GLOBAL INVESTOR ISF

Securities Finance Asia Pacific Guide 2017

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Contents

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Global Investor Incorporating ISF (USPS No 001-182) is a full service business website and e-news facility with supplementary printed magazines, published by Euromoney Institutional Investor PLC.

Annual subscription rate
US$1400 £825 (UK only) €965
ISSN 0951-3604

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Printed by Buxton Press

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Exciting times

Rakesh Patel, Asia Head of Equities, HSBC, says that securities lending activity is set for a strong year as hedge funds gain the opportunity to exploit less correlated markets

This year is already shaping up to be a much more interesting year for securities finance than 2016. Last year was characterised by events that caught many people by surprise – not least the US election result and that of the UK referendum on European Union membership – and led investment firms to become risk averse, as demonstrated by a significant drop in market volumes.

Already in 2017 clients tell us they see more opportunity in the market and that they observe a more bullish trend and more dispersion. Investors feel it is a market more suited to active management and alpha generation, which should encourage much more activity in terms of volume and conviction. We expect hedge funds will feel the need to take on more and bigger positions, both short and long, on stocks and sectors. I think we will see this take place in different countries, sectors and stocks right across Asia.

> "We expect hedge funds will feel the need to take on more and bigger positions, both short and long, on stocks and sectors"

Certain segments of our client base are looking forward to more active management versus passive management this year. Increased volatility, volume and engagement with clients is generally good for sell-side securities finance providers.

Hedge funds

Algorithm-based, or quant-type strategies, did very well last year and are still garnering perhaps the most interest from investors. However, while long-short strategies had a challenging time – in correlated markets they do not pay out – in 2017 with more dispersion they could do better.

There is also definitely a bifurcation within the industry in terms of size. The big hedge funds, the brand names, will continue to get bigger. But at the niche end there are quite a few start-ups coming through well. The middle ground can be more problematic.

Generally, there is a huge demand among hedge funds for efficiency of execution. Clients want really easy end-to-end execution, proper electronic STMA platforms in place offering both execution and the synthetic wrapper around it. Firms will continue to invest to get them to the appropriate level.

Beneficial owners

Asset owners globally are still definitely searching for yield and Asia Pacific is no exception. Rates are very unlikely to rise very far or quickly. They are often looking for a relatively high yield product with relatively low risk – and that is where securities lending comes into play.

There continues to be strong demand for liquidity. There is a general shortage of dollar financing so there is a demand for liquidity, stable funding and financing solutions. The search for yield, the need for liquidity and the push for optimisation are all good for the industry. As a bank we offer multiple types of financing solutions – we seek to be a partner of choice using the strength of our balance sheet across multiple currencies.

> "Asset owners are often looking for a relatively high yield product with relatively low risk – and that is where securities lending comes into play"

The key regulatory considerations are NSFR and LCR, which have been and will keep driving changes in the securities financing activity. LCR is being implemented with a full enforcement in 2019, while NSFR could be introduced as soon as 2018 in Hong Kong. We are already talking to clients about optimisation and longer-term financing solutions. It is a trend that will not go away.

Looking ahead

China is the most interesting market in Asia Pacific, with the tantalising prospect of it opening up over the next few years. The Shanghai and Shenzhen Connect programmes have been very positive moves and inclusion in MSCI Emerging Markets will happen at some point. Its continuous progress is a trend the whole market will watch closely.

At the moment foreign banks are only involved in the Chinese lending market via minority interests in joint venture companies – no licenses have been given to international banks for stock lending.

HSBC has agreed to establish a securities joint venture onshore in China, which would make us the first foreign bank to have majority ownership of a Chinese securities joint venture (JV). We are waiting for regulatory approval for the JV, which we believe has great potential for our clients globally and in China.

Client demand

HSBC launched prime brokerage in Asia Pacific and globally six years ago. From talking to clients recently I am in no doubt that there is a trend for them to want fewer and fewer counterparties, given the risk of having lots of relationships across the street. We are benefiting from that – being a prime broker with a strong balance sheet, that can help clients with multiple financing solutions, and is double-A rated puts us in really good shape with hedge funds.

Collateral challenge

Paul Golden considers the factors influencing collateral management and why providers are confident that demand for their services in Asia Pacific has considerable potential for growth

The Basel III liquidity coverage ratio, initial margin segregation for OTC derivatives reform and mandatory clearing are just some of the factors driving demand for collateral management in Asia Pacific. As a consequence, firms have to look at their liquidity profiles and some may need to leverage repo/financing markets to raise cash or obtain eligible assets to cover margin. In turn, these financing trades would typically require margining, compounding pressure on the same operational resources. This is not a region-specific issue – Asia Pacific regulators are typically looking to stay in line with global standards.

"Firms now transfer the cost of collateral via credit valuation and funding valuation adjustments, which has led to increased scrutiny of these costs," says Nasser Khodri, group managing director Asia Pacific institutional & wholesale at FIS. "To bring down these costs, they require sophisticated collateral optimisation systems."

Nicolas Faust, collateral and valuation services product specialist for Asia Pacific at BNP Paribas, stresses the importance of efficient and scalable platforms, processes and services that can handle higher volumes triggered by systematic margining.

Many local banks are busy deploying collateral optimisation systems in order to centralise and price collateral and at the same time equip themselves with support capability for tri-party repos and allowing third-party agents to provide initial margin segregation support, observes Davin Cheung, Clearstream's regional manager for North Asia, global securities financing.

"I think this trend will continue for years to come and will affect firm-wide capital and liquidity management, CCP and OTC margining and matching sell side-and buy-side needs depending on whether the entity is a bank, broker-dealer or buy-side asset management or insurance firm," he says.

Khodri identifies Singapore, Hong Kong, Australia and Japan as the most dynamic markets in the region. "Singapore has been in the lead so far in terms of next generation collateral solutions, while Japan has been working to adapt its older back-office technology and Australia cannot decide where collateral fits into its business model. Collateral optimisation systems have been scarcely adopted in Asia, so there is certainly plenty of scope for increased adoption over the next few years."

Northern Trust's head of derivatives & collateral management EMEA, John Southgate, says that collateral optimisation is rapidly becoming a core component of any collateral management service, although the emergence of new solutions does not mask the fact that this is still a relatively immature service.

Many regulations have not yet taken effect in Asia Pacific, which means the true economic impact of new collateral management requirements has not been felt, adds Stephen Bruel, global head of the derivatives and collateral management product groups for BBH.

"This will change over time as more regulations take effect and the cost of collateral will certainly increase as a result," he says. "For example, inefficient use of collateral will start to impact portfolio performance and that will drive an increase in optimisation. Many firms won't have a choice – it will be vital to use an optimisation tool to efficiently allocate collateral, as will optimising internal operations to ensure effective management of middle and back office implications."

Centralising collateral

At this stage priority is generally given to repapering and, with an even greater focus, settling variation margin calls in cash, adds Faust. "Only once this initial phase is implemented will there be interest in optimisation by using securities. We also see large asset owners centralising collateral management, including assets managed by third-party investment managers, in order to use asset classes that provide eligible collateral and leave the other asset classes fully invested."

Rather than concentrating on differences between national markets, Faust identifies different motivations for different client segments. For example, insurance companies of large banking groups may not be equipped with the required level of automation and face regulatory limitations in being able to leverage their group's capability, for example with regards to initial margin.

"The situation is similar for smaller banks, while large asset managers with significant OTC volumes – in additional to scalable processes – are usually keen to free up their front office resources for their core purpose of investment decision-making," he continues. "Smaller investment managers do not always have the expertise and resources to face the implementation of such a complex process alone."

In addition to a straightforward cost-benefit analysis, firms need to understand the changes still to come and decide if they are able to develop a roadmap that allows them to stay ahead.

Bruel suggests the collateral industry is ripe for more significant changes that will require technology investments and maintenance, operating model redesigns, improved data governance and increased interaction between the front and middle offices. "Most asset managers see portfolio management, not the increasingly complex discipline of collateral management, as their core competency and expertise."

The strength of Hong Kong in this area may seem counterintuitive given its financial history of relying on equity products versus fixed income derivatives, but the growth of offshore RMB deposits has driven swaps trading along with FX, lending and borrowing and structured products, says Finadium managing principal, Josh Galper.

In a recent survey Finadium conducted with 13 major regional banks, it found that 62% had a collateral optimisation platform in place, 23% were working on one and 15% had no plans. "The first group included the international banks with a strong presence in the region – no local bank had a platform or was ready to launch one," says Galper. "Regional Asian banks tend to partner with technology vendors in collateral as a preferred alternative to building their own platforms, which means that technology vendors should be primed for expansion."

"Collateral optimisation systems have been scarcely adopted in Asia, so there is certainly plenty of scope for increased adoption over the next few years"

Nasser Khodri, FIS

The Finadium survey also asked banks about the collateral types they preferred to accept, including bonds by government issuers. "Every respondent accepted government bonds by their country of residence and most were willing to accept Japanese and Australian government bonds as well," says Galper. "Banks were quick to point out the hypothetical nature of some of this acceptance, however – neither they nor their clients were asking to post or accept anything other than bonds of the national government or government-sponsored agencies."

In terms of trends for acceptable collateral, Cheung says there is an increasing acceptance of equity indices and names, albeit with a higher haircut than for government bonds. Khodri notes that participants are slowly moving towards delivering securities instead of cash to improve their Basel III ratios.

Bruel observes that although regulations allow for a relatively wide range of collateral, cash is still king in Asia. Firms that don't hold enough cash, perhaps because they don't want to hold a cash buffer, will want to use securities. However, as new credit support annexes are negotiated they may find counterparties won't accept collateralisation with securities.

Increasing levels of regulation-induced collateralisation is leading to the standardisation of the types of collateral to cover margin. "What we are seeing as a result of the uncleared margin rules is the sell side further tightening the types of assets they are willing to accept and even pushing for only cash to be accepted, which is compounding the liquidity pressures clients are facing," adds Southgate.

Outsourcing dilemma

One of the decisions facing firms in Asia Pacific is whether to handle collateral management internally or to outsource. According to Khodri, the size of the business in terms of the number of collateral agreements seems to be the most influential factor in this decision.

"The primary problem with outsourcing is that the providers of this service are large banks and servicing of smaller customers is not their strength," he adds. "In a market stress situation people will ask whether their provider will even pick up the phone. By insourcing you remove the wall between your business and the technology required to service your needs."

New demands on collateral are driving the trend to outsource, according to Southgate, who says firms of all sizes are looking to outsource to a scalable, robust solution. As well as requiring skilled staff to manage collateral, the infrastructure requirements are also driving significant costs for firms looking to support this function in-house.

Northern Trust's Southgate notes that tri-party agents, typically via a custodian, offer the buy side access to new pools of liquidity, such as corporates looking to put cash to work for returns higher than bank deposit rates.

"The tri-party structure supports greater efficiency and security of assets, as collateral is moved around within that agent's environment, as opposed to market settlements taking place," adds Southgate. "Some of the benefits here are favourable cut-off times, simplified collateral substitutions and greater transparency around collateral utilisation. We are working with a number of tri-party agents to ensure we can offer our clients access alongside their bilateral margin processes."

Cheung notes that tri-party agents offer holistic solutions for both liquidity and collateral management functions, including collateral eligibility checks and allocations, marking-to-market and auto-margin calls, collateral substitutions and counterparty introductions. "In our case we even provide simplified master tri-party repo documentation that clients sign once for all counterparties, thereby relieving them of the need to negotiate global master repurchase agreements bilaterally."

Yet, according to Khodri, these agents are expanding into other services and reducing their focus on this service offering as it is not a profit driver. "There is demand but supply is too concentrated," he suggests.

"We see large asset owners centralising collateral management in order to use asset classes that provide eligible collateral and leave the other asset classes fully invested"

Nicolas Faust, BNP Paribas

Technological demands

To comply with the regulations that have come into effect over the last few years, firms will need to support higher volumes of agreements and regulatory reports, additional business processes, shorter settlement cycles as well as sourcing more collateral assets and adopting new market standards. Fortunately, technology solutions are available to help them meet these requirements.

Technology is absolutely instrumental, says Faust. "Collateral management platforms need to be able to handle complexity, complete the process within a short timeframe and have the interconnectivity with other platforms to offer scalability."

He notes that complexity stems from the large scope of OTC instruments and the management of dual credit support annexes (CSAs), among other factors, and the timeframe is tight given the need for transaction capture, valuation, calculation of exposure and margins as per the CSAs.

According to Bruel, the only way to minimise the impact of new regulations is to maximise the use of technology. "For example, given the expected increase in collateral call volumes, firms need to embed automation throughout the collateral lifecycle," he concludes. "Methodologies to optimise collateral also require technology – not only related to selection algorithms, but also for data management, reporting and substitution management."

Super smart

Australian superannuation funds are using their scale and knowledge to create increasingly tailored securities lending programmes, reports *David Rowley*

Custodians and consultants report substantial growth in the number of participants in securities lending in Australia, rebounding substantially from a post-2008 slump, and renewed confidence in the market. Bad experiences with agent lenders and collateral – and correspondingly bad headlines – led many funds to stop lending assets. It was also the impetus for a wave of regulation in 2013 that requires super funds to be able to show the Australian Prudential Regulatory Authority (APRA) how their portfolios would manage under a number of market stress scenarios.

