

Derivatives Usage and the Buy Side: Asia-Pacific Perspectives

This paper discusses the uses and benefits of derivatives for buy-side firms – a category that includes investment managers, pension funds, insurers, hedge funds and non-dealer banks – and discusses some of the regulatory barriers and other constraints these firms face in using derivatives in the rapidly growing economies of Asia Pacific, noting the adverse consequences of these restrictions on the region's capital markets and economic development.

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EXECUTIVE SUMMARY

Derivatives are among the most commonly used financial instruments in the world. A wide range of institutional investors, such as asset management companies, pension funds, insurers, hedge funds and non-dealer banks¹ – collectively known as the buy side – use derivatives to manage business and financial risks, implement their investment strategies and generate returns.

Buy-side firms use derivatives for two main reasons: risk mitigation and exposure management. Risk mitigation involves limiting the impact of external factors like interest rates, currencies and equity prices on portfolio values. Exposure management refers to financial activities that support investment strategies.

Risk mitigation does not always imply directly hedging an underlying asset – it can also refer to broader approaches that reduce risk across an asset class or sector. Likewise, exposure management can entail using derivatives to take an exposure more efficiently or when holding the asset directly is not possible.

In the Asia-Pacific region, derivatives help the buy side to reduce risks, tailor exposures and efficiently access markets. Derivatives also allow these firms to diversify globally to facilitate portfolio management and asset allocation. These instruments play an important role in both hedging and seeking enhanced returns for investors.

Access to derivatives is especially relevant to countries in Asia Pacific because their rapidly growing populations are fueling both economic activity and the growth of the investment and savings sector. The region has approximately 4.7 billion people, roughly 62% of the world's population, with China, India and Indonesia totaling 3.1 billion.

However, several Asia-Pacific jurisdictions place restrictions on the use of derivatives by buy-side firms. This includes limiting derivatives usage to hedging activity, prohibiting derivatives on certain asset classes, capping transaction sizes or aggregate exposures and requiring pre-approval of counterparties.

These restrictions can have adverse economic consequences. As many Asia-Pacific economies continue their rapid growth, the demand for risk management solutions will rise. Product and market barriers that limit access to important risk management instruments can increase costs for businesses, discourage foreign investment and impede economic growth.

Furthermore, constraints on derivatives can undermine financial market development. Deep, efficient derivatives markets boost liquidity, price discovery and capital allocation. They also attract a broader range of domestic and global participants and contribute to a resilient financial system. Regulatory barriers undermine these benefits by excluding important institutional investors and reducing trading activity, market depth and financial stability in the long run.

Importantly, inconsistencies between regulatory jurisdictions and supervisory bodies can create uncertainty for market participants and discourage the use of derivatives. Divergent frameworks complicate cross-border transactions, and a lack of consistency increases compliance burdens.

The economic significance of the Asia-Pacific region underscores the urgency of these issues. China is the second largest economy in the world, and India will become the third largest by 2030. Unimpeded access to robust risk management capabilities will help the region sustain its economic momentum.

Derivatives play a key role in empowering industries and investors to mitigate complex risks in these dynamic markets. A safe, efficient regulatory framework would help buy-side firms better serve their clients and support regional growth.

This paper presents an overview of how buy-side investors in Asia Pacific use derivatives, the common restrictions they face and the implications for market efficiency and economic growth. ISDA will also publish jurisdiction-specific papers proposing amendments to existing regulatory frameworks and providing education on the use of derivatives as an effective risk management tool.

¹ Although they are not buy-side firms in the general sense, non-dealer banks are end users of derivatives and have similar risk management needs

DERIVATIVES AND THE BUY SIDE

Overview of Derivatives

Derivatives are financial instruments that derive their value from the performance of an underlying asset, such as an interest rate, equity, bond, currency or commodity. They typically represent commitments to exchange cashflows or to purchase or sell an underlying at specified future dates. They usually take the form of swaps², options³, forwards⁴ or futures⁵.

Derivatives are used for various purposes by a wide range of companies and investors. They give firms the ability to mitigate risk and uncertainty from changes in interest rates, equities or currencies. For instance, they are useful for manufacturers that want to lock in the cost of financing a new factory and reduce the potential impact of interest rate changes, and for food companies seeking to manage the risks of fluctuations in the price of wheat or other commodities. Derivatives also help asset managers to optimize their returns and protect the value of pension fund assets, enabling clients to plan for the future with greater confidence.

