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NEW CONNECTIONS DRIVE SECURITIES LENDING

Although the securities lending industry has not yet recovered from the financial crisis, there are pockets of hope. This is particularly true of the Asia Pacific region, whose contributions may pale in comparison to the West but its rate of growth outshines its counterparts. Hedge funds and traditional fund managers are setting up shop but the pace is still expected to be slow and steady. Lynn Strongin Dodds reports on the key trends.

THE LATEST FIGURES from Data Explorers have revealed a major increase in Asia's total equity lending income last year, coupled with predictions of further growth in 2011. Will Duff Gordon, a senior researcher at Data Explorers, which monitors the volume of securities made available to lend by investors and the amount taken by short-selling hedge funds and other market makers, says: "Our recent figures show that Asia accounted for 18% of the total equity lending income in 2010, which is up from 14% the previous year. The 125 delegates at our recent conference predicted that Asia's contribution could increase to between 20% and 25% of global equity lending income over the coming year for equities. I am not sure whether it will happen that fast but the opportunities for growth are much greater than elsewhere. It is important, though, to put the numbers in context. Securities lending is definitely growing in Asia but it will be some time before it overtakes that of Europe or the Americas."

Custodians and other securities lenders are optimistic on the back of strong stock market performance and corporate activity. "Last year, the MSCI Far East returned roughly 23% in comparison to the MSCI's All Country's 9.7% and the 0.35% of the firm's European index. Asia also dominated the IPO market, outstripping its Western counterparts. Figures from data provider Dealogic revealed that Asia-based issuers comprised over 60% of the \$280.1bn global tally. China led the way, accounting for 37.2% of all IPOs at \$104.3bn, up from 2009's \$50.6bn. The most notable deal and the largest on record—the sale of \$22.1bn shares—was from Agricultural Bank of China. As with many Chinese IPOs, it had a double listing in Shanghai and Hong Kong.

The region also produced a buoyant crop of merger and acquisition (M&A) transactions. South East Asia was particularly fertile and while the increase in numbers may not have been that impressive, the size of the deals was. The region recorded 2,755 deals worth \$108.6bn last year, up from 2,744 ►►



Giselle Awad, senior vice president, Asia-Pacific, at eSecLending in Australia. "The economies in Asia are growing, which equals more IPOs and M&A activity. As a result, hedge funds have increased their activity and are allocating more of their trading business to these markets, which in turn is driving the securities lending business." Photograph kindly supplied by eSecLending, January 2011.

valued at \$55.1bn in 2009. Francesco Squillacioti, Asia-Pacific regional business director for State Street's securities finance division, says: "Increased mergers and acquisition activity is a key driver for the growth of securities lending. This is because the upward growth in those types of corporate events generates demand for stock."

Andrew Cheng, head of securities lending, clients sales management, Asia ex-Japan & Australia, JP Morgan Worldwide Securities Services, adds: "The securities lending outlook in Asia Pacific is extremely strong. We're expecting to see significant activity in Asia when compared with Europe in terms of mergers and acquisitions and IPOs, and market prices for securities generally are also higher. We're also seeing many fund management houses setting up offices in Hong Kong, Singapore and Australia while hedge funds are increasing their business in the region. The other side of the equation is that there has been reduced activity in other parts of the world such as the US and Europe."

Figures from Data Explorers show that since the end of September 2008, the number of stocks based in Asia available to lend jumped 19%, whereas in Europe it has shrunk by almost 3%. Demand to borrow in the main securities lending markets in Europe and the US has also fallen sharply. This is mainly due to a lack of shorting activity on the back of tighter regulations and volatile markets which has made market participants less enthusiastic about taking directional bets.

Hong Kong also has come a long way since the start of 2008, when it only produced 24% of Asia's income. It benefits from not only having one of the world's most advanced capital markets framework but it also boasts the most prominent listing exchange for Chinese equities.

Giselle Awad, senior vice president, Asia-Pacific, at eSecLending in Australia, echoes these sentiments: "What we are seeing are fewer trading opportunities in the traditional western markets. Conversely, the economies in Asia are growing, which equals more IPOs and M&A activity. As a result, hedge funds have increased their activity and are allocating more of their trading business to these markets, which in turn is driving the securities lending business."

