Looking east for growth: Securities financing in Asian markets

Collateral Management Roundtable
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Increased emphasis is seen on securities financing in Asia

“Institutions are looking east for liquidity and returns.”

CHUNHUA OU
Collateral Management Sales ex-Japan, J.P. Morgan

Although global organizations may once have managed financing, lending and collateral activities from New York or London, that is no longer the case. Banks, broker dealers and agent lenders are taking a more balanced global approach, given the pace of growth in their activities in Asia Pacific, an increased focus on managing balance sheets more locally around the world and a desire for stability in commercial financing.

At a recent roundtable in Hong Kong moderated by Chunhua Ou of J.P. Morgan Collateral Management Sales, industry leaders from Citibank, Credit Suisse and UBS AG discussed securities financing, collateral and lending, with a focus on opportunities in Asia. In opening comments, Ou noted that as regulations and changing markets create pressure on capital and balance sheet and large global fund managers search for growth, institutions are looking east for liquidity and returns.

The discussion focused on key drivers, challenges and opportunities given the market emphasis on securities finance within the region during the last few years. Several key themes emerged, including the importance of Asia in providing liquidity and returns within the global marketplace; the anticipated impact of China and India; the regulatory and financing challenges that affect market participants differently; how collateral structures and services are evolving; and how tri-party can act as an enabler in developing these markets.

Sam Edwards, Head of APAC Equities Business and Liquidity Management at Credit Suisse notes that across the market there’s a need for more onshore liquidity, onshore financing and local entity management in APAC. “We are looking to grow access to onshore markets, and continue to invest in building out the infrastructure to support them.” The other panelists agreed, noting that their firms, and many others, are rationalizing their legal entities in order to manage Asian activity locally, rather than from the U.S. or Europe.

Borrowers seeking to increase their liquidity profile also see Asia as a logical place to expand. According to Jacob Boeding, Head of Asia Stock Loan Trading at UBS AG, “these markets allow firms to tap different liquidity sources than the more established markets, and a greater diversity of tenors will help address capital and liquidity requirements specified under Basel III and by LCR and NSFR.”

The panel discussed the need for the largest institutions to deliver across all markets in order to develop revenue sources, tap new cash and collateral providers and access wider margins. For example, a difference in spreads may mean that issuing half as much general collateral (GC) in Asia could generate the same return as in the U.S., while consuming less balance sheet. As global institutions now scrutinize the allocation of balance sheet and capital more closely, the need to utilize them efficiently has become increasingly important.

“Despite high barriers to entry, Asia is a growth area that can offer critical liquidity and returns.”

SAM EDWARDS
Head of APAC Equities Business and Liquidity Management, Credit Suisse

1 Liquidity Coverage and Net Stable Funding Ratios
Fragmentation in the financing markets is a challenge, tri-party is an enabler

“Working with a tri-party agent allows us to collateralize in the region on a real time basis.”

EUSEBIO SANCHEZ
Regional Head of Agency Securities Lending - APAC, Citibank N.A.

Edwards notes that the Asian markets have more intricacies than the more developed European and U.S. markets, and in-time zone support is necessary to provide the most flexibility. “Tri-party is an enabler - tri-party solutions give us operational comfort,” he stated.

J.P. Morgan’s Head of APAC Collateral Management Product O’Delle Burke says that, as a tri-party agent operating across Asia, the firm sees that certain markets act and behave in similar ways in terms of regulation and structure. “As new markets open, we can leverage functionality and structures already in place for existing markets. Our aim is to support clients and get them up and running.” For counterparties outside the region, this helps provide operational support and facilitates access—and making it easier for counterparties to enter new markets can promote liquidity.

According to Burke, J.P. Morgan has observed a trend of market players creating a clearly defined Asia strategy. Although some players still support their activities globally, or outside of the region, activities are increasingly being managed in-market. For example, in Japan, Korea and Taiwan, agent lenders and brokers are focused on tri-party. J.P. Morgan’s collateral agency solutions help make their financing or lending strategies more viable on the ground.

The tri-party structure itself can simplify access and operations, but the relationship between a collateral agent and the counterparties is particularly important in new markets. Burke notes that “it’s important for us to get input from our clients on their priorities and to work together to provide input to markets as they develop.” Edwards agrees, saying that Credit Suisse is “working with tri-party agents to push development and regulatory change in new markets, and leverage learning from other markets in terms of process, documentation, etc.”

Within the 15 or so Asia Pacific markets, Boeding sees certain commonalities in market structure. For example, Hong Kong, Australia and Japan are the easiest in which to trade or pledge collateral. New markets coming online are looking at existing market structures and deciding what they want to emulate.

Eusebio Sanchez, Regional Head of Agency Securities Lending in APAC at Citibank, concurs. “Over the last 18 months we’ve seen a trend in requirements to collateralize in region on a real time basis. Working closely with a tri-party agent allows us to facilitate this.” For example, it’s difficult to address fails without the in-market ability to handle substitutions promptly. The operational outsourcing that tri-party provides addresses many of these issues on the ground.
China and India will be game changers

“We see a continuum from more restrictive to more open.”

JACOB BOEDING
Head of Asia Stock Loan Trading, UBS AG

The panelists agreed about the importance of China and India. “As those markets open up, we’ll see a tremendous revenue opportunity for broker dealers, lenders, etc.,” states Boeding. The discussion focused on China, given recent developments such as Shanghai Hong-Kong Stock Connect. Although third-quarter 2015 macroeconomic woes and a delay in opening Shenzhen have tempered the expected rise in volumes, it’s anticipated that international investors will ultimately take advantage of the single access point and join the offshore locals currently trading onshore.

