lakyara vol.336

BOJ ETF exit discussions missing the forest for the trees

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10.March.2021

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Executive Summary

Amid mounting speculation about when and how the BOJ will exit its ETF purchasing program, many specific exit strategies have already been proposed by outside observers. One concern, however, is that these proposals prematurely delve too deeply into details. What is needed as a first step is an overarching blueprint, not disjointed specific ideas.

BOJ ETF exit discussions prematurely bogged down in details

Intrigue is swirling around the question of when and how the BOJ will offload its ETF holdings accumulated over the past decade. With the Nikkei 225 now trading at over ¥28,000 (up from around ¥9,300 when the BOJ decided to start purchasing ETFs), continuation of the BOJ's ETF purchases obviously makes less sense than it once did. Nonetheless, there is arguably a case to be made against halting the ETF purchases until the BOJ's +2% inflation target has been reached. To be sure, purchases of ETFs, as well as J-REITs, are part of the BOJ's comprehensive QQE program launched in April 2013 to achieve its inflation target. That said, the direct policy transmission channel through which the BOJ is pursuing its inflation target is interest rates, not stock prices. The ETF purchases therefore have no bearing on attainment of the inflation target. In other words, the BOJ could very well proceed to exit the ETF market.

However, given the impossibility of selling the BOJ's over ¥35tn of ETF holdings directly into the market without affecting stock prices, the consensus is that the BOJ will have to resort to an off-market approach to offloading its ETFs. A number of specific exit approaches[1)] have been proposed based on this consensus.

One idea is to bypass the market by having the Government Pension Investment Fund (GPIF) purchase the BOJ's ETF holdings at the BOJ's cost basis. Another is to offer the ETFs to the retail public at a discount to their NAV, following Hong Kong's old playbook[2)]. Other proposals include transferring the BOJ's ETF holdings to a University Fund slated to be established in fiscal 2021, distributing ETF shares into iDeCo (individual defined contribution) retirement accounts and asking companies to buy back shares from the BOJ.

NOTE

1) For example, the Nikkei published an online article outlining four potential BOJ ETF exit scenarios on January 17, 2021.

2) The Hong Kong Monetary Authority intervened in the local equity market on August 14-28, 1998, to thwart speculators seeking to drive the market down. The shares purchased by the HKMA were packaged into an ETF and offered to the public. The Hong Kong government sold the ETF to individual investors at a discount to NAV and incentivized them to hold it on a long-term basis.

The proposal involving the GPIF, however, would require the GPIF to drastically change its policy portfolio allocations. It seems not likely that GPIF would be willing to make such changes just because the BOJ needs to offload its ETF holdings. Conversely, if the GPIF were to buy the EFTs while leaving its policy portfolio unchanged, it would have to cut back on its planned market purchases of equities to offset its ETF purchases from the BOJ. Such a shift in the GPIF's equity purchases would inevitably weigh on the equity market. If the Hong Kong approach were adopted, retail investors, despite being offered the ETFs at discounted prices, would still be exposed to the risk of capital losses depending on equity market performance. Additionally, the BOJ's ETFs would likely be offered preferentially to qualified retail investors, which would be controversial from a fairness perspective.

The other proposals may likewise have drawbacks, but a bigger issue is that current discussions of the BOJ's ETF exit strategy, on the whole, seem to be delving too deeply into minutia while paying short shrift to the big picture, the level at which the various proposals should be evaluated. Another key issue is how to offload the BOJ's ETF holdings from its balance sheet at minimal cost. The extent to which the existing proposals have taken such big-picture issues into account is unclear[3].