In particular, APRA requires funds' auditors to review and test their systems, procedures and internal controls to ensure reliable information on securities lending can be reported. The auditor is then required on an annual basis to form an opinion on the reliability and accuracy of information provided. The fund's trustees, who may or may not be comfortable with the technicalities of such deals, are ultimately accountable and potentially subject to fines and public discredit.

As a consequence of the reform, funds have put in stricter lending limits, greater monitoring and are more particular about collateral before re-entering the market. It has been a blessing in disguise, resulting in renewed comfort in the practice.

Janice Sengupta, a partner at Aon Hewitt, recalls that when the crisis hit its AU$3bn superannuation fund was unable to exit the programme. "We patiently, slowly unwound positions. It took a couple of years," says Sengupta. "Some of us are far more probing about what goes on behind the scenes with securities lending now than in the past."

The search for yield

Custodians largely attribute the rise in participation to the desire of superannuation funds to find extra return in a low-yield environment. One fund commented that its lending activity "pays bills". One of the bills it notionally settles is the funding of large middle office teams to cope with the increased reporting requirements brought in by APRA.

The size of these middle office teams can range from 10 to 30 strong and are usually staffed

by ex-personnel of investment and custodian banks, as in the case of Peter Curtis, head of investment operations of AU$100bn AustralianSuper, who used to work as head of product at domestic custodian National Australia Bank.

The skillsets in some of the larger super fund middle offices have grown so sophisticated and confident that some will now initiate securities lending themselves. Natalie Floate, head of ALMT, FX and agency lending, Asia Pacific at BNP Paribas, says that some clients may agree some trades directly with brokers, but still want to leverage BNP's infrastructure for loan servicing such as settlement, marking to market and income/event protection.

Another new dimension in securities lending is the market information it gives to funds that carry out internal management. Dharmendra Dayabhai, head of portfolio analysis and implementation at AU$58bn fund UniSuper, says intelligence from lending informs the fund's biggest active positions in equities: "We could be holding a stock internally that we were very positive on – so it gives us insight to the short interest in a particular security."

Giselle Awad, director, head of investor services sales – Australia and New Zealand at Deutsche Bank, is seeing the same trend: "Securities lending is no longer viewed as an operational service tied to custody but rather increasingly seen as a flexible investment tool that plays a role in strategic portfolio management."

> "Securities lending is… increasingly seen as a flexible investment tool that plays a role in strategic portfolio management"
>
> *Giselle Awad, Deutsche Bank*

Heads of the large super funds take a more relaxed view of securities lending that is at odds with how it is depicted in the national press, which commonly characterises it a having a potential destabilising impact on companies and causes losses to shareholders.

For this reason, many super funds still feel the need to publish statements such as the following on their websites: "AustralianSuper believes that, over time, market values of shares return to a price based on profit (that is, dividend) achieved, which levels out any effect of short or long-selling activity."

Such public justifications are necessary as most super funds are open for any employee that wishes to jump ship to a better performing fund. They face a great deal of public scrutiny and a high level of transparency is demanded. Partly for such reasons, Cbus, the construction workers super fund, and UniSuper, the university employee fund, both emphasise that securities lending never gets in the way of voting. Indeed, both funds routinely recall shares for this purpose.

However, it is notable in this context that Australia's largest single fund, the AU$127bn Future Fund, which contains assets designed to back public service pension promises and reports directly to the national government in Canberra, does not carry out securities lending.

Drew Vaughan, principal at Dymond, Foulds & Vaughan, calculates that such funds tend to earn 1-2 bps on their security lending activities, a figure which might be higher were it not for the proportions of illiquid assets typically in the region of 25-30% at many funds.

Vaughan, who acts as a consultant and tender manager for custodian appointments on behalf of many superannuation funds, says that for participants to hold externally-managed segregated securities lending mandates they require AuM scale of AU$5bn+.

He says super funds are asking for shorter lending duration cycles, tighter counterparty credit and contractual limits and higher shares of total revenues from collateral.

Collateral demands

The change in collateralisation is the greatest area of change since 2008, according to BNP Paribas' Floate, noting that before the crisis 80% of loans were collateralised with cash but today this figure is around 50%. For some clients BNP Paribas works exclusively on a non-cash collateral basis – typically taking bonds as collateral – which removes the need to monitor reinvestment risk.

Super funds are typically conservative regarding collateral. UniSuper, for example, asks for cash, or securities with a "huge margin" says Dayabhai. "If it is securities, it needs to be top 20-30 [stocks] where there is a lot of liquidity," he says. UniSuper is also conservative in that it does not lend equities that sit outside the ASX200 and sets a limit the amount of assets that can be lent out at any one time, although this is not approached by the 10-15% of the portfolio that is on average out on loan.

> "Some of us are far more probing about what goes on behind the scenes with securities lending now than in the past"
>
> *Janice Sengupta, Aon Hewitt*

Stewart Cowan, head of securities lending, Asia Pacific at JPMorgan, says collateral flexibility is a key factor in enhancing returns – the more collateral options on offer the greater the chance of securing a loan at the best price.

Giselle Awad, director, head of investor services sales – Australia and New Zealand at Deutsche Bank, says that while accepted collateral generally includes high quality bonds she has also seen an increased acceptance of equities, with higher haircuts compensating for the higher price volatility of the liquid asset class.

Global regulatory reform around derivatives and other OTC products has also led to increased margin requirements as well as more conditionality around collateral quality from participants. This has increased the cost of high quality liquid assets (HQLA) and the returns for lenders.

"Investors holding HQLA are able to realise an incremental return on these assets as the intrinsic value in the securities lending and repo markets increases," says Awad.

In terms of demand and supply, Floate is seeing strong returns globally for high quality government fixed income that qualify as HQLA assets, particularly against non-cash collateral. For equities lending she is seeing continued strong demand for US, Hong Kong, Japanese, South Korean and Taiwanese equities held by Australian investors.

Growing pains

Despite volatile returns over the last 12 months most observers expect Asian hedge funds to perform well and attract new capital in 2017, despite strong competition from private equity. *Paul Golden* reports

HFR's November 2016 Asian markets hedge fund industry report found that total capital invested in Asian hedge funds increased to $111.8bn in the third quarter of last year, recovering the decline from the previous three months but remaining below the record high of $119.8bn reached in 2014.

Chinese hedge funds posted strong gains as the Shanghai Composite Index pared 2016 losses and the renminbi stabilised, while hedge funds focused on investing in Japan also produced positive returns as the yen posted intra-quarter gains against the US dollar and year-to-date losses on the Nikkei 225 were pulled back.

Asian hedge funds navigated intense regional equity and currency market volatility in 2016. With the macroeconomic and political overhang of both the US election and Brexit now removed, and as global M&A activity continues to accelerate, HFR president Ken Heinz expects specialised Asian hedge fund strategies to attract global and institutional investors in 2017.

"Interest in quantitative hedge funds in Asia has continued to expand, but they have been popular with Asian investors for some time and while Asian equity markets clearly declined in early 2016, there is no evidence of a causal relationship," he says.

Quantitative strategies

According to Eurekahedge analyst Mohammad Hassan, this trend is a reflection of quantitative strategies being able to identify, process and step into potentially lucrative trades ahead of the crowd. "Systematic strategies with exposure to commodity futures have the added benefit of low correlations to traditional equity market focused strategies. While there has been gravitation towards quant strategies globally, there is a real worry that perhaps there are too many copycat strategies out there crowding out trades."

Growing interest in quantitative hedge funds in Asia is perhaps an indication of a potential long-term trend towards computer-driven strategies. Peter Douglas, Singapore-based principal of the Chartered Alternative Investment Analyst (CAIA) Association suggests that it is more about the

rapid development of super-fast computing power, the development of tools to extract information from big data and the potential of machine learning.

"Any successful alpha strategy must, by definition, be doing something different from the mainstream and what we are seeing is a race to stay ahead of the technological curve," he says. "It should also be noted that any computer-driven strategy is only as good as the minds that conceived and built it. The industry still needs the smarts to make this work."

Philippe Ferreira, senior cross asset strategist at Lyxor Asset Management, says growing interest in quantitative hedge funds in Asia reflects a rebalancing between discretionary and systematic strategies. "Systematic strategies are attractive for portfolio diversification purposes, yet some long/short equity managers have faced more difficulties in reducing risk and protecting capital recently. Hence part of that growing interest in quantitative hedge funds in Asia is related to diversification purposes and the ability of quantitative strategies to have lower correlation to traditional markets. Disappointing equity returns have also played a role, though."

Foresee Global Asset Management (HK) partner and CEO, Tom Weiye Tang, says this has remained a theme. "Disappointing equity returns in 2016, especially in China, have driven money towards computer-driven strategies. The average performance of Chinese quantitative funds easily beat that of the long-biased funds last year and more and more investors are turning to quant strategies for stable and low risk returns in times of increasing uncertainty."

Another factor behind strong fund flows into quantitative strategies in Asia is the desire for attractive risk-adjusted absolute returns where investors are not also being overcharged for beta, adds Robert Frey, founder and chief investment officer of FQS Capital Partners.

Reliance on equities

Heinz accepts that Asian hedge funds are more reliant on equities than their international counterparts, observing that 76% of Asian hedge fund capital by AuM is in equity funds compared with 61% for the global industry. The disparity is even greater when measured by the percentage of hedge funds that are equity ones – 76% in Asia versus 47% globally.

Tang agrees with the view that Asian hedge funds are over-reliant on equities, noting that hedge funds based in Asia ex-China are predominantly trading long/short equity strategies and that alternative strategies such as CTA funds are hard to find. "In comparison, there are many more

CTA funds inside China due to its extremely liquid commodity futures markets. The fact that China's commodity markets are still closed to offshore investors, together with the lack of active commodity exchanges in Asia outside China, is one of the main reasons that Asian hedge funds are over-reliant on equities"

As Asian markets become more mature and sophisticated, it is only normal to see the hedge fund industry expanding outside of its traditionally long-biased equity space, suggests Frey. Moreover, its underlying market dynamics – with substantial volatility, liquidity and active participants – provide a fertile ground for all type of arbitrageurs, whether quant, macro or discretionary stock pickers.

"For instance, the Chinese market looks particularly attractive and we have seen a handful of successful managers in this area, but the key to making this a great opportunity for the long term will be the attitude taken by regulators and the ability for hedge funds to adapt. Shorting remains an issue and recent changes such as limiting futures hedging have made it even more difficult for arbitrageurs to operate," he continues. "We hope that as this market opens up further, the opportunity set will increase."

> "Part of the growing interest in quantitative hedge funds in Asia is related to diversification purposes and the ability of quantitative strategies to have lower correlation to traditional markets"
>
> *Philippe Ferreira, Lyxor Asset Management*

Hassan is more confident, noting data on the most popular strategies from 2008 to 2016 illustrate that reliance on long/short equities has fallen over that period, although it is still some way ahead of multi-strategy. This view is shared by Douglas, who observes that Asian hedge funds merely reflect the opportunities available to them and that the reliance on equities over other assets or contracts is a function of the underlying capital markets of the region.

"Asia – especially Greater China – is one of the most commercially active regions in the world and we see managers diversifying their portfolios into other asset classes to generate a good balance of asset allocation that is in accordance with the fund's strategy," adds Tony Kan, managing director of Custom House Fund Services Hong Kong. "The other asset classes that managers are diversifying into include OTC corporate bonds seeking stable yields, private placements and later stage pre-IPO deals to take advantage of growing investment opportunities in Greater China."

Stephane Macresy, head of hedge fund selection Asia at Lyxor Asset Management, notes that event-driven and long/short equity managers constitute the bulk of the strategies in Asia but also that other strategies have achieved positive returns. "Global macro, CTA and multi-strategy managers have also experienced great success, while relative value credit or volatility strategies are gaining momentum. So the issue has not been over-reliance on equities but rather the inability of traditional equity strategies to adapt to changing market conditions."

Eurekahedge data highlights a 60% increase in event-driven hedge fund AuM between 2008 and 2016, although the total for last year was approximately 18% down on the figure for 2011.

Private equity competition

There has been much talk of reallocation of assets from hedge funds to private equity in Asia, particularly by family offices with aggressive performance goals. UBS's 2016 global family office report notes a 0.9% decrease in hedge fund allocations and that this pattern is likely to be reinforced with family offices planning to move more money into private equity.

However, Hassan is unconvinced that this is indicative of a major shift in investor sentiment. "Private equity has historically sat well with Asian investors who like the idea of buying into a business and having some control over its destiny. Recent reports of reallocations from hedge funds to private equity have manufactured trends out of isolated events – with dry powder at historical highs in the private equity space, one needs to evaluate this more carefully. The opportunity set of hedge fund strategies is more diversified than it was 10 years ago. Asian hedge fund AuM is still around 8% of total global money invested in hedge funds so there is much room for growth here, although it is going to take some time."