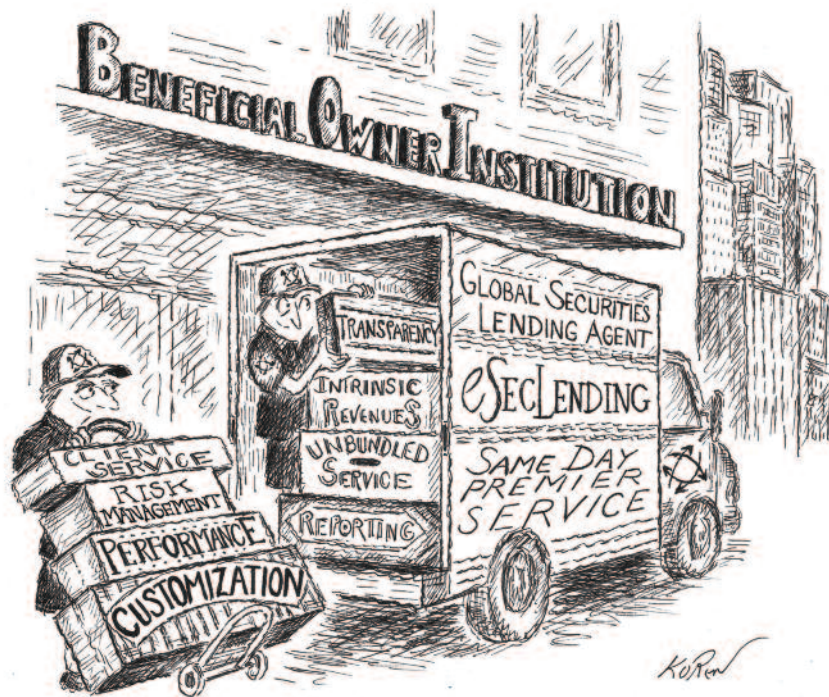
Last year, roughly ten leading hedge fund managers either set up shop or returned to the region. Soros Fund Management, Viking Global Investors and GLG Partners hung up their shingle while Fortress Investment Management decided to stage a comeback. Meanwhile, DE Shaw moved one of its six-person executive committee to Hong Kong and Maverick Capital added additional analysts to its Hong Kong office.

While the migration is expected to continue fuelling further securities lending business, activity is expected to remain within the confines of the four major markets—Hong Kong, Japan, Australia and Singapore. According to participants at a recent Data Explorer conference, the speed and clarity of regulatory reform will impact the future success of the industry in Asia. As Rob Coxon, head of international securities lending at BNY Mellon, says: "When you look at Asia in terms of securities lending, it is a two-tier market. There are the main established and mature markets and the more embryonic markets such as Korea, Taiwan, Thailand and the Philippines. This is because the markets are at different stages of regulation."

Attractive returns

Robert Lees, head of securities lending trading for Asia Pacific, Brown Brothers Harriman, notes: "Overall, we believe that the region, from both a supply and demand perspective, will continue to deliver attractive returns for our clients. Markets that will continue to evolve and develop will be Taiwan, Thailand and South Korea from both regulatory and liquidity perspectives. Separately, India and China will also become much more important and we are supportive of the regulators' efforts in developing market structures for investors."

Obviously China represents an attractive proposition and although there are encouraging signs coming from the market regulators, Lees believes it is important to exhibit some patience regarding a fully established platform. "Separately, Indian regulators seem to be stepping up their efforts to ►►



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Rebecca Nordhaus, global head of regulatory strategy for securities lending, Brown Brothers Harriman. "Hong Kong regulators had a different response but I think the regulators in Australia were responding to local political pressures. There is certainly pressure for Australia to move in line with the rest of Asia," she says. Photograph kindly supplied by BBH, January 2011.



Robert Lees, head of securities lending trading for Asia Pacific, Brown Brothers Harriman. "Overall, we believe that the region will continue to deliver attractive returns for our clients. India and China will also become much more important and we are supportive of the regulators' efforts in developing market structures for investors," notes Lees. Photograph kindly supplied by BBH, January 2011.

encourage the participation of the securities borrowing and lending programme. With continued efforts, we expect that this may become more of a key market in the future," he adds.

The signs are encouraging, with the Chinese authorities meeting last summer to hammer out the details of an operational framework. The key questions being debated included whether funds should participate in the securities lending business, when stakeholder meetings might be needed, how to price securities packages, and whether capital raised through securities financing should be re-invested.

Earlier last year, a government backed programme was introduced which allowed margin and securities lending products on a limited basis. The mechanism, which is still being reviewed, could potentially open a universe of stock worth \$3.2trn to investors and short-sellers, according to industry estimates. Squillacioti says: "That China has implemented a pilot programme for lending is directionally interesting. It is for the domestic market and I would hope that once there is comfort with the framework, consideration will be given to including offshore participants."

