



# J.P.Morgan



# Northern Trust

## Asia securities lending panel debate

It's been the focus as a growing and vibrant market for years, and Asia has done better than most during the downturn. But what are the issues that remain?

Ben Wilkie, editor



**Giselle Awad**  
eSecLending  
Senior vice president, Asia-Pacific

eSecLending is recognised as a leading global securities lending agent servicing sophisticated institutional investors worldwide.

The company's approach has introduced investment management practices to the securities lending industry, offering beneficial owners an alternative to the custodial lending model.

Its philosophy is focused on providing clients with complete programme customisation, optimal intrinsic returns, high touch client service and comprehensive risk management. Its process is to begin each client's programme with a competitive auction to determine the optimal route to market for different portfolios or asset classes whether it is via agency exclusives or traditional agency lending. This differentiated approach facilitates best execution while delivering greater transparency and control, allowing clients to more effectively monitor and mitigate risks.



**Sunil Daswani**  
Northern Trust  
International head of client relations for securities lending



**Zubair Nizami**  
Northern Trust  
Senior securities lending trader

Northern Trust began lending securities on behalf of its clients in 1981 and was one of the first banks to lend securities internationally in 1988.

Northern Trust aims to provide clients with flexible lending options and an opportunity for optimising returns for loaned securities.

Today, it actively lends in 50 different equity and fixed income markets worldwide and continually reviews and expands into additional markets to help benefit clients, seeking to optimise returns through a customised lending programme in the context of thoughtful risk management.



**James Slater**  
BNY Mellon  
Managing director & chief operating officer

BNY Mellon Asset Servicing offers clients worldwide a broad spectrum of specialised asset servicing capabilities, including custody and fund services, securities lending, performance and analytics, and execution services.

BNY Mellon is a global financial services company focused on helping clients manage and service their financial assets, operating in 36 countries and serving more than 100 markets. BNY Mellon is a leading provider of financial services for institutions, corporations and high-net-worth individuals, providing superior asset management and wealth management, asset servicing, issuer services, clearing services and treasury services through a worldwide client-focused team. It has \$25 trillion in assets under custody and administration and \$1.17 trillion in assets under management, services \$12 trillion in outstanding debt and processes global payments averaging \$1.6 trillion per day.



**Richard Meek**  
Brown Brothers Harriman  
Head of securities lending relationship management, Asia Pacific

With 100 per cent client referenceability, compelling economics, and no collateral impairment, Brown Brothers Harriman has proven that a securities lending programme can deliver outstanding performance and robust risk management. Ranked the no.1 Global Provider in the 2009 and 2010 Global Custodian Securities Lending Surveys, BBH provides customised third party and custodial securities lending solutions to many of the world's most sophisticated global institutional investors.



**Anne M. Sylvester**  
J.P. Morgan  
Head of regional technical sales and client management for financing and markets products

J.P. Morgan Worldwide Securities Services is a premier securities servicing provider that helps institutional investors, alternative asset managers, broker dealers and equity issuers optimise efficiency, mitigate risk and enhance revenue. Worldwide Securities Services leverages the firm's unparalleled scale, leading technology and deep industry expertise to service investments around the world. It has \$15.9 trillion in assets under custody and \$7.1 trillion in assets under administration.

### SLT: How did the Asian securities lending industry fare during the downturn? How would you describe the current state of the industry?

**Andrew Cheng:** Asia has its fair share of challenges during the downturn; however we have

seen that Asia markets rebounded faster than the rest of the regions. For example, from 2009 to 2010; the lendable size of Asian equities increased from \$684 billion to \$813 billion (+19 per cent), whilst during the same period of time, J.P. Morgan's lendable size increased by over 25 per cent. On-loan balance for Asian equities increased from \$87 billion to \$119 billion (+37

per cent), whilst J.P. Morgan experienced an increase in excess of this. In 2011 we are generally optimistic for the Asian markets, especially in Hong Kong and Singapore where we expect more IPO activities, higher dividend being paid and generally higher market value. In a recent survey by Data Explorers over 57 per cent of the participants stated that the percentage con-



J.P.Morgan



Northern Trust

tribution from Asia securities lending to overall lending revenue will be higher than 2010; only 43 per cent think it will stay at 2010 levels and none of the participants expect a lower revenue contribution. We also continue to see increased demand from Asian investors to lend their securities, attracted by the increased alpha that securities lending offers. We have experienced growth from investors starting lending for the first time as well as in our third party business.

