

## An exploration of Japan's repo market

Yuki Niimura, vice president at Japan Securities Finance Co., reviews the market, from new forms of repo trades in Japan and risk management, to the distinct role the firm plays in this space



Japan Securities Finance Co. (JSF) acts as an intermediary in the Japanese government bond (JGB) repo market, supporting the liquidity of this market. The JGB repo market, JGBs versus Japanese yen transactions, has continued to expand with a continuous increase in JGB issuance. The outstanding value of JGB repo transactions now reaches around ¥270 trillion (US\$1.7 billion), making it an extremely large market.

## Recent developments in Japanese JGB repo market

### General Collateral (GC) repo

There continues to be robust demand for GC repo, a means of raising cash or collateral, and the overall market outstanding has been growing. In particular, with rising demand for term repos, the GC rate has remained stable at levels close to the uncollateralised overnight call rate.

Under the Bank of Japan's (BOJ's) Yield Curve Control (YCC) policy, tight JGB supply-demand had previously led to high rate volatility in the repo market. However, since the YCC policy was abolished, supply-demand conditions have shown improvements and repo rate stability has increased. Nonetheless, at fiscal year-end (end of March for many Japanese firms) or immediately after a BOJ monetary policy meeting, market participants tend to hold back on lending out JGBs, resulting in temporary scarcity of bonds and it pushes repo rates down briefly during those periods.

### Special Collateral (SC) repo

Meanwhile, SC repo is driven by the need to build short positions in bonds for arbitrage or to cover those shorts. Although the total SC market balance last year fell compared to the previous year, it remains

a substantial market. The SC repo rate is generally determined by taking the GC rate and adding a premium reflecting the individual security's supply and demand. Similar to GC, there are times when certain specific issues experience scarcity, leading to a rate difference between GC and SC.

Under the YCC policy, specific JGB names with high BOJ holding ratio often became exceptionally scarce, sometimes resulting in significantly deviating from the typical level of the repo rates. Currently, however, resulting from improved supply-demand balance, such irregular situations have been decreasing. With newly issued bonds and certain issues with low liquidity, supply-demand imbalances can still occasionally impact repo rates.

## Arbitrage transactions utilising JGBs

There are many arbitrage opportunities in the JGB market. For example, an opportunity arises among the prices differences in the JGB market, the interest rate swap market, and the JGB futures market. Similarly, arbitrage trades targeting imbalances between supply and demand for specific JGB names are also possible.

As mentioned above, the supply and demand in the JGB repo market have been stable in recent years. JGBs could be procured or lent out fairly feasibly, turning out to be a major advantage for executing such arbitrage trades. On the other hand, during periods of extreme supply-demand tightness, obtaining the necessary bonds could be challenging. In such cases, JSF leverages its network with domestic and overseas financial institutions and institutional investors to swiftly procure and supply JGBs as needed. As a result, the JGB repos balance with non-residents at JSF has been increasing year by year.

## Repo transactions beyond JGB vs JPY

The Japanese repo market is still predominantly composed of JGB versus Japanese yen transactions. In recent years, however, appetites for repo transactions using other assets or currencies has been increasing. For example, Japanese equities or foreign equities versus JGBs are conducted for purposes such as balance sheet reduction and collateral optimisation. These types of transactions have proven to be an effective tool for financial institutions seeking to meet regulatory requirements and improve capital efficiency.

Domestically, there is a growing trend of 'cross-currency repo' transactions where JGBs are used as collateral to obtain US dollars or other foreign currencies. By acting as an intermediary in these cross-currency repos, JSF enables overseas investors and asset managers to transact under attractive terms while significantly reducing operational burdens.

Other new forms of repo transactions are also drawing attention, such as those using government-guaranteed bonds or municipal bonds as collateral. Government-guaranteed bonds or municipal bonds are — though they tend to be illiquid — valued for their stable creditworthiness. In today's environment of rising funding cost, these assets indicate potential as alternative sources of financing for investors. JSF is actively promoting repo transactions collateralised by diverse types of assets, fostering a market where participants can efficiently access the funds or securities as they need.

## Risk management in repo transactions

In the recent repo market, there has been a notable rise in spread trading that combine SC and GC to manage cash positions. When a market participant needs to obtain a special name, pairing an SC repo (to borrow the needed bond) with a GC repo (to invest excess bonds or cash) helps keep the overall cash position as neutral as possible. By conducting offsetting trades in this manner, participants can effectively offset interest rate risk and credit risk. This strategy has been gaining attention as market volatility increases.

From a risk management perspective, mechanisms such as margin calls and haircuts are utilised in cases where market fluctuations cause the depreciation in value of collateral. A margin call requires the additional cash or other assets as collateral, while a haircut involves deducting a certain percentage from the market value of the collateral, thereby lowering its evaluated value for collateral purposes. Among clearing participants, the Japan Securities Clearing Corporation (JSCC) acts as central counterparty to assume obligations, so in many cases such bilateral risk mitigants are not applied between those participants. However, for trades with non-clearing participants, it is common to employ these risk management measures to protect against counterparty and market risks.

## JSF's role

As a leading company in the JGB repo market, JSF has established trading relationships with nearly all financial institutions and institutional investors in Japan, supporting liquidity across the entire market. Within this framework, we play a pivotal role in connecting the domestic market with overseas markets, serving as a bridge for international capital flows.

In the Japanese JGB repo market, we actively utilise a variety of transaction types including GC and SC trades, spread trades, and cross-currency repo trades. In particular, the practice of using JGBs as collateral to raise US dollars and other currencies through cross-currency repos has been expanding, and our intermediation in these trades has improved market efficiency and made trading conditions more attractive for participants.

Additionally, we are focusing on transactions using assets other than JGBs. Repo trades backed by government-guaranteed bonds or municipal bonds, although still limited in overall market size, are gaining attention in the current rising interest rate phase.

We leverage the experience that we have cultivated over the years to not only support domestic market liquidity, but also to provide a flexible and efficient trading environment that links domestic and foreign market participants. As a pioneer in the market, we will strive for further development of the JGB-related transactions and continue to challenge expanding new transaction fields. ■