Canadian securities lending

Leading figures from Canada's securities lending market offer an update on the key issues of the moment, including collateral changes, cannabis short interest and adapting to an environment with COVID-19

Panel participants

Lisa Tomada, vice president, global securities lending, CIBC Mellon
Kyle Kolasingh, associate director, securities finance, RBC Investor & Treasury Services
Alexa Lemstra, head of EquiLend Canada
Katie Pries, president and CEO, Northern Trust Canada
Nick Conroy, director, head of Canadian securities lending, Scotiabank

To deal with the global pandemic, central banks have joined forces to maintain liquidity during this period of volatility. How has the Canadian securities finance market fared compared to other markets?

Lisa Tomada: In terms of securities lending, the majority of global markets have fared well, including Canada. High-quality liquid assets (HQLAs) have been at the centre of activity from both borrowers and beneficial owners. Borrowers sourced HQLA to shore up liquidity needs and were especially looking for term loans of HQLAs in order to secure sources of liquidity. Beneficial owners increased sales of HQLA to meet their own liquidity needs. With the addition of the quantitative easing programme by the Bank of Canada into the market, we have seen the need for borrowing term HQLA start to ease.

Canadian equities also experienced a spike in demand. Canada, being a resource-based market, was particularly hit hard with the recent crash in oil prices. From a securities lending perspective, demand in our programme spiked in the energy and materials sectors. We have since seen some stability return to demand and volumes within the Canadian equity space. Overall, the Canadian equity market was down due to negative market valuations.

Alexa Lemstra: The Canadian market felt the impact of this global event in much the same way that other markets did. Looking at DataLend for an overview of what happened, from an inventory, on loan and utilisation standpoint, the trends in Canada are very similar to the US and the global impact of the pandemic.

Canadian lendable and on-loan saw a general downward trend from the end of February through the end of March, with lendable value dropping 20 percent. Utilisation increased in both the Canadian and US Markets, from about 11 percent to over 13 percent in Canada from February to March and from under 10 percent to over 13 percent in the US during the same period. Each market has its own nuances, but generally, the Canadian market trends were in line with global markets.

Kyle Kolasingh: Given the COVID-19 pandemic and accompanying global market turmoil, 2020 is turning out to be an extraordinary year for the securities lending industry. Actions taken by the world's central banks added an element of economic stability although ongoing market volatility continued to impact the securities finance sector.

In Canada, we witnessed a significant increase in investment activity on the part of beneficial owners during March and April. Some lenders also realigned their securities finance programme parameters in order to adjust their risk-based investment strategies. While this combination of events resulted in a number of challenges for agent lenders, it also created an opportunity for beneficial owners as the securities lending market experienced an influx of transactional activity.

For example, one of the asset classes most impacted by the situation was HQLA as investors sought to create liquidity amidst the volatility. This sudden increase in sales activity translated into a temporary tightening of supply in the lending market and higher lending fees, particularly advantageous to those lenders who took part in duration structures (term lending).

Katie Pries: Overall demand remains strong for securities lending in Canada with spreads and utilisation off slightly from last year's pace. Canada

Lisa Tomada
Vice president, global securities lending
CIBC Mellon

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Associate director, securities finance
RBC Investor & Treasury Services

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is coming off an exceptionally good year in 2019, where the main drivers of securities lending revenue were HQLA trades (Canada government debt) and high demand (specials) equity such as cannabis stocks. In 2020, those same trends continue with added volatility associated with the global pandemic. Canada has not imposed short sale bans like ones seen in Europe which has allowed Canada's market to maintain active trading and hedging. Securities lending activities continue relatively uninhibited.

In addition to demand for HQLA and specials, as the result of current market volatility exchange-traded funds (ETFs) have become a prime source of liquidity and demand within the securities lending market. ETFs serve the purpose of providing liquidity for a variety of trade strategies, whether targeted at the broad market or a specific industry sector.

Nick Conroy: The actions of central banks to maintain liquidity in their domestic markets, as well as the strong coordination between them, has played an important role in easing strains in global funding markets during the COVID-19 pandemic. Lower interest rates and large scale asset purchase programmes have injected significant liquidity into global markets and our observation has been that the securities finance market has shown incredible resiliency during this period.

Throughout this volatile period, the stability of the Canadian market has been on display. We've seen intervention in certain parts of the world with steps such as imposing short-selling restrictions. In Canada, it has largely been business as usual with strong client demand and a greater willingness to put cash to use.