The size of the global derivatives market illustrates its significance. According to the Bank for International Settlements (BIS), total gross market exposure was \$18.1 trillion at the end of 2023⁶. Gross credit exposure, which adjusts gross market value for legally enforceable netting agreements, was \$3.1 trillion. This exposure is further mitigated by the amount of collateral (initial margin and variation margin) posted by market participants for cleared and non-cleared derivatives.

Derivatives may be traded on an exchange (exchange-traded derivatives (ETDs)) or bilaterally negotiated between two counterparties (over-the-counter (OTC) derivatives). OTC derivatives are customized to meet specific trading or hedging requirements and may be eligible for clearing through central counterparties (CCPs). ETDs are executed on regulated exchanges and are fully standardized – they have the same trading specifications, pricing benchmarks and settlement periods. All executed ETDs are cleared by a CCP. Table 1 summarizes the main characteristics of ETDs and OTC derivatives.

Table 1: OTC Derivatives vs. ETDs

	Exchange-traded Derivatives	OTC Derivatives	
Customization	Fixed contract specifications, including contract size, maturity and settlement procedures.	Highly customizable, allowing parties to tailor the terms of the contract to suit their specific needs and risk appetite.	
Place and Mode of Execution	Executed on organized exchanges.	Negotiated via voice or executed electronically on trading platforms.	
Types of Instruments	<ul style="list-style-type: none"> • Futures • Options 	<ul style="list-style-type: none"> • Forwards • Options • Swaps (eg, interest rate swaps, credit default swaps) 	
Clearing	Transactions are cleared through a central counterparty (CCP), which stands between buyers and sellers.	Standardized transactions may be eligible for clearing via a CCP, which stands between buyers and sellers.	Other transactions are settled bilaterally between counterparties. These transactions are subject to counterparty risk.

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² Agreements between two counterparties to exchange one series of future cashflows for another at agreed terms on a notional amount at regular intervals during a stated period

³ Contracts where one party has a right (but not the obligation) to purchase something at a pre-agreed strike price at some point in the future

⁴ Contracts between two parties to buy or sell an asset at a specified future time at a price agreed today

⁵ Exchange-traded standardized contracts for a pre-determined asset to be delivered at a pre-agreed point in the future at a price agreed today

⁶ OTC Semiannual Derivatives Statistics at End-December 2023, www.bis.org/publ/otc_hy2405.pdf

▶ continued from previous page

	Exchange-traded Derivatives	OTC Derivatives	
Margin	Margin is based on the rules of the regulated derivatives exchange and posted to the CCP.	Margin is based on the rules of the CCP.	Initial margin and variation margin (collateral) are exchanged between counterparties, based on margin rules for non-cleared derivatives.

OTC derivatives provide market participants with the flexibility to tailor the agreements to their specific needs and therefore address unique risk exposures.

In practice, market participants use both ETDs and OTC derivatives to pursue their business strategies. Recognizing and understanding the distinct strengths of each product type allows participants to navigate the financial landscape with precision, benefiting from the diverse choices available for risk management, investment and hedging. This synergy contributes to the overall stability and adaptability of the global financial system, ensuring that market participants can find the most efficient means to meet their needs.

Why the Buy Side Uses Derivatives

Buy-side firms – investment firms, pension funds, insurance companies, hedge funds and non-dealer banks – have their own operating models, business needs and investment strategies. Broadly speaking, there are two main reasons why these firms use derivatives.

The first is *risk management*, or hedging. Firms seek to limit or hedge the impact of changes in external variables (eg, interest rates, currencies, equities and commodities) on their investment strategies, portfolio holdings or financial operations.

The second is *exposure management*. Firms use derivatives to modify, adjust, add or diversify exposures in their investment strategies, portfolio holdings or financial operations.

Hedging may involve offsetting the risk of an underlying asset, such as a lender hedging a mortgage loan against the impact of a change in interest rates. But it can also involve a macro approach to risk mitigation, such as an asset manager using a currency swap to manage its overall exposure to Japanese equities and bonds.

Similarly, exposure management can entail using derivatives to take an exposure more efficiently or because it is not possible to access the physical asset. An insurance company, for example, could purchase a total-return swap to gain exposure to the US equity market more efficiently than buying the shares directly.