This sentiment was echoed at an EisnerAmper-sponsored Chinese Alternative Asset Management Professionals (CAAMP) event in late 2016, where participants were told of how Asia's hedge fund industry was undergoing a transformation. These changes include a shift from historically equity-centric managers to a broader set of strategies (including multi-strategy, Asian macro and credit-focused strategies) as well as North American investors paying more attention to Asian managers.

Macresy accepts that there may be some consolidation in the Asian hedge fund space and more managers entering liquid alternatives. But, within alternative investments, he expects private equity and hedge funds to grow in parallel. "Whereas large Asian investors have mainly been allocated to global brands, we expect that both Asian and overseas investors will focus more on Asian hedge funds, while investing in private equity, infrastructure and real estate continues to form a strong trend for investors in the region."

> "The fact that China's commodity markets are still closed to offshore investors, together with the lack of active commodity exchanges in Asia outside China, is one of the main reasons that Asian hedge funds are over-reliant on equities"
>
> *Tom Weiye Tang, Foresee Global Asset Management (HK)"*

Assets have been reallocated to private equity funds in Asia due to the lack of diversity and performance of Asian equity-focused hedge funds, but the private equity space is becoming overcrowded with too much capital. That is the view of Yang, who is confident that quantitative hedge funds will attract assets looking for private equity-style returns, due to their diversification benefits and low-risk nature.

It cannot be denied that Asian hedge fund managers face capital raising challenges that are exacerbated by extreme distances between managers and the investors they wish to attract and an industry that is still in its infancy compared to North America and Europe.

As Douglas observes, the institutional capital that is being "forced" into alternative assets prefers to collect illiquidity premia from private equity, direct lending, real estate and other long term assets. "These premia are inherent to the underlying asset and hence are perceived to be more sustainable than the 'skill-based' premia of hedge funds," he says.

However, the fact that North American investors – including family offices, funds of hedge funds and other groups looking for early-stage managers – are looking to Asia-based managers for returns with low or no correlations to those in North America and Europe should encourage regional firms, especially those who are able to demonstrate nimbleness and agility.

Revisiting financing solutions

To adapt to tomorrow's regulatory environment

Karl von Buren, Managing Director and Global Head of Equity Finance Delta One

Loic Lebrun, Managing Director, Head of Prime Finance EMEA

Karl von Buren, Managing Director and Global Head of Equity Finance Delta One; Vinay Raj, Managing Director, Head of Financing Solutions; Jean-Michel Meyer, Managing Director and Global Head of Repo; and Loic Lebrun, Managing Director, Head of Prime Finance EMEA

Key points

- **A wave of regulation introduced since the global financial crisis is pushing up the cost of bank funding and putting unprecedented constraints on banks' use of their balance sheets.**
- **This is redefining the relationship between prime brokers/banks and their clients across the investing community**
- **While this is likely to add to pressures on many second and third tier investors, there will be plenty of opportunities for banks and institutional investors prepared to embrace the changes brought about by the regulatory revolution**

Since the global financial crisis, the banking industry has been confronted with a wave of regulatory changes intended to ensure that the near-meltdown of 2008 is never repeated. At the core of the new regulations is the recognition that it was principally a liquidity crisis and an over-dependence on short term finance that drove the global financial system to the edge of the precipice. This is why one of the central pillars of the Basel III regulatory principle is the liquidity coverage ratio (LCR). This calls for banks to hold an adequate stock of unencumbered high-quality liquid assets that can be converted easily and immediately in private markets into cash to meet banks' liquidity needs within a 30 calendar day liquidity stress scenario. As the Bank for International Settlements (BIS) explains, the LCR was designed to "improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source, thus reducing the risk of spill-over from the financial sector to the real economy".[1]

The LCR, which was introduced at the start of 2015 and should be fully implemented by 2019, is to be supplemented by the net stable funding ratio (NSFR), which is due to take effect in 2018 This has been developed to ensure that lenders maintain a 'sustainable funding structure', in order to reduce the likelihood that disruptions to a bank's regular sources of funding will erode its liquidity position in a way that would increase the risk of its failure and potentially trigger broader systemic stress. "The NSFR limits overreliance on short-term wholesale funding, encourages better assessment of funding risk across all on- and off-balance sheet items, and promotes funding stability," according to the BIS[2].

These two key liquidity ratios have been complemented by the leverage ratio. Aimed to contain the build-up of excessive leverage within the global financial system, the ratio is a measure of a bank's leverage exposure to its tier 1 capital, and ranges between 3% and 6%.

Karl von Buren, Managing Director and Global Head of Equity Finance Delta One at HSBC, says that in aggregate, these regulations represent an effective set of tools for de-risking the system. But he adds that for the prime brokers which have traditionally been the principal source of financing for hedge funds and other institutional investors, the ramifications of the evolving regulatory regime have been complex and far-reaching. In many instances they are forcing banks to reappraise their financing strategies.

This is because a common objection to the leverage ratio, for example, is that it does not take account of the risk-weighting of assets in its calculation. "One of the effects of the leverage ratio is that it can tend to reduce the incentive for banks to lend against high quality assets," says Vinay Raj, Managing Director, Head of Financing Solutions at HSBC. "Higher quality assets attract a lower margin, but use up the same amount of balance sheet and hence capital, which makes it more challenging for banks to strike the right balance between balance sheet consumption and riskiness of lending."

Funding: What has changed?

More generally, the primary consequences of the cascade of new regulation for banks has been the increase in costs and complexity of bank funding. Because the LCR requires banks to hold sufficient cash to meet their commitments in times of stress, it is incentivising banks to rethink the structure of their deposit bases, which have traditionally been their most efficient and cheapest form of financing.

"Today, we have to look very carefully not just at where our deposits are coming from but also the forms those deposits take," says Raj. "Much of our funding focus is now on corporates which could be more beneficial for NSFR. This can be in a number of different formats ranging from simple triparty corporate repo to SPV-related notes, both of which are a strength for HSBC given the depth of our corporate relationships." HSBC was named 'World's Best Bank for Corporates 2016' in the Euromoney awards for excellence in June.

Jean-Michel Meyer, Managing Director and Global Head of Repo at HSBC, says that in the UK, another driver of rising funding costs for banks is ring-fencing of retail banking operations. "At HSBC, we are fortunate in the sense that we have multiple balance sheets all over the world," he says. "But we will still be affected because our UK retail bank - an important source of NSFRcompliant liquidity - will be ring-fenced."

Clients' funding pressure and collateral transformation

As Meyer explains, in the new regulatory environment it is not just bank lenders that are facing a barrage of new cost pressures which is in turn increasing clients' costs of access. Additionally the same regulatory pressure is changing the shape of the business clients are engaging in or need to engage in, with implications for financing and collateral transformation. For example, pension funds, although currently exempted from mandatory central clearing of over-the-counter derivatives contracts, are expected to become subject to initial margin requirements.

Margin requirements will also require collateral to be liquid, which could effectively mean that this would need to be in cash or government bonds. This is why collateral optimisation or collateral transformation is likely to become increasingly important for asset owners. As Von Buren explains, this is especially relevant in the case of equities. "While the main equity indices are regarded as liquid, price volatility over stressed periods is such that it takes out a large proportion of individual stocks," he says. "So our challenge is to transform what is fundamentally an illiquid book into a liquid one."

"We can make that transformation through a whole variety of transactions," Von Buren adds. "Some are as straightforward as borrowing government debt and lending out equity as collateral, which we call a collateral upgrade. Then there are various bespoke derivatives trades based effectively on the forward sales of illiquid assets."

Reshaping prime broking relationships

At the most extreme level, pressure on funding costs and banks' intensified scrutiny on the efficient use of their balance sheets is leading some to withdraw from prime brokerage entirely. Increasingly, this is creating opportunities for non-bank financial institutions to step into the gap, providing an alternative source of financing for hedge funds, but probably injecting an added element of counterparty risk into the system.

The banks that remain committed to prime brokerage – such as HSBC – are revisiting their business model in a number of ways.

Most obviously, it is leading them to reevaluate the viability of their relationships with institutional clients. This is because to date, many of the rising costs of prime brokerage have been absorbed by the banks themselves. Increasingly, however, it is inevitable that these costs could end up being passed in part or in whole to the end clients. This could add to the pressures on smaller funds, which are already having to adjust to a world of steeper compliance costs. Those hedge funds specialising in less liquid asset classes, and those with investment strategies that are highly dependent on leverage, are likely to be most negatively affected by mounting costs across the industry. "A long/short market neutral equity strategy which turns over its portfolio frequently and is prepared to trade synthetically is more likely to be attractive to service providers than a passive stock-picker," says Von Buren.

"At HSBC, we are fortunate in the sense that we have multiple balance sheets all over the world"

"Balance sheet constraints mean that there is now a finite amount of leverage available on the Street for clients, so banks have to be much more selective." adds Loic Lebrun, Managing Director, Head of Prime Finance EMEA at HSBC.

The result, he says, is that while tier one institutions with sizeable financing needs and a range of other financial service requirements may be better prepared to navigate the regulatory blizzard sweeping across the industry, tier two or tier three institutions lacking critical mass may be more negatively impacted. "In the past, banks may have been happy to maintain pure financing relationships with clients," says Lebrun. "Today, for that relationship to be sustainable, banks also need execution off the back of the balance sheet commitment. So there is now much more of a focus on how we bring together our financing and execution capabilities as a holistic offering for the client."

The impetus for the change in the relationship between banks and their clients will not come solely from prime brokers weighing up the size and attractiveness of institutions' wallets or their potential as a source of so-called execution dollars. As Von Buren points out, asset owners themselves are now increasingly rationalising the number of prime brokers they use."

Either way, it is likely that providers as well as consumers of liquidity will need to work together to explore creative solutions in response to balance sheet constraints. "The challenge for everybody is to find the most efficient way of delivering scarce balance sheet resources to clients in a way that generates an acceptable return for the bank while complying with the new regulations," says Raj.

Creative financing solutions

The challenge of maximising efficiencies in apportioning scarce balance sheet resources is already forcing banks to be more creative about how they provide financing for institutional clients. This is underpinning a notable rise in synthetic prime brokerage. "This is certainly an area where we are pushing for more growth, because if clients are trading synthetically it gives us a lot more control over the management of our balance sheet," says Von Buren. "Our ideal scenario is one in which a client wants to short a given stock on a synthetic basis and we can match the other half of the transaction from a client who wants a long exposure to the same stock. This is highly balance sheet-efficient, but depends on matching clients with opposite trading requirements."

> "The winners will be those that can navigate a market that is being pulled in two different directions and create solutions that can satisfy both sides of the market"

For many of the larger and more creative asset owners, which are able to channel resources into their treasury functions, the demand for a bridge between suppliers and consumers of liquidity dynamic is creating a new potential source of alpha. Hedge funds, in particular, are exploring ways of lending unencumbered assets to other investors.

"A lot of the conversations we're having with some of our larger and more sophisticated investor clients is about the opportunities that the new regulatory environment is giving them to act as liquidity providers," says Von Buren. "If we had suggested 10 years ago that hedge funds could provide the banks with financing, liquidity and balance sheet, people would have thought we were mad. But that is exactly where we are today."

A bank such as HSBC, meanwhile, is ideally positioned to leverage the combination of the strength of its balance sheet, the breadth of its global network and its credit rating to act as an intermediary. "Our global client reach means we are able to provide a bridge connecting different pools of liquidity be it by geography, client type or currency," says Raj

This mirrors HSBC's broader ability to address the thorny issue of liquidity mismatches that have been the driver of so much regulatory change over the last few years. "The regulators are asking consumers of liquidity to go longer-dated, and suppliers of liquidity to go shorter-dated," is how Von Buren summarises the financing dilemma facing the industry today. "The winners will be those that can navigate a market that is being pulled in two different directions and create solutions that can satisfy both sides of the market."

For more information, please contact us: markets.insights@hsbc.com

Notes

1 Basel Committee on Banking Supervision - Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools, January 2013
2 Basel Committee on Banking Supervision - Basel III: The Net Stable Funding Ratio, October 2014

Rules of engagement

Market regulation varies considerably around the region but that provides as many opportunities as costs, says *Paul Golden*

Developments in Hong Kong and Taiwan hint at a more progressive view of securities based lending regulation in Asia, although efforts to expand activity across the region are held back by limited infrastructure in a number of jurisdictions. Martin Corrall, chairman of the Pan Asia Securities Lending Association (PASLA) recognises that the regulatory environment for securities lending in the region is far from uniform. "Clearly some markets – for example, Indonesia – have yet to develop an infrastructure," he says. "Others have nuances that may make them more challenging to operate in, although they might consider themselves developed."

Considering regulation from an equity market perspective, Ed Oliver, managing director of product development at eSecLending agrees that the regulatory disparity across the region is a key consideration when considering whether it lend its clients', say, Indonesian assets.

"In general, the less standardised a market the bigger the revenue opportunity"

Ed Oliver, eSecLending

"Some markets such as Hong Kong are mature, but there are several others – such as Taiwan and Malaysia – which remain challenged in terms of regulation," he says. "In these markets, lending occurs but in an imperfect structure. There are also a number of jurisdictions, including India, Indonesia and the Philippines, that do not yet allow foreign institutional investors."