“The market remains limited now, and is especially complex given its T+0 structure,” remarks Sanchez. “But as Shenzhen eventually opens and the Renminbi (RMB) is included in the Special Drawing Rights basket (SDR), their capital market will need to open up. At that point we expect to see funding capability, liquidity, capacity and demand all increase.”

Boeding agreed, but noted that the market structure for China is still being developed. “Ideally, China would be a more open market, similar to Hong Kong, with which it has close ties. However, the Taiwan structure—which is less open, with tighter collateral and without omnibus structures—is also under consideration.” All panelists expressed their hope that industry input would be taken onboard as these markets develop.

2 SDR inclusion to help China lure trillion-dollar inflows, CNBC, November 30, 2015
Institutions are adapting to the changing regulatory environment

“Global banks and broker dealers have different binding constraints.”

SAM EDWARDS
Head of APAC Equities Business and Liquidity Management, Credit Suisse

Across the segment, institutions are carefully assessing how they meet revenue, financial and risk goals while adhering to regulatory requirements. Edwards notes that while global banks and broker dealers may “look the same,” each has different binding constraints based on how they do business, where they operate and differing legal entities or subsidiary structures, etc. Given the interplay of regulations, “you may be disadvantaged in one scenario but advantaged in another,” he comments. Boeding agrees, noting that—like other firms—UBS has a constant dialogue about how to allocate finite balance sheet among clients and internal demands. This includes substantive conversations about the value of a particular piece of business vis-à-vis the capital that must be allocated against it.

Capital requirements are also affecting agent lenders. Sanchez says that regulations, particularly Basel III, require capital allocation to support indemnification. “The methodology is changing the way we price and offer indemnification,” he states, but remarks that the playing field isn’t clear or level at the moment, as regulations and implementation vary by jurisdiction. “Some European banks are still pricing very aggressively; however, it’s no longer a race to zero.”

Beneficial owners value the ability of an agent, acting on their behalf, to indemnify their clients against any losses as a result of a borrower default. In fact, without indemnification, Sanchez believes that many beneficial owners would not take part in a lending program. “It’s important for the industry to recognize that the provision of significant liquidity relies on the ability to provide indemnification,” he states. Liquidity has also been affected by a reduction in the need for borrowers to hold large general collateral balances against certain activities.

The panelists discussed how their firms are changing to manage the complex interplay of capital, liquidity and other binding constraints. Each institution is juggling multiple priorities, from the rise of centralized treasury functions to manage financing and asset inventories, to a close alignment of unsecured and secured financing, to changing trading strategies that carefully balance tenor, structure and asset utilization. All panelists agreed that tri-party agents have a growing role in the financing space, and that a strong partnership between the agent and counterparties is critical.

“We all have to manage against binding constraints, and they are different for each of us.”

SAM EDWARDS
Head of APAC Equities Business and Liquidity Management, Credit Suisse
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The impact on collateral is global

“As agent, we see how tri-party structures can help simplify the process of investing in Asia.”

O’DELLE BURKE
Head of APAC Collateral Management Product, J.P. Morgan

Collateral is widely seen as a key component in managing risk and addressing binding constraints. In discussing the management of collateral, five global themes emerged:

1. Collateral efficiency
   As cleared derivatives become the norm, the amount of collateral will increase. However, the long-discussed collateral shortage is unlikely, as institutions will become skilled at netting and cross-margining to achieve efficiencies at the CCP.

2. Collateral transformation
   Although securities lending contracts and structures are used, Sanchez notes that these differ from traditional lending and require education. “While clients long on high quality liquid assets are getting a return on those assets by lending them out against a lower quality asset, the counterparties are different. Instead of the traditional broker dealer or prime finance client, we are working with two sets of investor clients.”

3. Limits on cash collateral
   The repo market is being affected by the limits that broker dealers are placing on the amount of cash collateral they will accept. Agent lenders are experiencing a low interest rate environment and increased cost to the balance sheet. This affects/reduces the supply of cash they have available for the repo market.

4. Expansion of tri-party
   As institutions seek to diversify their trading strategies, the tri-party agency model is expanding to accommodate new structures such as fully funded swaps or trades that use pledged collateral versus transfer of title.

5. Counterparty diversification
   A broader mix of counterparties is emerging, with a shift from the traditional financial sector (agent lenders, money funds and brokers) providing liquidity. For example, more corporates are getting involved in stock loan transactions.
The view ahead: Complex, but optimistic

The panelists see significant opportunities ahead—particularly in Asia—but note that the market environment is likely to remain complex for the foreseeable future. Sanchez believes that the regulatory playing field will ultimately level out. Boeding thinks that the ongoing focus on implementing regulatory change will create competition for scarce investment dollars, which may make it more challenging to bring new products or services to market. Edwards feels that more on-the-ground support—particularly skilled legal staff and a solid IT infrastructure—will be needed to capitalize on the opportunities in Asia. Burke closed the discussion by reinforcing J.P. Morgan’s focus on Asia and the potential for tri-party structures to help drive efficiency, deliver operational support to market participants, and simplify the process of investing in Asia.

We wish to thank Citibank, Credit Suisse and UBS AG for participating in this roundtable. The views expressed are those of the participants alone and do not necessarily reflect the official policy or position of J.P. Morgan.