USE OF DERIVATIVES BY THE BUY SIDE

Asset Management Companies

Asset management refers to the coordinated activity of an organization to increase the value of a portfolio over time while mitigating risk. Asset managers focus on acquiring, maintaining and trading investments to secure an increase in their value over time.

Clients served by asset management companies include retail investors, high-net-worth individuals, pension funds, insurance companies, government organizations, foundations, corporations and other entities.

There are several types of asset management companies. Some of them specialize in specific asset classes or strategies, while others embrace a range of market segments. Mutual funds, for instance, pool money from multiple investors to invest in a diversified portfolio of stocks, bonds or other securities. They are typically open-ended⁷. Index funds are offered by asset managers to enable investors to gain exposure to a segment of a major equity market like the S&P 500. These managers also offer exchange-traded funds, which track the performance of specific indices but trade like shares on a stock exchange. Private equity funds invest in private companies at varying stages of their growth cycle (eg, venture capital, buyout or growth equity), while other funds specialize by asset type, such as real estate, credit and infrastructure.

Asset managers are distinguished by the regulatory framework in which they operate. Some firms advise clients on securities trades and manage portfolios. They are closely regulated and must register with the supervisor (eg, the US Securities and Exchange Commission if managing over \$100 million in assets). Others act as investment brokers, serving as intermediaries on behalf of clients.

Asset managers pursue their business strategies by helping investors achieve their investment objectives. They conduct rigorous research, analyzing economic and market trends, reviewing corporate financial statements and making informed decisions to achieve the client's financial goals.

Asset management firms must solve many challenges to achieve investment returns for their clients. They may need to hedge their exposure to certain industries or companies in an equities portfolio. Their fixed-income holdings may require adjustments across the duration spectrum (from money market and short-term bonds to intermediate and long-term securities) and by credit quality (from investment grade to high yield). They may also need to manage exposure to commodities and foreign exchange markets, which at times can be more volatile than investments in traditional equity or fixed-income securities.

As a result, asset management companies use derivatives to achieve several objectives.

- To manage the risks arising from fluctuations in asset prices, interest rates and currency exchange rates.
- To tailor exposure to a specific risk to implement an investment strategy in the most efficient manner – for instance, by emphasizing a segment of the yield curve or a specific industry sub-sector in the equity market.
- To gain exposure to markets that may be difficult to trade directly.
- To diversify a portfolio globally, particularly for investing in emerging markets, where currency volatility can be a significant risk.
- To facilitate efficient portfolio management and asset allocation to adhere to the fund's stated investment objectives.
- To actively enhance returns by capturing trading opportunities that may help the fund exceed its performance benchmark.

⁷ An open-end fund is a diversified portfolio of pooled investor money that can issue unlimited shares. The fund sponsor sells shares directly to investors and redeems them as well. These shares are priced daily based on their net asset value. Most mutual and exchange-traded funds are open-end funds

Use case: An asset manager faces the risk that the value of fixed-rate bonds it holds may fall if interest rates increase. To help hedge against this risk and to maintain its ability to generate income at prevailing market rates, the asset manager enters into an interest rate swap agreement. Interest rate swaps involve the exchange between the parties (the fund manager and the dealer) to pay or receive interest on the notional amount of principal. The parties have the possibility of including several features in the swap agreement to tailor it to the needs of the fund, including:

- (i) Interest rate caps, under which, in return for a premium, one party agrees to make payments to the other if interest rates exceed a specified rate, or cap.
- (ii) Interest rate floors, under which, in return for a premium, one party agrees to make payments to the other if interest rates fall below a specified rate, or floor.
- (iii) Interest rate collars, under which a party sells a cap and purchases a floor, or vice versa, in an attempt to protect itself against interest rate movements exceeding given minimum or maximum levels.
- (iv) Callable interest rate swaps, under which the buyer pays an upfront fee for the right to early terminate the swap transaction in whole at zero cost and at a predetermined date and time prior to the maturity date.
- (v) Spread locks, which allow the interest rate swap users to lock in the forward differential (or spread) between the interest rate swap rate and a specified benchmark.
- (vi) Basis swaps, under which two parties can exchange variable interest rates based on different segments of money markets.

Use case: An asset manager would like to temporarily reduce its exposure to a particular security in response to changing market conditions. Although this could be done without the use of derivatives – the asset manager could physically sell securities to reduce exposure in falling markets, then buy them back as markets recover – the asset manager opts for using equity swaps and options to avoid high transaction costs. The asset manager benefits from the flexibility offered by derivatives to manage its risks without requiring it to change or rebalance its physical asset allocations.