In some Asian markets, borrowers are required to confirm that the stock is available before they can execute a short sale. Indeed, it is not just that the agent has to confirm the availability of the stock, it also has to identify which investor owns the securities, explains Roy Zimmerhansl, global head of securities lending at HSBC. Korea and Malaysia have specific identifiers for the investor that the agent has to give to the borrower so it can execute the short sale.

Evolving structures

Several Asian regulators have tweaked their securities lending rules in recent years. The Hong Kong Stock Exchange added a number of securities to its short selling list last year, while changes to Taiwan Stock Exchange Corporation's securities borrowing and lending rules in 2016 were also designed to boost securities lending.

"The capacity for securities-based lending was enlarged, thus enhancing market liquidity," explains a spokesperson for the Taiwan Stock Exchange Corporation, adding that the number of securities eligible for day trading varies slightly on daily basis.

This is just one reason why it is vital to be cognisant of the different rules in each market. Elsewhere, Korea recently introduced some changes to its short selling regulations, while in

Malaysia there is a difference in terms of the settlement times between buys and sells, which impacts securities lending activity observes Zimmerhansl.

"The regulatory requirements for securities lending activity in Asia are not onerous, but regulators in the region are extremely vigilant in relation to buy-ins," he continues. "They want efficiency in the markets and they don't want failed trades to add risk. This explains the focus on covered short sales and that if trades fail, you are more likely to get bought in than would be the case in other regions."

Moderating influence

Asian regulators have gained a greater appreciation of the fact that short selling and contrarian trading adds liquidity to the market but, more importantly from a regulatory perspective, tends to have a moderating effect on the peaks and troughs of the market, adds Zimmerhansl.

In some respects, the lack of standardised frameworks can present an opportunity for clients. Those that are actively investing in these markets tend to be familiar with infrastructural and operational situations, so once the lending agent has completed is due diligence on a market it is able to work with individual clients to explain the way securities lending works, the challenges that may exist and the risk mitigation that it believes should make them comfortable, explains Oliver.

"In general, the less standardised a market the bigger the revenue opportunity," he adds. "These are definitely markets where we feel we can make a strong impact on our clients' programmes. We work actively to educate clients and, where there is interest, implement an appropriate risk-managed securities lending programme."

Attitudes to repo

Regulators in Asia have supported the repo market and usually sponsored CCP solutions, says Nicolas Faust, BNP Paribas collateral and valuation services product specialist for Asia-Pacific. "However, the upcoming impacts of Basel III's ratios – LCR and especially NSFR – will put a lot of pressure on the repo business."

These regulations could severely restrict the ability of repo dealers to provide liquidity to the market according to Nasser Khodri, group managing director Asia Pacific institutional & wholesale at FIS. "Out of the 70 or so counterparties in the market trading repo we have found that a large portion have increased their use of total return swaps in order to improve balance sheet usage," he says. "This has led some banks to believe their derivatives system can also cover all of their physical financing needs."

Tri-party repo is becoming more prevalent as non-traditional lenders look to put cash to work, while central clearing of repos is also being seen as a potential solution. In this scenario, the regulatory capital charges faced by the dealer community are reduced, which leads to favourable rates being passed on to the borrower. However, John Southgate, head of derivatives & collateral management EMEA at Northern Trust, warns that both of these solutions may increase complexity from a collateral management perspective.

"The regulatory requirements for securities lending activity in Asia are not onerous, but regulators in the region are extremely vigilant in relation to buy-ins – they want efficiency in the markets"

Roy Zimmerhansl, HSBC

Trading technology

Technology is not only improving data quality and analytics in Asia Pacific securities lending – it is also facilitating more efficient trading strategies, says *Paul Golden*

A number of countries in Asia could still be defined as frontier markets and therefore require synthetic or other bespoke market access solutions. As a result, in many respects the region remains a fragmented CSD environment, further complicated by the fact that many banks still clear through their EU or US entities.

The Asian securities lending market is characterised by comparatively high volumes, offset by a rich specials market generating high returns, says Philip Morgan, head of business development at Pirum Systems.

"Settlement transaction costs are generally quite high, which when paired with both new loan and return volumes can be a significant factor in ensuring a profitable programme. There is typically more sensitivity around the recalls process and sell fails in Asian markets due to quite strict policies around settlement failures on the exchanges, which often results in clients holding higher buffers (up to 50% in some cases) for in-region securities. This means that significant specials revenue can be left on the table."

By closing the right position and using tools that allow minimum duration and return size, agent lenders can limit their transaction costs. Additionally, markets such as India have very specific CCP requirements and unique operating models, which require local technology builds.

Solution adoption

Without technology, trading and post-trade activities can be prone to errors from the manual processes involved. "Automated trading platforms and post-trade technology not only allow agent lenders and broker dealers to optimise their efficiency, but also reduce costs and minimise the risk of manual input errors," says Andrew McCardle, head of EquiLend Asia.

"Market data allows lenders and borrowers to make informed trading decisions. However, there are still some domestic markets within the region that are reluctant to accept technology vendors as eagerly as the global participants have. Even when you have a global standard, it does not mean that those standards are adopted by all markets."

McCardle suggests that beneficial owners in Asia Pacific face the same issues as their peers in other parts of the world and are demanding a similar level of clarification on performance. "There is certainly a better understanding of benchmarking by beneficial owners in smaller regional markets than there ever has been, due to the work agents have undertaken to educate these markets."

Real-time processing and a obtaining a multi-asset view of all securities and associated collateral are becoming central requirements. Broadridge's head of strategy and business development Asia, James Marsden, says that he is surprised by the number of legacy systems that are unable to cope with the shortening settlement cycles coming through in Asia Pacific markets, such as the move to T+2 in Australia and New Zealand and forthcoming changes in Japan.

"These shortening settlement cycles increase the need to borrow due to the higher likelihood of failed settlements with non-residents as a result of time zone differences," says Marsden. "As the market evolves we expect this drive towards greater transparency to become a feature of Asian markets. The ability to aggregate data, visualise it in a way that supports strategic decision making and then automate internal, client and regulatory reporting of this data is the key to dealing with the demands of the new market and regulatory environment."

Holistic perspective

The principal factors that strategic partners can provide are accurate and transparent data and analytical tools "The quality of corporate action and instrument reference data is vital, along with accurate management of collateral positions, with associated marking to market, to manage exposures," adds Marsden.

Centralisation and standardisation of data across siloed business lines includining securities finance and derivatives enables a more holistic, real-time view of risk at different levels of the firm. The ability to source and deploy eligible collateral at low cost quickly and efficiently in an automated way can also provide huge benefits during times of market stress.

"From a buy-side perspective, there is a trend for moving down the liquidity curve in the collateral being accepted and demand from the sell side for longer term structures due to regulations such as the Basel III liquidity coverage ratio," says Marsden. "The ability to manage the eligibility and concentration risk of this collateral using sophisticated technological solutions allows the buy side to increase returns from lending programmes and expand business opportunities in a way that is acceptable to the firm's risk profile."

Technology enables agent lenders to map supply with borrower demand regardless of the account structure and execute trades based on specific parameters, which reduces the amount of human intervention required for high volume daily flow activity, says Roy Zimmerhansl, global head of securities lending at HSBC.

> "There are still some domestic markets within the region that are reluctant to accept vendors"
>
> *Andrew McCardle, EquiLend*

"This facilitates increased volumes, but more importantly the borrower can direct their activity to lending clients that satisfy other criteria, such as the identity of the entity at a principal level, which determines the amount of capital the borrower has to set aside," he says. "It also enables the borrower to allocate to the correct entity from a collateral perspective."

This in turn supports more direct booking on a cost-effective basis, further improving transparency. Borrowers can identify who they are trading with to their regulator and the agent lender can show the borrowers where their exposures are. Zimmerhansl says that the head of HSBC's trading desk in Asia talks about his team evolving from traders into engineers.

Once the trade has been agreed and auto-booked, most organisations have straight through processing so the trade is booked to the right account and instructions sent to the settlement agents, so it can also be auto-reconciled, he says. "All this means that there is a plethora of information available to customers, whereas in the past only some of this information would have been available or maybe it would have been available in its entirety only from select providers."

SFTR challenge

While the benchmark rates delivered by market data service providers are helpful, technology is set to have an even greater impact on securities lending in Asia over the next 12 months as systems to support the Securities Financing Transaction Regulation (SFTR) are built out in the EU. Once implemented by the securities finance industry in EU, with support from vendors, it is seen as just a matter of time before this technology makes its way to Asia Pacific.

There has been a degree of negativity around the speed of some execution platform build outs, according to Morgan, with agent lenders expressing the view that there has been a lack of focus and knowledge in the region to assist with these transitions.

However, he observes that non-differentiated technology solutions are increasingly being considered by companies to improve market access as well as operational, regulatory and risk processes. "This is enabling participants to spend their limited technology budgets on alpha generation strategies that make them more attractive to their clients."

Monitoring of corporate actions on assets lent out remains a key challenge, as does automating the collection of dividend payments/management of stock splits. Says Marsden: "Many systems still lack automation in these key workflows. Depending on the market there are often specific rules on closing out and re-opening loans if there is a change in the number of shares to simplify the operational flow. Of course, this is harder in the retail space where the number of open positions may be significant and clients may not have alternative collateral, so firms may vary their approach."

Risk mitigation

The demands of central clearing and the forthcoming uncleared margin rules mean buy-side firms are required to source greater quantities of higher quality collateral for margining derivatives trades. The buy side also needs to move this collateral more frequently to more demanding settlement cut-offs.

According to Marsden, technology solutions allow buy-side firms to identify internal inventory that can be used to meet these needs at low cost, minimising the drag on alpha from holding larger quantities of cash and high quality liquid assets (HQLA).

Securities finance can also facilitate source margin in a cost effective way through collateral upgrade trades. "For buy-side firms that are long HQLA, there is also an opportunity to finance these assets in the market in collateral downgrade trades to generate additional alpha," he says. "Deploying technology solutions that can help the firm to manage this interplay between collateral supply and demand while also mobilising collateral in a more automated way can provide a strong return on investment and ease the burden of meeting regulatory deadlines."

"The ability to aggregate data, visualise it in a way that supports strategic decision making and then automate internal, client and regulatory reporting of this data is the key"

James Marsden, Broadridge

Morgan says that when it comes to paying for services, agent lenders typically cover their own operational and transactional costs while borrowers pay for tri-party collateral management. "Additionally, agent lenders maintain an indemnification programme for many beneficial owners and absorb the cost of this. Clearly, the fee split agreed with the beneficial owner should be reflective of the value [provided]."

McCardle adds that the firms that are paying directly for systems are the agent lenders and the prime brokers, but these costs and risk mitigation tools are part of the process that every agent lender highlights when they work with beneficial owners.

"There is obviously a cost to running a better risk management process, but global risk mitigation tools such as contract comparison are no longer a nice-to-have for many in Asia," he adds. "They fall in line with global standards as expected products within the securities-based lending programme of participants. Many would argue that they are a small price to pay for the risk mitigation that they provide."

Most clients take reporting from their agent lender, which is no different to how they would work with an investment manager, adds Zimmerhansl. "The most sophisticated clients might use more than one agent, in which case they need to aggregate the information. In some cases these clients are investing in specific technology that enables them to manage risk across multiple agents, but most are taking the agent data and running it through their existing risk engines."

Tools for the trades

Accessing Asia Pacific markets in a timely manner can be challenging, which makes both futures and securities lending invaluable for efficient trading. *Dan Barnes* investigates

Being able to take risk on or off quickly can make the difference between banking alpha and taking a big hit. In the markets across Asia Pacific in 2017 – which will be characterised by "low returns and high volatility" according to asset manager Newton Investments – investment windows will be tight and speed is of the essence.

In many markets around Asia this can present challenges. Limits on ownership of cash instruments, liquidity quality, market maturity and local regulation all have a bearing on market accessibility.

"As an investment professional you are always looking at the risks and the cost for entry and exit of an investment, and the risk associated with sustaining an investment in a specific market," says Hong Kong-based hedge fund manager Stephen Howard, who left Enhanced Investment Products on 27 February 2017. "Markets with sufficiently liquid hedging solutions are going to be gravitated towards by most institutional investors or investment firms because they need to have decent two-way liquidity for the risk pricing of those hedging solutions."

Given the diversity of market structures and rules within local Asia Pacific jurisdictions, portfolio managers and trading desks across institutional and alternative investment firms need to be aware of the mechanisms available for accessing liquidity quickly, for example using repos, listed derivatives or exchange-traded funds in lieu of cash instruments.

"At the individual security level, it really comes down to liquidity and cost," says Paul Solway, regional head of securities finance in Asia Pacific at BNY Mellon. "Markets with good depth of inventory where borrowing fees are low would suit borrowing, whereas markets that do not allow for or restrict borrowing/lending or shorting in any way, such as India and Taiwan, presents access to futures and options as useful alternatives."

