

Evolution amid diverse change

Participants discuss the current securities lending landscape in the region, the technology evolution born from the move to T+1, and the Bank of Canada's introduction of a settlement fail fee on bond and bill trades

Panellists

Dave Sedman, Senior Vice President, Banking and Markets group and Head of Canadian Agency Trading, **Northern Trust**

Sagar Patel, Executive Director, Americas Head of Triparty, **J.P. Morgan**

Jack Herron, Vice President, Agency Securities Finance Trading, Americas, **J.P. Morgan**

Kyle Kolasingh, Head of Market Services Solutions, **RBC Investor Services**

Ahmed Shadmann, Vice President, Head of Agency Trading Non-US Equities and Canada, **State Street**







How do you assess the performance of the Canadian securities lending market over the past 12 months?

Kyle Kolasingh: The Canadian securities lending market has continued to show strong revenue accretion and compelling portfolio optimisation opportunities in 2023, and so far in 2024. According to DataLend, revenues were collectively up 15 per cent in 2023, with average fees of 41bps. Approximately 40 per cent of this revenue stemmed from loans garnering more than 500bps. Various sectors, including cannabis, artificial intelligence (AI) and crypto, created attractive lending opportunities. During April 2024, average fees for Canadian equities soared above 90bps — one of the few asset classes to outperform year-over-year (YoY) comparisons, according to S&P Global Market Intelligence.

Meanwhile, in the fixed income space, demand for Canadian sovereign debt remains persistently high, concentrated at the front end of the yield curve. Demand for longer-dated bonds is proving equally attractive, especially in today's high interest rate environment. Term-lending demand, while still relatively high, has recently shown signs of softening as structured trades, particularly in the Canadian provincial bond space, have rolled off as banks became saturated with high quality liquid assets (HQLA). At RBC Investor Services (RBCIS), we continue to see a strong appetite from existing beneficial owners looking to further enhance their lending returns via risk-flexible changes, and from new beneficial owners entering the market in search of complementary revenue streams. The outlook is encouraging.

Jack Herron: Securities lending demand for Canadian equities has been strong for the past 12 months. We have observed a steady flow of general collateral, warm and hard-to-borrow

demand from our borrowers. Balances remained elevated throughout the year, and demand for specials increased. Borrower interest focused on the electric vehicles, cannabis, and mining industries. We continue to see additional borrowers reach out for Canadian supply, and beneficial owners add Canadian supply to their lending programme. Collateral flexibility remains critical, as borrowers seek to optimise their balance sheets.

Dave Sedman: In Canada, Northern Trust saw average lending fees, utilisation and overall returns increase across the board YoY. These increases can be attributed to several factors: continued demand for fixed income assets; Dividend Reinvestment Plan (DRIP) trading; and specials demand for individual securities.

Canadian government, provincial, and corporate bond demand, was spread across both the open and term loan space. Whether it was one-month rolling maturity structures or longer-dated fixed and extendible structured trades, borrowers continued to seek ways to better manage their balance sheets. The HQLA collateral upgrade trade was a large driver of revenue for 2023, as borrowers looked to more efficiently manage their balance sheets by pledging a wide array of non-cash collateral, including equities, corporate and convertible bonds. Additionally, there was strong demand centred around the Canadian government bond benchmark issues.

A significant amount of revenue generated from Canadian equities was driven primarily off the back of the DRIP trade and other market-specific seasonal demand. Canadian DRIP names saw healthy utilisation YoY and contributed to returns across the programme. The DRIP trade continues to yield attractive returns as demand remains strong, with

borrowers wanting to participate and compete for supply. Our clients that hold these specific names will see increased earnings around the high demand periods.

While mergers and acquisitions activity remained subdued, Canadian equity demand was largely driven by individual directional issues. The specials tend to be very name-specific and associated with industries where there has been volatility in the underlying share prices. While hedge funds continued to demonstrate their net long bias, the Canadian equity specials market did experience a slight increase in average fees over the previous year, as several equities continued to generate demand among the borrower community. Specific sectors in Canada that drove revenue in the securities lending market included the specialty healthcare and pharmaceutical sectors, as well as raw materials and mining. Soft demand for lower intrinsic value securities has continued.