## Nizami: We anticipate the China market moving very quickly in terms of developing a securities lending market in line with international standards

**Giselle Awad:** All securities lending markets were affected by the global financial crisis; however the Asian securities lending industry fared better than most. The Asian equity markets are continuing to develop and with this comes an increase in market activity. The increase in corporate actions, particularly IPOs and M&A activity has helped boost returns in the Asian region. This in turn results in proprietary desks and hedge fund's increasing their allocation to the Asian markets.

**Rob Coxon:** Asian markets generally fared well during the downturn with the exception of Australia where a series of restrictions and regulations have depressed the market dramatically from a securities lending standpoint (utilisation down by as much as 72 per cent).

In our experience Asian lenders in the programme similarly made some adjustments to their programmes as was the case in other parts of the world, but we did not see lenders exit the programme entirely. The general sentiment towards the securities lending activity itself seems largely positive in the Asian region.

**Richard Meek:** As a region, Asia fared relatively well during the financial crisis and didn't experience the same level of downturn that we saw in other regions. With Asia's contribution to global securities lending income increasing year on year and many markets either developing or enhancing their securities borrowing and lending infrastructures, the industry outlook for the region is very positive. We are seeing more trading opportunities in Asia than in the US and Europe, and coupled with the capital flows from

West to East, the industry is increasingly focusing on the Asian markets and the revenue generating opportunities resulting from the higher levels of M&A activity and IPOs.

**Zubair Nizami:** The Asian securities lending industry was certainly not immune to the effects of the global financial crisis. As in other markets, on loan balances declined due to a combination of significant hedge fund deleveraging, a reduction in supply as some beneficial owners restricted their lending programmes, and increased market volatility. As an industry, on loan balances in Asia fell by approximately 66 per cent according to various industry sources, from its peak in April 2008 to its low-point of October 2008. Although the Asian securities lending industry has recovered since then, volumes remain down by approximately 50 per cent.

The main markets affected by lower volumes have been Australia and Japan. Here, temporary bans on short selling, as well as the introduction of more stringent regulations, have resulted in additional barriers to investors looking to facilitate various trading strategies. That said, strong demand exists in Taiwan whilst volumes have remained relatively stable in Hong Kong and South Korea.

## SLT: Is it fair to look at Asia as a single region, with many mature markets and an equal number of developing jurisdictions?

**Coxon:** Asian markets can be broadly tiered into the mature markets such as Japan, Hong Kong, Australia and Singapore and the emerging lending markets of Korea and Taiwan. Japan, Hong Kong and Australia currently dominate the region in terms of available supply. Others such as Malaysia, Indonesia and Philippines are peripheral at this point in time. Of course there is always China which in terms of market capitalisation will be very interesting and should ultimately assume a dominant role in Asia.

**Meek:** The evolution of securities lending across Asia has been varied and has effectively resulted in a two tier market structure comprising the robust and well-established markets of Hong Kong, Japan, Australia and Singapore and the more emerging markets such as South Korea, Taiwan, Thailand and the Philippines. Whilst there has been some discussion about the creation of a harmonised pan-Asian securities borrowing and lending marketplace, this is considered to be a long term development and in the meantime the diversity of the existing market infrastructure will continue to contribute to the attractive returns being generated in the region.

**Nizami:** Asia can be assessed as having a relatively equal distribution between "developed" and "developing" securities lending markets.

One of the most vibrant developing markets currently is Taiwan. Here, participation by both offshore and onshore lenders has grown over the past few years as a result of the gradual liberalisation of securities borrowing and lending regulations. As more lenders enter this market, overall liquidity in the Taiwanese SBL market is likely to increase.

We anticipate the China market moving very quickly in terms of developing a securities lending market in line with international standards. We know that conversations have been taking place to this effect for some time now.