Last year, CASLA and other stakeholders were working with regulators on reforms for NI 81-102, which currently limited mutual funds' ability to accept equities as collateral. What's the latest there?

Kolasingh: Similar to US '40-act funds, current regulation limits the scope of eligible collateral for mutual funds under Canada's National Instrument 81-102. As the lending market continues to experience a lack of specials compared to recent years, the ability of lenders to utilise the full range of collateral is essential to revenue optimisation. Levelling the playing field across all categories of beneficial owners is key to enabling such optimisation. The mutual fund industry is facing a highly competitive environment with significant pressure to reduce fund expenses.

Securities lending plays an important role in facilitating cost reduction for unit-holders. Proposed regulatory changes to broaden loan distribution for Canadian mutual funds through deeper collateral optimisation will help managers further reduce their costs. As a member firm of the Canadian Securities Lending Association (CASLA), RBC Investor & Treasury Services (RBC I&TS) fully supports industry efforts to move forward with this important regulatory change.

Tomada: CASLA continues to work with the regulators on this initiative. It supports positive change for industry stakeholders, including the ability for Canadian mutual fund managers to expand their acceptable collateral profiles to include equities for securities lending transactions. CASLA continues to support positive change for industry stakeholders and the association looks to align and strengthen its presence with regulators across Canada and other global associations.

Pries: CASLA's efforts for the industry continues with reforms on NI81-

102. Northern Trust has representation on CASLA's executive committee and is an advocate for our clients through this industry group.

Besides weathering the disruption to business and market volatility, what else is on the agenda for Canada's market in 2020 and beyond?

Pries: Demand has waned somewhat within the general collateral (low-demand securities) space due to the greater focus on high-demand securities (specials). While specials continue to be very name-specific, the Canadian specials market benefitted from continued directional trading in the speciality pharmaceutical sector. Continued volatility in global commodity prices is also expected, furthering directional short interest across the oil and mining sectors. Also, with the retail industry facing headwinds from large scale unemployment, widespread shutdowns and weakened consumer spending demand for names across the sector will increase as many retailers will struggle to avoid closure amid plunging sales and earnings.

One trend that continues over the past year is the increased demand for fixed income securities, specifically HQLA assets, alongside growth in term structures as borrowers pursue additional means to utilise their balance sheets more effectively. There has always been a preference for non-cash collateral in Canada and our expectation is that non-cash collateral balances will continue to grow going forward. Borrowers continue to seek out opportunities to pledge a wider array of non-cash collateral including equities, corporate and convertible bonds as they look to manage their long portfolios with greater efficiency.

Beneficial owners can put themselves in a position to take advantage of this preference by reviewing their collateral guidelines and ensuring they are aligned with the trend toward non-cash collateral, accepting a wider range of collateral that fits within their risk appetite and that they permit entry into term trade structures.

Conroy: One of the challenges we anticipate is how do we adjust the economy for structurally lower-for-longer rates and lower-for-longer commodity prices. The economic disruption is ongoing and will be a major consideration for lower-for-longer impacts. We could possibly see a more domestic approach to goods and services that will impact international import supply chains. We could see a consistent reduction in Canada's energy and materials exports.

Kolasingh: Prior to COVID-19, two key themes within the Canadian securities lending market were environmental, social and governance (ESG) factors, and regulatory change. ESG was propelled to the forefront when one of the world's largest pension funds cited the fundamentals of ESG —particularly proxy voting and transparency — as its rationale for withdrawing from lending. Proxy events and governance have, however, co-existed within the securities lending paradigm for many years. At RBC I&TS, we work closely with our lending clients to understand their investment policies and governance requirements, including ESG factors, striking the optimal balance with a tailored securities lending programme. This requires timely dissemination of publicly available information, an area that admittedly requires further discussion and improvement across the industry.

In addition, several regulatory changes impacting global securities lending markets, including Canada, are planned to take effect in 2020.

Alexa Lemstra
Head of EquiLend Canada

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Katie Pries
President and CEO
Northern Trust Canada

One trend that continues over the past year is the increased demand for HQLA, alongside growth in term structures

The Securities Financing Transactions Regulation (SFTR), a body of European legislation designed to enhance the transparency of SFTs, including securities lending and repos, is top-of-mind with multiple implementation phases. The first phase was originally scheduled for implementation in April 2020 but, due to COVID-19, has been pushed to July 2020.

