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January 2025

Derivatives Regulations and Usage in Japan: Buy-side Perspectives

INTRODUCTION

Japan's regulatory landscape has generally been supportive of derivatives use by various segments of the buy side1. While there are some guidelines on the purposes for which derivatives can be used by certain entities, which are not unique to Japan, the overall regulatory environment recognizes the valuable risk mitigation function that derivatives can serve. Despite this regulatory environment, derivatives are not widely used by buy-side firms in Japan, and this could impact the ability of Japan to promote itself as a leading asset management center.

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REGULATORY FRAMEWORK

Regulations for the buy side are set according to the types of entities engaging in derivatives transactions. For some types of entities, the use of derivatives is further governed by guidelines and rules established by self-regulatory organizations, depending on the entity type and purpose of the transactions.

Sell Side vs. Buy Side

Sell-side firms (broker-dealers) are required to register or obtain a license under the Financial Instruments and Exchange Act (FIEA) and/or the Commodity Derivatives Transaction Act and are subject to various regulations. However, the use of derivatives by buy-side institutions does not necessitate an additional legal registration or other license. Further, an investment management company under the FIEA is not restricted in its use of derivatives as its business is to carry out investment management for investment in securities or derivatives[2].

Regulations and Guidelines Per Investor Type

Investment Trusts

Although there are no legal restrictions, the rules of the Japan Investment Trusts Association (JITA) prohibit publicly offered investment trusts from entering into derivatives transactions in cases where "a predetermined amount that the investment trust management company has reasonably for foreseeable loss caused by fluctuations in interest rates, currency prices, market prices and other indices or factors in financial instrument markets" would exceed the net asset value of the investment trust.

Insurance Company

Under the Insurance Business Act[3], derivatives transactions are permitted without any specific restrictions. Additionally, the Financial Services Agency of Japan's Comprehensive Guidelines for Supervision of Insurance Companies[4] assume that insurance companies use derivatives for their asset management and stipulate that it is necessary for insurance companies to establish a risk management framework.

[1] A generic term for institutional investors that purchase and manage financial instruments, such as stocks and bonds, from sell-side institutions – for example, securities firms (source: Nomura Securities website)

[2] Financial Instruments and Exchange Act (FIEA), Article 2(8)(xii) and (xv)

[3] Insurance Business Act, Article 98(1)(vi), (vii), (viii), (ix), (x) and (xi)

[4] Comprehensive Guidelines for Supervision of Insurance Companies, www.fsa.go.jp/common/law/guide/en_ins.pdf

Asset Owners

- **Government Pension Investment Fund (GPIF):** According to the Act on the Government Pension Investment Fund, Independent Administrative Agency[5], when GPIF conducts its own investments, derivatives are restricted to those "intended to manage the risk of investment losses" in the context of securities trading and trusts. This means derivatives are limited to risk management purposes. There are no explicit restrictions on outsourcing investments to investment management companies.

- **Pension Funds for Public Officers:** Regulations governing the management of reserve funds under the Enforcement Orders of the National Public Officers Mutual Aid Association Act and the equivalent one under the Local Public Officers Mutual Aid Association Act specify that use of derivatives shall be limited to "managing risks associated with investment losses". As with GPIF, this is interpreted to mean that derivatives can only be used for risk management purposes.

- **Employees' Pension Fund:** The Employees' Pension Insurance Act does not set specific regulations on derivatives, leaving the matter to be determined by each fund. In the examples provided by the Ministry of Health, Labour and Welfare for revisions to the basic investment policy of employees' pension funds[6], there are references to derivatives in the investment policy and management rules related to alternative investments. Additionally, sections 14, 15, and 40 of the Q&A Regarding the Guidelines on the Roles and Responsibilities of Asset Manager of Employees' Pension Funds (Notification), etc[7] address issues related to derivatives, with no restrictions like those imposed on public pensions.

Rules Provided by Self-regulatory Organizations

The Rules on Management of Investment Trusts, etc[8] by the JITA include provisions related to derivatives, focusing primarily on ensuring proper management. Specifically, the following regulations apply to derivatives:

- **Article 17:** The assumed maximum loss amount from derivatives transactions may not exceed total net assets.

- **Article 17-2:** Investment restrictions for the avoidance of credit risk concentration. The investment shall be managed so the ratio of exposure to one party to the total net asset value of the investment trust assets does not exceed 10% for each of the designated asset class categories and 20% in total.

