Canada securities lending panel

Securities lending specialists reflect on the drivers of performance in the Canadian market over the past 12 months, key changes in technology and market practice and how the future looks for the rest of 2023 and beyond

Panellists

Kyle Kolasingh, head of market services solutions, **RBC Investor & Treasury Services**

Lori Paris, head of client management, North America, **Northern Trust**

Mary Jane Schuessler, managing director, Global Equity Products, **BMO**

Ahmed Shadmann, head of agency lending trading, Toronto, **State Street Global Markets**

Mathilda Yared, managing director, Global Securities Finance, **National Bank Financial Inc.**

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

Mathilda Yared: The Canadian securities lending market fared relatively well in the past 12 months, despite challenging market conditions marked by a higher interest rate environment, reduction in funding needs and stress in the US and EU banking sectors. Balances shifted to lenders that could support wide collateral schedules, with a focus on access to liquidity, stability of trades, diversification and automation of execution.

We expect names that make up the TSX60 index to make their way into the top 10 revenue generators for Canadian equities, with a corresponding increase in utilisation. Increased short interest for names in the cannabis and cryptocurrency sectors, including Canadian exchange-traded funds (ETFs), also acted as a driver of utilisation and revenues.

The Canadian market experienced an upturn in Canadian-bought deals across various sectors, together with demand from retail clients and hedge funds, resulting in increased loan balances, utilisation, and revenues on names that otherwise would not have been on our radar.

Finally, US securities in the electric vehicle space and meme stocks have also been revenue generators for Canadian banks.

Kyle Kolasingh: There has been positive momentum in the securities lending market here in Canada over the past year. Overall fees, utilisation of assets and returns have seen double-digit growth during this time. Growth on the equity side has been primarily fuelled by erratic market conditions and ongoing usage of exchange-traded funds (ETFs) in hedging. Several cannabis names have rejoined the list of top equity earners, while financials and energy names continue to round out the top borrowed stocks. Like equities, the demand for fixed income assets has also increased.

In addition to directional plays, we have noticed a direct correlation between an environment of rising interest rates coupled with quantitative tightening and the demand for government assets and corporate bonds — particularly sovereigns and high yield, non-investment grade instruments.

Lori Paris: In the Canadian marketplace, average fees, utilisation and overall returns have increased year-over-year in Northern Trust's agency securities lending programme, driven primarily by demand for fixed income assets. Canadian government, provincial and corporate bond demand was spread across both the open and term loans. Canadian equities also experienced higher demand, with an overall marginal revenue increase in the asset class as on-loan market values were down compared to the previous year. Hedge funds continued their net-long bias, however. The Canadian equity specials environment saw a slight increase in relevance as measured by average fees over the previous year, as several equities continued to produce significant gains overall.

General collateral (GC) — those securities that have the least amount of demand and are typically used for financing — were in less demand, while there was an increase in demand for exchange traded products (ETPs) such as

ETFs because they are an efficient way to hedge or gain exposure to an entire index. The energy, specialty healthcare, pharmaceuticals and raw materials or mining sectors were prominent in driving revenue in Canada's securities lending markets. In addition, holdings in Canadian Dividend Reinvestment Plan (DRIP) names saw healthy utilisation year-over-year and continued to generate positive returns across the programme.

In the fixed income securities lending market, the collateral upgrade trade was a large driver of revenue for the past 12 months as demand continues for high-quality liquid assets (HQLA) and financial institutions look to optimise their balance sheets by pledging a wider array of non-cash collateral including equities, corporate and convertible bonds.

Ahmed Shadmann: The past 12 months have been a roller coaster ride, with the shadow of recession looming over the economy the entire time. The Canadian market experienced the fastest central bank rate tightening regime since the 1980s on the back of decades-high inflation and a tight labour market, which set the stage for market uncertainty and unease. This came in the form of a market sell-off south of the border in the first half of 2022 and that contagion spread into the Canadian market. We noticed short-interest pick up across multiple sectors, but particularly technology, crypto, cannabis, mining, and electric vehicle and related industries.