Among asset owners, as a consequence of the low rate environment, there is growing interest in alternative routes of alpha generation that can be used to help enhance performance.

"There is a spotlight being shone on products such as securities lending, where there can be opportunities for a stream of revenue that comes at relatively low risk," says Dane Fannin, head of capital markets at Northern Trust. "We are seeing beneficial owners that previously had no interest in securities lending suddenly now showing a lot of interest in it. That dynamic is probably going to continue in the near term."

The volatility of emerging markets relative to developed ones can make trading them as much an art as a science. The depth of lending liquidity can present challenges, says Solway, noting that putting on a loan can be easier than taking it off.

"That is where the skill comes in," he says. "As history has shown, some regional markets have resorted to short-sell bans in times of extreme volatility. Fines or penalties, buy-ins, and trading restrictions are all in play for failing trades [as is] timely short-reporting across many markets – so you need to do your homework."

Regulators can impose hurdles for investors that would not typically be a consideration in other markets, for example relating to settlement.

"In some of the markets in Asia there are punitive settlement structures, which can result in severe economic penalties for investors," Fannin says. "These drive non-standard requirements such as pre-notification of sales, for example, or could affect the way you need to structure operational support. While these might present barriers for some investors initially entering the market, they also present an opportunity for those who are able to navigate these complexities successfully with their providers to achieve first-mover advantage."

He gives the example of Taiwan, where the settlement structure typically requires pre-trade notification. Lenders or asset owners that were able to offer pre-trade notification when the market opened were able to enter that market with their providers, gaining greater advantage.

Local cost drivers

Using derivatives is equally dependent on local rules and there are clear cost drivers for utilising them where the market allows it, says David Strachan, head of clearing at UBS in Hong Kong.

"The most notable shift in client behaviour has been the migration from bilateral structures onto exchanges and into cleared structures, as clients' bilateral counterparties have been calling for greater capital contributions by way of margins," he says. "If you look at the transaction fees for creating equity exposure via futures across the major markets in Asia you will find it averages a quarter of the cost of gaining the same exposure through the swap market."

Asia Pacific equity and equity derivative markets saw a massive decline in trading volume in 2016 compared with the year before, according to data from the World Federation of Exchanges, an industry body. While cash equities fell by 26.1% year-on-year, stock options and single stock futures declined by 10.66% and 16.88% respectively while index options and futures saw falls of 43.11% and 49.57%. Interest rate options and futures also fell 16.12% and 14.02%, although bond trading volume by value increased 51.9%.

Australia, Hong Kong, Japan and Singapore, which all have mature capital market rules and infrastructure, follow international best practice in terms of access, allowing omnibus accounts, give-ups and post-trade allocation. Regulatory hurdles to trading listed derivatives in other jurisdictions can mean that not much activity takes place in the market.

Knowing in which markets specific instruments work well can create a greater range of choices for buy-side investors. Building the capacity to negotiate unique structures along with understanding client demand can help investment managers support end-investors more effectively.

"The big index futures markets attract great interest," notes Kent Rossiter, head of regional Asia Pacific trading at Allianz Global Investors Asia Pacific. "A lot of clients don't like buying the underlying if they just want broader index level exposure. Korea and Taiwan for example have expensive 30 basis points (bps) stamp duty on underlying share sales, so for some traders they'd be fine just getting index exposure, which is much cheaper via futures."

> "Institutional investors or investment firms… need to have decent two-way liquidity for the risk pricing of hedging solutions"
>
> *Stephen Howard, formerly of EIP*

India has one of the largest and most liquid single-stock futures markets globally, largly as a result of investors wanting leverage and to save on security transaction tax (STT), which with a couple of other fees adds up to a cost of around 11bps each side of buying and selling single stock shares, plus commissions.

"Indian single-stock futures offer leveraged exposure, with only about 10% margin being posted, and incur 1bp STT market charges each side versus 11bps on cash trades," says Rossiter. "So at only a tenth of the cost, and a tenth of the value needed for margining, it's an attractive proposition for short-term traders and arbitragers."

Around 90% of the approximately 240 Indian single-stock futures trade at premiums to the local shares, but since the annual roll cost can often be 6% they are not products for buy-and-hold investors, Rossiter notes. "Furthermore, the real liquidity is still seen in the top 25–50 stocks, but for those investors wanting to express and profit from negative views on stocks, the use of futures is one route."

Underlying liquidity

Keeping on top of the liquidity of instruments and their underlying securities is enormously important for investors. Getting under the skin of a market can unearth risks that might not be apparent at first glance and ensure a fund is picking its markets on a fully-informed basis.

"Listed single-stock options are accessible in Hong Kong, however you are probably only looking at maybe five underliers where you can get real two-way liquidity from a broad enough range of market makers and liquidity providers to a reasonable maturity profile – beyond three months," says Howard. "This can be a 'mouse trap' where the secondary liquidity for that option can be a real challenge to source at a fair market price. As a market professional you have got to acknowledge that there isn't that liquidity, and therefore focus your asset allocation on where you can find that two-way liquidity."

He notes that market structure and the architectural structure of prime brokers are both very important in supporting alternative investment firms in using these instruments. "Where they specialise in a discrete range of products – and offer an open, transparent model for everything else – they are easy to work with," he says. "An investment theme will be correct periodically and, where the market structure allows investors to asset allocate with ease, they will take those periodic opportunities."

Country profiles

Comprehensive guide to securities finance

The rise of repo

Iain Colquhoun, Head of Corporate & Bank Flow Sales, ICBC Standard Bank, says that repo will play an increasing role in Asia Pacific capital markets

This section of the Global Investor guide sets out recent developments and anticipated changes for the most active securities finance markets in the Asia Pacific region. The guide covers securities lending and synthetic finance as well as tri-party and repo. ICBC Standard Bank has supported this guide with expert eye sections on selected repo markets in the region.

Participation in Asia Pacific repo forms an important part of an increasingly international financing market.

Since the financial crisis, the repo market has changed fundamentally. A variety of new regulations, coupled with greater control from internal risk frameworks, have placed uncertainty around the product and, according to the latest International Capital Market Association (ICMA) survey, restricted growth.

"Asia Pacific repo forms an important part of an increasingly international financing market"

At the same time, central bank policy has provided large amounts of liquidity to banks. The onward use of this liquidity, during a period of low outright interest rates and reduced spreads, has resulted in the repo market generally looking for new horizons.

There has been a clear trend for global finance being provided into an Asia Pacific market with a vibrant domestic and international fixed income market.

Following the harsh lessons of the 2000s, the need is greater than ever for providers to co-opt local knowledge to gain a deeper understanding of the collateral they are trading and the counterparty that is in receipt of the cash. I hope you will find this guide useful and insightful.

Iain Colquhoun

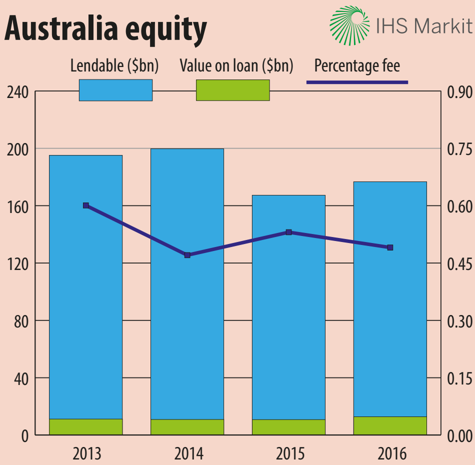
Australia

Australia is a mature lending market with a diverse range of supply and demand dynamics. It is well developed, with a robust regulatory framework and attractive liquidity profile. "These attributes make it an obvious destination for investors to deploy their trading strategies," says Dane Fannin head of capital markets, Asia Pacific, Northern Trust.

Australia has stable supply for the main index securities. "Overall, supply within the market has increased due to new participants and capital inflows to superannuation and managed investment schemes," says Stewart Cowan, head of securities lending, Asia Pacific, J.P.Morgan.

"As 2017 gets underway we continue to see strong appetite from beneficial owners to participate in securities lending. This is reflected in the lendable inventory in both equities and fixed income which has increased year-on-year."

Australia equity



- Australia is the fourth largest market in Asia Pacific
- Australian equity securities lending revenue grew by 15% to $73.7m
- The 4bps in fees registered was offset by an 18% jump in average balances
- Material firms were heavily represented among highest revenue generators including Fortescue Metals
- Inventories grew by 17% for the year to $195bn

Source: IHS Markit

Australia has a vibrant and dynamic onshore market and it is also open to offshore participants. In terms of specials, the supply versus demand dynamic is no different other mature markets except for the franking or imputation credit. "The franking credit is only available to onshore lenders, hence, there is differential pricing and certain demand dynamics between the onshore and offshore supply," adds Cowan.

Unfortunately, demand to borrow remains subdued due to Basel III and other regulations. "We saw increased volatility within the fixed income book as banks and broker-dealers needed to manage their balance sheet activities," added Cowan.

However, despite demand not keeping up with supply, the Australian market is expected to continue to generate reasonable returns buoyed by the commodity and retail sectors.

In September 2008, ASIC introduced a short selling ban which covered both naked and covered short sales. The ban was in response to concerns around market volatility which raised concerns around fair and orderly operation of markets. The ban was lifted in May 2009 and ASIC released a post-implementation report REP302 *(see http://bit.ly/2lyuHfX)*. It provided an interesting insight: "It should be noted, however, that the ban on short selling may have exacerbated market volatility.

It also potentially inhibited price discovery in the market and may have reduced market liquidity."

It is also improving in the eyes of beneficial owners, says Fannin: "Perceptions of securities lending are changing in a positive way, particularly in the context of a low interest environment. The idea that it can generate an attractive stream of alpha at relatively low risk is driving increased interest from beneficial owners."

The Australian Securities and Investment Commission (ASIC) issued Regulatory Guide 196 (RG196) in April 2011, which prohibits naked short selling and introduced short selling disclosure obligations. There are currently rules in place for naked short selling as well as various reporting obligations in relation to short sales and loans transactions. ASIC provides the market with transparency in relation to these positions and they are published on its website *(see http://bit.ly/2mfmlo5)*.

The most recent change has been to expand the reporting obligations for APRA (Australian Prudential Regulation Authority) regulated entities. SRF 720 & SRF 721 were introduced in July 2016 and request specific information related to stock loan and repo positions.

Industry participants can access inventory via all the traditional routes to market, although there are certain elements of Australia's infrastructure that are ripe for further development, according to Fannin. "Many participants still rely on bilateral collateralisation rather than leverage a tri-party solution – making trading flows relatively less efficient and expensive," he says. "However, we feel this situation will evolve as the market continues to grow and attract investment."

The Australian market has increasingly diverse and well-serviced range of collateral management offerings. The Australian Securities Exchange (ASX) recently launched a fixed income service with plans to expand to equities. The ASX partnered with Clearstream for its domestic tri-party offering, ASX Collateral. Other agents offer international tri-party.

Davin Cheung, global funding and financing sales, APAC, Clearstream Banking, says that activity is "picking up quite nicely". "The tri-party activity has really been going up significantly over this year – so you have the CCP, commercial banks and the central bank all in the tri-party platform that is operated currently by the ASX and supported by Clearstream. That's a good sample for tri-party activities."

"The trend for this year will definitely be a pick-up in momentum. There will be more local players looking to sign up for the platform and existing ones will increase their balances – I have no doubt about its growth. The global margin requirements, the LCR requirement and the domestic Australian regulatory requirements are all factors pushing for tri-party activity."

Traditionally, the Australian financing and stock loan activity was seen as largely between domestic counterparts, but this is now evolving to include global market participants. True domestic onshore trades are now enhanced by EMEA, US or Pan-Asian counterparts using global collateral.

Tri-party collateral managers are able to support the Australian superannuation funds and the global borrowing community, working to safeguard equity and fixed income collateral.

BNY Mellon is one of these tri-party providers. Natalie Wallder, head of collateral management & segregation, Asia Pacific, BNY Mellon, says: "We see an opportunity to support our clients in two key market developments. The first of which recognises the continued emergence of a domestic repo market and expansion over the coming year of regulatory OTC derivatives collateral needs."

China

Mainland China's two stock exchanges, Shanghai and Shenzhen, widened the list of stocks available for securities borrowing and lending (SBL) at the end of 2016. Over 70 new securities were opened up to lending, bringing the total number across the two bourses to 950.

Both bourses now link to Hong Kong through separate Stock Connect initiatives, creating an approved solution for lenders and borrowers of Chinese A-shares. Even so, SBL activity remains very subdued and it is considered uneconomic to trade.

"Securities lending is at a very early stage in China but as the market matures I am sure that it will become much more interesting," says Rakesh Patel, head of equities, Asia-Pacific, HSBC.

Last year's decision by MSCI to keep mainland-listed shares out of its key emerging markets index was a blow to China's regulators. Another review is expected in June and a green light would be viewed by many as a positive step for SBL activity.

