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Issue 346 20 February 2024

Be unique Be a pioneer

Japan Securities Finance's Yutaka Okada shares empirical research on the use of DLT in the securities finance market

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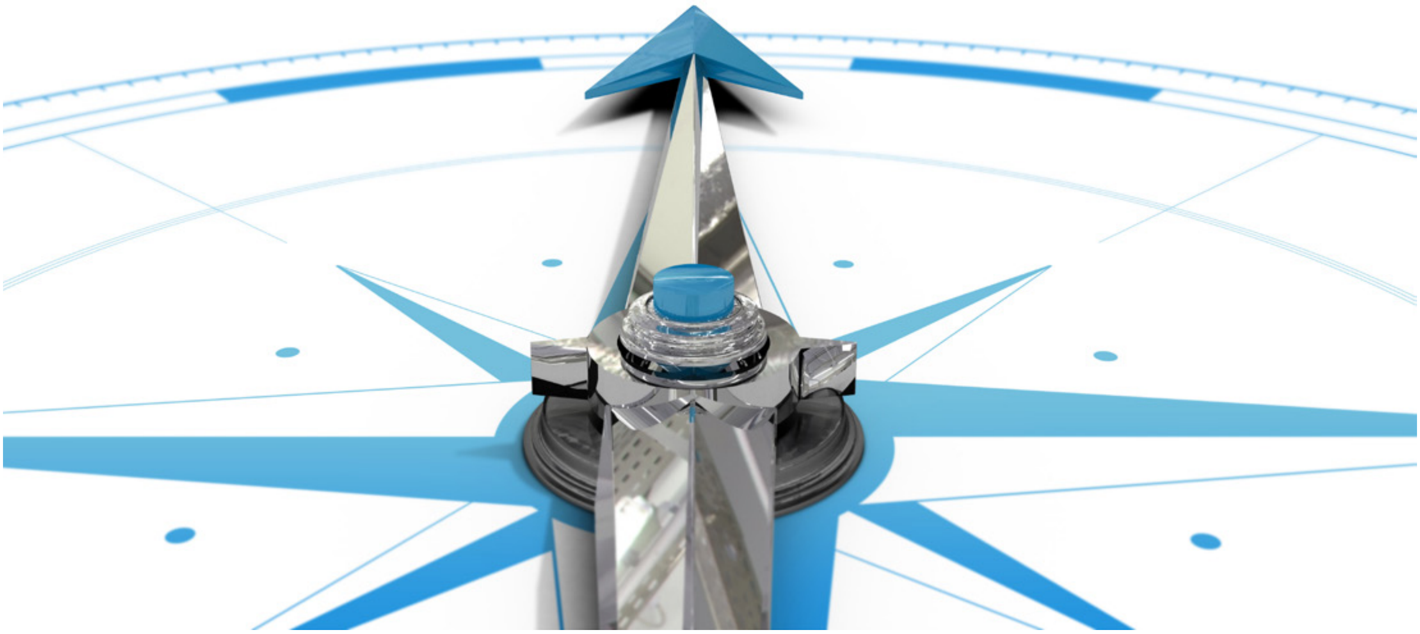

SEC adopts final rule to redefine securities dealers

The US Securities and Exchange Commission (SEC) has adopted a final Dealer Rule that will expand the definition of a 'securities dealer' and 'government securities dealer'.

The adopted rules will further define what it means to be engaged in a business of buying and selling securities "as a part of a regular business".

It will do so for both dealers and government securities dealers by requiring entities engaging in "de facto market making" activity to register as dealers or government securities dealers.

To be "part of a regular business" a firm will be "engag[ing] in a regular pattern of buying and selling securities" or "government securities" that has the effect of providing liquidity to other market participants. It may do so by regularly expressing "trading interest that is at or near the best available prices on both sides of the market for the same security — and which is communicated and represented in a way that makes it accessible to other market participants".

Secondly, it may do so by earning revenue "primarily from capturing bid-ask spreads, by buying at the bid and selling at the offer, or from capturing any incentives offered by trading venues to liquidity-supplying trading interest".

Market participants that engage in certain dealer roles — in particular, those who take on significant liquidity-providing roles in the markets — are now required to register with the SEC.

These participants will need to become members of a self-regulatory organisation (SRO) and comply with federal securities laws and regulatory obligations.

According to the SEC, principal-trading firms (PTFs) and other institutions are "acting in a manner consistent with dealers in the securities markets".

Continued on page 6

Inside this issue

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Trading Apps launch TA.Link

Trading Apps has celebrated the launch of its new messaging service TA.Link.

The Trading Apps team invited a number of market participants to the South Place Hotel in London to talk about the product's capabilities.

TA.Link provides an alternative connection which aims to mitigate the risk of using a single messaging service to communicate with counterparties.

With the ability to connect directly with users' front office systems, Trading Apps says the platform is a cloud-based Software-as-a-Service (SaaS) subscription offering, interfaced via standard Webservice API calls, making it "easily accessible to the market".

TA.Link is designed to cover all lifecycle events, providing increased efficiency and automation. Its features include sending and receiving targeted availability, counter offers and completed trade confirmation.

Founded in 2011, Trading Apps primarily produce front office trading tools for the securities finance business.

Commenting on the event, Trading Apps CEO Matthew Harrison says: "We are delighted with the success of the recent TA.Link launch event and with the interest in TA.Link generally.

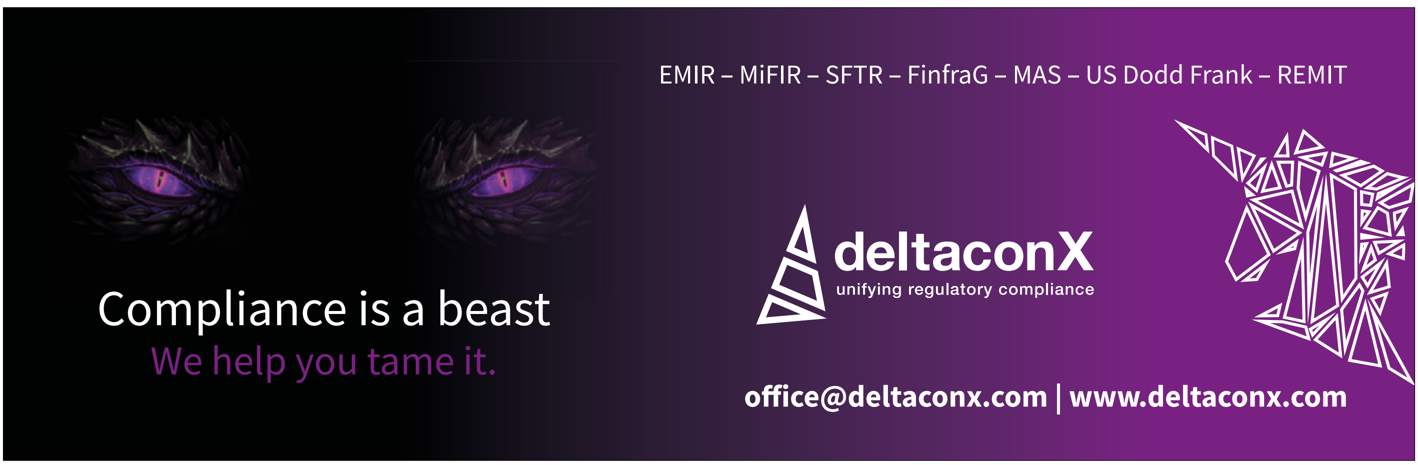
"Trading Apps is committed to digitising securities finance and to the reduction of the risk of concentration to a single distribution provider by delivering an alternative."

SEC adopts final rule to redefine securities dealers

Continued from page 3

It notes that PTFs that use high-frequency trading strategies are now participating "significantly" in the Treasury cash market. In 2019, these firms represented around 60 per cent of the volume on the interdealer broker platforms in the Treasury markets.

Despite these firms acting as de facto market makers, and despite their regularity of participation consistent with buying and selling securities or government securities "as a part of a regular business", the SEC



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says that a number of these firms have not registered with the Commission as dealers.

SEC chair Gary Gensler says that this deprives investors and the markets themselves of important protections that benefit market integrity, resiliency and transparency.

Gensler adds: “These measures are common sense. Congress did not intend for registration and regulatory requirements to apply to some dealers and not to others. Absent an exemption or exception, if anyone trades in a manner consistent with de facto market making, it must register with us as a dealer — consistent with Congress’s intent.”

The Alternative Investment Management Association (AIMA) indicates that the rules will require certain hedge funds and, potentially, advisers to register as dealers or government securities dealers if they meet one of two qualitative standards.

AIMA CEO Jack Inglis believes that the US SEC has “incorrectly concluded” that customers of dealers, including certain AIMA members, may be dealers themselves. He says it is a “clear departure from the statutory definition and understanding of what it has meant to be a securities ‘dealer’ for the past 90 years”.

Inglis continues: “Although the Commission did not adopt some problematic aspects that were included in the proposed rule, the final rule may nonetheless capture certain funds and strategies and therefore subject them to potential registration as a dealer and government securities dealer. AIMA will review the final rule text and assess next steps.”

The final rules will become effective 60 days after publication of the adopting release in the Federal Register. The compliance date for the final rules will be one year after the effective date of the final rules.

Bankaool selects Adenza Calypso Treasury Foundations solution

Mexican digital bank Bankaool has selected the Adenza Calypso Treasury Foundations solution to fulfil its treasury management requirements.

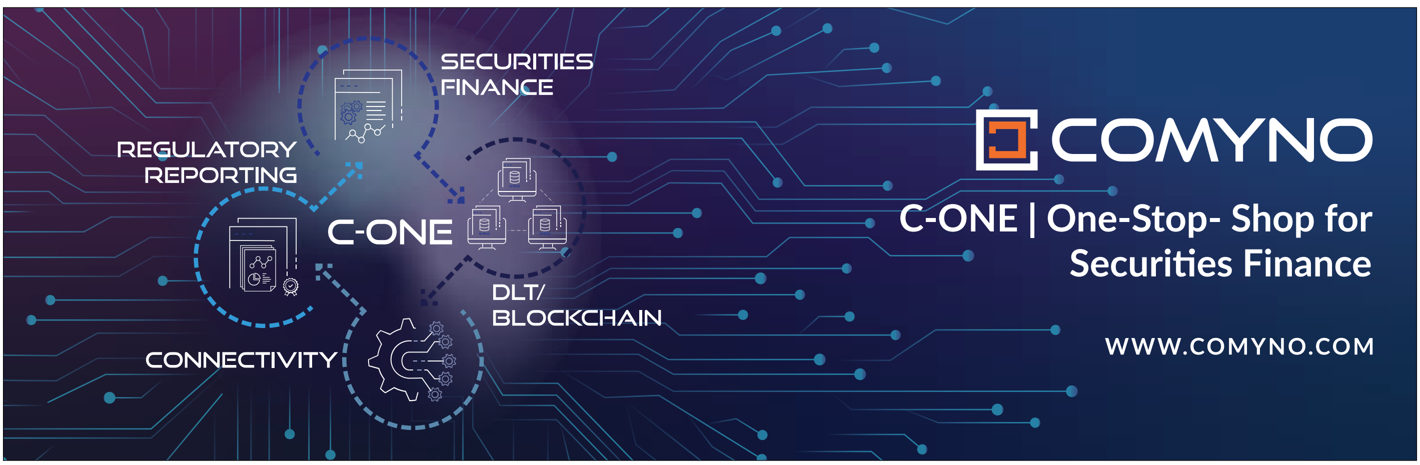
It will apply Calypso’s cross-asset front-to-back solution to strengthen its infrastructure for digital services and to meet regulatory requirements for accuracy and transparency across its treasury, liquidity management and post-trade functions.

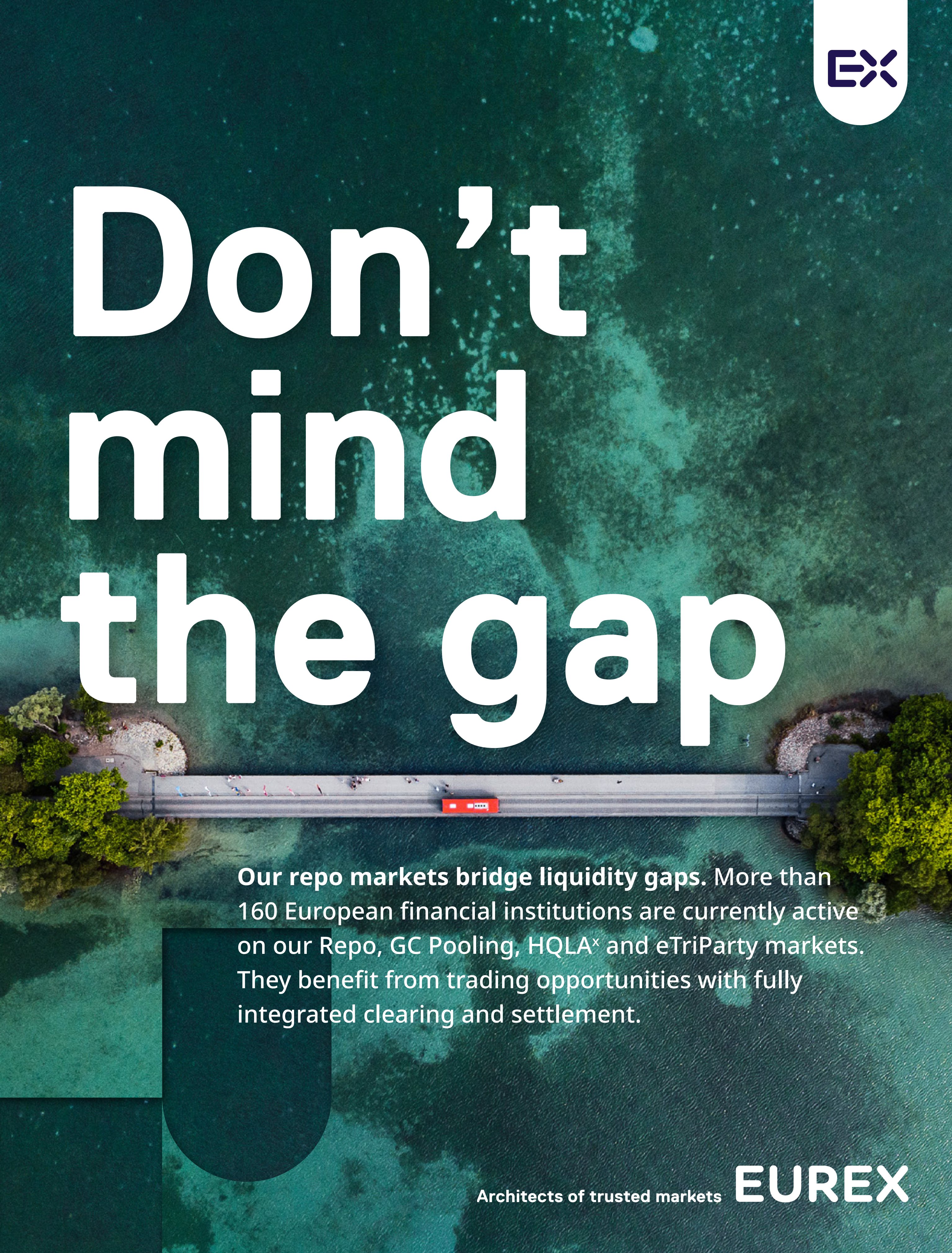
Bankaool is the first bank ever to receive a licence from the Mexican government to provide digital-only services.

Commenting on the development, Gerardo López Flores, CFO of Bankaool says: “This engagement reflects Bankaool’s commitment to operate with market-leading technology and embrace global best practices for data-quality processes and transparency.