The increasingly high interest rate environment saw the street position itself for corporate bond defaults, particularly those dwelling in the high yield space. That drove the borrow rates higher for companies that had piled on their balance sheet with debt in the easy money era. We also continued to experience high demand for borrows of government bonds across the yield curve, but that focus shifted to the front-end as the Bank of Canada continued on its rate hike path.

Generally, the above-mentioned factors have contributed to a year-over-year increase in earnings throughout our Canadian lending programme into 2023.

Central bank monetary tightening has been accompanied by significant geopolitical instability over the past 12 months. What challenges and opportunities is this presenting for your securities lending business?

Mary Jane Schuessler: The second quarter of fiscal 2023 has certainly brought its fair share of challenges between the heightened risk environment, cash and balance sheet concerns as well as deeper counterparty risk analysis and reviews. Unfortunately for the securities finance business, most opportunities exist when the market is healthy and fully functioning. As the central banks raise interest rates globally, there has been a general contraction in cash and therefore less financing opportunities exist as well. Volatility, however, can be good for the specials markets and we have seen some very interesting opportunities and new entrants to the lending space. Cannabis shorts have made a comeback, with some M&A activity in the space as well. The meme stock craze has also continued, with heavily shorted names in crypto and the electric vehicle space creating attractive lending revenue.

Shadmann: Record high inflation, tight labour markets, decades-high interest rate and the ensuing stock and bond market

rout resulted in market participants stepping into unknown and unchartered waters. Add continued geopolitical tension to the mix and we seem to have all the ingredients to create the perfect storm. This heightened uncertainty across both the equity and bond space made our clients pause in the second half of last year to re-evaluate their risk appetite for types of acceptable collateral. The concerns were quickly alleviated as clients became comfortable with the robust internal risk mechanism we have in place for collateral management. Once that challenge was put to rest, we found opportunities to deploy client assets in the short-interest driven space and to satisfy liquidity needs. Further, State Street's Direct Access peer-to-peer lending and Venturi peer repo platforms have helped further to alleviate our client risk concerns as they provide additional distribution routes to market.

Kolasingh: Market volatility has become a somewhat “colloquial” term of late. For the fourth consecutive year, the first quarter experienced market disruption on a global scale: the onset of the pandemic, the meme stock craze, the Russia-Ukraine crisis and now an unfolding banking crisis. The challenge over the past 12 months, and historically, has been to continue to drive alpha — the fire that fuels our industry’s engine — with a potential risk-reward trade-off. The securities finance industry has a proven ability to pivot and our resiliency is without question. That said, each scenario brings unique opportunities, whether it be new areas of directional interest or increasing demand for HQLA. The dominating drivers of Canadian HQLA have traditionally been liquidity and regulation. To this end, increasing interest rates, combined with quantitative tightening, have resulted in a noticeable uptick in utilisation of government securities, both sovereign and provincial.

Paris: A number of risk events in the past few months have led to souring sentiment and a flight-to-quality bid which saw investors pivot to the front-end of sovereign yield curves. In addition, the Federal Reserve continued to fight surging inflationary pressures, lifting the Federal funds range to 4.75-5.00 per cent by March. This has created an environment that has led to robust demand in the securities lending markets over the past 12-month period with on-loan volumes and fees remaining elevated.

With the 2-year US treasury yielding up to 5.00 per cent during the period, investors continued to pivot to the relative safety of the US government and parked cash in the short-end while waiting for greater economic and monetary policy certainty. This situation was amplified in the first quarter of 2023 as regional US mid-size banks Silicon Valley and Signature came under significant pressure, forcing government intervention to secure depositors across the sector. The demise of European giant Credit Suisse added to market stress and flight-to-quality activity in securities finance markets. These events further increased borrowing appetite for US treasuries and other highly rated sovereign bonds.