Hedge Funds

A hedge fund⁸ is a pooled investment vehicle that is privately organized and managed by a professional investment firm. Unlike other pooled investment funds, such as mutual funds, hedge funds are designed for sophisticated clients rather than the public. They often have high minimum investment levels and limits on an investor's ability to withdraw money from the fund. Moreover, hedge funds employ a variety of strategies to achieve their investment goals. They can sell securities short and use leverage to amplify their investment positions, which is consistent with their high-risk orientation.

⁸ The OECD Economic Outlook: Sources and Methods, available in the OECD Glossary of Statistical Terms, https://read.oecd-ilibrary.org/economics/oecd-glossary-of-statistical-terms_9789264055087-en#page1

'Hedge fund' is a broad term that covers a range of investment styles and strategies. They can focus on particular asset classes, such as currencies or distressed debt, or a type of investment strategy, such as quantitative trading or arbitrage. Many hedge funds use a diverse array of investment tools and techniques to carry out their investment strategies, including a wide range of derivatives⁹ instruments.

Hedge funds use derivatives to achieve the following objectives:

- To manage risk exposures to interest rates, equity values, currency prices and other assets.
- To amplify returns through leverage, which can magnify gains relative to an initial investment.
- To access diverse markets and implement investment strategies in a more efficient and cost-effective manner.
- To quickly execute an investment strategy, aiming to profit from market fluctuations.
- To create customized investment strategies, such as risk arbitrage, volatility trading or other specialized purposes.

Use case: A hedge fund has a positive outlook on an individual company but holds a negative outlook on other businesses in the same sector. The fund would like to establish a long exposure to the individual firm and take short positions in the other companies within the sector but wants to minimize transaction costs from executing multiple transactions. The fund can establish this exposure with an equity total return portfolio swap that provides long exposure to the individual company and short exposure to all the other businesses in the sector, providing the total returns of the positions, including dividends.

Pension Funds

A pension fund is a pool of assets comprising individual and employer contributions to a pension plan¹⁰ for the exclusive purpose of financing benefits to meet future obligations to their retirees.

Pension funds invest in a mix of bonds and equities, which account for nearly 75% of their assets, according to data from the Organisation for Economic Cooperation and Development (OECD)¹¹, with 48% of their portfolios in bonds and 26% in equities (although this asset mix varies widely across jurisdictions). Cash and deposits account for 9% of pension fund holdings on average. Pension funds also invest in alternative assets, such as structured credit, real estate and infrastructure¹².

Pension funds face the challenge of growing their assets to meet the future needs of retirees, while guarding against market downturns and volatility that could erode the fund's value. To manage these dynamic risks, many pension funds use derivatives.

⁹ IOSCO *Investment Funds Statistics Report*, January 2023, www.iosco.org/library/pubdocs/pdf/IOSCOPD725.pdf. This highlights that, on a gross notional basis, interest rate and FX derivatives are notably the largest derivatives exposures held by qualifying hedge funds globally (page 11, figure 9). Equity derivatives show the largest increase in both long and short positions from the previous year of the survey and are the largest derivatives exposures held by funds (page 11, figure 8)

¹⁰ There are a large variety of pension plans. Some are workplace based (occupational pension plans), while others are accessed directly in retail markets (personal pension plans). These arrangements can be mandatory or voluntary, and the benefits of these plans may be paid by a private sector entity (private pension plans) or by a funded public sector entity. For more information on pension systems, please refer to *OECD Pensions Statistics*, <https://doi.org/10.1787/data-00517-en>

¹¹ Pension Markets in Focus, OECD, https://www.oecd-ilibrary.org/finance-and-investment/data/oecd-pensions-statistics/pensions-statistics_data-00517-en

¹² Although no clearcut definition exists, they can be understood as investments that are distinct from traditional ones (stocks, bonds, cash or property) and are characterized by the application of innovative financial products and derivatives, the illiquidity of underlying investments, a greater reliance on the skill of the manager and the absence of a meaningful performance benchmark

Pension funds use derivatives to meet several objectives, including:

- To control the risks from changes in interest rates, inflation, foreign exchange values and equity prices.
- To quickly adjust portfolio investments in light of changing market conditions.
- To gain exposure to a market or asset class that is difficult to access because of transaction costs, liquidity or other considerations.
- To achieve a dynamic asset allocation as part of a pension plan's liability driven investment (LDI)¹³ strategy.