As for India, securities lending has been a feature for several years with the Securities and Exchange Board of India (SEBI) allowing the first transaction as early as 1997, via authorised intermediaries. A range of financial instruments was allowed, including cash, bank guarantees, government securities, credit default swaps (CDS) and other registered securities. As in China, the focus of Indian regulators was on the domestic market and the rules were geared

towards reducing the risk of settlement failures rather than developing securities lending as a financial product in its own right. However, over the years SEBI has relaxed regulations allowing short selling and more recently it has increased flexibility in the tenor of the contract and added a facility for borrowers and lenders to make an early recall/repayment of securities.

Jostle for position

Activity is increasing although market participants expect it to be gradual. As a result, the leading markets are expected to continue to jostle for position. Hong Kong upset the pecking order last year, having overtaken Japan as the top Asian market in terms of revenues, according to Duff Gordon of Data Explorers. Hong Kong accounted for 34% of overall Asian lending revenue, which may have only been one per cent higher than Japan's share but the latter country's income has been gradually falling.

Hong Kong also has come a long way since the start of 2008, when it only produced 24% of Asia's income. It benefits from not only having one of the world's most advanced capital markets framework but it also boasts the most prominent listing exchange for Chinese equities. Activity is being driven by demand to borrow outstripping supply, which in turn is leading to higher fees being charged by custodians.

According to Data Explorers fourth-quarter statistics, custodians reaped an average fee of 84 basis points (bps) for Hong Kong equities compared to 56bps for Japan and just ►►

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Francesco Squillaciotti, Asia-Pacific regional business director for State Street's securities finance division. "Increased mergers and acquisition activity is a key driver for the growth of securities lending. This is because the upward growth in those types of corporate events generates demand for stock," he says. Photograph kindly supplied by State Street, January 2011.

2bps for Australian equities. About 61% of the loans were against non-cash and only two per cent of the income was generated from cash re-investment.

Looking ahead, Hong Kong is expected to retain its pole position while activity is expected to remain steady in Japan although supply outstrips demand. Australia, on the other hand, will keep its third place ranking although some participant believe that stringent restrictions on short selling are prompting investors to leave and hampering the securities lending business. By contrast, Hong Kong has been praised for its non-interventionist policies when markets collapsed. As Coxon says: "Regulators in both Hong Kong and Singapore did not introduce any draconian rules after the financial crisis. Their regulation has been consistent and robust and, as a consequence, Hong Kong has been a strong lending market."

Awad at eSecLending explains: "Hong Kong had a robust regulatory framework and made little to no changes. Australia, though, did implement tighter regulations over the past two years, not to curb securities lending but to allow greater transparency into practices. While greater transparency is welcomed, how some of the regulations are being enforced is affecting liquidity in the market."

Rebecca Nordhaus, global head of regulatory strategy for securities lending, Brown Brothers Harriman, adds: "Hong

Regulation will remain one of the stumbling blocks hampering the growth of the industry outside the major markets. "The regulatory environment will be a key factor in driving demand and supply of securities available for lending," states Andrew Cheng, head of securities lending, clients sales management, Asia ex-Japan & Australia, JP Morgan Worldwide Securities Services

Kong regulators had a different response but I think the regulators in Australia were responding to local political pressures. There is certainly pressure for Australia to move in line with the rest of Asia. Indeed, a recent study showed that disclosure rules alone result in a 20% to 25% reduction in equity market short selling, which in turn results in lower trading volumes, wider bid-ask spreads, and greater intraday volatility."

Overall, regulation will remain a dominant subject and one of the stumbling blocks hampering the growth of the industry outside the major markets. As Cheng notes: "I think the way the business develops throughout the region will depend on the particular regulations of a specific market. The regulatory environment will be a key factor in driving demand and supply of securities available for lending. While the global economy will present challenges, there are also many market opportunities for the sector due to the robust nature of the region and its comparative good health when compared with other parts of the world."

Challenge of harmonisation

Squillaciotti says: "In many ways the greatest challenges also present the greatest opportunities. Asia is a big and varied region and there are many moving parts to keep track of. Countries are also at different stages of evolution with regard to their thoughts on lending. As a firm, we have to ensure that we understand the developments and have the right frameworks in place."

Nordhaus also believes that a pan-Asian solution could be in the offing, albeit in the distant future. "Market participants and regulators are focused on harmonisation given the likely development of distinctive regulatory schemes at regional and global levels. However, as we have seen with the European short sale regulations, harmonisation is challenging to execute because of perennial sovereignty concerns, local operational nuances and of course, local political pressures. I am certain harmonisation will be a goal this decade but am not sanguine about prospects for success."

Despite the differences, Squillaciotti believes: "The one thing the region has in common though with other markets is that there has been a greater demand for transparency and risk management products, especially since the financial crisis. Clients want to make sure that there is greater oversight and that they can set parameters around the lending programme in a much more granular way." ■