“With the overall optimisation of this state-of-the-art platform, Bankaool can provide more diversified and price-competitive financial transaction services in the future.”

Luis Gustavo Penteado, head of sales for Latin America, Adenza adds: “By leveraging the Calypso Treasury Foundations’ preconfigured reference model, Bankaool can fast-track its implementation timeline and begin serving customers including the unbanked community much sooner.”

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BNY Mellon launches digital direct-to-custody trading

BNY Mellon's Global Markets Trading team has launched NEXEN Markets, a digital direct-to-custody trading solution.

The integrated trading solution automates end-to-end, trade-to-settlement processing and allows clients to place equity, ETF and US Treasury orders directly from their accounts.

Clients are able to view their cash balances and positions on a real-time, transparent basis, supporting straight-through processing and reducing both settlement and operational risks.

Trade execution data is visible in real-time, and a price stream is available for click-to-trade capabilities.

Following the launch, clients are able to handle their entire portfolio and access fixed income and equities services through BNY Mellon.

BNP Paribas Securities Corporation joins LCH CDSClear

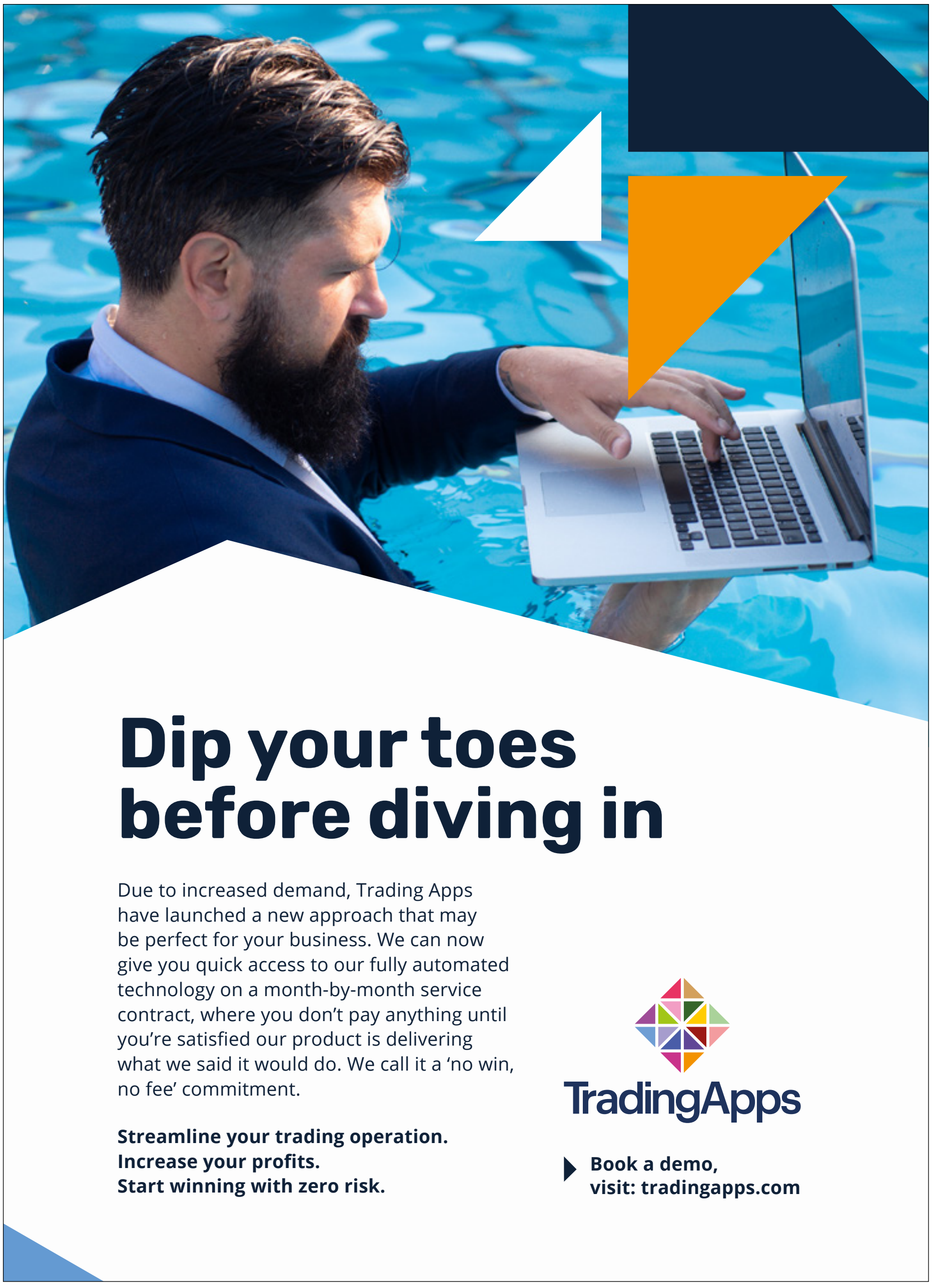
BNP Paribas Securities Corporation has joined LCH CDSClear as it expands its offering to the US market.

The company is the first futures commission merchant (FCM) entity to join LCH CDSClear and has cleared the first US buy-side trade on the service.

The partnership follows the expansion of LCH CDSClear's client clearing services to US credit derivatives market participants. LCH CDSClear aims to create greater access to the capital reduction, margin offsets and operational efficiencies available through clearing.

Frank Soussan, global head of CDSClear and head of SA EquityClear and CommodityClear at LCH, says: "Onboarding FCM members and expanding our services to US clients means we are not only extending the benefits of clearing to more market participants, but we are also increasing the choices that they have in CDS clearing.

"This is a significant step in our commitment to providing a truly global service with a single pool of liquidity to the cleared CDS



market and we look forward to continuing to support our clients globally."

Gaspard Bonin, deputy global head of derivatives execution and clearing at BNP Paribas, adds: "We are proud to be the first FCM member to go live with client clearing at LCH CDSClear for US market participants."

ESMA clarifies best execution reporting for MiFID II

The European Securities and Markets Authority (ESMA) has issued a public statement providing clarity to market participants on reporting requirements under RTS 28, pending full application of the new rules under MiFID II.

According to the European regulator, national competent authorities (NCAs) are not expected to prioritise supervisory actions towards investment firms relating to the periodic RTS 28 reporting obligation.

This will take effect from 13 February 2024 and until the forthcoming transposition into national legislation in all member states of the MiFID II review.

Previously, Article 27(6) MiFID II required investment firms to make public the top five execution venues where they executed client orders in the preceding year, as well as information on the quality of execution obtained.

Under the reviewed MiFID II and MiFIR framework, investment firms are no longer required to annually report detailed information on trading venues and execution quality through RTS 28 reports.

According to Recital 8 of the MiFID II review amending directive, evidence and feedback from stakeholders have shown that those reports are "hardly read and do not enable investors or other users of those reports to make meaningful comparisons based on the information provided in them".

Consequently, investment firms may still need to make these reports public in

2024 and until the date of transposition of the directive in the respective member state.

ESMA stresses the importance of the best execution requirements under both the current and the reviewed MiFID II framework.

It adds that investment firms are required to strictly adhere to best execution requirements and NCAs are expected to supervise their compliance.

After the date of entry into force of the new directive amending MiFID II, member states will have 18 months to transpose it into national law.

ESMA's recent statement aims to promote coordinated action by NCAs under MiFID II.

ADEX Holdings announce partnership with Asterisk Networks Solutions

ADEX Holdings (ADE) is partnering with Asterisk Networks Solutions (ANSL) to implement more efficient trading solutions.

ADE will list novel deliverable products while ANSL will facilitate the borrow and lend function, contributing to the orderly functioning of its markets.

Alternative Derivatives Exchange (ADE) is a regulated derivatives exchange, offering a full trading cycle from product issuance via its digital central securities depository.

ANSL is a multi-asset class negotiation platform delivering peer-to-peer connectivity for its participants.

The partnership will ensure that the clearing member will be able to source the underlying assets necessary for short positions in the spot markets, as well as the required collateral during the product deleverage stage.

Djordje Radic, CEO of ADE, comments: "We look forward to the strategic

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direction Asterisk will bring to our team, particularly as we expand our global clearing and settlement strategy with Clear Chain technology.”

Deutsche Börse reports 17% increase in net revenues

Deutsche Börse net revenues increased by 17 per cent to €5,077 million for the year 2023.

The increase was assisted by the acquisition of global software company Simcorp, which delivered net revenue volumes of €198 million in Q4.

The group reported a mixed year for the European fund industry in 2023.

Although it benefited from rising prices, the higher interest rates opened up alternative investment opportunities, prompting outflows from equity funds.

For Q4 2023, fund processing increased 8 per cent year-on-year (YoY) to €56.1 million while fund distributions declined 13 per cent YoY to €21.3 million.

For 2023, fund processing increased by 1 per cent YoY to €213.9 million, while fund distributions declined 5 per cent YoY to €85.3 million.

In securities services, custody and settlement were positively affected by ongoing high levels of fixed income issuance activity and higher index levels.

For Q4, securities services reported a 7 per cent YoY increase in net revenue to €371.5 million. For 2023, net revenue increased 35 per cent YoY to €1,510.7 million.

Custody services reported a 3 per cent YoY increase to €152.6 million for Q4 2023, and a 5 per cent YoY rise for 2023 to €615.1 million.

There was a 12 per cent YoY rise in settlement volume recorded for Q4 to €28.9 million, with 2023 volumes rising 9 per cent YoY to €114.4 million.

For 2024, the firm aims to increase momentum in fixed income by expanding its repo offering, increasing its market share in OTC clearing and by moving into short-term interest rate derivatives.

In trading and clearing, financial derivatives benefitted mainly from higher fixed income activity, futures and repo, while lower equity volatility resulted in a decline of margin fees.

For Q4, net revenue increased 8 per cent to €582.4 million. For 2023, results rose 3 per cent YoY to €2,262.8 million.

ESAs dismiss DCCC appeal

The Joint Board of Appeal of the European Supervisory Authorities has unanimously decided to dismiss the Dubai Commodities Clearing Corporation’s (DCCC) appeal against the European Securities and Markets Authority (ESMA).

The appeal was made in October 2023 following ESMA’s decision to withdraw the recognition of DCCC as a Tier 1 third-country central counterparty.

The ESAs’ original decision was made following the European Commission’s December 2022 inclusion of the United Arab Emirates on its list of high-risk third countries under the Commission Delegated Regulation (EU) 2016/1675.

The jurisdiction was found to be presenting strategic deficiencies in their national anti-money laundering and counter financing of terrorism regimes.

ESMA’s decision is now fully operational.

CME BrokerTec reports 11% rise in US repo

CME BrokerTec has reported an 11 per cent year-on-year increase in US repo average daily notional value (ADNV), generating US$228 billion for January.

However, repo activity slowed during the first week of the year. John Edwards, global head of BrokerTec, CME Group, reports that there were fewer positions to finance in many dealer inventories and less 'special' securities in the market.

In line with previous years, the first week of January started slowly across both Euro and UK gilt repo markets.

Volumes started to increase as the month progressed, resulting in notional ADV of €273 billion.

BrokerTec US Treasury ADV was up 2 per cent YoY to US$108 billion in January.

“Economic data in January was a mixed bag,” comments Erik Norland, chief economist at CME Group.

“European bond yields followed a similar pattern to US Treasuries, with yields rising during the first three weeks of the year. However, they did not rally as strongly as the US Treasuries did later in the month.”

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Be unique. Be a pioneer. The evaluation of DLT in securities finance

Japan Securities Finance's Yutaka Okada, senior managing executive officer, shares with SFT the significance of its findings on the use of distributed ledger technology in the securities finance market

Japan Securities Finance (JSF) has contributed to the development of Japanese securities and financial markets for a number of years as the only securities finance company in Japan. Being aware of its public role as an infrastructure in the markets, JSF is also striving to enlarge its frontier and has engaged in empirical research in how distributed ledger technology (DLT) can be applied in securities financing.

As a securities finance company, how does the service JSF provides contribute to the market?

JSF is a securities finance company licensed under the Financial Instruments and Exchange Act and was established in 1950. Through our core loans for margin transactions business, we have played an infrastructure role for the Japanese securities market, especially in providing liquidity as a lender of last resort for the stock market for more than 70 years, while developing various services related to securities finance to meet diverse client needs.

What initiatives are JSF undertaking with respect to the use of DLT?

In collaboration with the Graduate School of Engineering of The University of Tokyo, Laboratory of Professor Kenji Tanaka, we conducted empirical research to explore the feasibility of using DLT to facilitate securities financing transactions (SFTs) and released a report compiling the results on 30 May 2023.

Looking at the scale of SFTs in Japan, the balance stood at around JPY 200 trillion. However, there has been little research using DLT in Japan focusing on SFTs. It would be very valuable to explore the feasibility of using digital tokens in SFTs, which are essential for providing liquidity to the market. JSF therefore decided to conduct this empirical research.

How did you carry out this research and what were the key findings?

The empirical research addressed three key points of inquiry.

The first was the feasibility of SFT execution with regards to individual bilateral transactions. JSF tested whether various types of SFTs, including those involving the exchange of assets denominated in different currencies, can be smoothly implemented from the start of transactions through margin calls to the end of transactions. In addition to the exchange of security against cash (typical repo), we also tested the exchange of security against security.

The second evaluation focused on the system performance when processing transactions on a market-wide scale. Transactions that occur in the entire market were input into the system and its performance was evaluated. We analysed how resilient the developed system is in terms of a high concentration of transactions during market stress or recovery from system disruptions. In addition, we measured how resilient it is to the anticipated large system workload when marking to market and implementing margin calls every business day, where the system burden is considered to be heavy.

The third research focus involved the impact of collateral diversification and threshold setting for margin calls on net credit amount and necessary liquidity, including the impact in times of market turmoil.

We conducted simulations for each market scenario — normal time and market turmoil including rapid increase, rapid decrease and high volatility — depending on how diverse collateral is and whether or not a threshold is set when implementing a margin call.

What implications were identified within your research and what are the advantages of using tokenised assets for SFTs?

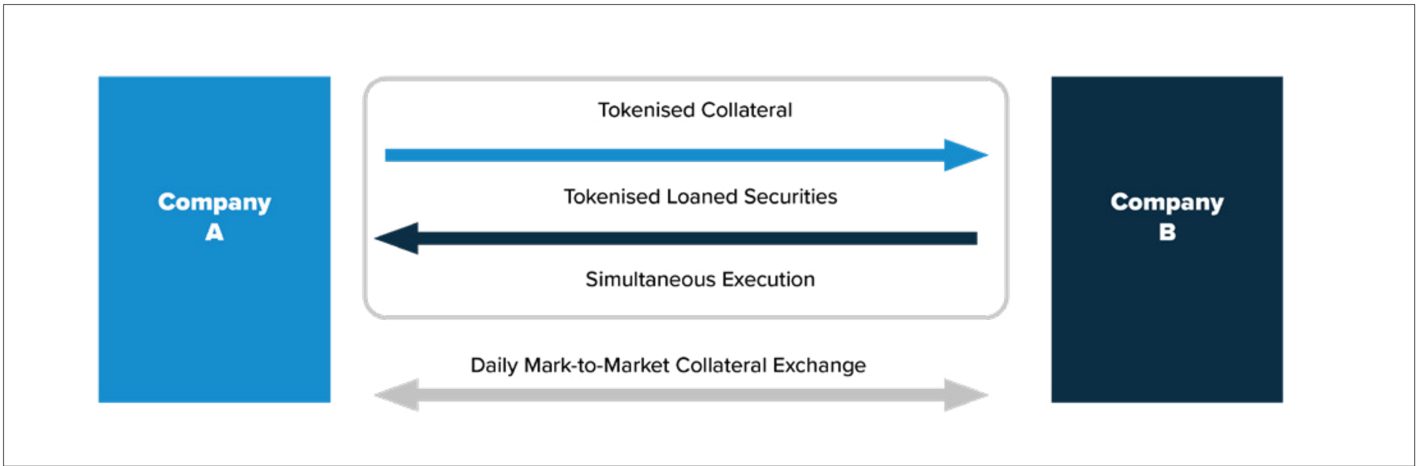
From this research, we drew five principal conclusions.