Use case: A pension fund holds floating-rate bonds and is therefore subject to interest rate risk. The pension fund swaps its cashflow for a fixed rate of interest through an interest rate swap. To do so, the pension fund agrees to exchange interest rate payments with a counterparty that has fixed interest payment obligations.

Use case: A pension fund would like to invest abroad to diversify its portfolio and access asset classes or markets that are not available in its home country¹⁴. This would expose it to movements in currency, which may contribute to portfolio volatility. The pension fund can use foreign exchange forwards or swaps to provide a simple and effective way to hedge currency risk at a relatively low cost.

Use case: A global pension fund implements a liability-driven investment strategy to address the rise in retiree life expectancy. In this strategy, asset allocations are designed to meet current and future pension liabilities. Since the value of the liabilities can be volatile, the pension fund can match its derivatives investments to its long-term liabilities and use repurchase agreements alongside interest rate or inflation swaps, adjusting the allocation over time. Long-dated liabilities are therefore hedged to ensure the assets are available when needed to pay retirees.

Use case: A pension fund would like to increase its overseas equity holdings. Some of its targeted investments are in countries they are unable to access via the local cash equity market. The pension fund can enter into an equity basket swap to achieve the exposure it wants. After determining the notional amounts of each of the underlying securities, the pension fund receives payments at specific intervals based on the performance of the basket in exchange for a floating amount based on a benchmark. If the value of the underlying notional amounts increases, the fund receives the cashflow difference. Conversely, if the notional value of the basket falls, the fund pays the counterparty the cashflow difference.

The safe and efficient use of derivatives by pension funds requires a responsible derivatives policy. This allows pension funds to manage key risks, while promoting transparency, clear valuations, strong controls and the avoidance of conflicts of interest.

Recognizing these challenges, international pension regulatory and supervisory bodies (eg, the OECD and the International Organisation of Pension Supervisors) have issued good practice guidelines on the use of derivatives by pension funds.

¹³ Some pension funds follow the concept of liability driven investment, which is an investment strategy that aims to ensure schemes have enough assets to satisfy their liabilities over the life of the scheme

¹⁴ For instance, Canadian pension plans use foreign markets as local fixed income and equity markets are highly concentrated

Insurance Companies

Insurance companies are financial institutions that provide a range of products designed to protect individuals and businesses from the financial risks associated with uncertain future events. They play a crucial role in managing and mitigating various risks for their policyholders.

Insurance companies face several business challenges, such as demographic shifts, extreme weather events exacerbated by climate change, emerging regulatory and capital requirements, technological disruption and cybercrime.

In particular, the ageing population in developed countries presents challenges for the insurance industry, as longer life expectancies and rising healthcare costs translate into higher demand for retirement planning, long-term care insurance and health insurance products.

Life insurance companies offer annuities, which guarantee a minimum level of income in retirement, regardless of market performance. Therefore, insurance companies must manage a range of investment risks so they can meet their obligations to annuity owners to provide a steady income stream during retirement.

Similarly, insurers in the property and casualty sector must maintain a sufficient level of reserves to pay claims to their clients for insured losses. Managing this investment portfolio is vital to the insurer's long-term success. Insurance companies have adopted investment strategies to ensure they have sufficient assets available to meet their future obligations while maintaining adequate liquidity for paying claims promptly.

These challenges lead insurance companies to use derivatives for a variety of reasons, including:

- To hedge contractual protections associated with annuity guarantees.
- To manage interest rate exposures on fixed maturity investments, long-term debt and guaranteed interest rates on insurance contracts.
- To limit equity risk, either at a portfolio or macro level, to protect against a decline in equity market prices.
- To reduce foreign currency exposures on foreign-currency-denominated investments and liabilities.
- To limit credit risk on certain investments in corporate debt instruments.
- To limit market risks arising from a change in credit spreads or manage the risk profile of certain credit exposures.
- To optimize asset and liability management through a more precise tailoring of the asset and liability mix to meet regulatory capital requirements.
- To manage liquidity positions, including the ability to pay benefits and claims when due.
- To optimize their balance sheet – for instance, through risk transfer transactions, which have become increasingly important as risk-based capital frameworks are adopted.
- To gain exposure to certain asset classes more efficiently – for example, by holding cash and equity futures instead of physical equities.
- To change the exposure to equity markets within a short time frame based on changing market conditions.

