Japan's unique Margin Transaction system

Kei Hashimoto, associate, securities lending (equities) of Japan Securities Finance Co. reviews a distinctive feature of Japan's trading framework as global interest in Margin Transactions continues to rise

In earlier editions of the Securities Finance Times, Japan Securities Finance (JSF) introduced readers to Margin Transactions, a distinctive feature of Japan's trading framework. With the Japanese stock market demonstrating robust performance and global interest in Margin Transactions continuing to rise, we are excited to revisit this topic and share our pivotal role within the wider securities lending ecosystem.

Globally, the standard way to initiate a short trade is to borrow stocks through the securities lending market and sell them. However, in Japan, investors can make use of the distinctive Margin Transaction market as an alternative to borrowing stocks. The advantage of the Margin Transaction system is that investors can freely short sell the majority of over 4,000 listed stocks without complex prior contracts, negotiations, or paperwork with lenders. In other words, anyone can easily initiate a short position on most Japanese stocks under this framework.

Margin Transactions account for approximately 15 per cent of total equity trading volume on the Tokyo Stock Exchange, and an estimated 60–70 per cent of stock trades by individuals use this scheme, demonstrating their significant presence in Japan's equity market. As a brief introduction of the mechanism, Margin Transactions in Japan are classified into two categories:

- Standardised Margin Transactions (SMT) — trades in which eligible securities and the terms are set uniformly by the stock exchange. Most listed stocks are eligible under these standardised terms, and investors can readily use SMT to obtain leverage or to short stocks.
- Negotiable Margin Transactions — trades in which individual securities companies set the terms and conditions. Investors may choose this type of transaction when they find terms that differ from those specified under SMT. While SMT remains the primary choice for margin trading, Negotiable Margin Transactions serve as an alternative option to accommodate specific needs.

In many countries with short selling regulations, a short seller must secure stock before selling short. It is also true for Japanese Negotiable Margin Transactions: the broker needs to have the shares lined up beforehand. SMT, on the other hand, benefits from an extremely efficient stock procurement scheme operated by JSF called Loans for Margin Transactions (LMT). Using LMT, neither investors nor brokers need to pre-borrow shares themselves; they can short sell any available stock on demand. In essence, SMT's existence, underpinned by JSF's LMT framework, is what enables margin trading to cover the vast majority of listed securities in Japan.

Reviewing SMT and LMT

Under a SMT, an investor deposits 30 per cent of the trade's value as margin to a securities company and then raises cash or borrows stocks to execute a leveraged buy or a short sale. This structure allows individual investors to enhance returns with leverage or conduct short sells as means of risk hedging.

For example, if you expect the price of a stock to decline, they can use SMT to execute a short sell instead of borrowing shares from a prime broker on the lending market. Within the repayment period (up to six months), if the stock price drops, you can buy back the shares at a lower price and return them to the securities company, profiting from the price difference. SMT can be also used for hedging purposes; for example, to avoid losses by short selling equivalent shares when expecting a price decline in stocks you already hold.

Behind every SMT lies JSF's LMT mechanism. Only securities finance companies licensed by the Prime Minister of Japan are permitted to conduct LMT, and JSF is the nation's sole securities finance company. When an investor places an order for a SMT with a broker, the broker in turn can obtain the necessary cash or stock for settlement from JSF via the LMT by depositing a certain level of collateral.

A question arises here: how does JSF procure cash and shares required to run LMT? The answer lies in JSF's robust financing capabilities. With a solid credit 'A' rating by S&P,

JSF raises funds in financial markets. For stock lending, JSF organises a daily auction on the business day following the trade date of LMT to source the shares required for T+1 settlement to cover all margin short sells executed. In this auction, securities companies or institutional investors holding demanded stocks can lend them to JSF. The auction mechanism ensures efficient, market-driven procurement of equities. This backstop is an exclusive feature of the LMT system and exemplifies JSF's role as a reliable stock lender in the margin trading framework.

The borrowing cost determined by the JSF auction is called the 'premium charge'. Premium charge rates are set according to a predetermined tiered schedule based on the value of the investment amount. All short sellers using SMT must pay this premium charge uniformly according to the size of their short position, whereas the lenders in the JSF auction (those who supplied shares) and margin buyers (long position holders in SMT) receive this premium charge based on the quantity of shares they lend or buy.

In effect, the premium charge flows from the short side to the long side and lenders, serving as an incentive mechanism to balance supply and demand. This will encourage short sellers to close their positions and new buyers to enter the market. Through this self-adjusting mechanism, the balance between margin buying and margin selling tends to find equilibrium under normal circumstances.

Nonetheless, supply and demand can sometimes become severely imbalanced. If the outlook for sourcing shares via the auction becomes uncertain due to

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special circumstances — such as sudden price volatility, corporate actions, or large short position over a record date — JSF may intervene by imposing temporary restrictions on new short sales in SMT. Depending on conditions, JSF can issue a caution (an advisory of limited stock availability) or enforce an application suspension (a prohibition on new margin short sale orders for the particular stock). These measures are designed to preempt excessive short selling and maintain market stability when supply mechanisms fall short.

The various data associated with JSF's operations serve as valuable indicators of supply-demand dynamics in the Japanese stock lending market. Recently, efforts have been made to utilise this data for predicting market supply and demand. JSF's data services, offering detailed LMT and stock loan market statistics, are increasingly in demand from domestic and international investors and researchers.

JSF's role in the general stock lending market

Apart from the margin transaction market, JSF also plays a vital role in the Japanese stock lending market. As the only securities finance company in Japan, JSF has cultivated relationships with domestic financial institutions and major shareholders over decades. Through this extensive network, JSF holds a substantial inventory of stocks on deposit from these partners. This unique positioning enables JSF to inject liquidity into the securities lending market, effectively acting as a lender of last resort to support the smooth functioning of the Japanese equity market.

While international investors become increasingly active in Japan's booming market, their activities have predominantly concentrated on large, highly liquid stocks. These names generally have ample liquidity and are well-covered by global securities lending participants, meaning JSF's services are not often called upon for mainstream large-cap shorting.

JSF's true strength, however, lies in less-liquid small and mid-cap stocks. Where typical lenders may not have inventory or are unable to lend a particular stock, JSF leverages its network to procure the shares and supply them to the market. By providing liquidity in these otherwise illiquid names, JSF plays a vital role in achieving one of the primary objectives of the recent Tokyo Stock Exchange market reforms — enhancing market liquidity — and we are proud to serve in this capacity. JSF regularly deals with lending transactions through industry platforms such as Bloomberg and EquiLend NGT, so feel free to reach out.

In addition, JSF actively commits to mitigate settlement failures in the market by providing T+0 stock loans for settlement failure. In practice, if a market participant faces the risk of failing to deliver stocks by the settlement cut-off time, JSF can swiftly step in to provide the required shares — often within just 15 minutes of the request in urgent situations. By serving as the final anchor of stock settlement in this way, JSF significantly reduces the incidence of delivery failures and enhances the overall stability and integrity of Japan's stock settlement system.

Conclusion

As Japan's sole securities finance company, JSF commits to the development of the nation's securities market infrastructure. We encourage global investors to take advantage of the unique trading schemes and actively participate in the Japanese market. The SMT and the associated LMT are complex in certain respects, but they are also highly effective mechanisms that can benefit your trading strategies. To learn more about these systems, please visit JSF's website for detailed information. ■