It has been a similar story in international sovereign markets, with global bonds remaining heavily sought. In a continuation from last year, European sovereign debt, notably core countries such as Germany, France and the Netherlands, were all in high demand, with fees widening accordingly. There were further signs of collateral scarcity emerging such as the overwhelming demand for bonds. It was a similar story in the UK, with surging gilt yields providing robust shorting activity along the curve and significant demand to source gilts. The situation was intensified in September given the volatility and disorder in the liability-driven investment (LDI) fund construct, which triggered forced sales and a series of emergency interventions by the Bank of England.

These events also impacted corporate and emerging market bond prices with increasing yields, higher funding costs and economic uncertainty weighing on sentiment and market performance. This resulted in ongoing wider fees than is typical from a securities finance perspective.

Yared: The past year highlighted the benefits of National Bank's robust and resilient risk management approach and the collaboration of each desk within its Global Securities Finance team as the industry navigated a market environment that led to increased overall regulatory scrutiny.

National Bank has continued to focus on automation of its securities lending business, utilising technology to facilitate the optimisation and refinancing of its securities lending book. Collateral management and diversification of borrow sources were also key to sustaining, and further developing, our Canadian securities lending activities.

What investments and adaptations to working practices have you made to sustain and grow your Canadian securities lending activity in this environment?

Schuessler: Optimisation is the name of the game for all firms in a year like 2023. With the looming recession, most firms are reviewing expenses and looking to squeeze revenue out of existing products before expanding or investing to achieve revenue targets. There is a major focus on optimisation within BMO, which sometimes results in a contraction in the amount we are borrowing. We are, however, very invested in growing our securities lending activity as we advance into the second year of our US Prime offering expansion.

Paris: Northern Trust is committed to Canada with a dedicated trading desk located in Toronto that works closely with both borrowers and lenders in the marketplace. Our Canadian trading team works with our global trading teams located in Sydney, Hong Kong, London and Chicago to bring local expertise to our clients globally. Northern Trust looks to bring global demand for client portfolios to the local market by offering a number of cross-asset and cross-currency trades. For Canadian clients, some of the most significant opportunities lie in lending Canadian government bonds (HQLA) against other global assets such as US Equities or Japanese Government Bonds. We continue to prioritise investments in our global infrastructure to support our local Canadian clients.

Shadmann: Two regulatory initiatives come to mind that garner the majority our attention. First, the move to T+1 settlement in Canada and the US. T+1 implementation requires that we are even more robust across our post-trade settlement activities — particularly with the

issuance of recalls moving from a manual to automated process, requiring that we integrate our internal system with vendors, TMX and the broker-dealer community. We are already active participants in CASLA's T+1 sub-committee, which is working to identify and implement industry best practices. Internally, we have established a T+1 task force which is evaluating T+1 implementation to deliver a smooth transition for both pre and post-trade services.

Second, implementation of the proposed penalties regime will impose a fee for settlement fails for Government of Canada bond and T-bill trades. Although still in its consultation phase, we feel that the proposed model currently lacks clarity around securities lending market fails. However, we believe this will be a positive development for the market when issues identified during the industry consultation phase have been addressed.

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?

Shadmann: The use of technology in a prudential and cost effective manner continues to be key to our growth strategy. By automating previously manual processes, this has allowed us to increase the size of our book this year and to venture into more nuanced pricing of our holdings. We continue to invest into our IRIS platform, which will continue to replace our legacy systems. This platform has the benefit of making our internal system more flexible in connecting with third-party platforms across the street, thereby making pre and post-trade settlement more seamless. At the same time, it provides us with greater flexibility in offering highly customised client programmes, for instance by offering versatility in the form of hybrid or insurance indemnity.

Paris: The most significant regulatory initiatives on the horizon include T+1 settlement in the US and Canada, securities lending trade reporting, clearing of secondary transactions in US Treasuries and US implementation of Basel III — also called the Basel III Endgame. Each of these proposed rules has the potential to dramatically shift the way securities lending operates today; some are expected to have beneficial impact for the industry and others may take the industry some time to digest. The key US industry groups have been actively engaged in consultative initiatives with the regulators to preserve the market efficiencies offered by securities lending, while also adapting to the regulatory objectives of delivering improved market stability and transparency. We expect to have a busy 18 to 24 months owing to these regulatory initiatives.