Ahmed Shadmann: In the Canadian market, the past 12 months have had their ups and downs. The last three quarters in 2023 saw robust demand in the dividend space, particularly within the Dividend Reinvestment Plan initiated by almost all of the big five Canadian banks. However, the DRIP discounts were soon discontinued as the capital and balance sheet positions of the Canadian banks improved in Q1 2024.

The first quarter of 2024 also saw a pick up in equities, with interest rate cut expectations buoying the market ever higher. In the lending space, borrowing counterparts seem to be in a holding pattern while they await an appropriate point of entry into the market and, in the meantime, are using internal supply to satisfy their financing needs. This is reflected in data as of April 2024, with global securities

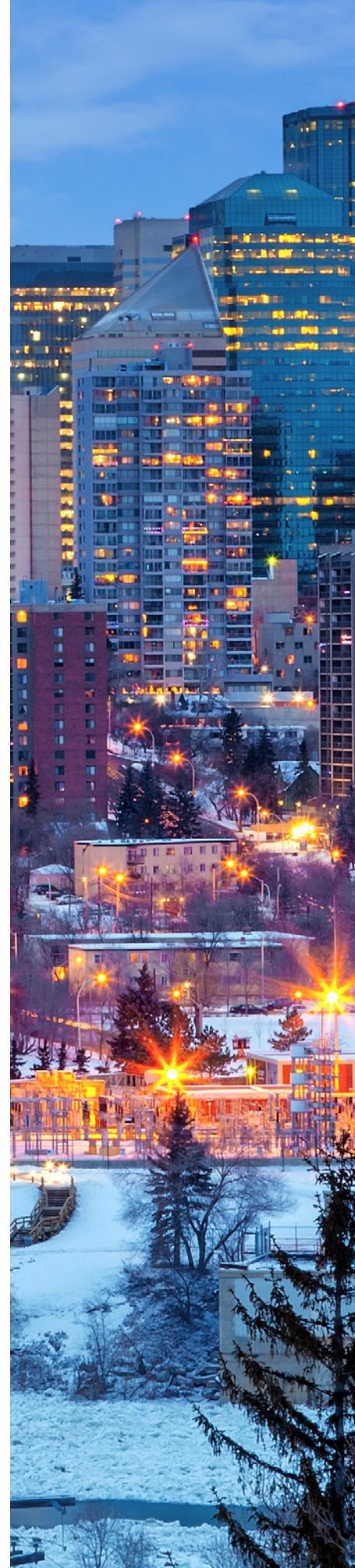
lending revenue down 20 per cent on a YoY basis, according to DataLend. This is in sharp contrast to Q1 2023 figures, where the market experienced more than a 35 per cent revenue bump on a comparative basis.

In February, the Canadian Investment Regulatory Organization (CIRO) proposed amendments to rules relating to fully paid securities lending and financing arrangements. How do you see these rules impacting the advancement of the Canadian market?

Sagar Patel: The proposed amendments provide various clarifications and outline the expectations of the firms offering fully paid lending programmes, largely for the benefit and protection of the underlying customers who are loaning out their fully-paid-for securities. Sufficient transparency and clear processes explicitly laid out in the regulations for scenarios, like dealer default, ultimately give the underlying customers adequate information on how fully paid lending programmes operate and their associated risks.

The underlying customers can then move to the next step to determine if consenting to such activity makes sense for them from a risk versus reward perspective. This type of transparency is key for the fully paid lending market to grow in Canada, or any jurisdiction for that matter. In other jurisdictions, such as in the US, fully paid lending programmes have been live for many years with meaningful retail-originated activity in the market.

J.P. Morgan has seen substantial growth in the US fully paid lending programmes we support as a collateral agent. Collateral is held by J.P. Morgan as an independent custodian, coupled with oversight provided by a third-party trustee





on behalf of underlying owners of fully-paid-for securities. This scenario provides confidence that the assets are appropriately segregated and will be protected in the event of a counterparty default or insolvency.

What investments and adaptations to working practices have you made to prepare your Canadian securities lending activity for the T+1 implementation?

