The Bank of Japan (BOJ) is scheduled to release the results of its "assessment" of monetary easing measures soon. While the assessment is expected to cover a wide range of policies, including negative interest rates, this report will focus on the purchases of exchange-traded funds (ETFs), which are attracting a lot of attention in the stock market, and will try to imagine what it will look like after the assessment.

**More criticisms to the ETF program of the Bank of Japan.**

The BOJ has purchased a total of 35.7 trillion yen worth of ETFs from December 2010, when it started buying, to February 2021. Since the BOJ has never sold any of its ETF holdings, due to the recent rise in stock prices, BOJ's ETF holdings appears to have temporarily exceeded 50 trillion yen.

While the Nikkei 225’s recovery to the 30,000-yen level for the first time in about 30 years became a hot topic in the market, there were increasing questions and criticisms such as “Does the Bank of Japan need to continue purchasing ETFs?” It is not clear whether the Bank of Japan took this situation into account, but at its Monetary Policy Meeting in December 2020, it decided to "conduct an assessment for further effective and sustainable monetary easing.”
What will change after the assessment?

I have been opposed to the BOJ’s purchases of ETFs for some time, but the common perception in the stock market is that these purchases will support the market. The BOJ has turned the stock market into an addiction, so to speak, and as a practical matter, it will not be able to stop its purchases any time soon.

In fact, "effective and sustainable" is the key phrase in this BOJ’s assessment, with "sustainable" being the key word. In other words, since the BOJ will continue (perhaps be forced to continue) to purchase ETFs, which has been pointed out to have harmful effects and side-effects, it is presumed that it will seek a way to avoid criticism.

What specific methods may be considered are discussed below.
(1) Flexibility in ETF purchasing

The issue of the ETF purchasing, which is currently set at 6 trillion yen per year in principle with the upper limit at 12 trillion yen, is of most interest to the stock market.

The BOJ is expected to consider multiple cases and make a final decision depending on market conditions, but if market conditions do not worsen, it may remove the "6 trillion yen per year" and leave only the "maximum 12 trillion yen."

By making the purchases more flexible (0-12 trillion yen per year), BOJ will be able to maintain its stance of supporting the stock market by buying large amounts of stocks in the event such as the COVID-19 related crisis, while minimizing its purchases if there is no need. The aim of this flexibility is to "reduce purchases to the extent possible without explicitly stating that purchases will be reduced."

Figure 2: Flexibility in purchasing (main examples expected)

<table>
<thead>
<tr>
<th>Market Environment/ Stock Price Level</th>
<th>Annual Purchase Target</th>
</tr>
</thead>
<tbody>
<tr>
<td>Good/High-priced range</td>
<td>0 - 12 trillion yen</td>
</tr>
<tr>
<td>Slightly unstable</td>
<td>3 - 12 trillion yen</td>
</tr>
<tr>
<td>Unstable/Downward trend</td>
<td>No change from current program</td>
</tr>
</tbody>
</table>

(Source)Prepared by the author

The reason for this is not only the increase in questions and criticism of the purchases of ETFs. There are other reasons why the pace of the increase in ETF holdings should be curbed.

There is no legal problem if the Bank of Japan continues to hold ETFs. However, if stock prices fall sharply, the BOJ will have unrealized losses on the ETFs. If this coincides with the end of the fiscal year at an inopportune time, the accounting rule is to post an allowance for unrealized losses.
When allowance is posted, a burden is placed on the public in the form of a decrease in the national treasury payment (general revenue of the country). Naturally, the larger the amount of holdings of ETFs, the larger the amount of unrealized losses when stock prices fall (and if the timing is not right, it becomes a burden on the public).

What is crucial is the break-even point of the ETFs held by the Bank of Japan. Currently, it is about 21,000 yen in terms of the Nikkei 225 (as of the end of February 2021), so there is no immediate risk of unrealized losses. However, if the Bank of Japan continues to purchase ETFs at stock price levels higher than the break-even point, the break-even point will rise and the resistance to stock price declines will weaken.

It is a necessary measure to make BOJ’s ETF purchases more flexible so as not to unnecessarily increase the amount held. Incidentally, in March 2020, when the spread of COVID-19 struck the market, unrealized losses temporarily ballooned to about 3.5 trillion yen (author's estimate). However, fortunately, stock prices recover to the level slightly above the break-even point at the end of March 2020.

On the other hand, if stock prices were to fall sharply for some reason, the BOJ would move to support stock prices to protect itself.

(2) Consideration for ESG and SDGs

In November of last year, the Bank of Japan's ETF holdings are believed to have surpassed the amount of Japanese stocks held by the Government Pension Investment Fund (GPIF). Needless to say, the Bank of Japan's responsibility as the world's largest holder of Japanese stocks has become heavier as never before.

