Set up and thrive

Trading in Asia requires excellent navigational skills, says Northern Trust's Sunil Daswani. Mark Dugdale reports

How would you describe securities lending activity in Asia today?

Investment growth within the hedge fund industry continues to gather momentum in Asia, largely driven by institutional investors seeking higher returns to offset suppressed fixed income yields in the current environment. However, not all of this growth has necessarily translated into increased securities borrowing and lending activity in Asia, largely a function of the nature of underlying strategies.

Long/short funds have remained the most successful strategies to date, and while historically they have tended to drive volumes, the majority of these funds maintained a net long bias as markets continued to rally throughout 2014, most notably Japan. Volumes have therefore remained largely flat, although there have been some noticeable shifts in focus within the region, making way for a more optimistic 2015.

Changes in demand from Hong Kong securities and into Japanese securities were most noticeable. As the 'consensus short' to a slowing Chinese economy dissipated, hedge funds were welcomed by the inception of Abenomics, which made way for growth in exposure to Japan, albeit with a long bias. Following a significant market rally, the perception now is that Japan is more conducive for fundamentals-based stock picking strategies, rather than high beta exposure, which should benefit lending activity in 2015.

There are also expectations for increased corporate deal activity, which has already been evident in more frequent capital raisings. Beyond Japan, demand has continued to gravitate towards the emerging market space in Asia, most prevalently in Taiwan, which remains the most attractive market from a potential revenue stream perspective. Notably, however, regulators in South Korea lifted the covered short sale ban on financial securities in late 2013, having imposed this in the wake of the financial crisis. While this did not stimulate demand in the short term, sentiments are for this to benefit securities lending in the long term, as it allows funds to deploy their strategies more effectively.

Are there any upcoming regulatory changes that may affect the securities lending environment?

Although the extent to which pending global regulation will affect the securities lending business remains uncertain, the industry is positioned in anticipation of imminent changes, the effects of which are already evident in Asia.

From a borrower perspective and specifically within the context of Basel III effective 2015, the most noticeable change has manifested within the collateral space, as equity finance desks have increasingly been leveraged as the vehicle to drive balance sheet optimisation in an effort to reduce funding costs and minimise capital charges.

In practical terms, not only has this demanded increased flexibility from lenders in the types of collateral accepted, it has also driven a change in the nature of trading, such as the growth of 'evergreen', or termed structures, to facilitate financing requirements. Lenders have therefore been tasked with ensuring their capabilities are well positioned to secure both existing and future growth, given that higher utilisation rates are generally afforded to those with greater flexibility.

Collateral flexibility also enhances borrower relationships by allowing them to swap collateral preferences as and when their funding requirements dictate.

How did you revamp your securities lending programme in response to the change in the market environment?

Northern Trust's main focus has been in product development. In addition to new reporting tools, we continue to expand our capabilities. These include a broader set of collateral being accepted when lending securities and increasing our counterparty list that we lend to so as to capture pockets of demand that are more strategic in nature. However, mainly in the Asia Pacific, expanding the number of markets we lend in has been both key for borrowers and beneficial owners, because it provides incremental revenue to them for lending their securities.

Of the markets that are operational, Taiwan continues to offer the most attractive returns for clients on a relative basis, although spreads have recently been eroded for two reasons. Firstly, Taiwan's supply curve continues to mature as agent lenders pursue the launch of new clients into the market, thus diluting overall fees. Secondly, restrictive short sale quota rules have constrained the ability for hedge funds to deploy selected strategies in scale, largely relative value-type funds.

The Indonesian Clearing and Guarantee Corp is making strides in developing a viable platform. It hopes to be able to launch next year. Borrower demand is indicatively robust and should be a lot deeper than other less developed markets, largely because Indonesia offers greater liquidity to hedge funds, allowing them to better deploy strategies effectively.

What sort of market factors should we look at to detect the next trend in borrower demand?

Undoubtedly, equities remain the dominant asset class from a securities lending perspective in Asia, and this is likely to remain the case for some time to come. However, demand for fixed income securities is growing and is likely to gather momentum as global regulation begins to materialise. Basel III is driving borrowers to optimise their balance sheets and pursue the collateral transformation ethos, which is encouraging increased demand for fixed income financing transactions out of the region. While activity remains modest in its current form, this is likely to gather prominence over the next few years ahead of Basel's implementation.

Demand for regional fixed income coverage is also being driven by increased Asia-based hedge fund flows, which require trade execution during local hours rather than via London at a later time.

What are Northern Trust's capabilities in collateral management?

There is no doubt that securities lending provides the type of framework that will help locate and

provide eligible collateral. Securities lenders will therefore continue to be a central part of the process as they facilitate the collateral supply and find new sources of eligible assets to support the potential collateral shortfall.

They will also be able to continue to increase returns generated by lending high quality liquid assets. This will be particularly true when the assets' lending value increases due to the collateral shortfall being big enough to force up the gross margin received from these types of lending trades.

Understanding where the loaned asset resides and having sight of it at all times will be essential, especially outside of the custody network and at the global clearing member or the central clearinghouse. Securities lenders will therefore need to be able to offer downsteam asset segregation all the way to, and including the central clearinghouse, as part of the loan deal.

They will also be required to recall and substitute assets intra-day and ensure the process is 100 percent settlement failure-free, so they can

guarantee access to their own highly liquid and high quality assets when they need them most.

At Northern Trust, we recognise the need to provide further flexibility to support clients globally to meet the differing appetite of asset owners for securities lending in a centrally cleared environment, and so have launched a suite of collateral and liquidity solutions that build on our existing collateral management capabilities.

The structure gives asset owners increased security and transparency, enabling them to lend assets for use in the clearing lifecycle with confidence that those assets are retained within their incumbent custodian and agent lender. This could drive asset owners to gain approval from investment committees to re-approach lending of assets.

What challenges does the industry face going forward?

Challenges include the lack of regulatory harmony across regional jurisdictions, specifically the impact of settlement rules on securities lending. While operating an 'offshore' lending business is relatively uncomplicated in markets such as Hong Kong, there are unique challenges in markets where regulation remains complex, such as Taiwan. Typically, this may require lenders to involve clients in more unconventional ways, such as pre-trade notification, for example, which ultimately constrains the pace of growth in supply from securities lending within that market.

However, these challenges do positively present revenue opportunities for those lenders and their agents such as Northern Trust, which are able to successfully navigate existing rules and achieve first mover advantage, allowing their clients to capitalise on higher spreads.

Importantly though, it is essential for lenders to adopt comprehensive risk management policies in such markets, to allow for the maximisation of returns balanced with the mitigation of settlement risk. **SLT**

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Sunil Daswani, international head of client relations, Northern Trust