Herron: The main theme for our T+1 implementation is automation. We are working very closely with our vendors and internal teams to streamline recalls, returns, and breaks to reduce settlement failures. With a more efficient settlement process, we expect the shortened settlement cycle to be absorbed into our policies and procedures.

Kolasingh: Over the past 12 months, RBCIS's focus has been geared toward automating trade processing flows, and re-socialising timelines and other upcoming changes with our beneficial owners. We have partnered with fintech providers to implement a recall service that automates the sending and receipt of recall notifications between the agent and borrowers.

This streamlined approach is helping to expedite recalls, increase operational efficiency and reduce timelines. Beyond technology, the RBCIS team has been speaking with our clients about the changes they have been making to remove any potential areas of friction within the trade and downstream loan flow processes. Unlike T+2, the T+1 transition requires both behavioural and structural changes, not only to the recall process but also to lenders' trade submission and affirmation processes. To better align with the shorter settlement timeframe, many

lenders are moving to more frequent batch processing or intraday communication protocols.

Shadmann: The move to a T+1 settlement cycle has accelerated the need to automate previously manual processes. The shortened settlement cycle has put the focus of technological advances that focus on straight-through processing (STP) and real-time data between internal systems. STP advances will now allow us to issue recalls to borrowers through the use of external vendors' post-trade services module on a real-time basis.

This is a significant shift away from a previous reliance on batch processing, or a manual push list, which have been staples of the industry for decades. State Street also continues to invest heavily in our proprietary IRIS platform. This new platform will replace our entire pre and post-trade legacy trading systems and will allow for greater flexibility in creating and maintaining highly customised client programmes.

Sedman: Northern Trust's focus on the Canadian transition to the T+1 shortened settlement cycle, scheduled for 27 May, has led the firm to streamline its procedure around the handling of trade instruction processing, loan reallocation, and borrower recall communication. These recalls will be issued multiple times throughout the day, either by electronic email notices or direct recalls via the EquiLend platform. In Q3 2024, we expect to utilise the newly developed industry recall hub developed by TMX.

While industry best practice indicates lending agents could issue recalls up to 23:59 ET on trade date (T), the RMA best practice guidelines have modified the time to 19:00 ET on T. Northern Trust will operate within the best practice guidelines, but still recommends that clients submit trades as soon as executed.

Sell-fail protection and contractual settlement practices will remain in place in alignment with published custody deadlines. Northern Trust's efficient operating processes will support clients in meeting their T+1 obligations.

What impact has the preparation for a shorter settlement cycle had on the overall financial market, and where do you predict this milestone move will lead the securities finance industry?

Kolasingh: Overall, the transition to T+1 here in the Americas is likely to serve as a case study for other regions and markets that are seeking to adopt the compressed settlement cycle. Technology implemented across the value chain to facilitate T+1 will undoubtedly benefit future advancements for our industry. Lenders and borrowers have implemented technological solutions to prepare for the changing settlement landscape as they look to optimise recall management processes and minimise operational risk.

TMX Group launched its Securities Lending Recall Hub to simplify the communication of recall notices for market participants. This facility provides for interoperability between participants and fintech — a welcome enhancement to the financial infrastructure. Any move to T+0 is likely to result in additional technological change, including the potential for distributed ledger technology (DLT) and AI applications designed to assist with anticipating demand and meeting recall needs.