Transaction feasibility

We confirmed that various types of SFTs can be smoothly implemented from the start of transactions through margin calls to the end of transactions.

With regard to the start of transactions, the recording and approval process was carried out smoothly even in times of market stress when the daily market-wide transactions were concentrated in one hour. Mark-to-market and margin call processing were possible, although it took a certain period of time even when assuming that one-third of outstanding transactions that exist in the entire market are concentrated.

Fig 1: Conceptual diagram of empirical research



Reduction of settlement risks and simultaneous execution of transactions denominated in different currencies

Blockchain technology can be utilised to exchange tokens for tokens simultaneously without a time difference. In the case of exchanges in existing settlement systems, which involve foreign currencies or foreign securities, the transfer of funds and securities must be executed during local time at the local transfer institution. For this reason, generally a time difference occurs before completion of transaction settlement or completion of margin call.

In this empirical research, on recording and approving the transaction on the blockchain after deal, the exchange of tokens for tokens on the blockchain could be executed simultaneously in real time — even if the underlying assets are denominated in different currencies. Also, margin calls can be automatically implemented after updating the daily market value without the need for operations by the transaction parties.

Reduction of credit risk and flexibility in economising liquidity

The project confirmed that automation of margin calls using blockchain technology reduces operational burden, making it easier to make margin calls and, as a result, this can also reduce credit risk.

Automation can almost eliminate the operational burden involved in managing collateral diversification and adjusting multiple assets posted as collaterals in margin calls. As a result, collateral diversification reduces volatility not only in collateral value but also in net credit amount, having a positive effect on credit risk management. In cases where a threshold is set to reduce operational burden associated with margin calls, the automation offered through blockchain and smart contracts is itself important in relieving the operational burden. Therefore, threshold setting also provides the benefit of controlling system burden following an increase in the number of margin calls.

When a threshold is set, margin calls will not be executed until the net credit amount reaches the threshold. Therefore, the net credit amount will increase compared to when no threshold is set. We confirmed that this effect can be mitigated or offset by diversifying the collateral securities.

Furthermore, the credit risk reduction effect and liquidity economising effect gained through such a combination of the threshold and collateral diversification effect proved to be particularly effective during market turmoil.

Streamlining of operations

Using blockchain in SFTs enables automated execution without manual intervention following predetermined conditions in a smart contract with regard to settlements. This captures details related to the start and end of the transaction and margin calls during the transaction term.

These results suggest that the use of blockchain can make it possible for straight-through processing (STP), improving the efficiency of SFT operations and managing operational risks. In particular, this has the potential to significantly reduce the operational overhead and time required to exchange transaction information and check execution status with counterparties located in foreign countries, thereby improving the efficiency of transactions.

Utilisation of assets with low liquidity

There are cases where the transfer of the rights of certain securities with low liquidity, such as unlisted shares, involves a significant operational burden and time as the actual certificate must be transferred or changes must be made to the registry. It will become easier to transfer rights of low-liquidity assets by tokenisation. This provides potential not only to hold these low-liquidity assets, but also to utilise them as collateral in SFTs. Furthermore, it is believed that increasing the usage as collateral in this manner has the potential to increase the valuation of the underlying assets.

The results of this research are published in a paper entitled "Empirical Research on SFTs using Distributed Ledger Technology" (https://www.jsf.co.jp/english/media/report_dlt_en.pdf).

What future initiatives do you have in the pipeline for the use of DLT in SFTs?

Through this research, we found that there are various possibilities for utilising blockchain to support SFTs. Although there are issues to be addressed, such as connection to external systems and handling of legal considerations, we aim to explore the possibility of conducting actual transactions on a trial basis.

Is there anything else you would like to share with our readers?

In November 2023, JSF formulated and published the Long-Term Management Vision, which includes the corporate message "Be unique. Be a pioneer". In the field of DLT, we aim and strive to be unique and a pioneer.

We also proactively participate in international conferences organised by the International Securities Lending Association (ISLA) and the Pan Asia Securities Lending Association (PASLA). We look forward to engaging in exciting discussions with market participants on such occasions.

Yutaka Okada

Joined the Bank of Japan in 1987. He was engaged mainly in the financial stability, payment and settlement systems and financial markets. He also participated in the Committee on the Global Financial systems, at the BIS and the Committee for Financial Markets at the OECD. From 2015 to 2018, he was head of Currency Issue Department of the bank. In 2018, he joined JSF. As senior managing executive officer of JSF, he currently oversees corporate strategy, business development, treasury and international relations.

Asia Pacific: an exciting but fluid future

Record balances and revenues point to the scale of commercial opportunity within the APAC region, says Stephen Howard, CEO of the Pan Asia Securities Lending Association, who speaks to Carmella Haswell about the securities lending outlook across the region

How do you view the current securities lending environment across the APAC region? What is driving activity in this area?

It is a bit like the opening of A Tale of Two Cities: ''It was the worst of times, it was the best of times.” On one hand we see balances exceeding historical peaks and revenues achieving the same, according to both EquiLend and S&P Global data. At the same time, there are challenges in a number of regional markets as they review their market structure and the way that securities financing fits into their own capital market positioning.

PASLA has been engaging with the developing markets in the region, including China, the Philippines, Indonesia and Sri Lanka, to help them to enhance their capital markets by initiating reviews of either short-selling or securities lending.

Real investment appetite is key, so the underlying companies, the growth vector and opportunity are the fundamental factors driving securities financing activities in the markets. There is a significant variance in market profiles and investment returns across the region, as you would expect in a region as diverse as APAC. But it is clear that the more open capital market structures have benefitted significantly as they continue to encourage the free flow of risk capital.

What are you hearing from your members in terms of demand and where do you identify the strongest opportunities in the market for 2024?

Demand flows are strong. As our member firms adapt to the increased rate environment, they are all adjusting how they consider capital and collateral costs, so the demand drivers continue to be a combination of hedging, financing and the creation of acceptable collateral. The returns dispersion among equity indices within the region reflects this as Japan hits all-time highs in the Nikkei 225, while other regional benchmarks have struggled in 2023-24.

Key sectors of demand focus are as broad as any other region, but there continues to be particular interest in property, transport, technology and industrials as Asia — and not just China — remains the engine room for the rest of the world.

Deep markets that offer liquidity at a time of macro uncertainty — such as Japan, Hong Kong and Australia — are active and healthy in terms of demand and supply factors and we look to the issuance calendar for the year ahead.

What are the key priorities for PASLA over the coming 12 months?

More with more. As we grow the association, both in terms of our membership and the reach and impact of our advocacy, we will continue to develop our delivery for our member firms that is anchored in their requirements and aligned with the needs of all our stakeholders. We expect to see more bespoke thematic discussions that drive the agenda for the industry across Asia Pacific.

Our top priorities include the following:

- **Progressive integration of securities finance across APAC:** We want to play a proactive role in driving progress towards the greater integration of securities finance within capital markets structures across the region. APAC markets are on a long-term journey towards integrating securities finance. While we do not expect the characteristics of securities finance to be uniform across such diverse markets, maintaining progress towards the integration of securities finance in market structures is critical as this delivers benefits including increased liquidity, more efficient price discovery and greater attractiveness to global investors.
- **Rethinking securities finance:** Securities lending and the ability to cover short positions are core elements of securities finance, but developing a robust, liquid market structure involves a broader spectrum of securities finance activities. PASLA is committed to educating all stakeholders about — and advocating for — all aspects of securities finance, including market access, securities-backed lending, repo and margin financing.
- **Leveraging innovation:** The digitalisation of securities finance is poised to deliver meaningful benefits to financial institutions and underlying markets. Emerging technologies such as distributed ledger technology (DLT) can enable streamlined processes, risk reduction and capital optimisation in the securities finance ecosystem. PASLA works to educate our members, as well as APAC exchanges and regulators, about the innovation landscape, supporting them in making informed strategic choices.

Which new emerging markets are currently attracting the most attention from market participants? How do you see these markets progressing over the next year?

From a market access perspective, it continues to be about the efficient use of capital to gain access to regional markets, so securing economic exposures while ensuring assets can be financed is critical to a large segment of the PASLA membership. This enables members to continue to scale their business activity and to address the needs of their client base, while managing their own scarce resources. Basel III and the proposed capital changes will only increase this focus on the financing quality of an asset.

> **"With a strong capital markets infrastructure and a world-class regulatory environment, Singapore has scope for a more vibrant securities finance ecosystem to help enhance turnover."**

We have also seen constructive deregulation in Indonesia and the Philippines as they seek to develop a broader range of hedging solutions for investors within their capital market structures.

How did the associations decide on Singapore as this year's PASLA Conference destination? How significant is the country's performance in the overall securities lending market in APAC?

Singapore is a leading financial centre in the region and a key hub for many of our member firms, as well as the broader community of asset managers, family offices and regional sovereign wealth funds. That makes it a natural choice for this year's PASLA conference.

With a strong capital markets infrastructure and a world-class regulatory environment, Singapore has scope for a more vibrant securities finance ecosystem to help enhance turnover, particularly if it can leverage its strengths in wealth and asset management.

What can market participants expect from this year's conference? What are the predominant themes of the event?

One of the themes is the advocacy for the full product suite that exists within securities finance. We are embracing the business activities of all our members and this is a clear focus for our new executive leadership team.

In terms of breadth, our agenda brings perspectives from inside and outside of our industry on themes including asset allocation, emerging markets, fixed income, hedge funds, liquidity investors, market access derivatives, operations, technology and leadership.

For depth, PASLA is bringing together the whole APAC securities finance community, as ever. This year, the conference will be attended by asset allocators, asset managers, beneficial owners, central banks, custodians, prime brokers, technology providers and other participants. We are looking forward to welcoming participants from more than 22 countries and territories.

With regards to optimising for the future, securities finance in Asia Pacific faces an exciting, but fluid, future. Record balances and revenues point to the scale of the commercial opportunity in the region, but market participants must balance their global focus on costs with the case for investment to capture growth in APAC.

Stephen Howard
CEO
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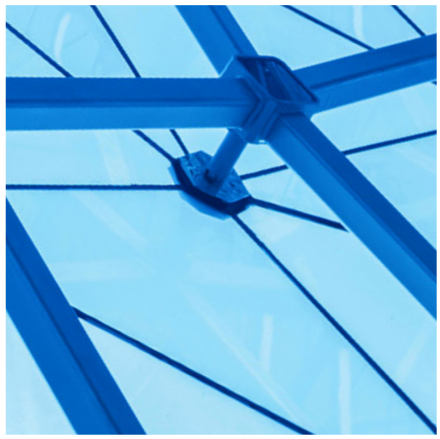

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Singapore: navigating economic uncertainties

Singapore might be one of the most prosperous countries in the world and an international financial centre, but in securities finance, market activity remains muted. Sophie Downes reports

The appeal of Singapore is apparent: cultural hub, visionary airport, major financial centre. As reported by the International Monetary Fund, the country's GDP per capita exceeded US$91,000 in 2024. Nonetheless, a closer examination of the region highlights muted activity and vulnerabilities felt by market participants, even as sustainable initiatives pose the country as a significant environmental figurehead.

Singapore in context

The Monetary Authority of Singapore (MAS) believes that the global financial environment is a key concern for financial institutions in Singapore. In their Systemic Risk Survey, conducted in October 2023, the regulatory body reported that "macrofinancial risk arising from the cumulative effects of restrictive monetary policy by major central banks, slower global economic growth, and contagion from a slowdown in China remained the top-cited risk" by financial businesses.

Matthew Chessum, director at S&P Global Market Intelligence, highlights the same concerns when discussing Singapore's place in the wider context of the Asia Pacific (APAC) region. Like MAS, he believes that a slowdown in China's economic activity has been "weighing heavily" on the Singaporean markets, as evidenced through the slower volumes recorded in securities lending. The lack of conviction in Southeast Asian markets, due to uncertainty around China's economic data and future, has led market participants to be more cautious when investing.

"The APAC region presents interesting dynamics due to country-specific factors affecting securities lending," contends Chessum. Singapore and some Southeast Asian markets have been more muted due to economic uncertainty from China's slowdown, while countries such as Taiwan, South Korea and Japan have seen strong activity. Singapore is one of the smaller lending markets across the Asia Pacific region, with a similar market capitalisation to Thailand and Indonesia. However, during 2023, Singapore equities generated slower returns than usual, reporting US$16.3 million in securities lending revenues.

"Despite the market being one of the more straightforward markets across the APAC region to transact in, securities lending revenues in Singapore have been in decline over the last few years," Chessum observes. "Revenues have reduced over the last four years as average fees have fallen across the market." The decline in average fees has taken place against a backdrop of growing supply, with average lendable assets growing from US$45.6 billion in 2020 to US$62.8 billion in 2023. Balances have increased over the same period, growing from an average of US$1.97 billion in 2020 to US$2.40 billion during 2023. This growth in balances has kept utilisation stable at around three per cent over the period.

Market Activity

In Singapore, there are a handful of stocks that remain popular among borrowers, all of which have experienced sustained demand for a number of months. For an indication of size, highly shorted stocks in Singapore typically have around five per cent of outstanding shares on loan, compared to around 40 per cent for highly shorted stocks in the US.

Investment holding company AEM Holdings Ltd (AWX) was the top shorted stock, with 12.32 million shares borrowed and 3.99 per cent of SI Outstanding. This was closely followed by Singapore Airlines Ltd (C6L) with 117.73 million shares borrowed and 3.96 per cent SI Outstanding. While Chessum acknowledges that data from Singapore is regularly included in weekly S&P reports of top five shorts in the APAC region, "activity is limited in comparison to larger markets due to the smaller size of companies listed on the Singapore exchange".

The low valuations can also be attributed to the respective challenges facing companies in their various sectors. He suggests that the pandemic is responsible for the "underwhelming" profits reported by AEM Holdings as the semiconductor sector struggles following a post pandemic dip in demand: "Factories have reinstated their inventories post-Covid-19 and requirements for semiconductors have fallen as the demand for electronic goods has declined."

Similarly, Nanofilm Technologies continues to suffer from ongoing macroeconomic challenges, such as persistent inflationary pressures, high interest rates and geopolitical tensions. Chessum believes that these challenges "have led to reduced consumer discretionary spending that has impacted demand, especially given the softer than expected economic recovery in China".

Singapore Airlines currently has 3.96 per cent of its market capitalisation on loan (STI average of 0.43 per cent). "Despite air travel picking up recently, a lot of airline stocks are still trading far away from their pre-pandemic levels," explains Chessum. "An increase in interest rates is expected to hit consumer spending and leisure travel, if a recession does kick in as a result."

Chessum's forecast may be assuaged by the government's recent announcement of a 30-Day Visa-Exemption Arrangement between Singapore and The People's Republic Of China. The mutual agreement is expected to bring opportunities to investors by boosting the tourism, hotel and entertainment industry as more people visit. The impact may be seen on representative stocks such as Singapore Airlines and Genting Singapore.

SFTs

Nonetheless, MAS has provided a positive outlook for securities finance transactions (SFTs) in its Financial Stability Review of 2023. The SFT market in Singapore, primarily consisting of bond repos and securities lending, has experienced significant growth. From March 2017 to June 2023, figures have expanded from US$106.4 billion to US$287.2 billion, representing 4.9 per cent of national financial system assets.

