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Response to the Disclosure Framework for Securities Settlement Systems: The-BOJ-NET JGB Services

Introduction

This document provides answers to the "Disclosure Framework for Securities Settlement Systems", a survey questionnaire drawn up by a joint working group of the Committee on Payment and Settlement Systems (CPSS) of the Bank for International Settlements, and the International Organisation of Securities Commissions (IOSCO).

The Securities Settlement System (SSS) here is the "Bank of Japan Financial Network System (BOJ-NET) JGB Services", which is the Japanese government bonds (JGB) settlement system in Japan. The answers as prepared by the operator of the system, the Bank of Japan, are intended to help current and future participants in the settlement system to appropriately understand and assess the risks associated with it.

The answers provide basic information about the BOJ-NET JGB Services as they were in October 1997 (when the answers were prepared). The BOJ-NET funds transfer system is also referred to where necessary.

Please note that the answers are intended to provide a general explanation, and the information may not apply to every individual case.

Utilization of Financial Institutions' Self-Assessment in Enhancing Credit Risk Management

Summary

The government's Prompt Corrective Action (PCA) measures to be implemented from April 1998 require financial institutions to conduct adequate assessment of their assets and to calculate appropriate "loan-loss write-offs and provisions" based on their own internal rules and referring to guidelines of the authorities. The Japanese "Big Bang" reform package is expected to be conducted by the year 2001. Given these situations, large financial institutions in Japan are making great efforts to enhance credit risk management. Medium and small-sized financial institutions are on their way to establish basic credit risk management systems under the PCA measures. Since information derived from self-assessment can be useful in a wide range of activities from strengthening risk management systems to formulating business strategy large differentials in business management are likely to arise among financial institutions depending on the utilization of this valuable information.

The Bank of Japan introduced the Tracing Method of asset assessment and loan losses in order to support financial institutions to maximize the use of their own assessments as a management tool. The Tracing Method is used to observe changes in the condition of individual assets in a time series and is one way to utilize financial institutions' self-assessment of assets. The Bank conducted a follow-up analysis in the recent on-site examination to analyze how many of the loans classified in the previous examination (1993-94) were later "written off and others" in relation to financial losses ("others" are defined as specific loan-loss provisions, losses from support by

renunciation of claims, and losses from sales of nonperforming loans to the Cooperative Credit Purchasing Company [CCPC]).

These empirical studies using the Tracing Method suggest the following four points of importance for enhancing credit risk management.

(1) Importance of strengthening the early warning functions

It is vital to control loans classified as "substandard" (S) because the likelihood of loan losses in terms of "write-offs and others" reaching a substantial size in the long term may vary substantially depending on the adequacy of the long-term management of this classification of loans.

(2) Importance of utilizing statistical methods which cover the life-span of loans

For example, for loans classified as (S), there is a tendency for the loan-loss ratio to rise after the third year following the assessment.

(3) Importance of avoiding loan concentration

Financial institutions with highly concentrated loans in terms of industry had higher loan-loss ratios, while institutions with diversified loan portfolios had relatively low ratios.

(4) Importance of gathering financial institutions' own default data for risk quantification

The estimated losses may be understated when only publicly disclosed bankruptcy data are used since losses incurred through loans against "de facto bankrupt borrowers" and recipients of financial support are not covered in such data. The latter type of losses accounts for a significant share of outstanding losses. The Tracing Method covers all these data and enhances establishment of financial institutions' own default data for credit risk quantification.

On our part, the Bank of Japan will continue to check and monitor the credit risk management systems at financial institutions on the off-site basis and also during the on-site examination in a more risk-focused, seamless and flexible manner, taking individual institutions' circumstances into consideration. In addition, the Bank will continue to research methods of quantifying credit risks as well as conducting follow-up analysis of the Tracing Method, in line with the worldwide trend to further enhance credit risk management.

Revision of the Wholesale Price Indexes to 1995 Base

Introduction

The Wholesale Price Indexes (WPI) system is one of the three sets of price index statistics presently compiled by the Bank of Japan, along with the Corporate Service Price Index (CSPI) and the Input-Output Price Indexes of Manufacturing Industry by Sector (IOPI). Each has different coverage and purposes. The WPI provides a measure of average changes in the prices of goods in inter-enterprise transactions. It functions as (1) an economic indicator; (2) a barometer of the purchasing power of the currency; and (3) a deflator.

A base-year revision of the WPI from the 1990 base to 1995 has been conducted to incorporate changes in Japan's economic and trade structures.[1] While the basic framework of the

index system remains unchanged by the revision, the selected commodities (i.e., the smallest unit of commodities for which indexes, calculated based on sample prices, are published) have been revised and expanded in order to further increase the precision of the index. This paper outlines the details involved in the revision of the WPI to the 1995 base, figures on the new base having been released in December 1997.

1 A base-year revision of the WPI, involving the updating of the base year for both indexes and weight calculation, is conducted every five years based on a recommendation made by the Statistics Council in March 1981. In the revision to the 1995 base, indexes were recalculated from the 1990 average = 100 base to the 1995 average = 100 base, and the weights used in the calculation of indexes were updated based on 1995 data from such sources as the Census of Manufactures" of the Ministry of International Trade and Industry and the Trade Statistics of the Ministry of Finance. The framework of the index system is also reviewed as necessary at the time of the base-year revision.