However, MSCI's snub proved to be an opportunity for certain firms. In February, BBH analysts noted an uptick in demand to borrow Deutsche X-trackers Harvest CSI 300 China A-Shares ETF (ASHR) following the index provider's decision. ASHR tracks the CSI 300 Index and offers direct access to Chinese A-Shares. BBHs expect ETFs in general to remain in demand, specifically ASHR.

Hong Kong-listed Chinese property stocks, which proved too hot for short sellers in early 2016, saw a jump in shorting activity mid-2016 as high investor demand drove prime urban real estate prices higher.

There's evidence to suggest margin financing and securities lending balances are continuing to grow domestically; balances exceeded RMB1.1trn in 2015, according to KPMG statistics. However, regulations do not currently permit offshore participants to engage directly.

In addition, extreme stock market volatility two years ago means the Chinese Securities Regulatory Commission's (CSRC) focus has shifted away from continuing liberalisation of markets towards stabalisation. This approach has extended to securities finance.

"China will want to move at its own pace when liberalising capital markets – they will not be forced into running at anyone else's pace," says HSBC's Patel. "They will have a very thoughtful and systematic approach to securities lending alongside the general evolution of the capital markets. It will take time but I think there is a growing appreciation of what securities lending can offer the market – liquidity provision, encouraging domestic flows and encouraging multi-asset strategies.

"There is no doubt that China will be one of the biggest lending markets globally. I am sure about that. But it will not happen in the short term."

Davin Cheung, global funding and financing sales, APAC, Clearstream Banking says that the prospect of tri-party in China is "quite exciting", given it is the third biggest bond market in the world and there are thriving OTC and exchange markets for cash and bond repos, plus a growing stock loan market.

"The market for the moment is quite domestic, but we recently opened a link into China (CIBM) whereby our international clients could basically buy-and-hold those China bonds and safekeep them in Clearstream. We have initiatives and MOUs with multiple infrastructures such as CSDs to share ideas in terms of, for example, how to mobilise and internationalise those assets and to further create collateral value from these assets for market players."

Issues to consider include how quickly bonds would be turned over and, from the regulator's point of view, whether a withholding tax would be required. "Major CSDs in China already have the knowhow and systems and they are just waiting for the green light to jump start tri-party offerings in China," says Cheung.

Some participants in China fear the exchange rate and repo market is growing too big. New issues can be repo-ed immediately, which leaves the exchange holding market risk. "Obviously, based on international experience, products such as tri-party could mitigate market and credit risk if we look further into how the collateral is to be mobilised, eligibility criteria and the imposition of appropriate haircuts," adds Cheung.

Looking at China's economy more broadly, there are increasing signs of corporate earnings and profitability improving. "With growth on track, policy has shifted towards a focus on risk control (e.g. the property market, leverage, non-performing loans (NPLs), and capital outflows). The government will likely also focus on tax reduction and state-owned enterprises (SOE) mixed-ownership reform. Southbound flows could cushion the downside risk for MSCI China amid higher RMB volatility, although higher US rates tend to dampen EM inflows," HSBC analysts said in an investment outlook in February.

"We think China's structural economic challenges remain largely unsolved. Policymakers also face the dilemma between curbing the risk of property bubbles in selected cities while supporting the property sector as a key growth stabiliser."

Expert eye on repo

China is a huge financial market and home to some of the largest credit institutions in the world, with future developments that are set to open up the financing market even further. Noticeably, many Chinese onshore assets are utilised in repo transactions, conducted out of Hong Kong and other neighbouring jurisdictions.

At present, the legal opinion for repo conducted within China is not clear, which means that bespoke legal advice is required prior to entering into global master repurchase agreements (GMRA) with domestic players.

Iain Colquhoun, Head of Corporate & Bank Flow Sales, ICBC Standard Bank, comments: "The Chinese market shows enormous potential but it is clear that a good deal of this potential is currently restricted from global participation. At ICBC Standard Bank we are able to provide a good link into the mainland and welcome discussions with international participants who may look to deploy resources in this area."

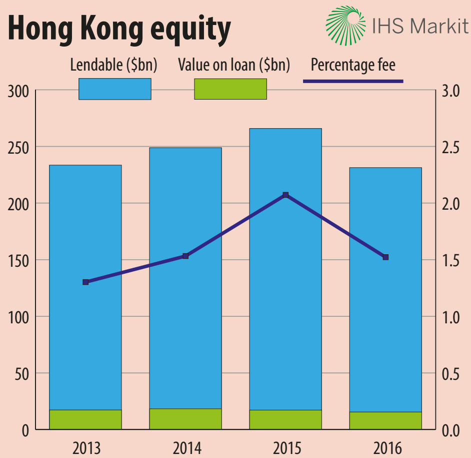
Hong Kong

Last year was not a particularly good one for securities lending in Hong Kong. Gross revenue totalled (US) $238m in 2016, down 34% from US$358m the previous year, swopping places in the league tables with Japan (which increased from US$196m by 50% to US$294m). Nonetheless, it was the second greatest revenue generating market in Asia Pacific.

"Average rates decreased a lot over the past year," notes Ariel Winiger, head of secured financing Asia Pacific, Societe Generale. "Rates [fees] reduced on average by about 30%. I see no indication for this to turn upwards again – it could go lower – but this really depends on corporate activity."

There are still isolated pockets of high fees. "The only exception is China-based ETFs, which are heavily in demand," says Winiger. "The fees come in and out – sometimes they are traded at a really high level but it is quite volatile. It is definitely a good trade but the problem here is that not many lenders can lend ETFs so the holdings are relatively modest."

Hong Kong equity



- Hong Kong is the second largest market in Asia Pacific
- The $247m of revenues generated in 2016 missed the 2015 total by over 30%
- The disappointment was driven by fees which shrank by a quarter to 1.52%
- Balances also contributed to falling revenues as they fell by 10% on average to $15.4bn
- Holders of China Huishan Dairy generated over $31m of revenues
- Inventories also fell, with an 8% decrease in lendable to $237bn

Source: IHS Markit

At the moment there is not enough supply, in part because interest in China is not particularly high, investors are typically more cautious than bullish. However, there is also the question of ownership. "The main investors are retail ones and these stocks do not normally come to the lending market," notes Winiger.

Chamil Ioussoupov, head of equity finance Hong Kong, Natixis says: "The biggest impact we saw in 2016 was the development of the Chinese story. China ETFs absolutely hijacked the story of the Hong Kong stock lending market."

At the beginning of the year the inventory of private banks was not targeted but as soon as Chinese ETFs became hot people rushed to the private banks to fund the supply.

"The interesting thing was that the market corrected itself," says Ioussoupov. "The effort of people trying to get the ETF supply in the first part of the year paid off and the market naturally cooled off in the second part. Because ETFs were very hot, people found an alternative way to fund the supply and the market normalised, as happens in Europe."

The only major change to the equity market was the Shenzhen Connect going live at the end of last year. As with the established Shanghai Connect, the stock lending facility is not really workable. It is reasonable to assume that the facility has been consciously implemented in a way that does not foster activity and that Chinese regulator will make changes if and when its wants lending to take off.

While investors can almost get near full access to the Chinese markets, the two Connects are not being utilised for stock lending for several reasons including issues around title transfer and the CNY repo market. It all adds up to not being commercially viable.

The reconciliation of these issues is under consideration by the Chinese authorities but is not thought to be a top priority. Says Ioussoupov: "I would say the key regulatory factor is now the development of China – the Shanghai and Shenzhen Connects and the all new bond channel. Beyond that the next step is of course the opening of derivatives."

By contrast, the Hong Kong regulator is widely considered to be supportive of securities lending. "HKMA is a very pragmatic body – it always consults on the impact on market participants," says Ioussoupov.

Tri-party collateral management

"Hong Kong collateral continues to be easily accessible to source and a popular choice of asset to hold for many financing and stock lending traders," says Natalie Wallder, head of collateral management & segregation, Asia Pacific, BNY Mellon.

"China continues to increase in importance as the market explores new infrastructure to connect to China. BNY Mellon already supports offshore renminbi tri-party repo transactions and offshore renminbi collateral assets in tri-party, both settling through Hong Kong. It is certainly exciting times ahead, with room for more innovative ways to help support this market evolution including facilitating tri-party access to Connect, which is an area where we are currently supporting within our asset servicing solutions."

Davin Cheung, global funding and financing sales, APAC, Clearstream Banking, says: "We are seeing quite a number of major Chinese investment banks setting up repo and securities finance desks in Hong Kong. They are looking at tri-party, because they are holding quite large portfolios of paper that they are looking to finance as a basket."

ICBC Standard Bank

Expert eye on repo

Hong Kong is the traditional hub for the repo market in Northern Asia. Like Singapore to the south, it is home to a number of banks and many professionals operating in a varied financing market. Business conducted in Hong Kong does not often involve securities denominated in HK dollar (HKD) and is incredibly varied in terms of collateral, currency and tenor. Typically, as a percentage of overall volume, there are more structured transactions conducted in Hong Kong than in any other major centres in Asia.

The international banks tend to have local Hong Kong teams in place to ensure thorough regional coverage, but trade using their main balance sheet either domiciled in Europe or the US.

Simon Clairet, who co-ordinates ICBC Standard Bank's regional operations from the Hong Kong office, says: "Hong Kong is a busy financing market. Together with a good deal of interest in structuring longer-term financing trades there is very regular flow financing business, which provides the collateral to deliver returns to a number of our tri-party accounts domiciled in Europe."

The market is mature and well-developed and the bulk of collateral is US dollar-denominated and settled in Euroclear.

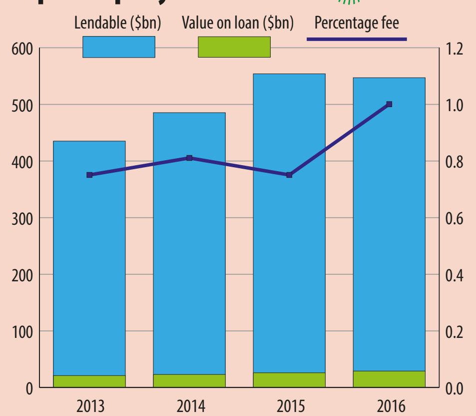
Japan

Japan's equities earned more than 50% additional revenue in dollar terms than the total recorded for 2015, according to IHS Markit data. This bumper surge means Japan was responsible for one-third of the region's equities revenue – a sharp increase from the 22% share seen in 2015. It was the single largest force behind the 10% jump in Asian securities lending revenues registered last year.

"The revenue momentum has continued into the New Year as Japanese equities have generated 45% more revenues in local terms for beneficial owners in the opening six weeks of 2017 than they did over the same period in 2016," said IHS Markit analyst Simon Colvin.

This jump is even more significant in dollar terms as the rising value of the yen means that the $40m generated by Japanese equities lending year-to-date is 50% ahead of the $26.5m generated at the same point in 2016.

Japan equity



- Japan is the largest market in Asia Pacific
- Japanese equity had a very strong year and total revenue surged 50% to $305m
- Fees rose by a third to 1% while average balances jumped 12% to $29bn
- Cyberdyne generated $20m for lenders
- Inventories held flat at $575bn

Source: IHS Markit

"This will come as welcome news for the industry considering that the rest of the Asian region is has so far failed to match the revenues generated at this point last year," said Colvin. "In fact, Asian equity securities lending revenues are trailing the $112m earned in the opening six weeks of 2016 by 3%."

Fees are by far and away the single largest contributing factor behind Japan's rosy revenue figure. The weighted fee commanded by Japanese equities ranged between 75bps and 80bps from 2013 to 2015, however that number went on to surge to 100bps last year. The increase in fees is showing no sign of slowing down in 2017 as the weighted-average fee charged to borrow Japanese equities so far this year is 124bps, far above the 80bps weighted average fees generated in the opening six weeks of 2016.

"This massive 57% increase in the fees commanded by Japanese loans has so far failed to scare off investors as the average balances were JPY3trn in the first six weeks of 2017 – roughly on par with the JPY3.2trn seen over the start of 2016," says Colvin.

The minority of Japanese stocks that trade special have played an outsized role in the surge in fees as their proportion has doubled over the last two years. Japanese stocks now have a 12% chance trading special (using a threshold of 100bps for fees). "This proportion is by far and away the highest out of any period registered over the last 24 months," adds Colvin.

Furthermore, these specials are getting increasingly more expensive to borrow as the weighted average fee of all specials registered a 24-month high of 670bps in the opening weeks of the year. The Japanese specials fee has come in somewhat over the last month to 550bps; however the current rate is still materially higher than the 430bps needed to borrow Japanese specials over the middle of 2015.

"These specials are more than likely driven by short seller demand as technology and consumer discretionary firms, which have long been favorite targets of short sellers, make up over half of the current crop of Japanese specials," says Colvin.

Standout tech specials includes such firms as internet messaging portal Line Corp which now costs over 11% to borrow after a series of lackluster earnings took its shares below their IPO price and AI software provider Jig-Saw which commands an astronomical 33% in the securities lending market.

Highlights in the consumer discretionary sector, which includes retailers and automobiles firms, include electronics retailer Edion, which has 16% of its shares outstanding on loan, as well as airbag maker Takata whose shares cost more than 15% to borrow after the some of its products were found to be defective.