The majority of domestic SFT activity occurs between banks, while cross-border SFTs constitute 86 per cent of transactions involving Singapore-based entities. Domestic banks are prominent in both domestic and cross-border transactions, often engaging with foreign banks as counterparties. Domestic hedge funds, on the other hand, primarily transact with foreign banks and dealers.

The proportion of SFTs collateralised by government securities has increased from 58 per cent in 2017 to 66 per cent in 2023. MAS argues that this is “possibly reflecting cash lenders’ increased preference for relatively safer and more liquid instruments in view of heightened macrofinancial uncertainty”. The trend indicates a shift towards more risk-averse investment strategies in response to market conditions.

Going for green

Singapore is extending the focus of its environmental policies as sustainable initiatives have been implemented across multiple sectors. The country’s ‘Green Plan 2030’ was implemented in 2021, with their ambitiously named ‘green economy’ being one of five pillars that the country is working on to promote sustainable development. As part of the Enterprise Sustainability Programme, Singapore businesses will be supported on sustainability initiatives by promoting training workshops, capability and product development projects and key enablers such as certification and financing.

Moreover, as the securities finance industry becomes increasingly technological, Singapore is demonstrating the way in which automation can be adapted to bolster environmental policy. “Technology will not slow down for anyone,” Cecilia Skingsley, head of the BIS Innovation Hub, stated in January 2024. “As the financial industry adopts new technologies, we need to understand how they affect central banks’ core work.” Technological imperatives include Project NGFS Data Directory 2.0, led by the Singapore Innovation Centre. The project plans to build on the data directory platform of the Network for Greening the Financial System to make climate-related data gaps more accessible as a public resource.

Elsewhere, the push for sustainable initiatives is being seen on a macrocosmic level across the financial sector as industry figureheads spearhead the movement. In their 2023 Financial Stability Review, MAS pledged: “Going forward, MAS will step up its efforts to improve internal and industry capabilities in climate risk assessments. This will enable financial institutions to better factor the implications of climate change and the climate transition.”

Meanwhile, in a sustainability report conducted in November 2023, the Singapore Exchange (SGX) recorded that almost all companies had improved on their commitment to environmental initiatives. Based on the Task Force on Climate-related Financial Disclosures (TCFD) framework, 73 per cent of companies had provided some form of disclosure about practices in the workplace for the first time. While this still leaves room for improvement across the Exchange, it is evident that ESG initiatives are becoming increasingly visible across technology and regulation.

Future forward

In MAS’ Systemic Risk Survey, there were two other areas of concern for financial institutions going forward: geopolitical and cyber. The survey reported that respondents were concerned “that a further escalation of geopolitical tensions, such as the US-China strategic rivalry or the war in Ukraine, could lead to sharp market and commodity price volatility, and cause supply chain disruption”.

Likewise, fears around technology and cyber risk were also pertinent following the recent banking service disruptions in Singapore. In response to these fears, the regulatory body says that it will use the report to inform risk assessment and “work closely with the industry to manage identified risks through supervisory engagements and policy reviews”.

Tan Boon Gin, CEO of the Singapore Exchange Regulation, believes that there is a lot to be working on. Referring to 2023 as “a year of firsts”, he outlined his focuses for 2024: “Getting climate reporting, board renewal, and shareholder rights right all call for lots of details, lots of data and lots of deliberation. These are not the only things that we are going to do, just what we are going to start doing first.”

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Asia-Pacific securities finance panel

Key participants in APAC securities finance speak about market dynamics, the impact of short sale bans, the advance of emergent markets and growth prospects for 2024 and beyond

Panellists

Jansen Chua, head of financing solutions, APAC, **State Street**

Phil Garrett, head of securities finance, APAC, **Northern Trust**

David Lai, product manager, agency securities finance, APAC, **J.P. Morgan**

Reona Sasaki, director, institutional sales department, **Japan Securities Finance**

Paul Solway, head of securities finance, APAC, **BNY Mellon**

How do you assess the performance of APAC securities lending markets during 2023? What key lessons have you learnt from this period that will help guide your business through the next 12 months?

Reona Sasaki: The APAC market was strong overall in 2023 as EquiLend and other sources have indicated. Japan, in particular, has attracted attention from foreign investors in an unprecedented way. This is partly due to the Bank of Japan's (BOJ's) monetary policy, and such global recognition benefitted JSF's business as well. We have had more opportunities to do transactions with overseas financial institutions. Therefore, we feel it is crucial to analyse international market trends to obtain a better understanding of the background of our business partners' needs.

Over the past few years, APAC securities lending markets have been subject to regulatory revisions related to collateral and short-selling. As a result, expectations for APAC as a growth market are increasing steadily. Our immediate priority is to further strengthen our commitment in the APAC region outside of Japan.

Jansen Chua: Performance across the region was mostly in line with expectations and demonstrated growth. However, the short sale ban in South Korea did register as an unfortunate surprise in the later part of the year and this dampened further demand for borrowing.

Phil Garrett: Like most other years, 2023 produced winners and losers across the APAC markets. Japan was the strongest performing stock market, buoyed by investor inflows, and this drove the Nikkei 225 to its highest level for 33 years. Stricter governance rules, performance pressures and an increase in activist shareholder activity were catalysts to drive stock valuations higher and foster an environment ripe for M&A deals, placements and other corporate activity. The long-held taboo of hostile takeovers in Japan is also slowly eroding, further encouraging dealmaking, drawing in the arbitrageurs and giving a significant boost to securities lending revenues. This pushed Japan into the top spot for 2023.

Taiwan also performed strongly once again, with the mania surrounding artificial intelligence driving the technology-heavy TWSE index higher. This provided a fertile hunting ground for directional, relative value and long-short strategies. Elsewhere, China's stock market suffered from post-Covid blues, with the troubled property market and low consumer confidence dragging on the economy. Hong Kong's stock market, intrinsically linked to China's fortunes, remained subdued. While there was strong borrow demand across certain sectors, including real estate and electric vehicle (EV) manufacturers, the depressed market valuations resulted in lower outright lending returns relative to other markets. South Korea (EVs) and Australia (lithium miners) produced other pockets of good performance.

If 2023 taught us anything, it reinforced the lesson that we should always expect the unexpected. At the beginning of 2023, investors hoped that the end of Covid lockdowns in China would stimulate growth and drive markets higher. The consequence would be to allow share prices to be driven by fundamental factors, allowing short sellers to make better informed decisions and increase market exposures, as well as inducing the type of conditions we have seen in Japan, perhaps giving rise to increased deals and capital raising activity. As we now know, this has been far from the case.

In early 2023, there was also a growing confidence that South Korea's regulator would remove the short selling ban for constituents of the KOSPI 200 and KOSDAQ 150 indices. Again, this did not happen — and, in fact, a total short sell ban across all listed stocks was implemented in early November and this is set to remain in place until at least the end of June 2024. It is therefore a dangerous tactic to rely heavily on any single market to produce next year's performance numbers. Diversity is the key. For Northern Trust, this means diversity across our product suite, working with our clients to capture opportunities by providing access across multiple financing markets and asset classes through customised and innovative technology-driven solutions.

David Lai: In 2023, the Hang Seng Index in Hong Kong experienced a tough year compared to some of the other markets. China's post-Covid recovery was slower than anticipated, coupled with widespread credit concerns in the property sector, and this has adversely affected investor and consumer sentiments. The Chinese tech sector faced headwinds in 2023 off the back of tightening regulations initiated in 2020. This resulted in some diversion of foreign tech investments away from China. Industries such as Quantum Computing, Artificial Intelligence, and Advanced Semiconductors witnessed significant reductions in investment.

In Japan, the Japanese stock market saw strong increases in the first half of 2023, with momentum continuing into the second half of last year. The Nikkei 225 recorded its strongest performance since the late 1980s. The continued strength of the US dollar against the Japanese Yen further boosted offshore investments into Japan, contributing to overall market increases. Upbeat sentiments in Japan promoted an increase in capital-raising activities, resulting in the highest number of IPO listings in nine years, including substantial offerings like Kokusai Electric and Rakuten Bank. In addition to primary listings, increased stock placements and takeover activities have contributed to heightened borrower demand. Japan continues to lead in terms of overall market lending revenues in APAC, owing to the size and depth of its equity markets.

Investor confidence remained high in Taiwan, particularly tech-heavy and chipmaker sectors, attracting foreign investments into the equity markets last year. The stock market approached an all-time high, last seen at the beginning of 2022, making it one of Asia's best performers last year. The surge in the market has led to strong demand for borrowing Taiwanese equities across both large and small-cap spaces. Despite onshore lenders becoming more sophisticated, the demand for stable and efficient offshore supplies remains strong, solidifying Taiwan's position as a key revenue market globally for beneficial owners and market participants.

Paul Solway: On the backdrop of the Nasdaq, S&P and MSCI All World index rallying more than 44.22 per cent, 24.58 per cent and 20.38 per cent respectively, the Hang Seng Index has been losing investors' interest as one of the

worst performing benchmarks globally (-13.93 per cent) in 2023. Q4 marked the surprise imposition of new gaming curbs, reviving market fears of a government crackdown on the Internet sector. Riding on the AI-Tech theme, South Korea and Taiwan indexes have been again excelling in Q4 (TWSE +9.64 per cent, KOSPI +7.72 per cent) and have achieved a year-to-date positive gain (TWSE +26.83 per cent, KOSPI +18.73 per cent)

South Korea's securities market lending revenue was up around 23 per cent YoY, but dropped close to 25 per cent QoQ in Q4 with the introduction of another short sell ban which drove the closure of fund positions. Hong Kong's market revenue was slightly up, with Taiwan's revenue slightly down. Japanese specials took a more active role in 2023 with significant revenue inflow across the market.

2023 will be remembered for increased geopolitical tensions, high interest rates, banking balance-sheet scrutiny, market volatility, heightened regulatory oversight, and a continued investor search for safe-havened, sustainable, quality investments. S&P called 2023 a 'banner' year for securities lending, producing the highest revenues (US$12.9 billion) since 2008 — with APAC coming in at US$2.2 billion. DataLend has it at US$10.7 billion, representing a record year for the region across a decade of data.

This is a reminder that uncertainty and volatility are fundamental factors that help to drive the industry's revenues.

Lai: I will provide an update on two further markets. In South Korea, the market operated under a partial short-sell ban, where only the constituents of the KOSPI200 and KOSDAQ150 could be short sold. Despite this restriction, the Korean market still saw strong demand, remaining one of the highest-spread markets in Asia along with Taiwan. Top lending revenue stocks for the second half of 2023 were dominated by stocks from both Korea and Taiwan. However, market sentiment took a downturn towards the end of 2023 as the country's regulators re-implemented a full short sell ban from November 2023 until at least June 2024. The Financial Services Commission is exploring improved regulations and frameworks as part of its ongoing investigations.

The Australian Securities Exchange faced pressure in the second half of 2023, declining to a 52-week low at the end of October before rallying in the last two months of 2023 to approach all-time highs. Market optimism was fuelled by easing inflation locally and the anticipation of the central banks easing monetary policies earlier than expected in 2024. Australia's resource dominance once again underpinned domestic performance, receiving tailwinds from China's reopening after its Covid recovery. The lithium sector, in particular, garnered attention as spot prices declined amid increasing global supply. M&A activity for smaller resource players surged as global mining giants and investors sought to dominate the supply of commodities crucial to the clean energy transition.

In which APAC markets do you identify new opportunities for growth of your lending business during 2024?

Lai: There have been recent market developments and announcements that are encouraging for the industry. For instance, the Philippines Stock Exchange recently allowed short selling of certain designated securities and the Securities and Exchange Board of India (SEBI) has updated its short-selling framework. These developments highlight the region's progress, though it is noted that other countries are at different stages of their development work.

As an established agent lender, J.P. Morgan Agency Securities Finance is committed to working with our clients, stakeholders, as well as external partners, to align with the established securities lending frameworks.

It is important to recognise that developments in short selling and the introduction of new securities lending frameworks are also beneficial to the respective marketplace. For instance, numerous articles highlight how short selling contributes to enhanced liquidity in financial products by facilitating hedging and arbitrage strategies.

Moreover, recent articles have sought to establish a correlation between increased liquidity and the criteria for defining a market as developed.

Solway: Respective overhangs remain for the Hong Kong property sector and, for China, 'have we bottomed?' Taiwan tech will always have a place in the hearts of directional investors — especially as AI chips become the norm.

In 2023, the Tokyo Stock Exchange (TSE) pushed corporate governance and shareholder value by requesting listed companies with low price-to-book ratio to action which included — but was not limited to — dividend hikes and share buybacks. Corporate events such as merger and acquisitions (M&A) have been more active, with cash-heavy Japanese companies deploying capital to add value. We believe this will continue in 2024, with more companies making concerted efforts to raise return on equity amid TSE reform.

In a high interest rate environment, we see rising interest in rights issues, which some issuers believe offers a cheaper funding option than debt financing.

Last November, The Philippine Stock Exchange gave the green light to introduce short selling for the first time to boost trading volume and to improve market liquidity. However, we do not have a new market ready for domestic and foreign participation just yet. Legal remediation in the Philippines is only being considered at this point by the financial authorities and this will not fly for the heavyweight offshore lenders or borrowers. However, we hope this legal landscape will open up soon.

Garrett: There have been extremely encouraging developments in the ASEAN securities lending space, with the Philippines and Indonesia both making great strides to develop their domestic SBL models. China offers huge potential and its evolution is attracting close attention from the majority of international lenders. More recently, we heard news from the SEBI that short selling will be allowed in India. However, at the time of writing, few details have been provided. Given the lead times necessary to get to the point of first trade execution, it is unlikely that any of these market development stories will have a material impact on revenue growth for 2024.

At Northern Trust, we will deliver continued growth through our multi-pronged, client-focused approach to bring differentiated solutions. Regulation and alpha generation are the driving forces. On the one hand, we are working with our lending clients to deliver tools that will help with optimal asset deployment, enhanced liquidity solutions and bespoke collateral profiles. On the other, engaging with our market counterparts to deliver balance sheet efficient trading strategies is key to this growth.

Sasaki: We see business opportunities in Taiwan, Hong Kong and South Korea, and opportunities in Malaysia, Indonesia and the Philippines have been growing rapidly. We have now started funding with securities from these countries. APAC has diverse regulations and characteristics for each country and therefore we identify opportunities to provide solutions in these markets. Although we have no office outside of Japan, we are collaborating with triparty collateral management services to conduct transactions that comply with local rules. The APAC market is expected to develop further beyond 2024. We will continue to concentrate on this region and would like to contribute to its expansion as a player from an Asian country.

Chua: We anticipate increasing demand from both buy-side and sell-side firms across the APAC region for central clearing solutions in the US Treasury securities market. This is to get ahead of rule changes for repo activity adopted by the Securities and Exchange Commission (SEC) in late 2023. Having collaborated closely with the Fixed Income Clearing Corporation (FICC) for many years on their centrally cleared repo offering in the US, we are actively engaging with our clients in preparation for the proposed rule changes.

Which regulatory initiatives in APAC markets will consume most attention for your agency lending and collateral management teams over the coming 12 months? What programmes are ongoing within PASLA, and at industry-level more broadly, to support this agenda?

Solway: In November, South Korea re-imposed (for a fourth time) a short sell ban until June 2024 to improve the short-selling mechanism. The previous ban was lifted in May 2021 for KOSPI 200 and KOSDAQ 150, with short selling now accounting for about 0.6 per cent of the KOSPI's market value and 1.6 per cent of the KOSDAQ. The ban might complicate South Korea's bid to seek developed market status in the MSCI indices.