3) In December 2020, NRI's Takahide Kiuchi published a column arguing in favor of establishing a special-purpose entity to purchase the BOJ's ETFs, modeled after the Japanese Banks' Shareholdings Purchase Corporation established in 2002

Transfer of ETFs from BOJ to government in exchange for subsidy JGBs

Whatever exit strategy is ultimately chosen, the BOJ's ETF holdings will have to be transferred to the government as an intermediate step. While the BOJ's financial soundness, a subject of frequent concern, is an important consideration, it is even more important for the government to be the one that decides what to ultimately do with the BOJ's ETF holdings. The challenge is how to fund the transfer. If the government purchases the ETFs from the BOJ, the simplest way to fund the purchase would be to raise the requisite ¥35tn through JGB issuance. However, ¥35tn exceeds Japan's pre-pandemic annual new JGB issuance. It's unlikely that the government could get away with issuing ¥35tn of JGBs that do not generate any effective demand in the real economy.

The solution we propose is to use subsidy bonds to fund the transfer, assuming that legislation is enacted to enable such an arrangement. Subsidy bonds are JGBs issued in lieu of cash to recipients of certain government benefits[4]. From

4) Ministry of Finance, Debt Management Report 2020, https://www.mof.go.jp/english/jgbs/publication/debt_management_report/2020/esaimu2020.pdf (p. 106)

the bondholder's standpoint, they can be thought of as receivables that can be collected by redeeming the bond. Because their issuance does not generate any cash proceeds, it is not counted as new JGB issuance in the budget for the fiscal year of issuance. The government issues subsidy bonds and exchange them for the BOJ's ETF holdings. If the subsidy bonds and ETFs are swapped at price-wise parity with each other, the BOJ could avoid recognizing a loss on its ETF holdings' transfer off its balance sheet and the government's fiscal position upon issuance of the bonds would remain unchanged from previously. Subsequently, the government and BOJ should coordinate the cadence of subsidy bond redemptions to balance them against dividend income from the ETFs and/or the BOJ's annual remittances to the national treasury.

The biggest advantage of such an exchange is that it enables the BOJ/government to formulate the best ETF exit strategy without having to worry about the risk of the BOJ incurring a loss on the ETFs' removal from its balance sheet. If, for example, the BOJ were to decide upon an exit strategy predicated on realizing capital gains by selling its ETF holdings, its ability to execute the strategy would be contingent on equity prices. Our proposal would eliminate such uncertainty.

Basic policy for ETFs' ultimate disposition by the government

Broadly speaking, once the BOJ has transferred its ETF holdings to the government, the government would have three options in terms of the ETFs' ultimate disposition: it could hold them indefinitely, sell them or give them away gratis. If it holds them, the ETFs would become a source of recurring revenue in the form of dividends. While the government would likely be criticized for maintaining a major ownership stake in the equity market, long-term government ownership of the ETFs is theoretically possible. In the first half of fiscal 2020, the BOJ earned some ¥600bn of dividend income from its ETF holdings[5]. Such an income stream would be a significant revenue source even for the government. If the government sells the ETFs, the sales proceeds would become a fiscal funding source. Given the magnitude of the BOJ's ETF holdings, selling them would likely take considerable time. Lastly, if the government gives the ETFs away gratis, it would distribute them to the private sector in their existing ETF wrapper without receiving any consideration in return. The private-sector recipients would most likely be the general public, not corporations. This third option would come into play if the government decides to utilize the BOJ's ETF holdings as a resource for advancing various policy objectives instead of as a funding source. Conversely, it

5) BOJ, Financial Statements for the First Half of the 136th Fiscal Year (Fiscal 2020).

would be off the table if the government decides to monetize the ETF holdings in their entirety.

How to best combine these three options in alignment with fiscal plans and/or economic policies is one key decision that needs to be made. Another is how much to ultimately reduce government-owned ETF holdings over how long of a timeframe. Without such guiding principles, the debate over the BOJ's exit from its ETF purchase program is liable to get bogged down in a plethora of specific ideas that miss the forest for the trees. Additionally, failure to move forward with an ETF exit in a timely enough manner could have adverse consequences, including an excessive buildup in expectations of the BOJ's ETF holdings as a fiscal funding source and unreasonable selling pressure on the equity market. In this sense as well, what is needed as a first step is an overarching blueprint, not disjointed ideas. Even with the government playing the lead role in discussions to arrive at such a blueprint, the first priority should be to transfer the BOJ's ETF holdings to the government.

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