Unsurprisingly these resilient fees, and the ensuing revenues they generate, are increasing the attractiveness of Japanese equities for beneficial owners who are willing to lend these assets. Beneficial owners have earned two thirds of a basis point from the JPY68trn of Japanese equities in lending programmes; one third more than the year-to-date earnings figure registered at the same point last year.

Bumper revenues generated from lending Japanese equities have so far failed to attract any significant new supply looking to grab a piece of the action. If anything the lendable pool has been getting shallower over the last 12 months as the value of Japanese equities in lending programmes only jumped by 25% in yen terms. While significant, at first glance it's worth noting that the surge in lendable is 5% less than the 30% jump registered in the Nikkei 225 index over the same period.

Expert eye on repo

Japan is becoming a more important jurisdiction for domestically based repo transactions. Everyone in the repo market is familiar with the activities of the megabanks, however there is a definite increase in the amount of business conducted offshore using local legal agreements. Daisuke Tanimoto from AMT Law, a premier law firm in Asian financing, highlights: "There are two types of repo transactions in Japan: Gentan repo transaction (i.e. a security lending transaction collateralised by cash) and Gensaki repo transaction (i.e. a sale of securities for cash with a commitment to repurchase).

Although Gentan repo transactions are still prevalent in Japan, there is a shift towards a wider use of Gensaki repo transactions. In light of the introduction of a T+1 Japanese Government Bond (JGB) settlement cycle, which is expected in 2018, the Japan Securities Dealers Association (JSDA) has taken initiatives to introduce a new Gensaki repo transaction framework, designed to reflect the global standard. For such purpose, the JSDA revised its self-regulatory rules and published a new set of standard form contracts for new Gensaki transactions in July 2016."

This movement will see more offshore participants engaging with the local banking community providing diversity of funding.

"Specials in Japanese equities were mainly found amongst the more illiquid names, small caps rather than large caps, and there is no indication that this will change anytime soon. 2016 has not been a great year from a specials perspective," says Ariel Winiger, head of secured financing Asia Pacific, Societe Generale.

Collateral management

A major theme from 2016 was that providing Japanese government bonds (JGBs) as collateral became very popular. Winiger adds: "JGB usage increased a lot over the last year or so. That was perhaps the standout trend in Japan – JGBs were one of the cheapest types of collateral to deliver last year, behind JPY cash. This is likely to to continue."

Davin Cheung, global funding and financing sales, APAC, Clearstream Banking says: "Japan was one of the earliest countries to implement initial margin segregation rules for OTC derivatives in September last year, so all the Japanese banks are grading tri-party accounts in order to post or receive initial margin collateral."

In phase one only the largest banks are affected and later phases will take in smaller and buy-side entities "so you are talking about quite significant amount of new collateral accounts to be opened in subsequent implementation waves," predicts Cheung.

Natalie Wallder, head of collateral management & segregation, Asia Pacific, BNY Mellon, says: "Given the increasing requirements to provide high quality liquid assets, the popularity of Japanese government securities within tri-party continues to rise as clients source alternative quality collateral, which for BNY Mellon specifically, now makes up a significant portion of our global book."

The market infrastructure in Japan continues to evolve. On 1 January 2016 Japanese and non-Japanese client assets were permitted, for the first time, to be comingled at Japanese depositaries providing opportunities to facilitate cross-border exchange of collateral within tri-party.

Market settlement deadlines for JGB were also extended in 2016 to 9pm Tokyo time. "We hope to see further positive market developments as Bank of Japan's consultation with market participants continue," adds Wallder.

Singapore

Market participants have witnessed Singapore's capital market rules and infrastructure mature over time, aligning with international best practice. Political and economic stability have also attracted companies to the region. It remains, however, more of a back-office hub and struggles to match the lending and borrowing levels of its main rival Hong Kong – where most brokers choose to set up shop and do business.

Back in 2014 the average value of lendable equity securities totalled $50bn (all figures USD). This figure has reduced in recent years ($43bn in 2015, $37bn in 2016) although the value of equity securities on loan has remained relatively constant around US$2.7bn and average fees have stayed just north of 1.1%.

Singapore Exchange (SGX) is the preferred listing location for close to 800 companies, including a large proportion of foreign listings.

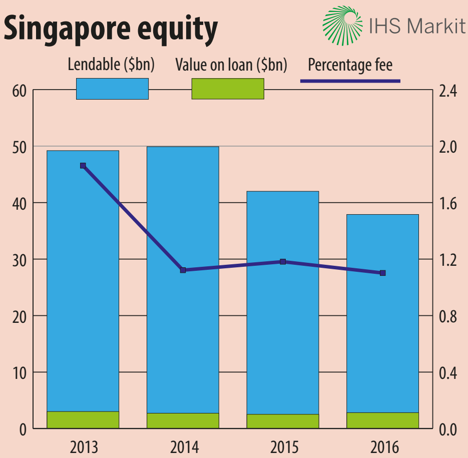
The Monetary Authority of Singapore (MAS) recently proposed new rules that would require investors to report short sales of shares – a further sign authorities are stepping up scrutiny of investors who take a negative view on listed companies and aggressively sell their shares.

However, MAS has said short selling "can enhance the price discovery process and maintain market discipline". Its proposals aim to enhance transparency by requiring market participants to mark short-sell orders to the exchange and report short positions above a certain threshold.

MAS said the regulations would bring Singapore in line with international short-selling guidelines. The rules would apply to the immediate legal owners of the stocks, while designated market makers would be exempt. The regulator intends to give the industry four months to implement the new rules, once they are finally published. Reportable positions include those equivalent to or more than 0.05% of eligible shares or S$1m ($700,000) in aggregate value.

Tri-party collateral management is set to be being increasingly adopted by local banks, which are facing increasing regulatory demands along with their global peers. "In Singapore we are seeing some local players upgrading their systems in order to become active," says Davin Cheung, global funding and financing sales, APAC, Clearstream Banking.

Singapore equity



- Singapore is the sixth largest market in Asia Pacific
- Singapore stock lending revenues grew by 6% in 2016 to $33m
- Average fees fell by 8bps to 1.1% which was counteracted by a 12% jump in balances
- Noble and Semcorp Marine generated the most revenue for lenders
- Inventories grew by 8% to $38.5bn, a new all-time high

Source: IHS Markit

"They are not active yet partly because system and relevant support capability is not there to support tri-party, but some are willing to invest good amounts of money to update and prepare for OTC derivatives margin rule implementations and selection of third-party collateral agents. That is quite a significant development over the past 12 to 24 months."

Looking ahead, the Singapore market's defensive nature helps cushion against downside risks in a risk-off environment. The dividend yield is one of the highest in the region, while healthy balance sheets and free-cash-flow generation are supporting dividend payout ratios. There are tentative signs of earnings bottoming.

"Calibrated monetary easing and fiscal measures, such as tax and wage credits for businesses and measures to ease corporate credit conditions and restore cost competitiveness, provide a favourable backdrop to support supply-side reforms," HSBC analysts stated in an investment outlook in February.

"The government has responded to the structural growth slowdown with a step-up in inter-agency collaboration to help industries/companies and workers to cope with structural challenges, identify and expand new growth sectors as well as address frictional unemployment and shortfalls in social policies and infrastructure etc."

However, Singapore's economic growth outlook remains fragile, with external weakness spilling into weak domestic demand and negative repercussions for the labour market. There is a risk that rising trade protectionism and anti-globalisation negatively impacts global trade and regional financial centres such as Singapore.

"The country's transition from a labour-driven growth model to a productivity-driven one remains challenging and incurs short-term pains. Singapore faces the risk from rising US interest rates," HSBC's analysts added.

"A shifting manufacturing landscape, higher corporate and household debt servicing burden amid worsening profitability and labour market, tighter financial conditions, and a weak property market are headwinds.

"Concerns about banks' asset quality, particularly their exposure to the oil & gas sector, linger, although lending to the sector accounts for a small portion of the total loan book and the recent rebound in oil prices, if the trend sustains, may help mitigate such risk."

Expert eye on repo

Singapore is the main financial centre for South East Asia. There are no legal impediments to conducting GMRA business and the local market is mature and well-established.

There is a great deal of activity in US dollar-denominated securities, with a preponderance for high-grade papers. Singapore is regarded as an important centre for repo trading of US Treasuries and US dollar-denominated bonds issued globally.

The Singapore dollar (SGD) market is also developed and despite a number of participants pulling out of the cross-currency space in the past 18 months, there is still a degree of interest in financing paper against US dollar.

Wei-Shee Chia from ICBC Standard Bank comments: "The bulk of the non-UST demand I see derives from a cross-currency financing for SGD-denominated assets. The market views these papers as high quality and the level of haircut we are able to charge against US dollar makes it an attractive proposition for our customers among local financial institutions."

South Korea

Last year was another stand-out year for South Korea in terms of gross revenues produced, with 43% year-on-year growth from $165m to $236m. It established South Korea as the third largest market in Asia Pacific, just behind Hong Kong at $238m (down 34% in 2016 from $358m) and the number one market Japan at $294m (following its 50% increase from $196m). It is the sixth largest market globally.

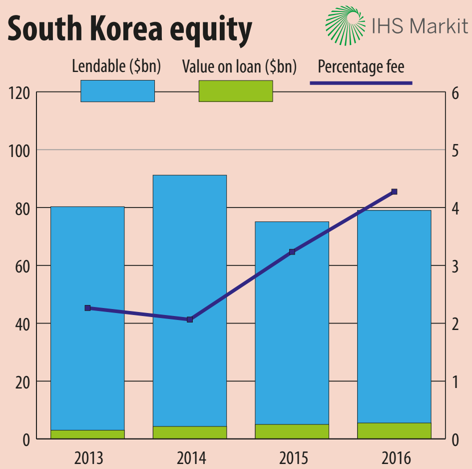
South Korea remains an attractive trading destination, which has enjoyed increased demand over the last two years. "This has largely been driven by various regulatory changes aimed at facilitating increased market liquidity, as well as its exposure to a slowing China. Regulatory changes in other jurisdictions have also helped make South Korea a more attractive destination," says Dane Fannin head of capital markets, Asia Pacific, Northern Trust.

Under Korea's system, the borrower and the lender choose the type of transaction and enter application details into the web-based Korean Securities Depository (KSD) securities borrowing and lending (SBL) system. A trade is matched when the application details of the lender and the borrower are met on issues, quantity and fee rates among other metrics. Securities are directly transferred by book-entry from the lender's account to the borrower's account. More than 4.9 billion shares were traded this way in 2016, according to the KSD, up from around 4.5 billion in 2015.

South Korea operates on a pseudo-CCP model in respect of the requirement for SBL to be intermediated by the KSD, Korea Securities Finance Corporation (KSFC) or an authorised local broker.

Darren Measures, executive director, product manager for agent lending, Asia Pacific, J.P.Morgan, says: "This hybrid model has proven to be a popular reference point for success in the market as developing markets in India, Philippines, Indonesia and Vietnam look to emulate an SBL process that gives control and transparency to the local exchange, while being open enough to attract international borrowers, agents and lenders into the market."

South Korea equity



- South Korea is the third largest market in Asia Pacific
- South Korea also performed well in 2016 as revenues jumped by 45% to $242m
- Average fees, already the highest in Asia, climbed a further 30% for the year to 4.3%
- Balance also climbed, jumping 8% on average for the year to $5.5bn
- Celltrion earned a massive $84m for beneficial owners, over $60m more than any other Korean stock
- Inventories were flat at $82bn

Source: IHS Markit

South Korea continues to be dominated by specials, with wide variability month-on-month. During 2016 trading values ranged KRW12.9trn to KRW23.8trn (average KRW15.82trn) and in terms of shares traded between 341 million shares to 579 million shares (average 413 million).

"Korea was the bright star of the middle of last year. Fees were going really high and there were lots of specials. The outstanding notional values were not biggest, but they were decent. It is still an interesting market with very attractive average fees – but the demand seems to have reduced," says Ariel Winiger, head of secured financing Asia Pacific, Societe Generale.

A leading example of this is renewable energy equipment firm Celltrion, which was the top special in Asia and the fourth biggest globally, contributing almost 3% of revenue (Tesla, the biggest, contributed 8%). During 2016 the fees were between 15% and 20% but this has since reduced to 6%.

Other top revenue earning stocks included: Oci Co Ltd, Kakao Corp, Hotel Shilla, Hanmi Pharm and Samsung Heavy Industries.

South Korea represented 59% of emerging markets' total revenue, with Taiwan at 20% and Malaysia at 6%. It also takes the number one spot in available inventory with 36% (versus 22% from South Africa and 16% from Taiwan) and loans with 40% (versus 24% from Taiwan and 19% from South Africa).

"Interestingly, from an emerging market perspective, South Korea is now the global number one emerging market in terms of revenues, loans and inventory, claiming the top spot by a very long margin from local markets such as Taiwan and Malaysia," says Measures. "Given the exposure of South Korea to China, and lack of international SBL opportunities in China domestically, this emerging market predominance is expected to continue until workable international models are implemented in India and China," adds Measures.