In October, the China Securities Regulatory Commission (CSRC) announced that steps will be taken to strengthen management of securities lending and re-lending businesses, including higher margin requirements (the margin ratio is to increase from 50 per cent to 80 per cent for ordinary securities borrowing and to 100 per cent for hedge funds), as well as restricting lending of shares by strategic investors and senior management in newly listed companies. Unfortunately, the CSRC has just published a press release announcing that it will suspend the lending of 'restricted stocks', effective from 29 January 2024.

PASLA continues to lobby and proactively interact with the Korean (FSS, FSC, KSD) and Chinese (CSRC, CSFC) authorities to shape market practices, ideas and solutions for all stakeholders — domestic and foreign.

Garrett: The current ongoing regulatory review on short selling by the South Korean authorities was the focus of attention for Northern Trust, PASLA and most of the securities finance industry in APAC in the latter part of 2023. This will continue until at least June 2024 while the short selling ban remains in place. The importance of engagement across the key Korean institutions cannot be underestimated and this will shape the future of short selling and securities lending in South Korea for years to come. It is critical that open and candid dialogue leads to a consensus-based outcome that supports an open, transparent and liquid market. This will be beneficial for both domestic and international investors.

APAC markets which are still in the early stages of their SBL and short selling journeys will continue to evolve. For some, including China, Philippines and Indonesia, regulatory clarifications or adjustments are still necessary to allow for full international investor participation in those markets. Northern Trust is well represented within PASLA through the executive committee and working groups and it is committed to driving the advancement of our industry. The important work being undertaken by PASLA, engaging with regulators and regional stakeholders to promote securities lending and short selling in capital markets, will continue through 2024.

Chua: The APAC region remains an area of huge opportunity for our clients and we are engaged with various industry bodies such as PASLA and the Asia Securities Industry & Financial Markets Association (ASIFMA) to advocate for market structure development and reform. We believe markets such as China, Indonesia and the Philippines will require further collaboration to promote market evolution and adoption of best practices — and there will need to be continued engagement with South Korean regulators on short-selling issues.

Lai: J.P. Morgan Agency Securities Finance now has representatives actively participating in two PASLA working groups, including a native speaker who previously served on the executive committee. This transition aims to enhance value and synergies, leveraging their expertise more effectively within these groups.

From a regional perspective, our firm proactively monitors regulatory initiatives in terms of their applicability to our business — for example, recent updates regarding the management of 'outsourced services' and various developments in the area of digital assets.

This year marks the implementation of the T+1 settlement cycle in the US, Canada and Mexico and it is likely that some APAC markets will look to move towards a similar set-up. This will be interesting in markets which can impose mandatory buy-ins for unsettled sale trades. Therefore, at J.P. Morgan, we have advanced our efforts to identify and develop the support and tools our clients require, spanning from trade instruction to trade processing.

What investments and adaptations to technology and working practices have you made during 2023 to sustain and grow your securities lending activity in the Asia Pacific region?

Solway: The complexities of the individual markets must always be accounted

for: differing rules and regulations, settlement cycles, intermediaries, reporting requirements, and buy-in or no-fail requirements dictate how we approach our internal processes. This, in turn, defines our commercial client offerings.

Globalising and unifying settlement teams across time zones is critical. Investing in people talent remains a key directive at BNY Mellon. While London has traditionally been the ‘quarterback’ region for international settlements and collateral, we continue to invest in our teams across India, Hong Kong, Singapore and Japan for local talent and expertise — powering our culture in every region.

Technological advancement is crucial as we run our company and businesses better across the globe, connecting our technology either with external partners, including Pirum and HQLA^{X}, or internally across lines of business such as custody, triparty, liquidity and margin or treasury. Securities finance enables timely optimisation and allocation of securities and cash.

Lai: We have progressed the client experience by enhancing transparency across all aspects of the J.P. Morgan Agency Securities Finance programme. This builds on recently completed initiatives such as digitising our Rules and Limits framework to help define a client’s programme. In 2023, additional investment was made to enhance data accessibility further through API gateways. New data sets were made available, capturing the series of activities that represent the full trade lifecycle of a loan transaction. The enhanced reporting offers an additional dimension, capturing upcoming changes to loan positions.

Our client portal, Securities Finance Central, hosted within the J.P. Morgan Markets platform, remains a valuable resource for gaining insights into programme performance. The platform empowers end-users to analyse revenue, and we have enriched it further by incorporating analytics, highlighting simulated revenue opportunities, while also supporting oversight and governance.

Chua: We developed and launched our operating model to support APAC clients within the FICC’s Sponsored Member Repo (SMR) programme. The FICC SMR programme provides clients with access to highly liquid investment and financing at competitive rates with the benefit of reduced counterparty credit risk. Our operating model allows APAC clients to access this liquidity during APAC business hours, supported by a high-touch client service and operational support element in the region.

Our client-facing treasury and liquidity platform, Venturi, offers cutting-edge pre- and post-trade decision-making tools while allowing them to seamlessly execute optimal strategies in an industry-first peer-to-peer (P2P) marketplace. We have seen a lot of traction across the suite of modules, with a major focus on three: the P2P repo marketplace, the liquidity optimisation engine and the Agency Lending Portal (ALP). The P2P platform brings new liquidity opportunities to repo markets by directly connecting participants (or peers) on a stable, secured and trusted system. Participants can trade bilaterally, and State Street guarantees the payment of the repurchase price to the buyer, inclusive of proceeds from liquidating the repo securities.

The liquidity optimisation engine offers solutions to drive greater portfolio transparency and decision-making through its margin analytics and optimisation modules in derivatives and collateral trading. Finally, ALP allows direct connection and execution for our Agency Lending product, delivering real-time availability and a self-service request for quote (RFQ) workflow for all lendable assets. The industry sees this as a cost-efficient venue and a resiliency option for lending transactions.

Garrett: Nexus is our multi-year transformational project to reinvent securities finance data, consolidating it into a single platform which supports a suite of new and existing financing solutions. Making use of both cloud-based architecture and event-driven data streams, Nexus performs calculations and provides access to transaction level information on a real-time basis, enabling data-driven decision making.

Northern Trust launched Nexus in early 2023 and, as part of a multi-year investment, the platform is continuously evolving to bring together a suite of new and existing services across securities lending, borrowing, financing, liquidity and collateral management that would serve as the single point of interface with our capability set.

Foundationally, this includes the provision of real-time securities lending data across the client portfolio and will enable users to evaluate datasets via various pre- and post-trade analytical tools.

Through interrogation of data, users will be equipped to make data-driven decisions, to identify optimal use of financial resources while realising efficiencies and enhanced alpha within their desired risk framework.

The continuous, agile development of Nexus and regular addition of new data, views and functionality enables Northern Trust to act on user feedback, delivering benefits more quickly to clients.

In June, the Monetary Authority of Singapore published its findings on Project Guardian which reviewed designing open and interoperable networks for digital assets. How do you interpret the use of digital assets and the stability of its future incorporation in the region?

Chua: The Monetary Authority of Singapore has taken a lead regionally in establishing an operable framework for tokenisation. Project Guardian is a collaborative initiative with policymakers and the financial industry that seeks to test the feasibility of application in asset tokenisation and decentralised finance (DeFi), while managing risks to financial stability and integrity. While we applaud efforts taken by the industry in cooperation with financial regulators, investors should be aware that tokenisation is relatively nascent and has yet to receive regulatory backing across any jurisdiction. We continue to work with regulators and industry groups to advance the discussion around digital assets and to participate actively in conversations with clients expressing interest in this cutting-edge technology.

Solway: There are many proof of concept projects surrounding the digital asset space – either at a corporate, exchange or regulatory framework, often resulting in a partnership or memorandum of understanding (MOU) across participants.

There are further examples, in addition to Singapore, that explore digital assets, tokenisation and other technologies that aim to provide better real-time data synchronisation, improved scalability and other steps to improve the speed, efficiency and transparency of security and cash processing. Bursa Malaysia established a project to explore blockchain in 2019, for example. There is also the Hong Kong Exchange's Synapse in 2023 and ABD's Project Tridecagon relating to bond cross-border settlements.

Garrett: MAS has long been an advocate for digital asset innovation and continues to nurture an environment in the region for financial institutions to research, develop and pilot new capabilities via initiatives such as Project Guardian. Its emphasis on creating an ecosystem via a cohort of participants enables all to learn from the journey in a safe space, with MAS themselves then able to craft appropriate guardrails and risk-based regulatory regimes to foster progress and adoption.

At Northern Trust, we absolutely see a role for digital assets to be incorporated into our future state vision and servicing for our client base. In our "Custody reimagined" paper launched in 2021, we estimated that 10 per cent of our asset universe could be digital by 2030. We still believe this number is reasonable and we will continue to invest in this space to be ready for these eventualities. The digital asset landscape is made up of a broad range of sectors and can offer value and efficiencies to different parts of the value chain.

The range of potential use cases is vast — whether digitally issued (or tokenised) assets or digital cash or equivalents — and these should be in unison to unlock the promise that is on offer through gains in capital efficiency, settlement or increased liquidity.

Through the mission and efforts of our Digital Assets and Financial Markets group, we continue to drive the exploration and development of new digital asset capabilities which will position us to support clients in their pursuit of digital assets. For us, market access, connectivity and asset safety will remain critical in our offering as a trusted partner across both traditional and digital ecosystems.

Lai: Onyx by J.P. Morgan serves as the firm's blockchain-focused business unit, leveraging blockchain technology to transform the movement of money and assets for our clients.

Last year, as a part of Project Guardian, Onyx by J.P. Morgan and Apollo Global Management collaborated with various partners to develop a technical proof of concept, where we demonstrated how the implementation of tokenisation and smart contracts could significantly improve the management of discretionary portfolios, including streamlined incorporation of alternative investment funds in these portfolios. Having proven the technological feasibility of automating portfolio management for asset managers, our aim is to productionise this through 2024 and beyond.

Onyx Digital Assets (ODA) is J.P. Morgan's digital assets platform that enables the creation of innovative financial products through tokenised traditional assets. Through our current live products, we enable our clients to enhance utilisation of their assets, boost settlement efficiency and mitigate settlement risks.

We created the first application on ODA — called Digital Financing — to significantly enhance active intraday liquidity management and to reduce reliance on unsecured funding. Through this application, we provide access to secured financing through the exchange of cash for tokenised collateral using the mechanics of repo.

In October 2023, we launched the Tokenized Collateral Network (TCN), the second offering on the ODA platform. Focused initially on tokenising money market fund (MMF) units, TCN aims to bring greater mobility to collateral, expanding the universe of assets available for use as collateral.

How have monetary conditions shaped securities lending opportunities in the Japanese market? How are you positioning yourself to maximise opportunities for lenders and borrowers in this environment?

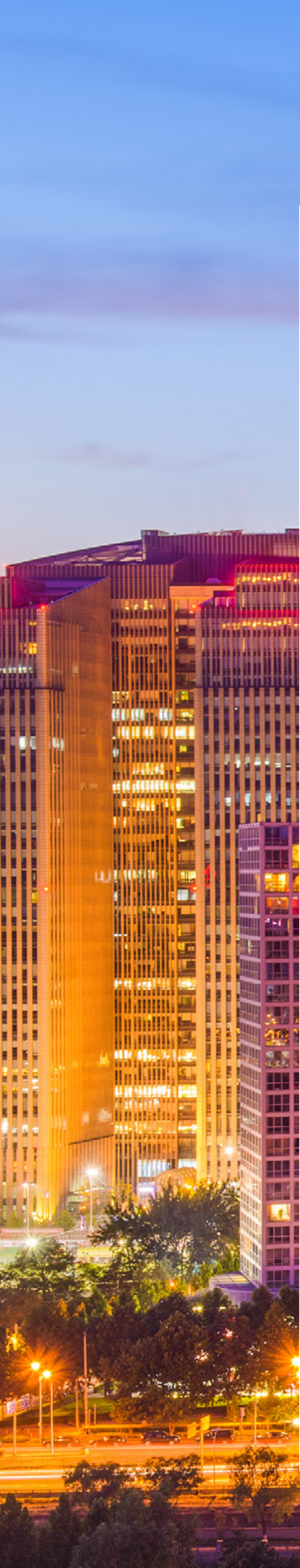
Lai: The Bank of Japan's monetary policy normalisation is likely to start adjusting from March or April and market consensus is that the negative interest rate policy is likely to be removed in around mid-2024. On the other hand, the market is almost certain that the Fed has completed its rate hike cycle and the next move will be a cut in interest rates. The resulting USD and JPY cross-currency spread could bring increased opportunities in JPY funding requirements. Also, Japanese Government Bonds (JGBs) could continue to grow, given borrowers' requirement for both liquidity and directional trading. In November, the Philippines Stock Exchange welcomed the decision to permit short selling of index stocks within the region, while South Korea's Financial Services Commission has posed a ban on stock short selling in domestic markets.

Solway: Japan was a big winner in the region for securities lending during 2023: the Topix and Nikkei 225 both touched 33-year highs with a YoY increment of 25.09 per cent and 28.24 per cent respectively.

Specials and seasonal activity have always upheld sustainable alpha revenues for Japanese equity portfolios for our clients and we expect 2024 to be no different, despite proxy voting (and subsequent recalls) becoming more in focus to many ESG-aware clients. We look forward to helping our clients to balance such needs with educated, commercial outcomes in the year ahead.

In the fixed income space, JGB lending is picking up via 'specials' activity and we are looking forward to monetising those assets as demand grows.

Garrett: Continued loose monetary policy allowed the cross-currency basis spread between the USD and the JPY to remain wide through 2023, while heightened geopolitical concerns and banking crises also acted to drive the dollar premium wider. This meant that arbitrage opportunities remained strong, notably the US Treasuries versus JGB as the standout trade. In



addition, volatility in the JGB curve prompted significant specials value, meaning lenders could finally enjoy intrinsic value from lending in-demand assets. Low interest rates and the cheaper yen also played a material role in the heightened M&A activity and the ability to do deals.

2024 is likely to see the end of Japan's yield curve control policy as inflation starts to take hold. At some point during Q2 or Q3 it is expected that the BoJ will raise rates. This will lead to a shift in market dynamics which may affect the status quo of the past few years. However, geopolitical risk remains a constant theme that is impacting sentiment in the wider market and in securities finance activity. The war in Ukraine continues to threaten geopolitical stability and, more recently, the Israel-Palestinian conflict has further heightened market risk. Any escalation is likely to prompt a flight-to-quality bid for US treasuries and dollar-denominated assets in general, therefore pushing the USD-JPY cross-currency basis wider and increasing on-loan fees when accepting JGBs as collateral.

Lastly, with market participants preparing for new Basel Endgame regulations, we should expect regulatory capital efficient trades, while constraints on dealers' balance sheets might force them away from capital intensive, low reward cross-currency FX and repo trades. As such, lenders and beneficial owners should remain nimble to take advantage of these opportunities when they arise.

Chua: The negative rate environment has presented both challenges and opportunities. Our JPY cash collateral facility was established more than 10 years ago and continues to deliver significant competitive differentiation for our clients and counterparties. The facility supports cross-currency trading, enabling lenders to achieve higher utilisation of their assets and, for borrowers, a means of generating value from their JPY cash collateral holdings.

Sasaki: Short transactions of JGBs, mainly implemented by hedge funds and other overseas firms, have been increasing due to speculation about changes in the BOJ's monetary policy. In the equity market, the rising market price of Japanese equities has led to increased demand from investors and traders for all Japanese assets. JSF has more than 70 years of history operating domestic margin transactions and covers most financial institutions in Japan. Having this strength, we play an important role as an intermediary between the domestic and overseas repo markets. Furthermore, in accepting a wide range of collateral and supplying liquidity across a range of durations, we provide an optimal solution to each of our customers.

