book-entry settlement. A set of new regulations toward dematerialized securities went into effective from Feb.2002 for Commercial Paper (CP) followed by government and corporate bonds from Jan.2003. However, settlement infrastructures for these dematerialized securities are not ready except for Government bonds. Japan Securities Dealers Association (JSDA) announced a report "Towards Japan Securities Settlement Systems and Infrastructure Reform" on Nov.2002 and key milestones are defined. Please see attached "English Summary[22]" of the report for more details.

1-2. What are we trying to do?

Along with regulatory and infrastructure changes, tax framework and various market common practices need to be reformed toward more efficient and less costly capital markets. From corporate issuers standpoint, there remains following issues even after new regulations and new infrastructure are introduced.

1. Timely issuance (suspension period, disclosure requirements, etc.)
2. Restriction of investors (qualified institutional investors, private placement)
3. Reporting requirements (non-resident trade report, etc.)
4. Taxation (withholding tax, tax report requirement, etc.)
5. Non-resident requirements (identification requirement, restricted stocks, etc.)
   (These issues are revisited in later sections.)

In the past two years, we mainly focused on regulatory changes to materialize dematerialized securities and its settlement infrastructure. Now, we widen our focus toward our final goal, which is smoothening corporate financing and cash management in Japan based on new regulation and new infrastructure. Thus, we are going to make efforts on eliminating unnecessary and obsolete common practices.

[22] http://www.kessaicenter.com/kisha/suishin-yoyaku_e.pdf
http://www.kessaicenter.com/kisha/hokoku623_e.pdf

1-3. What do we expect from this mission?

Asian markets, as most recently developed and highly growing markets, will provide us new insights on creating better capital markets. Also, lessons learned through the recent course of actions in Asian capital markets will be beneficial to promote reforms in Japan.

Through this research, we intend to develop a set of recommendation on reforming regulatory and tax framework, common business practice and securities settlement system in Japan.

2. Visiting members

2-1. Who we are?

This research mission is sponsored by the Corporate Finance and Treasury Association of Japan (CFTA) and the Japan Capital Markets Association (JCMA) both of which were formed by major Japanese corporate issuers to represent issuers opinions towards regulatory bodies and market infrastructures such as CSD.

Member firms of CFTA and JCMA are major Japanese corporate issuers and most of JCMA members are also members of CFTA. CFTA mainly focuses on regulations and legal frameworks and JCMA mainly focuses on business processes and market common practices.

2-2. Delegates

Delegation members of this mission are as follows.

Shigehito INUKAI
Secretary-General, Japan Capital Markets Association
Deputy General Manager, Corporate Strategy & Research Dept., Mitsubishi Corporation
Senior Fellow, Policy Research, National Institute for Research Advancement
Junichiro ANDO, CMA
Manager, Finance Dept. and CI & Public Relations Dept., Hitachi Capital Corp.
Takashi KATO
Manager, Corporate Finance and Treasury Association of Japan
Secretariat, CFTA and JCMA
Mamoru FUJIMOTO
Managing Director & COO, TradeWin Co., Ltd.
(Consultant of this research mission)

3. Questions / Meeting Agenda

- Please note that all of the questions may not be relevant for all of the interviewees. Some questions may be only applicable for CSD or underwriter.

3-1.Market size and its growth history

1) Market size from the following point of view

  - Direct financing vs. In-direct financing (bank loans)
  - Direct financing instruments and their outstanding amount
  - Domestic financing vs. International financing
  - Public placement vs. Private placement
  - Primary market vs. Secondary market
2) Main players in the market
  - Type of issuers (domestic vs. international, financial vs. non-financial)
  - Type of investors (banks, institutional investors, etc.)
  - Underwriters (banks, investment bankers, etc.)
  - Fiscal Agents (banks, custodians, etc.)
3) History of Debt Market development
  - Historical growth by instrument type
  - Major events which trigger the market growth

3-2. Regulatory and tax framework

1) Issuing debt instruments (Issuer's regulation)
  - Registration / filing approval requirements
  - Disclosure requirements (filing, prospectus, etc.)
  - Credit rating requirements
  - Exemptions for private issues
  - Exemptions for specific instrument type, e.g. CP, MTN
  - Minimum lead time (number of days) for registration approval
  - Availability of shelf registration and associated documentation requirements
  - Regulated suspension period (this may relates to investor protection)
  - Other requirements
2) Buying debt instruments (Investor's regulation)
  - Restrictions for investors (investment grade, etc.)
  - Definition of Qualified Institutional Investors if exist
  - Non-resident requirements / restrictions
3) Tax requirements
  - Withholding tax for CP, Bonds and other instruments (wholesale, retail)
  - Tax reporting requirements for issuer / paying agent
  - Tax exemption requirements for non-residents
4) Regulatory reporting requirements
  - Reporting requirements in case of direct deal between issuers and investors
  - Reporting requirements in case of cross boarder deal
5) Challenges / Expected changes
  - Issues on current regulations
  - Expected regulatory reforms

3-3. Securities settlement system

1) Legal definition of debt instruments
  - Existence of uniform legal framework for all types of securities
  - Dematerialization / Immobilization vs. Physical securities

- Legal ownership structure of dematerialized / immobilized securities
- Legal ownership transfer mechanism

2) Securities settlement infrastructure
    - Existence of CSD and Book entry system for debt instruments
    - Existence of DVP and RTGS mechanism
    - Existence of execution matching mechanism
    - Settlement scheme (Gross-Gross, Gross-Net, Net-Net) for CP, Corporate Bond and other debt securities
    - Settlement cycle for CP, Corporate Bond and other debt securities
3) Challenges / Expected changes
    - Issues on current settlement infrastructures
    - Expected changes on settlement infrastructures

3-4. Costs

1) Average issuing costs for CPs and Corporate Bonds
    - Registration fee at CSD
    - Transfer fee (CSD, Bank)
    - Underwriting fee
    - Fiscal Agent fee
    - Other fees
2) Average on-going costs for CPs and Corporate Bonds
    - Maintenance fee at CSD
    - Interest payment / redemption fee at CSD
    - Interest payment / redemption fee at Paying Agent
    - Brokers commission (if applicable)
    - Other fees

End of questionnaire