**Cheng:** The Asia market is very diverse with different stages of sophistication and depth of securities lending / capital market; each of the jurisdictions may have different regulatory, tax and reporting requirements; the driver for securities lending activities may also differ from one another. We see continued strong demand for Hong Kong, Singapore, Korea and Taiwan, whilst we are actively monitoring developments within China, India and Malaysia as they consider developing SBL model for non-domestic participants

**Awad:** From a time zone and administrative perspective it is easy to view the market as a single region, however there are certainly differences. There is a clear distinction between the developed markets of Hong Kong, Singapore, Japan and Australia compared to the developing markets of India or China, for example. The same can be said about Europe and Eastern Europe or North American and South American markets.

## SLT: Where do you see the biggest growth coming from, both geographically and in terms of instruments traded?

**Meek:** As Asia becomes increasingly relevant to the global economy, our expectation is for growth in all markets across the region - in the more mature markets, improved market conditions will lead to increased stock market prices, more M&A activity and IPOs and in the emerging markets regulatory and operational environments will continue to evolve and mature. As mentioned, Taiwan, Thailand, and South Korea continue to evolve and provide opportunity.

But of particular interest are the developments in India where the Securities and Exchange Board of India (SEBI) continues to relax regulations to encourage increased participation in its securities borrowing and lending programme and in China where the launch last year of a government backed programme to introduce margin and securities lending is seen as the first step to unlocking potentially significant new supply.

**Sunil Daswani:** We see key growth in the region as being on the equity side. Taiwan is probably the stand out growth market and remains a key



J.P.Morgan



Northern Trust

priority for both lenders and borrowers. Volumes have grown over the past few years as a result of relaxed regulations, allowing more lenders to enter the market, both offshore and onshore, which in turn has helped improve liquidity and facilitate various trading strategies.

Significant growth potential exists in Malaysia in the short to medium term, as well as in India and Indonesia in the long term.

**Cheng:** In 2011 the biggest growth in Asia will come from increased corporate activities such as IPOs; we expect Hong Kong and Singapore to have an edge over other markets. From a percentage growth perspective, new markets such as Taiwan should also record good growth in 2011 as more participants enter into the market. We are closely keeping our eyes on developments across India and China – with the significant amount of investment flows into these markets, these markets as they evolve could present significant lending opportunities. Additionally, we continue to see a strong flow of new investors lending securities for the first time and this has fueled much of our growth in the region over the last several years.

**Awad:** Both the increased focus on Asia by hedge funds and a general growth in asset values means returns will continue to gradually increase in Asia. While Asia is expected to see the most growth, the US and Europe will remain the highest in absolute terms.

**Coxon:** Hong Kong has seen steady growth and this market remains one to watch given that it now rivals Japan in terms of overall volume. We have high hopes for Korea going forward and we believe that further regulatory developments in Taiwan will certainly help to release more supply into that market too.

It is clear that the general interest around the economic powerhouses that are India and China have fuelled overall interest in Asia and as the global economic balance of power shifts there is no reason to see this trend reverse in the near term and the growth in Asian equity lending and ETF issuance and lending is likely to continue.

**SLT: The US and Europe are going through huge regulatory upheavals, but we're not seeing the same levels of change in Asia. What are your views on this?**

**Coxon:** Hong Kong is a prime example of a market that thought long and hard about the regulatory regime it wanted to oversee short selling and lending and borrowing. It is now clear that it achieved a good balance between the need for robust reporting without overtly dampens the ability to trade by onerous disclosure requirements or cumbersome on-shore lending arrangements through depositories or CSDs. The

results are clear to see in terms of the growth in the Hong Kong market combined with minimal post-2008 adjustments to the regulatory regime. Compare and contrast this with what has happened in Australia and the European markets and the USA where an interminable debate rages with no logical, useful outcome in sight. This has been detrimental to market evolution and recovery.

I'm concerned that many of the new regulations on short selling in Europe will affect market liquidity and its efficiency, whereas Asia has not over reacted and therefore, should not suffer from issues such as asset bubbles.

**Meek:** Whilst regulators in Asia will closely monitor regulatory developments in the US and Europe, the existing regulatory regimes in Asia are viewed as being sufficiently robust to ensure transparency and client protection. At the same time, the existing regimes have been supportive of the established securities borrowing and lending business and the benefits it brings to the capital markets, especially in emerging economies.