- **Article 18-2:** For certain types of investment trusts (such as long-term corporate bond investment trusts, medium-term government bond funds and other investment trusts specified in the rules), the use of derivatives should be limited to hedging purposes.

The JITA also has Rules on Complex Investment Trusts that are Similar to Over-the-Counter (OTC) Derivatives Transactions[9], which require appropriate product structuring and preparation of disclosure materials.

[5] Act on the Government Pension Investment Fund, Independent Administrative Agency, Article 21(1)(i) and (ix)

[6] Examples of Revisions to be Incorporated into the "Basic Investment Policy" of an Employees' Pension Fund, www.mhlw.go.jp/topics/bukyoku/nenkin/nenkin/kousei/qanda-01.html

[7] Q&A Regarding the Guidelines on the Roles and Responsibilities of Asset Manager of Employees' Pension Funds, etc. (Notification), www.mhlw.go.jp/topics/bukyoku/nenkin/nenkin/kousei/qanda.html

[8] The Rules on Management of Investment Trusts, etc, www.toushin.or.jp/files/profile/5/jita-reg12.pdf

[9] Rules on Complex Investment Trusts that are Similar to Over-the-Counter Derivatives Transactions, www.toushin.or.jp/files/profile/5/jita-reg30.pdf

Furthermore, the JITA's Guidelines on Investment Restrictions Related to Derivative Transactions[10] outline basic principles for proper management and operation to ensure compliance with derivatives-related investment restrictions. For example, when giving investment instructions for derivatives that are not hedges, certain risk management requirements apply, including using the standardized method or the value-at-risk (VAR) method.

There are no specific restrictions on the use of derivatives in the Japan Investment Advisers Association's Standards to be Taken into Account in the Business Operation[11] and the Standards of Operating Fund Management Businesses[12].

NON-REGULATORY CONSTRAINTS AND ISSUES[13]

The regulatory environment in Japan is generally favorable for the use of derivatives by buy-side firms. However, actual use of these instruments remains limited. Various factors cause this gap between regulatory permissibility and actual usage, including operational complexities, internal policy constraints and the market environment. These challenges create a landscape where derivatives, while available as a risk management tool, are not sufficiently used.

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Low Hedging Needs Due to Recent Market Environment

The long-standing negative interest rates policy and yield curve control (YCC) adopted by the Bank of Japan had a significant impact on the demand for derivatives in bond portfolios, particularly in relation to hedging strategies. Since 2016 until March 2024, the YCC framework has aimed to keep 10-year Japanese government bond yields at around 0%, suppressing interest rate volatility. This artificial stabilization of long-term interest rates has reduced the need for traditional interest rate hedging tools, such as interest rate swaps or options, because the likelihood of significant interest rate movements was perceived to be minimal.

Market Practices and Perception of Derivatives

Japan's buy-side firms, particularly asset owners like pension funds, are very cautious about the risks posed by using derivatives, based on the perception they are speculative and high risk. The practice of using derivatives for risk management has not taken root. This aversion likely stems from the 2008 financial crisis and high-profile losses by certain users. There may also be insufficient knowledge and understanding about the benefits of derivatives as a risk management tool. In contrast, OTC derivatives like interest rate swaps are widely used by pension funds in Europe for financial solvency risk management purposes[14].

[10] The Guidelines on Investment Restrictions Related to Derivative Transactions, www.toushin.or.jp/files/profile/5/jita-reg30.pdf

[11] The Standards to be Taken into Account in the Business Operation, www.jiaa.or.jp/profile/pdf/kisoku/gyouun20240613.pdf

[12] The Standards of Operating Fund Management Businesses, www.jiaa.or.jp/profile/pdf/kisoku/fundgyouun20210324.pdf

[13] Based on ISDA interviews with Japanese and global asset managers and sell-side entities (dealers)

[14] According to PensionsEurope, financial derivative assets held in the second quarter of 2022 amounted €97.9 billion (PensionsEurope Report 2022, page 15, https://pensionseurope.eu/wp-content/uploads/PensionsEurope-report-2022-Trends-and-developments-in-funded-pensions_compressed.pdf)

The need for flexible portfolio management using derivatives is also relatively low among Japan's buy-side firms due to the limited use of long-short strategies, such as those adopted by hedge funds. This can be attributed to the difficulty of taking short positions in Japan's corporate bond market and the very small size of the credit default swap (CDS) market. Additionally, derivatives trading is often associated with speculation and a limited number of funds make use of leverage.