Yared: The T+1 Securities Settlement initiative will consume most of the industry's time and attention over the next 12 months. Moving from a T+2 to T+1 settlement cycle is a significant change and requires investment in technology, operations, internal synchronisation and coordination across the securities lending industry. With a go-live date of 27 May 2024 for Canada and 28 May 2024 for the US, most of the operational and IT focus is on implementation at this time. We expect this initiative to be a priority in the coming year for all market participants. For the securities lending community, it will be interesting to note whether new market practices will emerge as the result of a shortened settlement cycle, especially as it relates to recalls.

We are also following the developments of the US Securities and Exchange Commission's (SEC) proposed 10c-1 rule, which would require lenders of securities to provide the material terms of trade for securities lending transactions to a registered national securities association, such as the Financial Industry Regulatory Authority (FINRA). When comparing the SEC's proposed 10c-1 rule in its current form to the European Securities Financing Transactions Regulation (SFTR) rules, it is noteworthy that despite the moderate number of required reporting fields (i.e. 12), 10c-1 implementation is expected be more onerous since it requires that securities lending trades are reported within 15 minutes of execution, In contrast, the EU reporting requirement is on T+1. A final version of the SECs proposed 10c-1 rule is expected later this year.

Kolasingh: The move to T+1 and implementation of a "fails regime" on Bank of Canada government securities — both planned for 2024 — will drive the regulatory change agenda for the next 12 months and beyond. Similar to the recent adoption of the Central Securities Depositories Regulation (CSDR) in Europe, we expect T+1 to drive significant technology enhancements into the securities lending value chain, as well as more efficient execution and settlement processes across the market. The move to a shorter settlement cycle may also present various opportunities as demand for fail coverage is likely to increase.

Regardless, changes to processes, systems and behavioural patterns will be required by all stakeholders, including agent lenders, borrowers and beneficial owners. While the proposed changes may be challenging to implement in a matter of 12 months, the resulting benefits will be substantial. Improved trade submission, recall management and security returns will only add to the sustainability of the financing market and its importance as a source of liquidity to the capital market system.

Schuessler: At BMO, we concentrate efforts on post trade services — marking, returns, recalls etc. The upcoming migration to T+1 has forced many to take a closer look at their post-trade service enhancement. Canada has very little automation for recalls and returns when compared to the US and this must be drastically improved before T+1 takes effect!

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

Yared: CASLA has put in place a T+1 working group (CASLA T+1 WG) that includes agent lenders, Canadian pension funds and Canadian banks. The CASLA T+1 WG is working closely with CDS/TMX, as well as vendors such as Equilend and Pirum, to discuss the challenges the Canadian securities lending industry will face under a shortened settlement cycle, along with potential solutions. CASLA's role will be key in clarifying market practice for Canadian securities lending participants in a T+1 settlement cycle environment.

Kolasingh: One of CASLA's key objectives is to ensure the long-term viability of the Canadian securities lending industry, with a focus on efficiency and security of the marketplace. In this vein, CASLA continues to be engaged on several regulatory and market infrastructure

initiatives. As the CASLA coordinator over the past 12 months, I have had the opportunity to work closely with our members as we navigate changes in the Canadian marketplace. We currently have a T+1 sub-committee with representation from more than 10 member firms, working hard to ensure the smooth application of shorter settlement cycles within the securities lending value chain — domestically and in partnership with fellow associations in the US. We have also been engaged with the Government of Canada Market Functioning Steering Group, which recently published a consultation paper on the proposed fails regime. As the market evolves, CASLA will continue to be a key voice for our member firms.

As a collective global voice for the securities lending industry, GASLA seeks to enable positive engagement with stakeholders, including regulators, policymakers and standard-setting bodies in all regions. How has CASLA identified benefits through its participation in GASLA?