Secondly, ESG and SDGs are expected to be taken into consideration, and ESG-related ETFs targeting Japanese stocks may be added to the list of ETFs to be purchased.
From this perspective, keywords such as "ESG" and "SDGs" are likely to be added in the assessment. Currently, the Bank of Japan's purchases ETFs linked to TOPIX, the Nikkei 225 and JPX-Nikkei 400, as well as ETFs to support companies that are actively investing in capital and human resources.

None of the ETFs mentions ESG or SDGs, and there is no room to argue against the point that "just because it is monetary policy, does that mean they do not have to take ESG and SDGs into consideration?" Not only the GPIF and other major institutional investors, but also major central banks in Europe and the United States have already taken ESG and SDGs into account in their monetary policies, and the Bank of Japan needs to take immediate action.

Figure 3 shows the ETFs that may be added to the BOJ's purchase list. However, the number of financial instruments advocating ESG and SDGs in the Japanese market is still small, and the BOJ's purchases are likely to be limited. Nevertheless, it would be beneficial if the BOJ's change in behavior were to spread to ordinary investors as well.

Figure 3: ESG- and SDGs-related Japanese stock ETFs

<table>
<thead>
<tr>
<th>Index</th>
<th>Code</th>
<th>ETF</th>
</tr>
</thead>
<tbody>
<tr>
<td>MSCI Japan Empowering Women Index</td>
<td>1652</td>
<td>Daiwa ETF MSCI Japan Empowering Women Index (WIN)</td>
</tr>
<tr>
<td>MSCI Japan Empowering Women Select Index</td>
<td>2518</td>
<td>NEXT FUNDS MSCI Japan Empowering Women Select Index ETF</td>
</tr>
<tr>
<td>MSCI Japan ESG Select Leaders Index</td>
<td>1653</td>
<td>Daiwa ETF MSCI Japan ESG Select Leaders Index</td>
</tr>
<tr>
<td>FTSE Blossom Japan Index</td>
<td>1654</td>
<td>Daiwa ETF FTSE Blossom Japan Index</td>
</tr>
<tr>
<td></td>
<td>1498</td>
<td>ONE ETF ESG</td>
</tr>
<tr>
<td>S&amp;P/JPX Carbon Efficient Index</td>
<td>2560</td>
<td>MAXIS Carbon Efficient Japan Equity ETF</td>
</tr>
<tr>
<td></td>
<td>2567</td>
<td>NZAM ETF S&amp;P/JPX Carbon Efficient Index</td>
</tr>
</tbody>
</table>

(Source)Compiled from TSE website
(3) Review the cost of the ETF purchases

Holders of ETFs bear the cost of trust fees (operation and management fees). The Bank of Japan has so far borne an estimated amount of just under 210 billion yen for trust fees (not a few ETFs also bear audit fees and trademark royalties separately).

In reality, investors and the Bank of Japan do not pay separately, but rather a daily deduction from the net assets of each ETF in the form of an "annual percentage rate" of the market value of holdings. For this reason, it is not included in the Bank of Japan's financial statements.

The point is that the trust fees varies from ETF to ETF, and ETFs in which the Bank of Japan has a large amount of holdings tend to have higher trust fees (Figure 4). Naturally, this not only increases the burden on the Bank of Japan (in effect, the burden on the public), but it has also been criticized for hindering price competition in the ETF industry.

The ETFs that the Bank of Japan purchases are managed to track the index such as TOPIX and the Nikkei 225, so there is almost no difference in the investment performances. Moreover, the Bank of Japan purchases ETFs managed by Japan's leading asset management companies. All of them can be considered to be of the highest quality and almost the same performance.

It is common to choose ETFs with lower costs if the quality is the same, and in light of the purpose of the "sustainable" assessment, it is also important to consider reducing the cost of monetary easing policy. Specifically, this means switching from an ETF with higher trust fees to a cheaper ETF within the same category.

Furthermore, the Bank of Japan might consider measures to reduce the cost of the ETF purchases. There is also a scattering of large holdings of ETFs with relatively high trust fees, and replacing these with the lowest-cost ETFs would reduce costs by about 33%.
Under the current holding structure, the trust fee for one year is 57.2 billion yen, but if the entire amount is switched to the cheapest ETF in each category, the cost would be 38.4 billion yen, a 33% reduction. This is an extreme case, but given the fact that we will have to continue to hold a huge amount of ETFs for the time being, we will have to consider negotiating with the asset management companies to lower the trust fees.

Figure 4: Large holdings of high-cost ETFs

(Note) The amount held by the Bank of Japan is an estimate by the author.
(Source) Compiled by the author from Bank of Japan, Bloomberg, and TSE website
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Shingo Ide heads the Japanese equity research team at NLI Research Institute. A financial researcher with more than 20 years Japanese equity research experience. NLI Research Institute is a think tank of Nippon Life Insurance Group and it was established in July 1988.

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