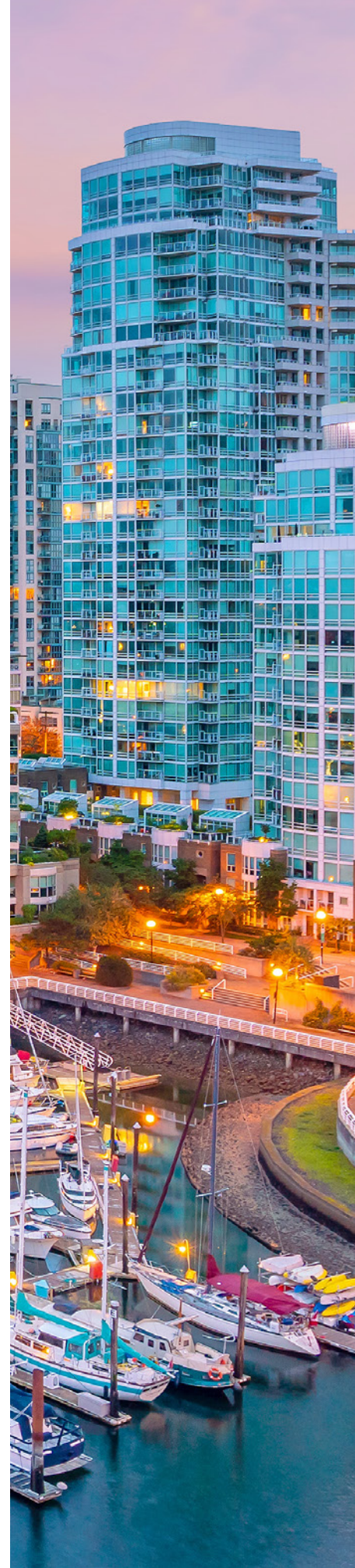
Shadmann: The preparation for a shorter settlement cycle has forced the entire market to focus on efficiency and the reduction of manual workflows. A shorter settlement cycle has led to firms adopting and implementing automated processes, which should lead to a

more efficient market overall, allowing sales and trading to focus more on idea generation and higher value trades and strategies. Initially, there is an expectation that as the street implements their T+1 solutions, there will be healthy volatility. However, in the long run, implementation should make for more efficient trading desks, focused on more value-add and higher-spread trades. Further, this focus on a shorter settlement cycle has also started the conversation across the street on the readiness for T+0. Most firms have taken this opportunity to take a long, hard look at their T+0 capabilities, and are using the existing technological budget to make sure T+0 readiness is also part of the equation.

Herron: The T+1 shortened settlement cycle will force all market participants to become more efficient. These efficiencies will lead to more opportunities and additional business, which will be beneficial for all of us.

Which regulatory initiatives will consume most attention for your teams over the coming 12 months? And which initiatives that focus on standardisation, digitisation and technology enhancement?

Sedman: In 2024, we are seeing regulations impacting the securities lending industry that focus on enhancing transparency, agility and technology, to improve efficiency and resiliency in the industry. The Securities and Exchange Commission's (SEC) Rule 10c-1a initiative is aimed at enhancing transparency of the securities lending market by increasing disclosure requirements, transaction reporting, and compliance oversight. Clients participating in the US market will be required to submit security-level transaction reporting.





In addition, capital-efficient trade structures also remain in focus as Basel III Endgame approaches and counterparties look to lessen their risk-weighted asset (RWA) usage. Borrowers may consider 'smart bucketing' clients based on RWA, with the lowest RWA counterparties benefiting from the most flow. This could be challenging for clients with 100 per cent RWA, which may find it more difficult to lend out their available supply of securities. With that in mind, initiatives such as alternative pledge structures, central clearing counterparties, and alternative forms of indemnification are being developed and implemented to offset some of these potential challenges.

Kolasingh: Once the T+1 transition is behind us, local focus will begin to shift to the Bank of Canada's (BoC) planned introduction of a settlement fail fee on government of Canada bond and bill trades, as well as assessing the impact of the SEC Rule 10c-1a. In an approach akin to the implementation of the US Treasury Market Practice Group's fail charges in 2009, the BoC fee aims to incentivise timely and efficient settlement, mitigating systemic risks associated with failed trades.

The proposed regime will help promote optimisation of the borrower settlement process through the introduction of punitive costs, while minimising operational risk. The first trial period, expected to begin in Q4 2024, will include fails tracking, but fail fees will not be exchanged by participants. Meanwhile, Rule 10c-1a is intended to enhance transparency and oversight in governing the securities lending market, bolster investor confidence, and promote more informed decision making. Based on our preliminary assessment of the Financial Industry Regulatory Authority's (FINRA) draft rules, there will be no reporting obligation

for beneficial owners using an agency lending model.