In November, the Philippines Stock Exchange welcomed the decision to permit short selling of index stocks within the region, while South Korea's Financial Services Commission has posed a ban on stock short selling in domestic markets.

How do you assess potential for growth of securities lending and short selling activity in APAC?

Garrett: Potential is an often used term when it comes to the opportunities that

APAC presents. There is still so much untapped opportunity in markets such as China and India. The developmental progress in Indonesia and Philippines during 2023 is just the start for those markets. International lender participation will take time to grow, but they are moving in the right direction. On the farther horizon are markets including Vietnam and Sri Lanka. We see a region filled with potential, which is integral to the future success of Northern Trust's securities finance offering.

It is obviously a drawback when regulatory decisions are made that result in a contraction in lending activity. However, we will always face challenges, whether these are caused by economic uncertainty, geopolitics, disruptive technology or some other unforeseen event. These challenges also present opportunities. With South Korea, the opportunity is there for the regulators and market participants to build a consensus-driven solution for short selling and securities lending activity which will hopefully reduce or eliminate the need for future intervention.

Solway: No two markets are the same in APAC when it comes to short-selling rules and guardrails for investors, whether retail or institutional. While this can be challenging as clients navigate the region, it also provides a natural diversification of opportunities for lending. We saw this during 2023, with Korea tightening its regulations while the Philippines did exactly the opposite — within days of each other.

At BNY Mellon, we have made significant investments and improved our lifecycle management for Taiwanese equities. This will enable more of our clients to take advantage of the significant fees that are available in Taiwan, with an average fee of 250 bps in 2023.

How do you assess the outlook for APAC securities lending markets for 2024?

Sasaki: Although the current focus is on the growing uncertainty in the Chinese market, other markets in APAC are steadily growing. Regarding securities lending markets, many countries are in the process of developing market systems to attract overseas investors — such as the recent launch of a short-selling system in the Philippines. We expect that this growing trend in APAC's securities lending markets will continue as they become more attractive. With such expectation, we recently assisted in the establishment of PT Pendanaan Efek Indonesia, an Indonesian securities finance company. We will continue to foster our unique business to connect the rapidly growing Asian market with the global market. By doing so, we will enhance our presence as Asia's leading institution specialising in securities finance.

Solway: There is a lot ahead in 2024. Retailers are coming out to play. Advanced and progressive brokerage platforms now have inventory and scale, mostly born out of the meme era of 2020. Global brokers are actively asking about lending participation. I sometimes fear that the more traditional asset owners will be left behind as more modern, versatile supply sources expand and become more attractive.

Settlement and reporting standards are not just in APAC anymore. T+1 settlement and 10c-1 reporting is coming to the US. If we compare with Korea or Taiwan, these are similar challenges involving tight settlement cycles and stringent reporting mechanisms. In fact, the cultural expectation right across Asia is to settle on time while meeting specific obligatory reporting requirements.

US central clearing for US Treasuries will have a significant impact globally, especially in Asia where timing will be key for navigating solutions in the US time zone. Fortunately, BNY Mellon has turnkey solutions for our clients that are seeking to repo or reverse-repo US Treasuries.

Given the relative consolidation of global brokers in APAC, there is the constant drumbeat of competition, relative de-globalisation and optimisation of finite resources. BNY Mellon continues to seek out quality regional counterparties that add diversified and differentiated distribution channels for both equities and fixed income.

Finally, expanding into new segments such as Chinese qualified domestic institutional investors (QDII), which connects previously restricted supply to global demand, is an exciting opportunity for 2024 and beyond.

Chua: The Philippine and Indonesian authorities made positive strides to align their securities-based lending (SBL) rules to global industry standards in 2023 and we expect this momentum to continue through 2024. Changes in monetary conditions, and the continued push by authorities to increase competition and accountability in 'Corporate Japan', should also support corporate event deal flow. This, in turn, will assist stock borrowing and lending demand.

The de-risking theme by offshore investors from China and Hong Kong investments is likely to remain a challenge for these markets and will continue to negatively impact SBL demand in those markets. The industry will also continue to innovate for capital efficiency solutions (such as central clearing, pledge collateral) with the Basel III endgame approaching, thereby creating opportunities for borrowers and lenders. However, the fragmentation of jurisdictions in the region will continue to present a significant challenge in making central clearing platforms a reality in 2024.

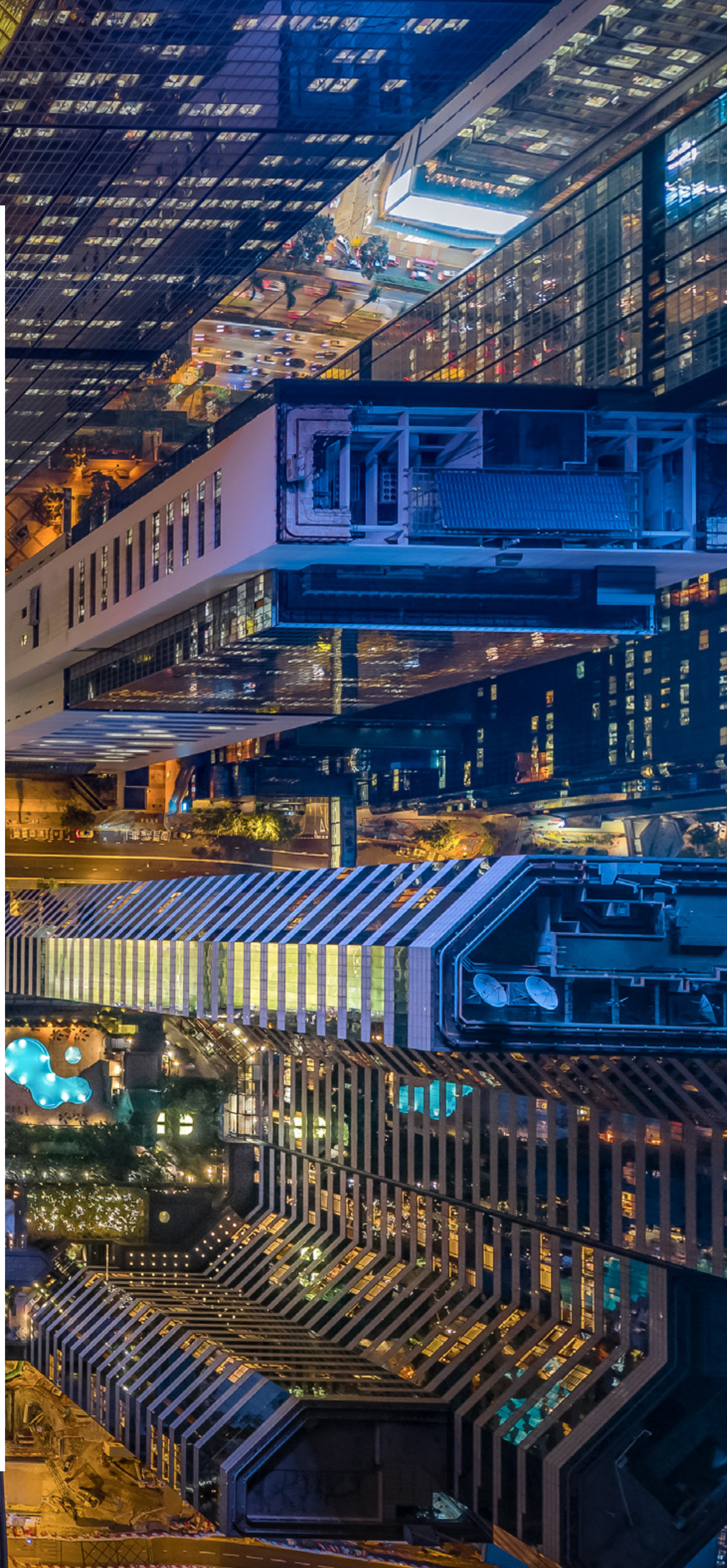
Garrett: We are looking forward to a strong year in the APAC securities finance markets. As I mentioned previously, most years will see some markets win and some markets lose a little. 2024 will be no different. The effects of higher interest rates in Japan and the pivot to lower rates elsewhere will change market dynamics. It will be interesting to see how this plays out across the APAC markets, the impact on regional investment deployment, and ultimately lending demand.

Finally, we look forward to continued long term growth across all APAC markets enabled by development of legal, regulatory and operational infrastructure forged through the collaboration and partnership of market participants and supported by industry bodies such as PASLA.

Lai: Ongoing credit concerns across the China and Hong Kong property sector stocks will affect consumer and investor confidence throughout 2024. Asset prices are at decade lows in Hong Kong and indications that the US Federal Reserve will pause or reverse its rate hiking cycle could help to encourage more spending again. The outcome of the Taiwanese presidential elections could influence US-China relations going forward. Taiwan's semiconductor industry continues to trend strongly and its broader equity markets are trading near historical highs.

In South Korea, securities-based lending activity will continue to be muted in the first half of the year as the short-sell ban will limit demand to borrow stock. The Korean presidential elections in April could address the ban and bring some clarity to the government's stance on this issue as we head into the middle of 2024. In 2023, the Japanese stock market was one of the strongest globally and there is expectation that this strength will continue in 2024. The Tokyo Stock Exchange's corporate governance reforms in 2023 have helped to boost company performance while promoting the efficient use of capital.

Finally, the focus in Australia will be on the Reserve Bank of Australia's (RBA's) easing of monetary policy. Prospective interest rate cuts will help keep bank debt levels low and spark a lift in borrowing activity, aiding higher profits in the financial sector. This will be accompanied by continued strong commodity demand for the all-important resources sector.



Risk and regulatory capital: getting the balance right

ISDA's head of capital Panayiotis Dionysopoulos and head of clearing services Ulrich Karl speak to Bob Currie about the implications of the US Basel III Endgame and G-SIB Surcharge proposals and the key recommendations in their joint consultation response submitted with SIFMA

Two industry associations, the International Swaps and Derivatives Association (ISDA) and the Securities Industry and Financial Markets Association (SIFMA), have collaborated to deliver a joint response to the US Basel III Endgame and G-SIB Surcharge consultations.

In this joint submission, submitted on 16 January 2024, they warn that the proposals are likely to lead to a sizeable increase in capital requirements for banks with activities in US markets.

Significantly, they contend that these proposed increases in regulatory capital against banks' trading and clearing activities do not align with the underlying risks associated with these activities. Implementation of the US Basel III 'endgame' proposals, they suggest, will make it harder and more costly for banks to provide these services. If banks are forced to reduce their engagement in these areas, this could have a negative impact on liquidity and vibrancy of US capital markets, thereby increasing costs, reducing choice and impairing risk management for market participants and for US businesses more widely.

Commenting on the background to their joint submission, ISDA head of capital Panayiotis Dionysopoulos tells Securities Finance Times that the aim was to maximise efficiency and minimise duplication in responding to this consultation process. “ISDA and SIFMA have both focused on capital markets activity and we have considerable overlap in terms of our membership,” he says. “Consequently, it makes sense when responding to major technical proposals, such as the Basel III proposal and the G-SIB surcharge proposals, to collaborate in preparing our responses.”

Quantitative impact survey

To evaluate the potential impact of the proposed rule changes, the two associations conducted a quantitative impact survey (QIS), with responses from eight US global systemically important banking organisations (G-SIBs). This analysis, which provided the foundation for their consultation feedback to the Basel III notice of proposed rulemaking (NPR), indicates that market risk capital would increase by between 73 per cent and 112 per cent, depending on the extent to which banks use internal models. “That is a lot of extra capital, which we think is not justified by the levels of risk,” say the two associations.

Expanding on these conclusions, Dionysopoulos indicates that the impact on market risk has been top of mind for many large banking organisations. Under the US Basel III proposal, banks will need to meet stringent requirements to use internal models for market risk. The 112 per cent upper boundary is calculated for a firm applying the standardised approach to the full portfolio and, by making it more difficult to apply internal risk models, firms are moving closer to that upper boundary.

For credit valuation adjustment (CVA), most banks are currently constrained by the US standardised approach, which includes credit risk and market risk. However, the revised US Basel III proposal will include operational risk and CVA as part of the expanded risk-based approach (ERBA), which will become the new binding constraint for more US G-SIBs — so the CVA element is fully additive when compared with the current standardised approach.

For clarification, the CVA is an adjustment to the market price of derivatives and securities financing transactions (SFTs) to take into account the default risk of the counterparty.

In the QIS, ISDA and SIFMA modelled more than 40 scenarios to evaluate the potential impact, utilising aggregated and anonymised data supplied by survey respondents. The scenarios cover aspects across market risk, CVA, securities financing transactions and clearing business.

Client clearing

Looking more closely at the derivatives clearing component, the trade associations advise that the proposed changes to bank capital rules may prompt some clearing banks to reduce client clearing activity. As an unintended consequence, this may act as a brake on the efforts of policymakers, since the 2009 G20 recommendations, to encourage wider use of central clearing across a range of transaction types.

The impact will vary from bank to bank, depending on how its business is structured and how it manages clearing of clients’ portfolios. However, ISDA’s head of clearing services Ulrich Karl anticipates that this will create pressure on some clearing firms to reduce their derivatives notional exposures and become more selective about their range of clients. On balance, this is likely to create additional pressure on the clearing capacity of the affected banks — and, by association, it may make it more difficult for some clients to access clearing for their derivatives transactions and SFTs.

Data from the QIS reveals that adding clients’ derivatives notional exposures cleared under the agency model to the complexity indicator added 69.4 G-SIB points, based on data from six G-SIBs. Adding these transactions under the interconnectedness indicators had a smaller impact of 4.5 G-SIB points (see box on p.26). Therefore, in total, the proposal is expected to increase the G-SIB score for the six participating banks by 74 points.

To put this in context, 20 G-SIB points adds a further 10 basis points of additional surcharge. While this would result in an increase in the method surcharge of slightly more than 7bps on average per bank, this increase, applied to risk-weighted assets (RWAs) calculated under the proposed ERBA, would result in an additional capital contribution of approximately US$5.2 billion across the six G-SIBs (G-SIB response, p 3).

G-SIB Surcharge methodology

The US capital framework requires a G-SIB to maintain capital above and beyond generally applicable minimum risk-based capital requirements. The G-SIB surcharge requirement reflects the Federal Reserve's unilateral assessment of systemic risk as measured by the weighted sum of a select set of indicators, expressed as a systemic risk score. A higher score implies a higher applicable G-SIB surcharge.

Two calculation methodologies are proposed for evaluating the G-SIB surcharge, with the higher of the two being applied. "Method 1" is the standard adopted by the Basel Committee on Banking Supervision for identifying and setting the surcharge for G-SIBs and depends on five sets of systemic indicators – size, interconnectedness, complexity, cross-jurisdictional activity, and substitutability. "Method 2" is a US-only model that generally employs the Basel methodology, but replaces the substitutability indicator with a short-term wholesale funding (STWF) indicator. During periods of stress, reliance on short-term wholesale funding might make firms more susceptible to runs that could potentially impact financial stability.

In practice, the Method 2 surcharge always equals or exceeds that of Method 1. SIFMA notes that this is one of several binding capital constraints for US G-SIBs that are calibrated at a higher level.

https://bit.ly/49AR1N3

Prudential regulators may conclude that there is a case for requiring banks to put up additional capital against this client clearing activity. But, for Karl, they should be aware that this may make it more difficult for some buy-side firms to access clearing services and therefore act as a disincentive for clearing. "Most market participants agree that central clearing has made markets much safer," he says. "For that reason, we have urged the Federal Reserve to liaise with other market regulators, particularly the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC)."