**Coxon: Hong Kong is a prime example of a market that thought long and hard about the regulatory regime it wanted to oversee short selling and lending and borrowing**

**Daswani:** This reflects largely positively on Asia as a market. Lawmakers and regulators in Asia were compelled to restructure their procedures and implement robust regulatory frameworks in the wake of the Asian Financial Crisis of 1998 and, as such, were well prepared for the 2008 crisis and the ensuing market volatility. That said Asia has not been completely immune to regulatory changes, as some jurisdictions have introduced various changes to tighten-up their frameworks.

**Cheng:** Many Asian markets made significant changes to securities lending regulation during the Asian financial crisis in 1997/1998; much of the regulation still stands and is adequate for current market conditions. That being said, many participants in the Asian markets are the large international names and so many of the best practices operated elsewhere are also operated and leveraged across the Asian region. So for example, the ability to customise the lending programme, support separately managed

cash re-investment accounts, provide detailed reporting to aid transparency, all supported by an indemnity backed by a large and stable capital base are essential requirements sought by Asian investors wishing to lend securities

**Awad:** Asia is seeing less regulatory change as the securities lending markets were established later and therefore already had robust regulatory frameworks in place that addressed securities lending practices in the modern marketplace. In addition, a lot of the markets are in various stages of development and therefore the regulations are being created as the market opens, compared to after the fact.

**SLT: As in most other markets, short selling is a major issue. How do you feel regulators in Asia have dealt with short selling?**

**Nizami:** Asia was not completely immune to the introduction of bans on short selling. Australia imposed a temporary suspension, which was completed lifted on all stocks in May 2009 whilst in South Korea an indefinite ban remains in place on the short selling of financial securities. However, some jurisdictions have particularly strong regulatory frameworks in place, such as Hong Kong and Japan. Indeed, Hong Kong's robust short selling mechanism has long been in place and, to its credit, the strength of this framework meant that the Securities and Futures Commission (SFC) did not feel the need to intervene by changing its existing regulations. That said, tighter regulations for short selling have been imposed in Australia and in Singapore, where these exchanges revised their buy-in rules in order to clamp down on any potential market abuse for failed trades.

Additionally, the Australian and Japanese regulators have made additional disclosure of short positions compulsory and sometime in 2011, it is expected that the SFC will announce some additional reporting requirements with regard to short positions.

**Cheng:** As with the question above, many markets (Hong Kong, Singapore and Japan) already have procedures in place to deal with short selling and only require minimal amendment to deal with current situation. We feel that these markets have implemented sensible rules, which have struck a good balance so as to allow lending to continue, which brings significant liquidity to the markets. In Australia, which has implemented more stringent requirements, we have seen volumes and liquidity be negatively impacted.

**Awad:** As with the other regions in Asia, the biggest focus is on naked short selling, not the curbing or banning of short selling all together.

**Coxon:** Even before the credit crisis the Asian



J.P.Morgan



Northern Trust

markets, with the exception of Australia, were sensitive to the impact of short selling and unlike Europe already had robust and workable regulations in place. As mentioned above, Hong Kong is a good example of a market that did not introduce knee jerk regulations.

**Meek:** While Australia tightened regulations, there is general consensus that short selling regulations in the majority of the region were sufficiently robust both in the pre and post financial crisis periods and required little to no revision. As a result markets, such as Hong Kong, have prospered from this consistent approach and we may see Australia receive more pressure to align its rules with the rest of the region.

### SLT: How has the focus on risk management changed the industry?

**Cheng:** Risk management is at the forefront of all lenders' and all participants' minds. The ability to be able to customise each lending programme to the specific needs of each lender is paramount within the industry, and this is true across Asia as it elsewhere. Lenders now demand greater transparency and flexibility across their programme; part if not all of the securities lending function has moved to the front office; more focus on balance sheet strength and risk management culture of the lending agent and last but not least, all lenders are demanding separate cash collateral reinvestment accounts.

**Awad:** As participants develop a deeper understanding of the industry, they are increasingly recognising that securities lending programmes should be treated with the same level of due diligence as any other investment decision. Participants are also realising that they should have a comprehensive understanding of the risks and rewards inherent in their programmes and feel confident about proper oversight and controls. Subsequently, they have been looking at ways to structure their programmes including the review of alternative providers and routes to market in recognition of the industry's changing landscape.