In the coming year, RBCIS will continue to focus on modernising our technology and operational flows. This will further enhance trading capabilities, enabling us to optimise client assets and streamline procedures within the compressed settlement infrastructure. In partnership with trusted fintech vendors, our advanced technology and flexible capabilities will future-proof RBCIS's securities lending solution. At the end of the day, our singular focus is on meeting the needs of RBCIS's lending clients in an ever-changing environment, generating yield, controlling risks, and unlocking the full potential of their investment portfolios.

Herron: T+1 will be the main initiative consuming our attention for the next few months. On top of T+1, a large focus will be incorporating AI into our daily activities. AI is a remarkably valuable tool, and implementing it correctly into our business is pivotal.

Shadmann: The implementation of the BoC's proposed penalties regime for failing to settle government of Canada bond and T-bill trades, will be a focus of ours. This initiative, once mature, will be a positive evolution in the Canadian fixed income market, through the introduction of an incentive that will effectively decrease the number of fails and therefore increase the efficiency of the overall market.

Another regulatory initiative that will consume a lot of our attention is the SEC's Rule 10c-1a. This rule is intended to enhance transparency of the securities lending market, which should bring confidence to a wide swath of participants and encourage involvement in the lending space. The end result is hoped to be a more liquid market.

Finally, the move to a T+1 settlement cycle is at the front and centre of regulatory initiatives demanding our attention. As noted previously, a lot of time, effort and investments have been made to enhance our systems to better align with the industry and smoothen pre and post-trade workflows. Once T+1 is live, system enhancements will continue to be worked on to smooth out our system and further enhance STP.

What programmes are ongoing within CASLA, and at industry-level more broadly, to support this agenda?

Kolasingh: Two of CASLA's key objectives are to (i) provide a forum to share and exchange ideas, information, as well as best practices across the industry and (ii) to work closely with regulators and other industry associations to ensure an efficient and secure marketplace. Consistent with these objectives, our work over the past 12 months has been focused on keeping members informed on T+1, providing guidance, as well as commenting on the proposed rule amendments and related guidance pertaining to fully paid securities lending and financing arrangements.

CASLA will continue to work closely with fellow trade associations to share learnings from T+1, as other markets look to align with the shortened settlement period. Much of this work has already begun, stemming from the efforts of our T+1 working group. Finally, as the impact of Basel takes shape, implementation of a new fails regime gets underway and the new SEC Rule comes into effect, CASLA will continue to assist our members, coming together to educate and ultimately ensure the ongoing sustainability of Canada's securities lending market.

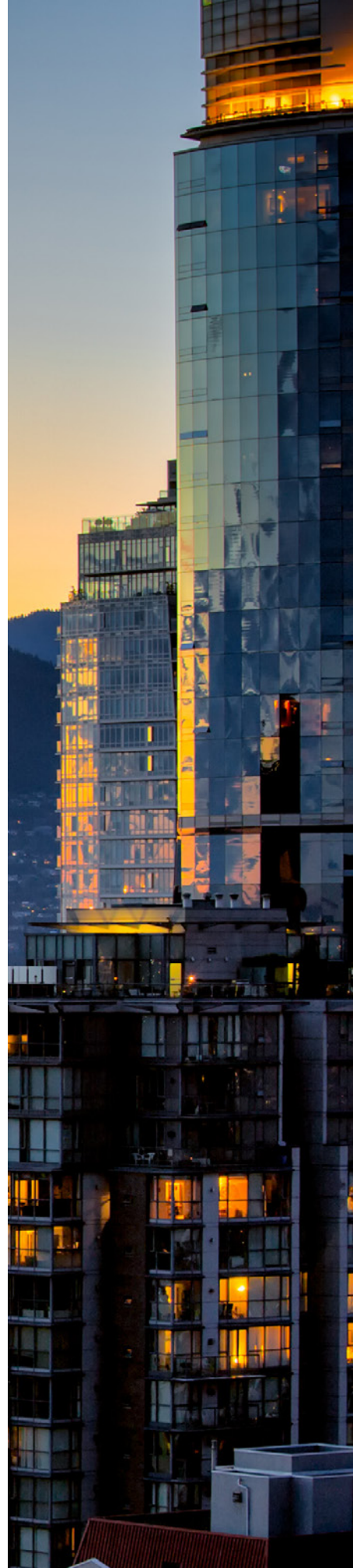
How do you assess the outlook for the Canadian securities lending markets for 2024-5?