Use case: An insurance company would like to mitigate the risk from interest rate guarantees it made through its annuity products. The insurance company buys a derivative in which it agrees to pay an index-based floating rate in return for a fixed interest rate. The derivative will be exercised if interest rates fall below those guaranteed by the insurance company. Once the derivative has been exercised, the insurance company receives fixed interest payments and pays the floating rate to the counterparty. The insurance company has effectively transferred its interest rate risk to the counterparty.

Use case: An insurance company holds 10-year bonds but needs to match them with 30-year liabilities. To address this asset-liability mismatch, the duration of its assets should be adjusted in line with its liabilities. By entering into an interest rate swap, the insurance company can exchange fixed-rate cashflows from the bonds for floating-rate cashflows that align better with the liability duration.

Insurers maintain stringent policies governing the use of derivatives in connection with their business activities, with regular monitoring of open positions and annual reviews of derivatives programs. In addition, many policies include limits that are specifically set for each authorized counterparty, based on an internal credit risk scoring system, as well as use of collateral to mitigate risk exposure.

Non-dealer Banks

Banks provide a broad range of services to institutional clients, from financial intermediation in securities and derivatives markets to banking services, such as lending, transaction processing and managing customer deposits. Banks also have sizeable investment portfolios containing a wide range of government and corporate securities. For the purpose of this paper, non-dealer banks (banks that do not make markets in derivatives) are included as part of the buy side.

Non-dealer banks' activities can expose them to a broad a range of risks – credit risk from lending, interest rate risk on both sides of the balance sheet, foreign exchange risk from financing and trade receivables, and liquidity risk from maturity mismatches between assets and liabilities.

These risks can be especially significant for non-dealer banks in many Asia-Pacific countries, where banks play a vital role in financing private companies and driving economic growth. Non-dealer banks generally focus their lending activities on short-term, floating-rate loans matched against short-term deposits. As a result, banks may not be able to provide the longer-term financing that many corporations seek. This creates higher costs for fixed-rate loans, which may impede their ability to invest and grow.

In this context, non-dealer banks use derivatives to hedge exposures and manage risks. This includes:

- The interest rate risk associated with holding longer-dated bonds.
- The risk associated with the mismatch between the term of their loan assets and their deposit liabilities.
- The concentration of credit risk that can occur in a bank's loan portfolio.

The strategic use of derivatives empowers banks to structure their assets and liabilities in ways that align with the needs of their customers and the broader economy. Stability in loan offerings can lead to reduced costs and additional lending capacity to serve borrowers, encouraging corporate investments and contributing to economic growth. This is particularly true for the use of interest rate derivatives¹⁵, which provide non-dealer banks with the flexibility to offer loans that are more aligned with market demand and borrower needs.

¹⁵ Such a need was acknowledged by the Bank for International Settlements (BIS) in the context of attention paid to interest rate risk in the banking book (IRRBB) by policymakers and market participants in all jurisdictions, including emerging market and developing economies (EMDEs): "IRRBB is an important risk that arises from banking activities and is encountered by all banks. It arises because interest rates can vary significantly over time, while the business of banking typically involves intermediation activity that produces exposures to both maturity mismatch (eg, long-maturity assets funded by short-maturity liabilities) and rate mismatch (eg, fixed-rate loans funded by variable rate deposits). In addition, there are optionalities embedded in many of the common banking products (eg, non-maturity deposits, term deposits, fixed-rate loans) that are triggered following changes in interest rates"

Use case: To exchange the fixed interest payments it receives from its government bonds for floating-rate payments, a non-dealer bank enters a fixed-for-floating interest rate swap. This transformation of fixed-rate income from long-term bonds into a floating-rate income stream mirrors the nature of the bank's liabilities, thereby reducing the risk mismatch. This hedging mechanism is particularly beneficial in scenarios where market rates rise, as the increased floating-rate payments received by the bank on the swap can help offset the higher interest costs it must pay on customer deposits.

Use case: To offset the risk incurred by offering its customers fixed-rate mid- to long-term mortgages, a commercial bank enters a fixed-for-floating interest rate swap. This transformation of fixed-rate income from loans into a floating-rate income reduces the impact of a rise in interest rates, as the floating-rate payments received by the bank can offset its higher short-term funding costs.