Kolasingh: It will be two years this September since the Global Alliance of Securities Lending Associations (GASLA) was formed and released its first joint publication. How time flies! CASLA's participation in this important industry forum has enabled our members to play an important role in the global dialogue, along with our fellow associations. In particular, I cannot stress how beneficial it has been for GASLA to be at the forefront of the ESG discussion and for the Canadian view to be part of formulating industry guidance on this important topic. I fully expect that ESG is only the first of numerous other industry-wide topics that will be moving to the forefront in times ahead, including the Common Domain Model, digital assets, and diversity, equity and inclusion. I am looking forward to meeting some of my GASLA colleagues on stage at this year's CASLA conference to discuss industry trends, opportunities and challenges — and the importance of our collaborative efforts.

How do you assess the outlook for the Canadian securities lending markets for 2023-4?

Schuessler: There are so many tools when it comes to optimisation, revenue concentration, collateral management as well as customisation. Those with the ability to implement quickly, adapt to the trends quickly and be agile in their offerings will no doubt have a successful 2023-4.

Yared: The past three years have taught us to expect the unexpected and we remain cautiously optimistic with regards to the outlook of the Canadian securities lending market for 2023-2024. Firms with a solid liquidity profile, sound balance sheet management, automation, optimisation and refinancing will be well positioned in 2023-2024.

A key trend to keep an eye on is Fully Paid Lending, which is still in its infancy. Historically, the securities lending market has been limited to large institutional players. National Bank will continue to develop its Fully Paid Lending programme, which allows retail investors to participate in the securities lending market. We see an active and robust Fully Paid Lending programme as a significant value-add for the client and potential key differentiator in the future.

We anticipate that the hard-to-borrow space will continue its current trend, driven by bought deal names with two to three weeks durations and sustained short interest in the Canadian cryptocurrency and US electric vehicle space. With interest rates remaining high and the potential for a market downturn, retail supply may diminish, leading to stronger short interests across sectors.

Paris: The Canadian securities lending market continues to show steady demand and resilience despite the headwinds and uncertainty in the global markets. As a leading provider of securities lending and securities finance solutions for our clients, Northern Trust has a global presence that provides clients with access to more than 51 securities lending markets. Canada remains a primary focus for our clients located in Canada and for those that hold Canadian assets.

Looking ahead, we expect overall demand will remain robust for securities lending in Canada. Demand for HQLA and Canadian government bond benchmark issues will provide opportunities in both the term and open lending markets. Also, financial institutions need to optimise and manage their balance sheets more efficiently, which will drive demand for lenders to accept a wide range of collateral. The expectation of continued volatility in global commodity prices would drive demand for specific equity securities in the materials and energy sectors, given Canada's key role in these industries. We also expect dividend reinvestment trades to continue to provide a steady revenue stream throughout the remainder of the year with the proliferation of Canadian banks' stock purchase plans.

Clients that employ collateral flexibility take a key step to enhancing their programme performance. Clients are also taking a more hands on approach to generating alpha; this may be reflected in programme internalisation, peer-to-peer lending or directed trades. We also see securities lending moving from a back-office operations function to a front-office, investment-oriented job title.

Kolasingh: I remain optimistic about the Canadian securities lending market as we hit mid-year and consider what is beyond 2023. Despite a volatile first quarter, growth has continued in equity and fixed income borrowing, with specials popping up in each area. This, along with strong beneficial owner participation rates and engagement, suggests that we will be in for a fruitful second half of the year. While there is a challenge with T+1 and the associated changes that will be required, the benefits to be realised as part of a more automated and efficient value chain will undoubtedly be worth the effort.

Shadmann: We continue to face extreme market conditions. 2021 brought the covid pandemic and in 2022 we experienced decades-high inflation and fast paced monetary tightening policies implemented at unpreceded speed. These events allowed us to evaluate and tighten up our lending programme, both in terms of the efficiency of asset deployment into the market and in keeping our clients' risk appetite front and centre. The events of the past two years highlighted the importance of engaging with our clients and forming a deeper understanding of their needs. This positions us well to be better stewards and agents of our clients' assets into 2023-4. We expect short-interest themes will continue in sectors driven by market events and we are hopeful that our clients will continue to benefit from the positive revenue stream that is provided by the securities lending programme.