Use of Derivatives in Investment Policy

While there are no explicit restrictions imposed by rules or guidelines on the investment policies of investment trusts, the use of derivatives is predominantly sought for stable management and hedging purposes, rather than achieving excess returns, except for leveraged trading in bull-bear funds. Derivatives are widely recognized as a means of hedging interest rate and foreign exchange risks, but exchange-traded derivatives (especially futures) tend to be used in practice. Use of OTC derivatives, which offer more flexible risk management options, is still limited.

Operational Constraints

The assets of Japan's investment trust schemes are held in custody by trust banks. Investment trust management companies can give investment instructions to the trust bank, and the trust banks execute the buying and selling of securities based on those instructions. Although there has been some recent improvement in collateral management services and in trust banks' capacity to handle relevant operations, the operational resources of trust banks in OTC derivatives markets remain limited, meaning their operational capacity is also limited. This is believed to be due to regulatory reforms relating to OTC derivatives, including margin requirements, plus the shortening of settlement periods, which require more complicated operations. These changes have led to increased costs and operational burdens associated with establishing adequate systems and infrastructure and automating key processes, as well as challenges in securing sufficient resources.

Some issues are observed in proper pricing and prompt settlement in connection with mark-to-market valuation and collateral management. In some cases, repackaged bonds that include derivatives have been preferred to avoid daily mark-to-market valuation and generate stable returns. As another example, while CDS investments are required to be marked to market, credit-linked bond investments are not.

To avoid these issues, some investment trust management companies prefer to set up offshore investment trusts instead of domestic investment trusts.

Need for Enhanced Knowledge and Skills in Derivatives

The lack of human resources on the buy side with expertise in derivatives is thought to be one of the factors limiting the use of derivatives. This is particularly evident in asset management firms, including investment trust management companies, especially in domestic asset management firms. Due to a prolonged unique market environment – ie, negative interest rates and yield curve control – there has been a decline in professionals with practical experience in the trading and risk management of interest rate swaps. This shortage is apparent across the market, making it difficult to secure experienced personnel. Derivatives require advanced financial knowledge and risk management skills, making the development of human resources an urgent necessity.

Documentation

The ISDA Master Agreement is a standard contract for OTC derivatives transactions that is widely used around the globe and plays a crucial role in defining the terms of a derivatives relationship. However, entering into an ISDA Master Agreement can be seen as an obstacle to the use of derivatives by Japan's buy-side institutions.

- **Lack of Expertise:** The ISDA Master Agreement requires personnel with specialized knowledge, particularly for contract negotiations in English. Such resources are limited in Japan, making it challenging to secure appropriate staff in sufficient numbers.

- **Dependence on Japanese-language Original Contracts:** Some transactions use Japanese original templates instead of the ISDA Master Agreement. However, these templates deviate from international standards, potentially leading to basis risk. Moreover, Japanese original contracts are often not accepted by global dealers or asset management companies.

- **Longer Negotiation Periods:** For domestic investment trusts, a tri-party agreement (among an asset management firm, trust bank and dealer firm) is required, which can lead to prolonged contract negotiation periods. Adjusting terms can be difficult, and negotiations may take several months.

CONCLUSION

Despite relatively lenient regulatory constraints on the use of derivatives by the buy side in Japan, their use remains limited. This is due to a combination of factors, including market environment, market practices, perceptions of the risks associated with derivatives, a conservative trend for setting out investment policies, operational challenges, a lack of expertise and skill levels and barriers related to documentation.

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To expand the use of derivatives by buy-side firms in Japan, a review of current regulations and guidelines will be required. If regulations are overly conservative, they should be reconsidered.

Reforming market practices is also essential. Efforts should be made to increase understanding and awareness of the benefits of derivatives while fostering a more balanced approach to risk-taking that aligns with economic rationality. At the same time, operational systems and infrastructure should be enhanced to ensure derivatives can be traded in an efficient, accurate and timely manner. Equally important is the training and retention of skilled professionals in areas such as derivatives trading, risk management and documentation, as their expertise will be critical to supporting the broader use of derivatives.

ABOUT ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 1,000 member institutions from 76 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on LinkedIn and YouTube.