In the case of a clearing member default, the proposed changes may also make it more difficult to 'port' client portfolios to a new clearing member. To do so, other clearing members must be able to meet the additional capital requirements to take on clearing activity from new clients. The proposed rule amendments may impair this process by adding to the capital overhead borne by banks against their clearing activity.

"On balance, we believe these proposed changes would directly contravene the longstanding public policy objective to promote central clearing," say the two associations.

Capital markets liquidity

To protect the liquidity and vibrancy of the US capital markets, ISDA and SIFMA have recommended that US agencies revise how banking organisations can recognise risk diversification when calculating market risk RWAs under the EBRA, thereby delivering a risk calculation methodology that aligns better with their actual risk exposure and the risk management frameworks they apply. "Getting the right recognition of diversification in the capital framework is hugely important," notes Dionysopoulos.

The two associations have also urged the US Federal Reserve to review its plans to implement a framework for minimum haircut floors for SFTs. The minimum haircut floors framework for SFTs was introduced into the Basel standards in 2017, taking into account a recommendation made by the Financial Stability Board (FSB) to introduce numerical haircut floors for non-centrally cleared SFTs in which secured financing is provided to non-banks against collateral other than government debt.

With respect to securities finance transactions, ISDA and SIFMA estimate that the application of the minimum haircut floor would result in a significant increase in bank capital requirements against this activity. Based on the QIS results, the total impact for SFTs would be an 18 per cent increase in capital requirements.

Other jurisdictions outside the US, including Canada, the EU, Japan and the UK, have not implemented minimum haircut floors. With respect to the EU, the European Banking Authority has raised concerns over potential implementation of the minimum haircut floor framework, asking for further discussion on the range of transactions and organisations that fall into scope of this provision and its impact on certain parts of the market, including securities lending and borrowing and the application of netting in cleared transactions.

For ISDA and SIFMA, the overarching conclusion is that implementing the minimum haircut floor framework would lead to competitive disadvantages for banking organisations that are subject to the US capital rules when compared with firms operating in the EU and UK that do not fall into scope of this framework.

"The capital cost implications for SFT activity are similar to the client clearing business," observes Dionysopoulos. "These are low margin businesses and, when you start adding more costs, these activities may become uneconomic for some firms providing these services." This could potentially result in further consolidation across the industry and a reduction in the choice of clearing providers active in this market segment.

For credit valuation adjustment, ISDA and SIFMA are recommending the addition of further granularity in the framework. "This is important for the financial risk bucket, where there is currently a single bucket with the same risk weight for regulated and unregulated entities," says Dionysopoulos. "This is not in line with the underlying risk profile of those entities."

In the UK, for example, the Bank of England has introduced an additional bucket for pension funds in recognition of the different risk profile presented by their businesses.

The overarching question is how US agencies can make this framework more risk sensitive, given that large banks will no longer have the option of applying their own internal models for CVA and will need to apply the standardised approach or the basic approach.

The two associations have also recommended an exemption of the client-facing leg of a cleared derivatives transaction from CVA capital requirements, given that — in their assessment — these exposures do not pose any CVA risk (fig 2). They estimate that the removal of the CVA charge for client cleared transactions can mitigate capital requirements for the clearing business by US$1 billion.

Implementation timeline

The two associations have recommended that the implementation deadline should be extended from the 1 July 2025 implementation date currently proposed to be at least 18 months from the finalisation of the rule.

Fig 1: ISDA and SIFMA advise that the following elements of the Basel III NPR relating to Securities Financing Transactions (SFTs) need to be removed or revised:

SFT minimum haircut floor framework	Remove the SFT haircut floor framework in line with major foreign jurisdictions, which would also eliminate conflict with pre-existing broker-dealer regulations.
Collateral recognition	Retain the ability to recognise the risk-mitigating effects of: • Investment grade corporate debt securities regardless of whether the corporate issuer (or its parent) has a publicly traded security outstanding • Non-investment grade corporate debt securities of term repo-style transactions by not requiring to include them in the market risk measure • Clarify that the netting set formula applies to eligible margin loan transactions booked as a single unit of account for GAAP and also permit it for single repo style transactions with multiple securities as collateral.
Market price volatility haircuts	Reduce market price volatility haircuts for US Agency debt to be better aligned with underlying price risk.
Sovereign exposures	The minimum haircut requirement, if implemented, should not apply to SFTs with underlying sovereign collateral, including US sovereign collateral regardless of technical defaults.

Fig 2: ISDA and SIFMA advise that the following elements of the Basel III NPR relating to Credit Valuation Adjustment (CVA) should be reconfigured:

Client-facing leg of client cleared derivatives	Exempt the client-facing leg of a cleared derivatives transactions from CVA capital requirements because these exposures do not pose any CVA risk (i.e., banking organisations do not suffer CVA losses on client-cleared activity).
Distinguishing between regulated and unregulated entities within the financials bucket	Distinguish between regulated (i.e., pension funds, insurance companies, registered investment funds) and unregulated financials to reflect more appropriately the differences in risk profiles.
Appropriate recognition of hedges for exposures	Improve recognition of single name and index hedges under both the basic CVA approach (“BA-CVA”) and standardized CVA approach (“SA-CVA”) frameworks.
CVA MPOR	Revise the Margin Period of Risk (MPOR) for CVA purposes to be no greater than 5 business days for derivative transactions subject to regulatory margin requirements in alignment with CVA calculations, recognising the significant improvements in OTC derivatives markets, including the introduction of margin rules for uncleared swaps requiring initial margin and daily variation margin.

In the context of counterparty credit risk:

Investment grade corporates	Revise the risk weight for investment grade corporate counterparties (as defined under the current U.S. capital rules) to 65 percent as opposed to 100 percent irrespective of whether the entity (or its parent) has securities listed on a securities exchange.

“The time frame will be dependent on when a final set of rules is approved and published,” explains Dionysopoulos. “Banks cannot finalise their model development or produce the required data for model applications until they have a final rule set to work with.”

Banks will need to put in considerable work to reconfigure their capital modelling and the data inputs required to inform this process. For market risk, banks that plan to apply to use internal models will need to refine their modelling and submit applications for the trading desks in scope. Financial supervisors will then require time to review and approve those applications.

Significantly, standardised approaches under the US Basel III proposals are becoming more demanding — these need to be calculated more frequently and require a larger set of data points to produce these calculations. This represents a departure from the standardised approaches of the past that were, in relative terms, simpler and more straightforward. Under the new proposals, standardised approaches are more risk sensitive and banks will require time to make the required changes and to attain the necessary approvals.

More broadly, banks must consider the implications of these revisions not just in the US, but across their global businesses. Trading in derivatives and SFTs is global in nature and one of the biggest concerns for member firms is having major regulatory changes going live at different times in different jurisdictions. For global banks operating across a wide range of jurisdictions, these regulatory changes may have a major impact on how they manage their trading books in different locations.

The consequence for the real economy, the associations argue, is that commercial end-users — and other derivatives end-users — will find that the cost for derivatives may increase or some products will become less readily available. Considered together, there is a danger that the combination of increased CVA, market risk and operational risk capital requirements will significantly impair the ability of corporates, insurance companies and pension funds to hedge their business risks.

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Understanding the treasury clearing reforms

Tom Ciulla and Kishore Ramakrishnan, both managing directors of Treliant's Capital Markets Advisory, evaluate the implications of the SEC's US treasury clearing proposals and the adaptation challenges this will present for market participants

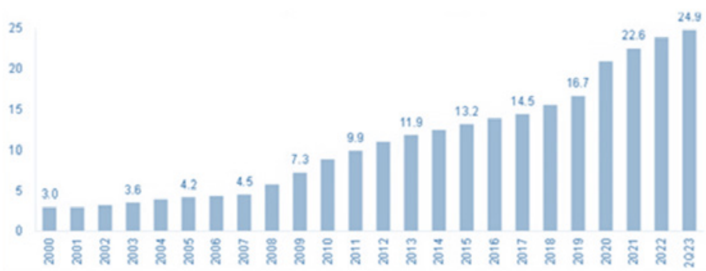
Regulators seem to enjoy playing Santa Claus around Christmas each year by gifting multiple regulatory mandates to the banking industry. Christmas 2023 was no different, as we witnessed a multitude of significant rules and consultations from regulators on either side of the Atlantic and Pacific, including a 400-page Treasury clearing mandate from the US Securities and Exchange Commission (SEC).

This article distills key takeaways from the SEC's new rules as they expand mandatory central clearing in the US$26 trillion US Treasury market, mirroring the earlier Dodd-Frank Act swaps clearing reforms. By taking the 80 per cent of the Treasury market that is still uncleared and ultimately pushing it into the cleared territory, the rules will potentially translate into roughly US$1 trillion of daily trades handled by independent clearing houses.

Treasury market structure

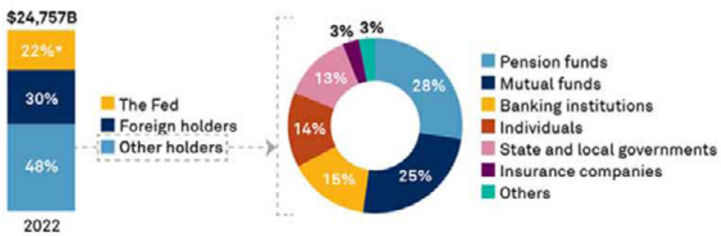
Over the last two decades, the US Treasury market has grown more than five-fold as the issuance of US government debt has continued to expand. Close to 60 per cent of this market is held by the Federal Reserve and foreign governments, with the remaining portion held between institutional investors (including pension funds, mutual funds, banks) and retail investors via retail accounts (wealth managers, private banks, high-net-worth investors).

Fig 1: Total Treasury Securities Outstanding (US$ Tn)



Source: Data from US Treasury, Monthly Statement of the Public Debt reports

Fig 2: US Treasury Securities by Market Participants



Source: Securities Industry and Financial Markets Association (SIFMA)

To determine the legal, operational and technology implications of the SEC's Treasury clearing mandates, it certainly helps to understand the Treasury market microstructure, covering the products and participants. The US Treasury market is largely comprised of the following:

A. **Cash market** — for the outright purchase and sale of securities segmented into:

- **An interdealer market**, whereby both counterparties to the trade are dealers or market makers, including banks and non-banks, accounting for over 50 per cent of the cash Treasury market. Interdealer markets are dominated by principal trading firms (PTFs) that tend to use automated, high-speed strategies for electronic trading within the interdealer market. Trades between dealers are usually centrally cleared via a central counterparty clearing house (CCP).
- **A dealer-to-client (D2C) market**, whereby one counterparty to the trade is a net liquidity taker (i.e., asset manager, hedge fund, non-dealer bank). The D2C market is settled bilaterally via a clearing bank. The Treasury Market Practices Group has estimated that 13 per cent of cash transactions are centrally cleared, 68 per cent are bilaterally cleared, and 19 per cent involve hybrid clearing, in which one leg of a transaction on an interdealer broker (IDB) platform is centrally cleared and the other leg is bilaterally cleared.

B. **Repo market** — segmented into bilateral and triparty repo markets. The repo market is complex, with several different trading avenues for those in the industry. The US Treasury repo market can be segmented into four main trade type categories:

- **Non-centrally cleared, settled bilaterally** — This will be eliminated as the clearing mandates get enforced. A 2021 Federal Reserve Board report titled Hedge Fund Treasury Trading and Funding Fragility: Evidence from the COVID-19 Crisis, indicates that most hedge fund repo is transacted bilaterally, with only 13.7 per cent of this repo centrally cleared.
- **Centrally cleared, settled bilaterally** — The Fed has noted that approximately 20 per cent of all repo and 30 per cent of reverse repo is centrally cleared via the Fixed Income Clearing Corporation (FICC). In this model, cleared repo transactions between FICC members are executed electronically or by voice through IDBs. It is worth noting that FICC's sponsored service allows for transactions between non-traditional institutional participants such as money market funds and hedge funds, with their obligation to FICC guaranteed by an FICC sponsoring member.
- **Non-centrally cleared, settled on a triparty platform** — This is a major funding market where the trade settlement between cash holders (i.e., money market funds) and dealers is facilitated by a clearing bank. Such transactions are settled at a clearing bank

which holds the securities in custody and is not a counterparty to the transaction.

- **Centrally cleared, settled on a triparty platform** — Trades are cleared by FICC and settled on the BNY Mellon triparty platform. In September 2021, FICC also introduced a sponsored general collateral repo service in which centrally cleared repos between sponsored members and their sponsors are settled on the triparty platform.

Transactions in the futures market remain outside of the scope of the SEC Treasury clearing proposal, given that this is an exchange-traded and centrally cleared market and is interlinked to the cash and repo market via arbitrage.

In terms of key market players offering Treasury clearing services, they can be segmented into:

FICC Clearing

- Sponsored member service (delivery-vs-payment, or DvP, and general collateral, or GC)
- Prime brokerage clearing
- Correspondent clearing
- Full-service netting membership
- Centrally Cleared Institution Triparty (CCIT) service

Repo Clearing

- LCH Group's RepoClear — as a RepoClear member or dealer, or sponsored member.
- Eurex Repo — via general clearing or direct clearing membership, individual segregated account (ISA), direct clearing or ISDA Direct Indemnified clearing membership, clearing agent or Futures Commission Merchant (FCM) clearing member, whether disclosed or undisclosed.

Treasury trading models

Trading of Treasury securities can be fully electronic on a third-party e-trading platform with central limit order book (CLOB), RFQs, disclosed or anonymous, auction, dark pool, or crossing networks. The price transmission usually occurs via direct pricing streams, actionable indications of interest (IOIs), stream or click-to-engage whereby a particular security at a particular price is pushed to potential counterparties by dealers and market makers. Electronic trading accounts for two-thirds of US Treasury trading by notional value.

The trading can also occur via voice-processed platforms, where the price negotiation and trade matching takes place by phone, email or instant message with trades entered in an e-trading platform for post-trade processing.

US Treasury clearing: what's in, what's out?

Treasury transactions involving banks and broker-dealers leveraging IDB platforms are predominantly covered for clearing by FICC. These include all cash transactions (i.e., purchase and sale of Treasury securities between a direct participant and a counterparty, which could include registered broker-dealer, government securities dealer, government securities broker or interdealer trades).

This could also involve cash transactions between two non-FICC participants through an IDB, which needs to be cleared through FICC where the IDB is a FICC direct participant.

As for repos, both legs of the trade through FICC must be cleared. However, transactions involving hedge funds and principal trading firms (PTFs) leveraging interdealer broker platforms largely remain outside the scope of central clearing. Furthermore, repo transactions with some counterparties such as a central bank, sovereign entity, CCP, local or state government or a natural person (i.e, individual) are exempt from this clearing mandate. Even the inter-affiliate transactions conducted between affiliated entities within the same corporate group are excluded from the scope of the clearing mandate.

Operational, technology and legal implementation

Under the Dodd-Frank reforms, a strong distinction was made between direct participants and indirect participants which traded via an intermediary such as a designated contract market. In the wake of various irregularities, Dodd-Frank required that margin be segregated between these two types of participants, such that an indirect participant's margin payments and posted collateral could never be conflated with those of the primary dealer. The Treasury's clearing reforms extend this same principle to the Treasuries market, maintaining a strong distinction between direct and indirect participants, and enforcing segregation of assets.

The operational, technology and legal impacts of the reforms on a given participant depend on the participant type. Direct participants are those which trade via the sponsoring member and agent clearing member models; indirect participants are those using the sponsored member and executing firm customer models. Depending on the model employed, the market participants are subject to a wide range of responsibilities.

Onboarding processes and documentation will be one source of cost. All participants will be required to create new trade agreements and new onboarding procedures, while sponsoring members will need to create a new onboarding procedure for each of their clearing relationships. Onboarding procedures will specify the sponsoring member agreement, member guarantee and authorisation from the relevant executing firm customers. Such paperwork will take a minimum of three to four months to prepare, with costs of up to US$150,000 to onboard a single broker. Legal documentation costs will be considerable for all participants, but especially those direct participants dealing with multiple customers.