FOSTERING THE USE OF DERIVATIVES BY THE BUY SIDE

Restrictions Encountered in Different Jurisdictions

The benefits of using derivatives are widely recognized, but there are numerous restrictions and concerns about risks in the Asia-Pacific region that limit their use and prevent companies and other users from realizing their full potential. These restrictions vary from one jurisdiction to another and affect buy-side participants differently. In some instances, they encompass an entire market segment or type of activity, and they can be based on statutory regulations or supervisory or market practices.

The restrictions on derivatives in Asia Pacific can be grouped into three categories – limits on activities, limits on asset classes and limits on risk exposure.

Limits on activities: Certain countries in Asia Pacific allow derivatives to be used by the buy side only for hedging or risk mitigation and prohibit the use of derivatives as a standalone investment strategy.

Limits on asset classes: Limitations or prohibitions on the use of certain derivatives asset classes by buy-side institutions (for example, equity derivatives) are widespread in Asia Pacific.

Limits on risk exposures: Several jurisdictions in Asia Pacific restrict the use of derivatives based on the size of the transaction or its risk – for example, derivatives exposure is capped and may not exceed a certain level.

Policy Framework for Safe, Efficient Use of Derivatives in EMDEs

In addition to regulatory considerations, there are often other areas of a jurisdiction's policy and legal framework that affect the ability to use derivatives. Derivatives have a vital role to play in the development of capital markets in emerging market and developing economies (EMDEs), and in enabling a wide range of end users in these jurisdictions to better manage the business and financial risks they are exposed to in their normal course of business. For these reasons, it is important for EMDE policymakers to establish an appropriate framework to ensure safe and efficient derivatives activity.

In a previous paper¹⁶, ISDA outlined the key elements – legal, regulatory and risk management – that policymakers should consider. It draws on previous work by global standard setters, regulators and supervisors in advanced economies, as well as market participants and others, to identify issues and practices in these areas. Importantly, the paper discusses the relevant transposition of derivatives policies and rule sets developed by global policymakers and market participants in advanced economies to EMDEs.

There are, for example, some practices, laws and/or rules that are essential in every jurisdiction (eg, the legal certainty of derivatives transactions and the enforceability of netting agreements between counterparties).

However, not every global rule set can or should be implemented in every jurisdiction (eg, a clearing mandate should not be prioritized in a market with few transactions or with a closed currency). It is important that a jurisdiction's policy/regulatory framework is aligned and evolves with the development of its capital markets and derivatives activity to foster growth and enable access to prudent risk management practices.

Among the key issues for policymakers to consider are the Group-of-20 (G-20) nation's global derivatives market reforms, which cover clearing, capital, margining, reporting and trade execution, and whether and how they might be adopted in specific EMDEs. Another important consideration includes risk governance and management issues, ranging from the nature of the firm's approach to derivatives risk management and responsibilities of the board of directors and senior management to the risk management tools, processes and systems that are in place to measure and manage exposures. By focusing on these issues, EMDEs can facilitate the development of regulatory frameworks that enable beneficial risk management activities, while working to ensure that risk exposures are understood, documented and appropriately managed.

¹⁶ www.isda.org/a/YHVgE/Policy-Framework-for-Safe-and-Efficient-Derivatives-Activity-in-Emerging-and-Developing-Markets.pdf

Adverse Consequences of Restrictions on the Use of Derivatives in Asia Pacific

From a general perspective, restrictions on any market or investment activity are justified only if their benefits outweigh their costs. The restrictions on derivatives faced by buy-side institutions in Asia Pacific impose a substantial cost.

Restrictions on the use of derivatives impede the efficient management of critical business risks, block the emergence of mature capital markets and constrain economic growth. A robust financial ecosystem that offers a conducive environment for investment is essential to support continued economic growth in Asia-Pacific economies.

The costs imposed by these restrictions will continue to increase. This is because the demand for hedging and risk management tools will rise as companies in Asia Pacific grow. Businesses and investors will seek to protect themselves against market volatility and economic uncertainties, and derivatives offer efficient solutions for these needs, enabling participants to tailor their risk exposure to fit their precise requirements. OTC derivatives can be especially useful as their flexibility allows users to address complex risk exposures that may not be adequately covered by standardized exchange-traded products. These financial instruments play a crucial role in managing and mitigating the risks associated with currency fluctuations, interest rates and commodities.