The delay was generally welcomed by the securities finance community as stakeholders were focused on implementing business continuity practices related to COVID-19 during April. While RBC I&TS was ready to implement SFTR, the additional time has enabled further testing with our vendors and counterparties. We also continue to prepare for the Central Securities Depositories Regulation (CSDR) and Shareholders Rights Directive (SRD) II, both of which have near-term implementation timelines. From a settlement perspective, CSDR has the potential to be beneficial for the lending industry, particularly over the long term, as the market becomes more efficient through enhanced processes and technology to manage the transaction lifecycle. We could also see an uptick in demand as increasing numbers of financial institutions borrow more securities to avoid penalties included as part of CSDR's Settlement Discipline Regime. As for SRD II, we have established an internal project team that continues to engage with various industry bodies, while further progressing our implementation plan.

Tomada: As Canada and the rest of the world work through and recover from this pandemic and its economic impact, we expect to see continued demand in the sectors most impacted by this economic slowdown – energy, materials, travel, airlines, retail and potentially the financial sector. We anticipate a sustained interest in the borrowing of HQLA as firms continue to source and potentially shore up liquidity needs. As borrower demand has been changing rapidly and evolving in this unprecedented environment, we will continue to discuss with our clients the impact of collateral flexibility on their securities lending programme. We also expect a continued focus on technology innovation and automation across industry participants.

Lemstra: As our clients emerge from the market throws of March and April, they appear to be back on track to business-as-usual, albeit still in a work-from-home mode in most cases. Systems operated well during the market volatility, however, strong themes of efficiency and automation continue to be as much of a priority as they were pre-COVID, if not more so now. Collateral management, trading and post-trade efficiency are all key areas for adding scalability and efficiency to day-to-day business operations, particularly in volatile markets. The rest of 2020 entails creative ways to communicate and engage with clients, colleagues and counterparts as we figure out this new norm as an industry.

Stocks related to the cannabis sector have been the big earners for lenders for a long time now. Do you foresee that trend being overturned soon, given the current situation?

Lemstra: The four top cannabis stocks made up 42 percent of the annual lending revenue generated in Canada in 2019, and so far in 2020 the same four names have made up 44 percent of total revenue. However, fees in the broader pharmaceutical sector have been declining since mid-February through the end of April.

Conroy: The Cannabis industry has been a major driver of securities lending revenue in Canada over the past few years. Rebalancing due to index deletions is expected to disrupt supply. Cannabis stock market values have dropped by 60 percent to 90 percent from their 2018 highs, which has led to a reduction in the overall notional on loan. This has resulted in a reduction in revenue despite lending rates remaining elevated. We are likely to see the lending levels remain special for as long as a material portion of the market is restricted from owning or lending these securities.

Pries: Directional short demand is still highly prevalent in this sector with no expectations of decline given it remains heavily indebted with ongoing supply issues, regulatory challenges and potential mergers and acquisitions activity expected as the industry continues to mature. The feeling that the speciality pharmaceutical sector remains greatly overpriced was reinforced after the much-anticipated roll-out of edibles and drinkables in late January which failed to live up to the lofty expectations of certain analysts. March also saw an increase in short interest, borrower demand and in companies burdened by high debt levels and poor cash flow as dispensaries were forced to close to help reduce the spread of the coronavirus. Prior to the pandemic, with the expectation of a considerable drop in pricing and margins, companies in this sector issued revenue warnings for the fiscal 2020 outlook. The effects of the pandemic have only increased the likelihood the anticipated revenue downturn will be realised.

Tomada: The cannabis sector continues to be a leading securities lending revenue generator, but the revenue for Canadian equities is now more widely distributed across various asset classes. With the market correction that occurred in March, there was downward pressure on rates for selected securities within the cannabis space, thus reducing revenues from previous highs. With recent events, we may see increased consolidation in this sector.

Kolasingh: Following legalisation of cannabis in Canada more than 18 months ago, the cannabis sector continues to show strength in the lending market. Since the end of 2018, cannabis has consistently topped specials (excluding corporate event-driven names) amidst a somewhat depressed environment for warm and hot securities.

However, lending levels remain volatile, largely a reflection of underlying securities prices but also due to the dynamic macro-economic climate and a constant stream of news coverage generated by the sector, including various players' financial results.

While lending levels were up in March, overall revenue attributed to the sector declined due to sharp price depreciation. Nevertheless, the cannabis industry is currently a significant source of incremental value in the Canadian lending market and we anticipate this trend to remain throughout 2020.