The need to support new collateral obligations will impact operations teams and potentially affect the management of trade and counterparty data. Firms currently making uncleared Treasury trades will face significant costs implementing data and business logic changes around margin calculation, fees and haircut and eligibility tracking, as well as implementing processes to post and reconcile collateral. Firms already engaging in collateral or inventory optimisation will need to factor the new collateral obligations into that optimisation. Operations teams will need to consider maintaining new trade and client reference data to make determinations for appropriate central clearing and to identify exclusions, such as affiliate trades.

Direct participants will further be required to support collateral segregation, which will mean collecting client collateral separately and holding it in separate accounts from the direct participant's collateral. Direct members accepting done-away trades will have additional concerns. The operations team will also need to update their processes to account for amendments to the SEC 15c3-3a customer protection rule, requiring the Treasury CCP to debit the margin and deposit in the customer reserve formula — thereby enabling broker-dealers to collect margin from their sponsored members and pass it on to the FICC.

In addition to these operational and process changes, there will be technology impacts since firms will need to build integrations with clients, custodians and the FICC, and these integrations will need their own control and reconciliation processes.

Implementation timings

The SEC aims to adhere to the following implementation framework:

31 March 2025 — Go-live dates for FICC to implementing:

- Safekeeping of customer assets (i.e., separation of client and house margins)
- Access to clearance and settlement services
- New risk management practices
- Amendments as it relates to 15c3-3a requirements

150 days after the rule is published in the Federal Register:

- FICC rule changes pertaining to the clearing of eligible secondary market transactions

31 December 2025:

- Eligible secondary market cash transactions to be cleared by direct participants of FICC

30 June 2026:

- Eligible secondary market repo transactions to be cleared by direct participants of FICC

Closing comments

Broker-dealers that are, or plan to be, direct participants of FICC need to both enhance their customer clearing models and implement onboarding processes for clients that seek access to FICC via sponsored membership. Those brokers that currently clear their Treasury cash and repo trades bilaterally will need to select the direct or indirect FICC access model that is the most efficient fit for their strategy.

Buy-side participants will need to implement a process to calculate and post collateral, select an appropriate access model and re-engineer their trading processes and broker relationships. Buy-side firms choosing direct access can be expected to make determinations around capital considerations, clearing funds and capped contingent liquidity facility obligations, while those choosing an indirect model will need to make choices such as gross or net margining and sponsored or agent clearing.

In either case, operational and technology changes will be required, though their precise scope will depend on a firm's role and access model.

The European roadmap

Cyril Louchtchay de Fleurian examines a roadmap for growth and efficiency gains in European repo markets, including a case for the repositioning of GC Pooling and €GCplus solutions

The first contribution to this three-part article, published in Securities Finance Times Issue 345, examined synergies in clearing and triparty repo. This, the second part, looks more closely at the ecosystem supporting use of general collateral baskets in Europe and potential designs for repositioning GC Pooling and €GCplus.

The micro-economic and technical analysis of the GC Pooling and €GCplus pair partially explains some current pitfalls. It is a key preamble — necessary but not sufficient — towards outlining solutions aimed at increasing volumes towards the potential target of €500 billion.

In addition to this first aspect, it is necessary to zoom out our analysis and explain why the evolution of these GC offers is important. What problem are we trying to solve by repositioning GC Pooling and €GCplus? Why should we collectively invest to do so?

To answer this question, we have identified two fundamental issues that crystallise this problem and in which GC Pooling and €GCplus can play an instrumental role. The first concerns the decline in the velocity of collateral circulation. The second relates to the shift in bias on liquidity conditions, necessitating a change in the temporality of monetary operations. These are systemic issues and are likely to be subject to close scrutiny from central bankers.

In these circumstances, it becomes necessary to stimulate collateral velocity and related liquidity to minimise systemic risks. To achieve this result, it is first necessary to broaden the base of flows and concentrate them — to increase the execution speed and rotation of collateral, notably by changing the temporality of certain operations through the introduction of ‘intraday’ transaction management.

Collateral velocity

As an explanation, there is a relatively unknown indicator that collapsed from 3.0 in 2007 to 1.8 in 2016 (-40 per cent), rebounded to 2.3 in 2020, only to decline again to 2.0 in 2022. This indicator has lost more than 30 per cent over 15 years, without making headlines, although it should have.

This indicator is the collateral velocity rate, in other words, its circulation speed. This refers to how frequently collateral is exchanged or used in various transactions — a measure of how quickly it changes hands or is reused in the financial system. Collateral velocity is influenced by factors such as market liquidity, financial institutions' risk management policies, and prevailing regulations. Higher collateral velocity indicates more active use in financial transactions, suggesting more efficient asset utilisation and better allocation.

In the European markets over the past 15 years, collateral velocity has significantly decreased for four main reasons: risk aversion since the 2008-09 financial crisis; balance sheet constraints faced by banks; the expansion of quantitative easing by the central banks; and regulations limiting dealers' intermediation capacity. The direct consequence is a structural limitation of collateral availability, essentially resulting in a net destruction of collateral. Less collateral in the system affects market liquidity and becomes synonymous with increased systemic risks.

In schematic terms, market collateral liquidity depends on two parameters: the stock of mobilisable securities and its rotation speed. Based on a European repo market of €5.4 trillion, if the rotation speed drops from 3.0 (the level in 2007) to 2.0 (the level in 2022), the system mechanically destroys €1.65 trillion of collateral, equivalent to 33 per cent of the European repo market. This is more than 50 per cent of the French debt. This decline is not an epiphenomenon but a structural trend; it is the "drying up" syndrome.

"European offerings GC Pooling and €GCplus can serve as ‘standards’ and possess all the necessary qualities to be pioneers."

To prevent this inevitable risk, there are several possible approaches. One is to intensify regulatory pressure. Alternatively, the central bank can increase its interventions. Both paths have been utilised extensively in recent years and could be counterproductive today.

More sustainably, collateral velocity can be stimulated by developing interoperability between triparty links to enhance collateral fluidity — this technical bridge in 2024 is called GC Pooling or €GCplus. Since we have the tools, let's seize the opportunity to provide the market with tangible means to structure its self-regulation.

Defragmenting silos

In this context, innovative solutions such as the creation of digital tokens or tokenisation supported by blockchain technology are particularly suitable. The goal is to have easily real-time mobilisable guarantees without friction. Here again, European offerings GC Pooling and €GCplus can serve as 'standards' and possess all the necessary qualities to be pioneers. To illustrate my point, exchanging the key to the safe is more effective than its contents — less friction, the same guarantees, better traceability, better dynamics.

However, these solutions should not be considered in isolation but revolve around a technical improvement of the pipes through which collateral circulates. We have already discussed the logic of 'breaking down walls', in other words, defragmenting existing silos. In addition to this foundational principle, this evolution involves the digitisation of transaction processes, adopting digital processing platforms, electronic collateral management negotiation systems, and data collection and analysis solutions.

"In this space, the connectivity of an HQLA GC basket to the Central Bank Digital Currency remains promising and technically tangible today."

Electronic negotiation improves efficiency, speed and transparency. The automation of operations, settlements and reports reduces dependence on manual entries and, more generally, human interventions. Data collection and analysis involve market data, price information, credit ratings, historical performance and investor preferences, responding to the implementation of more sophisticated and responsive strategies.

Access and connectivity simplify interactions between participants, thereby expanding the market's scale. Finally, risk management monitoring and compliance verification can occur in real-time through enhanced transparency. All these elements, in combination, replace outdated capital with new and technological capital which, by design, will stimulate collateral velocity.

Intraday management

The second risk issue we want to zoom in on relates to aligning market temporality. Behind this obscure term lies a new and systemic issue that brutally manifested itself in the US banking system a few months ago through the failures of Silicon Valley Bank, Signature Bank and First Republic Bank.

In essence, it becomes necessary to align the near-instantaneous ability that individuals and businesses have to manage their cash in their bank accounts with the operations and risk management capabilities that banks possess in the market. Factually, this shift in bias observed in liquidity conditions — facilitated by the digital tools available to economic agents — requires evolving the temporality of monetary operations.

This involves developing the concept of intraday management. In other words, the same-day value date is no longer an impassable horizon but must be restructured around distinct intraday time slots, allowing for processing, settlement and delivery based on specific intra-day time points. It is nothing less than a matter of systemic security.

Exit is the dilution of the same-day value date in a single and homogeneous temporal continuum. Thanks to their specific design (clearing, digital execution, back-office support allowing real-time valuation, substitution and margin calls), GC Pooling and €GCplus are inherently equipped to meet this major challenge. The technological synergies in terms of connectivity, tokenisation and blockchain, along with anticipating defaults through machine learning or artificial intelligence (AI), will enable real-time responses to possible bank runs that jeopardise market integrity. In this space, the connectivity of an HQLA GC basket to the Central Bank Digital Currency (CBDC) remains promising and technically tangible today.

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Bellows promoted

Northern Trust has appointed Clive Bellows as EMEA president and a member of the Northern Trust Management Group.

He replaces Teresa Parker, who is set to retire later this year, and will report to Pete Cherecwich, president of asset servicing.

Bellows has more than three decades of industry experience, and currently serves as head of EMEA global fund services at the company. Prior to this, he was a managing director and head of relationship management for asset managers and hedge funds at JP Morgan Chase.

Earlier in his career, Bellows was an executive director and global head of client services for global markets at Deutsche Bank.

Michael O'Grady, Northern Trust chairman and CEO, says: "Clive brings a wealth of experience to this role and is an ideal leader to head our EMEA region."

Martocci departs from Citi

David Martocci is to depart from Citi after 13 years with the group.

Based in New Jersey, Martocci has been managing director and global head of securities finance at Citi since 2012.

In a previous role as global product manager, he was responsible for the client management, sales and development of Citi's securities lending programme.

Martocci has extensive experience in all aspects of financial services, having held vice president positions at J.P. Morgan and Lehman Brothers earlier in his career.

The move comes as a part of a company-wide restructuring and follows the appointment of Pitts Robinson, global product head of securities finance, in January.

Sweeney joins Natixis

Joseph Sweeney has joined Natixis Corporate and Investment Banking as vice president of US clearing.

Based in New York, he will focus on US securities clearance.

Sweeney brings extensive experience in securities lending, having held senior positions at various banks since 2011.

Previously, he was vice president at Mitsubishi UFJ Financial Group (MUFG) between 2022 and 2024.

Earlier in his career, he held a 10-year tenure as vice president at financial services firm Mizuho.

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Cook promoted at Tonic

Tonic has appointed Philip Cook as global head of post-trade.

In the Chicago-based role, Cook is responsible for building tailored post-trade solutions to help clients accelerate their business and commercial goals.

Cook has more than 20 years of industry experience, and has been a senior project manager at Tonic since April 2023.

Prior to this, he was a vice president for derivatives and collateral operations at investment manager PPM America and held a number of managerial and vice presidential roles at Northern Trust Hedge Fund Services.

Commenting on his appointment, Cook says: "As we move into a T+1 settlement, US Treasury clearing, needs for operational efficiency and resilience and further regulations including SEC 10c-1, there is a lot of ongoing transformational change across post-trade. I am excited to partner with our clients on value-add projects."

Measures departs from Citi

Darren Measures has departed from Citi after more than six years with the firm.

He formerly acted as director of execution services sales at Citi's Hong Kong office.

Prior to joining Citi, Measures held a number of positions at J.P. Morgan between 2005 and 2017, where he was based in the New York and Hong Kong offices.

He was most recently APAC sales lead for agency financing, collateral and liquidity at J.P. Morgan. At the firm, he also worked within product, sales and client management.

Earlier in his career, Measures was an associate director at UBS Investment bank between 1995 to 1999 and previously worked within the equity derivatives back office at Bankers Trust.

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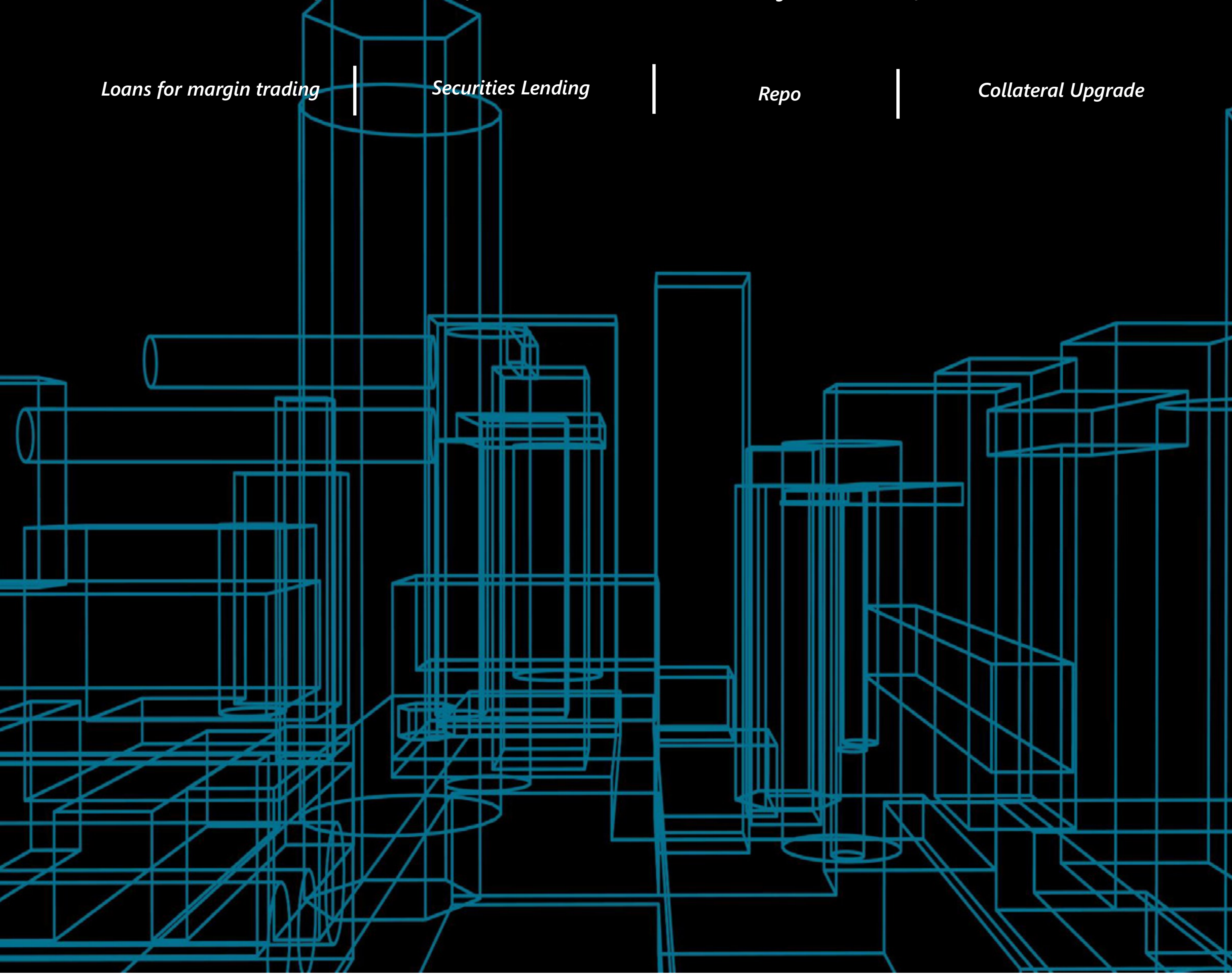

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