The SBL model at KSD continues to evolve, and good progress was made in 2016 in working through nuanced issues in the market. Standing proxies can now send in details of each month's transactions, while duration limits in between have been loosened and ETF collateral valuation ratios have been improved to give borrowers more headroom. "KSD organised an international securities financing forum in Hong Kong in October, which was well received by the market and continues to show the partnership that exists to try and evolve in the process and system to fully meet its long-term potential," says Measures.

However, challenges remain for market participants. For example, "various corporate action events routinely require lenders to action immediate recalls of securities, in order to protect beneficial owner entitlements," says Fannin. "This is an unusual requirement that dampens broader market liquidity, particularly for those securities trading special. South Korea also requires borrowers to pre-borrow prior to any intended execution. This increases borrower transaction costs in cases where trades are ultimately not executed."

Chamil Ioussoupov, head of equity finance Hong Kong, Natixis, says: "Korea, in comparison to other markets, is already very restrictive and controlled in terms of reporting trades and registration. The framework is already in place. The main barrier in the market today is the foreign ownership limit, but that has existed for a long time."

The most recent development was a note released by Korea Exchange (KRX) in early February

announcing its intention to change its rules regarding the designation of "overheated" short-sold stocks. Detail has not yet been provided but it will include strengthened penalties against the short selling rule violators and will take effect from 27 March 2017.

"Any new limitations or finger-pointing is of course important, especially if it brings the license into question or heftier fines," says Ioussoupov "But what is more important is the framework, rather than just one mechanism"

At the moment it is not clear how it is going to work, or its scope. "Suspensions and limits exist in every market, on particular stocks or even more widely," says Ioussoupov. "If it aligns the market mechanism controlling liquidity to prevent abrupt moves, it's absolutely fine. But if it's super-tight, very hard to manage or understand, then I'm more sceptical."

Another source, who asked not to be named, says: "The Chinese regulator tried it last year and it was basically a massive failure. It's not exactly the same thing, but there is a parallel. You have to be very careful about the effects of any new implementation because you also will influence how the market liquidity will react."

Hedge funds

"The Korean hedge fund industry is expanding sharply," says Rakesh Patel, head of equities, Asia-Pacific, HSBC. "There are now around 250 hedge funds based in Korea, which has come up from nothing five years ago, mainly backed by domestic life and asset management companies. The AuM is not particularly large but the Korean government bodies are trying to promote a larger industry."

"Today, the reality is that the main driver of the market is the offshore community," says Natixis' Ioussoupov. "Onshore hedge funds have not had a meaningful impact yet but it is a growing space."

"Korean onshore hedge funds are much more likely to take positions in single stocks, especially the smaller names, rather than sector or country exposure. Korean hedge funds will be very focused only on Korea whereas international demand will see Korea as a sector – the approach is completely different."

Collateral management

Korean collateral can be managed and allocated by either a transfer of title or by the Kun-jil-kwon pledge solution. Both collateral solutions and the choice of which largely depend on our clients' need including preferences, which need to be agreed between the collateral provider and receiver. "The use of Korean collateral has been a very popular discussion topic for the Asian trading community and we expect this to continue into 2017," says Natalie Wallder, head of collateral management & segregation, Asia Pacific, BNY Mellon.

"We are starting to see some domestic Korean counterparts emerging into the marketplace whose need is to source collateral for OTC derivative margining requirements. This trend will likely continue and has the potential to develop into demand for support related to other types of collateralised trading instruments, domestically in Korea."

"Korean collateral continues to be an interesting proposition for any tri-party collateral agent whereby the market infrastructure continues to evolve, particularly in the collateral transaction space where the market is hopeful that certain changes will be adopted in 2017. Financing in Korea tends to be against US dollar lending and the Korean collateral financing market is expected to expand further over the course of 2017."

Ioussoupov predicts that 2017 will see a "huge" increase in liquidity. "The next layer is to develop the financing side of Korean assets, so you can see the development of tri-party on a more liquid basis. Tri-Party agents will have to focus on Korea to make it as smooth as they can."

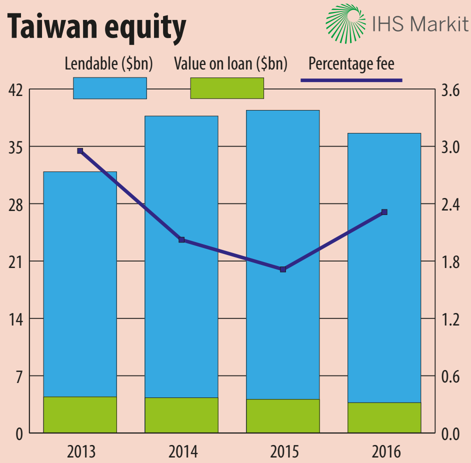
Taiwan

Taiwan's bourse made it easier for market participants to look up rules and regulations on securities borrowing and lending (SBL) in February. The welcome move saw the Taiwan Stock Exchange (TWSE) collect 14 letters of interpretation regarding the practical aspect of SBL and place them under the respective chapters and articles.

Eventually, the exchange plan is to have all the rules covering SBL rules in one place – including regulations governing the opening of an SBL account at a brokerage, how to price SBL and how a lender makes a request for an earlier than planned return of securities.

At the same time, TWSE also announced a new piece of legislation which forbids securities borrowers from taking out any new loans within 10 days of the deadline of an existing outstanding loan.

The calculation of collateral value, related to submission, withdrawal, and the marking-to-market of foreign currency collaterals, were updated.



- Taiwan is the fourth largest market in Asia Pacific
- Revenues jumped by a fifth to $87m in 2016
- Balances fell by a tenth to $3.6bn but fees counterbalanced this by jumping by a third
- Tech firms continue to drive revenues in the market
- The value of lendable inventory grew by 14% to $39bn

Source: IHS Markit

Officials have continuously modified SBL rules over the last several years, showing careful thought and commitment to the securities lending industry. The 2016 changes to the regulations were also designed to boost securities lending.

"The capacity for securities-based lending was enlarged, thus enhancing market liquidity," a spokesperson said at the time, adding that the number of securities eligible for day trading varies slightly on daily basis.

Regulators have also reduced the securities transaction tax (STT). Regardless of the gain or loss derived from trading of securities, the STT is imposed based on the transaction amount. The move by finance ministers to lower the rate to 0.15% from the previous 0.3% from the start of 2017 pleased local stock investors and could boost market turnover going forward.

In part, these modifications combined with regulatory flexibility have led to Taiwan becoming one of the hottest Asian SBL markets. Healthcare and biotech stocks saw strong demand from borrowers in 2016. OBI Pharma was one of the top-grossing name in the Taiwanese securities lending market.

In 2016, IHS Markit equity statistics show the average lendable totalled $39bn during 2016 with $3.6bn out on loan. The loans commanding an average fee of 2.31%, beating 2015's 1.71% figure even through more assets were then out on loan ($4bn on average).

Even so, total lendable assets and revenues in Taiwan still fall behind the likes of Japan, Hong Kong, and South Korea. Lending occurs, but in an imperfect structure.

Looking ahead, lenders and borrowers should keep a close eye on the global macro environment and domestic issues impacting Taiwanese securities.

"There has been improvement in near-term earnings momentum and a tech-led cyclical recovery in Taiwan. Positive export/production momentum appears to also be building in some non-tech sectors, such as metals, chemicals and machineries," HSBC analysts wrote in a monthly investment outlook in February.

"Taiwan maintains its competitiveness in the global themes of Internet of things and electric vehicles. The government focuses on revamping the economy through cultivating high-tech/ innovative industries and trade & investment policies (to diversify the product mix & markets)."

Meanwhile, there are potential threats to equity market prices. US trade, tax and foreign policies under a Trump administration casts significant uncertainty over Taiwan's economic and market outlook, according to HSBC. This is due to a combination of openness to trade, large direct and indirect exports to the US, equity market exposure to exporter sectors, and current security relationships with the US.

The tech sector is also facing challenges from muted global end demand and increasing competition throughout the supply from China. Alternative growth drivers – other than tech, manufacturing and exports – have not been built.

Expert eye on repo

Taiwan is a large market for repo and the presence of large financial groups, such as Sinopac, KGI and Yuanta, along with a number of other significant asset holders, means that there is a considerable scope for financing. The participants are experienced users of GMRA, and the open and transparent legal system places no issues around netting.

The amount of international business conducted locally depends on the attractiveness of repo interest rates compared to the Taiwan Futures Exchange (TAIFEX), which tracks the provision of cash from the Central Bank. The market is flexible and adaptable, and statistics show that the bulk of trades in the market are in the short-term.

Eric Li, repo trader at KGI Securities, sees the need for financing to further expand in the domestic market in 2017. "Given the low interest rate environment in the domestic market and the relatively lucrative US dollar-denominated papers, Taiwan's market has been showing strong demand since last year, and is expected to remain in its strong momentum for growth in 2017."

In general, the diversity of names and the overall liquidity in Taiwan's repo market grew steadily during 2016 and it is expected to remain highly active and favourable for trading among the dealers.

"Any tension in the Sino-US-Taiwan relations or deterioration in cross-strait relationship under the new government remains a concern, with pressure from China continuing to complicate Taiwan's progress in negotiating free trade agreements with major trading partners and Chinese tourist arrivals in Taiwan slowing sharply," HSBC's note added. "Currency and commodity price volatility is a swing factor for exports, the economy and earnings."

Up and coming markets

Beyond the major lending markets there are several others on the verge of becoming established including Malaysia, Indonesia, India and the Philippines

MALAYSIA

Malaysia is the seventh largest market in Asia Pacific in terms of equity lending revenues, according to IHS Markit data. It is certainly one to watch, with revenues jumping 40% over the year. Although the total remains low by regional standards at $32m it is over 10 times that generated five years ago.

Last year was also a strong year in terms of average balances, growing 30% to $933m, from inventories that increased by a similar percentage to $9bn. This was achieved with fees staying flat at 3.2%. The most revenue generated for lenders came from Maxis and Digi.com.

"There has definitely been an increase in business in Malaysia," says Rakesh Patel, head of equities, Asia-Pacific, HSBC. "It is the one ASEAN market that really pops, in terms of an increase in activity. It is certainly an interesting market going forward."

It is uncertain whether the rapid progress can be sustained, at least in the short term, as interest peaked during the year. "The outstanding notional values came up quite quickly last year – but in the meantime it seems that the demand has reduced a little," says prime broker based in the region. "There is a functioning market in place now."

Bursa Malaysia offers two securities borrowing and lending models: central lending agency (SBLCLA) and negotiated transaction (SBLNT). In the SBLCLA model Bursa Malaysia acts as the central lending agency for all SBL transactions between authorised lenders and borrowers. The SBLNT provides an on-shore route to agree transactions an over-the-counter basis and report to its representatives.

INDIA

India is at the early stages of securities lending relative to other Asia markets, but it is evolving and starting to mature and become more open to international market participants.

"India looks very interesting, having gone through a de-monetarisation phase," says HSBC's Patel. "Hedge funds and clients I speak to think India looks like a worthwhile opportunity to explore. India is at the early stages of securities lending relative to other Asia markets. But as an equity market it is maturing, it's evolving, which will hopefully follow through into the lending."

India is a very large market but one where the authorities have not wholeheartedly accepted the merits of SBL. A separate source who requested to remain anonymous says: "The Indian authorities have been relatively averse to having instruments for shorting capability onshore so it has been challenging from a securities lending perspective. As the market evolves they will understand that lending adds to liquidity, so it ends up being a good thing for everyone. India is at the early stages of that now."

INDONESIA

Indonesia remains one of the region's most exciting opportunities. Its untapped liquidity profile and economic growth expectations make it an attractive frontier market for investors, according to Dane Fannin Head of Capital Markets, Asia-Pacific, Northern Trust.

While it does not have a securities borrowing and infrastructure in place, this makes for a viable offshore model. In addition, "we are aware that regulators have been consulting with their counterparts in other markets to progress Indonesia's market further, says Fannin.

Current key challenges include the need for local currency collateral and for counterparts to transact under local law. These issues will require resolution if Indonesia's potential as a jurisdiction for securities borrowing and lending is to be fulfilled, and industry participants are continuing to engage with regulators to reach that end-goal.

THE PHILIPPINES

The general regulatory framework for securities borrowing and lending (SBL) in the Philippines was put in place in 2006. SBL remains bilateral and is mostly for fails settlement. Parties to the SBL are usually trading participants and investment banks.

"The Philippine stock market has yet to experience the full vibrancy offered by SBL given the limited supply and the absence of short selling," said Hans B. Sicat president and CEO of the Philippine Stock Exchange. "With the launch of ETFs and the expected introduction of short selling in the market, the PSE realizes the need for increased access to SBL."

Sicat says the exchange has been in regular contact with international banks throughout the development process of its SBL and short selling regulations. "We think that there is significant interest, which we hope to realize by providing regulations that will be acceptable to these participants."

"Increasing the supply available for securities lending and getting our short selling programme off the ground is therefore one of the priority initiatives of the exchange."

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