According to RBC, Canadian pension funds recorded healthy returns in 2019. How is 2020 shaping up by comparison? What are the key drivers that will affect their revenue?

Kolasingh: Canadian pension plans continue to perform well in the securities lending market despite the ongoing decline of primary revenue drivers such as specials. This may be due to the large quantity of HQLA held by pensions as part of their long-term investment horizon, which is conducive to duration-structured term loans. Amidst the market volatility

Nick Conroy
Director, head of Canadian securities lending
Scotiabank

One of the challenges we anticipate is how do we adjust the economy for structurally lower-for-longer rates and lower-for-longer commodity prices of the first quarter of 2020, HQLA stood out as an increasingly in-demand asset class, enabling us to capture this heightened demand and further optimise beneficial owner portfolios. As investment strategies continue to evolve in this space, Canadian pension plans stand to further optimise their portfolios through dynamic securities financing relationships with their agent lenders.

At RBC I&TS, we continue to work with beneficial owners to tailor solutions that, depending on their particular needs, combine agency borrowing and self-borrowing within an overall securities lending mandate. This can help support greater revenue optimisation through the delegation of collateral management and reduced borrowing costs while creating efficiencies for pension plans and their investment managers.

Lemstra: Canadian pension plans are down 8 percent in average fee and 13 percent in utilisation Q1 2020 over Q1 2019. This decrease is a trend across the global beneficial owner community, which also saw a drop in fees and utilisation of 16 percent and 10 percent, respectively.

Pries: Having a strong presence in Canada and being close to the market, Northern Trust supports the growth and performance aspirations of the Canadian pension market. It is our view that securities lending will likely continue to be a positive contributor to pension fund returns in 2020.

A couple areas that beneficial owners will want to keep an eye on are: collateral expansion, term structures and emerging markets. While we have discussed collateral and term previously, emerging markets continue to be an important source of securities lending revenue for beneficial owners. Northern Trust, through our global network of borrowers and trading desks provides the market expertise and access to securities lending in both the developed and emerging markets.

Tomada: The Q4 2019 median return of the BNY Mellon Canadian Master Trust Universe – a BNY Mellon Global Risk Solutions fund-level tracking service that provides peer comparisons of plan sponsors' median returns – was +2.52 percent for the fourth quarter of 2019 and the one-year median return as of 31 December 2019 was +13.92 percent. As CIBC Mellon reported in its 3 February 2020 press release on the Q4 2019 universe results, Canadian plan sponsors continued to post positive median returns last year amid easing economic uncertainty.

In contrast, for the first three months of 2020 – as CIBC Mellon reported in its 4 May press release on the Q1 2020 results of the BNY Mellon Canadian Master Trust Universe – significant market losses were experienced as well as a worldwide economic decline, and all equity segment returns displayed negative results across the board due to the global pandemic and market volatility. The median return of the BNY Mellon Canadian Master Trust Universe was -7.23 percent for the first quarter of 2020 and the one-year median return as of 31 March was -1.13 percent. Canadian foundations and endowments posted the lowest performance among plans for the first quarter of 2020, with a median performance of -10.70 percent. The BNY Mellon Canadian Master Trust Universe outperformed the median returns of Canadian pension plans over $1 billion by 39bps for Q1 2020.

While we have seen markets rebound from the significantly negative returns, investors must continue to deal with increased market volatility, and overall market confidence, to fully rebound from the Q1 negative returns.

CASLA's annual conference was one of the many industry events that fell victim to the global lockdowns. What were the highlights of the event meant to be, for those industry participants who do not focus on the Canadian market year-round?

Conroy: It is easy to imagine the next CASLA discussing the material changes in the market due to COVID-19. Technology has played a huge role in overcoming the challenges of working from home. The actions by the Bank of Canada and the second and third-order effects of such policies have put a defining stamp on the year to date.

This year's conference would have been the 10th anniversary of CASLA. There were plans to have a Canadian twist on a wide range of things: buy-side client panel, ESG discussion and the effects on securities lending, liquid alts, fully-paid lending and regulatory challenges. The board did a fantastic job planning and securing guest speakers.

Tomada: The CASLA conference has become an important gathering for securities lending participants. This year would have seen several topics including an update on the Canadian cannabis sector, a session on women in capital markets, an economic update from CIBC World Markets, and a panel session discussing ESG in the Canadian market. The topic of ESG was to be a focus area at the event as ESG investing continues to gather momentum globally.