Many are looking for greater transparency, control and customised solutions built around their unique parameters and goals. Increasingly, they are viewing securities lending as an integral part of the investment management process in generating alpha, with a strong risk management focus, rather than an operational service tied to custody which was the historical norm.

**Coxon:** The demand for further transparency and risk management is fuelling a procession of consultation papers and debate as to how markets should be regulated. This has caused firms to divert resource to legal risk management and compliance resource to be in a state of preparedness for upcoming changes in regulatory regimes. Securities lending businesses have

been similarly affected as borrowers, lenders and intermediaries such as prime brokers and custodians will all be affected.

While the uncertainty prevails firms will continue to focus on trying to predict the future and or review what they do now to try and future-proof their business model and while this environment prevails, recovery will be hampered.

**Meek:** In line with their global counterparts, post financial crisis, beneficial owners in Asia conducted a thorough review of their securities lending programmes and as such now have a greater understanding of the risks associated with securities lending. Beneficial owners are correctly demanding specific and customised collateral and programme parameters, and as a result some less flexible securities lending providers have been pressured to become more nimble. An approach BBH has embraced since the inception of our programme, beneficial owners in general are now increasingly viewing securities lending as an investment management activity with a risk profile which needs to be appropriately managed. Securities lending agents are now selected on their merits as agents, rather than because of custodial or other relationships.

**Daswani:** Clearly, the market events of 2007 and 2008 led to a restructuring of parts of the industry. Initially, beneficial owners focused their attention on analysing their lending programmes and scrutinising the risks associated with lending. For some, these reviews resulted in steps being taken to reduce risk, while others chose to suspend their participation.

One of the key areas where some beneficial owners sought to reduce risk was in the reviewing of investment guidelines with respect to the reinvestment of cash collateral. As a result, the use of tighter investment parameters to reduce credit and duration risk, coupled with the low interest rate environment, reduced the yield on cash reinvestment funds. These changes led to a renewed focus on the profitability of lending, thus impacting on some lenders' willingness to participate in trades of low intrinsic value. Accordingly, many beneficial owners are now transforming their programmes to focus on maximising their returns within their risk profile.

It is our experience that borrowers, and particularly hedge funds, are now looking to the future in terms of evolving their trading strategies and risk appetite, following a period of de-leveraging and minimising balance sheet exposure.

Securities lending is an evolving business which we expect to continuously develop forward as the economic environment improves and participants' appetite for risk continues to return. We see that a wider understanding of risk now exists within the beneficial owner community, and that we have emerged as a stronger industry as a result.

### SLT: Which non-traditional SBL routes to market (ADRs, GDRs, ETFs etc) are going to prove most successful?

**Daswani:** ETFs probably carry strong growth potential in the long term. ADRs and GDRs have been traded for some time and represent a relatively mature market for securities lending activity. ETFs on the other hand are still a relatively new product, especially in Asia.

From a demand perspective, ETFs are very popular as they provide ease of exposure to a market or sector without the investor needing to borrow a broad based index or portfolio. In the US, many of the larger ETFs offer high levels of liquidity, and a good depth of lendable supply exists. Borrower demand for ETFs in Europe is also growing, but this market is less mature with fewer offerings.

### Daswani: One of the key areas where some beneficial owners sought to reduce risk was in the reviewing of investment guidelines with respect to the reinvestment of cash collateral

In contrast to these markets, Asia has more limited lendable supply. However, strong demand for ETFs has emerged more recently, due in part to their ability to provide investors with exposure to restricted markets such as China.

**Cheng:** Lending activity and demand to borrow ETFs continues to grow. The borrowing of these securities offers the borrower an efficient means to hedge risk given the also exact correlation with the underlying. We see the demand for ETFs continue to rise over the next several years.

**Coxon:** ADRs ETFs and GDRs are not so much routes to market, but are asset classes that are traded like any other. Clearly ETFs seem to be in the ascendancy at the moment and we see this trend continuing. This is down to their popularity with investors driven by their ability to offer both long and short exposure to a diverse range of asset classes and geography in one instrument. This is reflected in the steady increase in supply and balances outstanding, especially in the Asian ETF category. **SLT**