Given the growth and diversification of Asia-Pacific economies, market participants will increasingly need derivatives for better cashflow management and to hedge against risks they are exposed to in their business value chain. The use of derivatives to hedge can help reduce volatility, stabilize financial performance, reduce capital cost and boost investor confidence.

Restrictions neglect the fact that a well-developed derivatives market not only provides risk mitigation tools for businesses, but also serves as a catalyst for innovation, investment and efficient capital allocation. In an era of digital transformation, the financial landscape in Asia Pacific is evolving to meet the demands of a dynamic market. The deepening of derivatives markets will enhance liquidity and will facilitate price discovery, which is crucial to attract both domestic and international investors seeking exposure to the region's promising economic prospects.

Economies and financial markets are increasingly interconnected, and restrictions on derivatives impair the ability of Asia-Pacific companies to compete in global markets. If the region's derivatives rules are closer to international standards¹⁷, domestic companies would likely benefit in terms of higher business volumes and increased investment. Aligning with global standards also creates the potential for cost savings as market participants leverage economies of scale in developing and implementing their risk management systems, enabling cost savings to be passed onto investors and customers.

The diverse industry landscape in Asia Pacific would be well served by access to a range of derivatives products. By providing a robust and extensive spectrum of derivatives contracts, jurisdictions can empower their economic stakeholders to effectively navigate the complexities of a dynamic global economy. Access to a broader range of products¹⁸ is key to meeting their hedging and investment objectives.

¹⁷ For example, the US Securities and Exchange Commission adopted rules for the use of derivatives by registered investment companies in October 2020. See Use of Derivatives by Registered Investment Companies and Business Development Companies, Investment Company Act Release No. 34078 (October 28, 2020), www.sec.gov/rules/final/2020/ic-34084.pdf

¹⁸ In India, the expansion of credit default swaps (CDS) could play a key role in addressing the intricate challenges associated with fostering the development of the country's corporate bond market. Currently, the corporate bond market in India grapples with a significant impediment whereby market participants are dissuaded by the limited availability of CDS as a risk management tool. Realizing the full potential of the corporate bond market necessitates the establishment of a robust CDS market capable of offering investors an effective mechanism for credit risk management. Enabling market participants to hedge against default risks through CDS has the potential to enhance investor confidence, consequently encouraging greater engagement in the corporate bond market. This mutually beneficial relationship between a vibrant CDS market and a flourishing corporate bond market has the capacity to overcome the existing impasse, paving the way for a more resilient and dynamic financial ecosystem in India

Furthermore, restrictions on derivatives limit institutional participation, notably by buy-side firms, which often seek tailored solutions to meet specific risk and return requirements. For example, customization may include non-standard strike prices, expiries and contract sizes, as well as specific arrangements relating to pricing features, valuation terms, dividends, corporate actions and other adjustments, risk allocation terms and margin. Allowing OTC equity derivatives would attract increased institutional participation, contributing to greater market depth and liquidity. Ensuring a diverse range of participants on both the buy and sell side is a fundamental necessity to foster the growth of a resilient, liquid and efficient OTC derivatives market.

The success of any market is typically measured in terms of depth, liquidity, efficiency and stability. This is predicated, among other things, on how widely the market is used by various participants in addressing their needs. Having a wider set of participants typically ensures a good medium for risk transfer from one participant to the other as their needs may be offsetting. Hence, the diversification of market participants across the buy and sell side is an essential requirement for financial stability and market efficiency.

Bringing more consistency to the regulatory treatment of OTC derivatives would provide clarity to market participants, reduce uncertainty and enhance confidence. The numerous restrictions that currently exist across Asia Pacific impose high compliance costs for buy-side institutions and undermine the investment attractiveness of the region. Asia Pacific economies would benefit from regulatory reforms that grant buy-side entities wider access to OTC derivatives to provide flexibility for managing and hedging risks, as well as executing trading and investment strategies.

The implementation of post-global financial crisis G-20 reforms (eg, reporting to trade repositories, capital rules, central clearing and margining for non-cleared derivatives) has made derivatives markets much safer. Some of these reforms have already been implemented in certain Asia-Pacific jurisdictions and provide a useful foundation for opening these markets to further innovation and growth.

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](#).