Shadmann: The 2024-5 period should be an interesting year for the securities lending market. We are facing a market expectation of rate cuts, the timing of which remains elusive as central banks remain steadfast on cuts being contingent upon favourable data. This hawkish-to-dovish seesaw is causing markets to whipsaw on a daily basis, which does provide some healthy volatility into the market. As such, we expect short-interest themes to continue in sectors driven by market events. Which sectors exactly remain to be seen as the interest rate environment continues to evolve.

Another point of interest will be the adoption of AI across the industry at an asset class level. AI adoption will allow trading desks to consume and process massive amounts of data. This has a potential for immense utility towards predictive pricing and decision suggestions at an individual security level. Factors such as availability, frequency of locates, corporate action events, and general market information could be harnessed and distilled at a much faster pace to come to informed decisions at the trade level.

Herron: The Canadian securities lending industry has a positive outlook for the next 12 months. The business is trending towards further growth in 2024-5. After T+1, we expect to be more efficient, these improvements will lead to additional business opportunities. More market participants and collateral flexibility will also enable further growth.

Sedman: Currently, overall demand remains steady for securities lending in Canada. After a cool down towards the end of the year in 2023, and a slower start in 2024, specifically





with demand for Canadian sovereign assets, demand has steadied and opportunities are presenting themselves through name-specific trading and general collateral trading. We expect that securities lending will continue to be a positive contributor to revenue for our clients throughout the year and into next year.

For the start of 2024, Canadian equity lending volumes continued to soften and remain relatively flat despite the backdrop of global inflation and geopolitical uncertainty. General collateral securities demand has waned somewhat this year, but there are signs it is picking up in certain names and sectors, as the market continues to vacillate. Any pick up in M&A activity could provide a boost to demand as funds look to position themselves ahead of any pending deal. Additionally, the last of the Canadian banks discontinued their discount through the DRIP programme after having achieved a more favourable capital position, this is likely to soften demand going forward for those securities. Our expectation is that dividend reinvestment and seasonal dividend trade demand will continue to provide a steady revenue stream for the remainder of the year, and going forward.

In the fixed income market, overall demand remains strong in Canada, with utilisation and on loan balances continuing to grow significantly. There are still opportunities available in term and collateral upgrade structures, although we have seen some softening in demand and downward pressure on those fees as some trades start to mature. There continues to be demand for the most highly sought after benchmark Government of Canada issues, even in the face of lesser demand overall for Canadian sovereigns. Fixed income revenue for clients will come down to owning specific issues and types of securities as the market stratifies, based on narrow differences in issues.

Collateral expansion, term structures, and emerging markets are a couple of areas that beneficial owners will want to keep an eye on. Borrowers continue to seek out opportunities to pledge a wider array of non-cash collateral, including investment grade corporate bonds, equities (including ETFs), and convertible bonds, as they look to better manage their long portfolios with greater efficiency.

Kolasingh: Time and again, the Canadian securities lending market has proven its ability to evolve amid diverse change — be it market volatility or otherwise. Looking ahead, I expect ongoing change in response to T+1 with some stakeholders continuing to tighten up areas of friction both inside and outside securities lending. With the technical rules on SEC 10c-1a now published by FINRA, market participants will be assessing its impact.

Furthermore, I anticipate that technological improvements to workflows will go beyond recall automation, as various thoughts and ideas that were put on hold over the past 12 months rise to the top of the priority list. Digital asset integration, AI, and DLT used to support a potential T+0 environment, may now begin to germinate in the shadows of T+1 — although we are still some way off. From a market perspective, trading desks across Canada and the globe will be hyper-focused on the geopolitical landscape and global interest rate environment, particularly the upcoming US election. Each of these events has the potential to impact the domestic financing market — be it positively or negatively. The one constant is that the Canadian financing industry will continue to provide not only a source of liquidity to the capital market ecosystem, but also return-enhancing opportunities through risk-adjusted yields for beneficial owners. ■