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Securities Finance Americas Guide 2017

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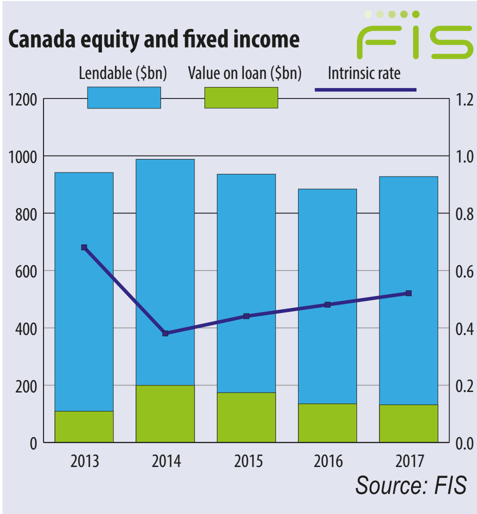
Canada



The value of Canadian assets across equity and fixed income available for lending was just shy of $1trn (US dollars) during the month of May 2017, with $135bn of that amount on loan according to FIS statistics. Year-to-date (end-of-May) the country has been a bright spot in terms of revenue for agents and their beneficial owners totalling $155m and an average intrinsic rate of 0.57%.

Donato D'Eramo managing director, global head of securities lending, RBC Investor & Treasury Services, says that while securities lending possesses a global footprint, many are surprised to learn about Canada's leadership in the sector. "Many factors are in constant motion in securities lending. Here in Canada, equities and fixed income play a leading role in our work, as does enhanced transparency and high-quality liquid assets (HQLA). Understanding their role and impact are what drive successful results."

Return of specials

Phil Zywot managing director, Canada regional trading head, BNY Mellon Markets, says that over the last year, the Canadian market has been very active and we have seen a return of specials in the Canadian equity space. "Many resource-based companies and firms that were linked or exposed to these companies were in demand and drove Canadian equity levels higher," he explains. "Since February 2016, we have experienced a rebound in the commodities space while weighted average fees for Canadian equities have remained stable."

With the commodity rebound, Zywot adds that some short covering has occurred in the resource sector, but has been offset by increased demand for financials. For example, Home Capital – Canada's biggest non-bank mortgage lender – generated $18m of revenue in Q1 2017. "Booming housing markets in both Toronto and Vancouver have put financials, specifically mortgage financing companies, in the crosshairs of short sellers," Zywot notes.

Dave Sedman, head of securities lending trading Canada at Northern Trust in Toronto, says specials tend to be very name-specific and associated with industries where there has been volatility in underlying share prices. "The Canadian specials market benefited from continued demand in financials, specifically mortgage lenders, as their heavy concentration in nonprime residential mortgages implies greater vulnerability versus most Canadian banks.

"Directional demand in the healthcare, pharmaceutical and specialty pharmaceutical sector was seen in 2016, over year-end, and throughout the first quarter in 2017. An increase in M&A

activity coupled with a negative outlook within department store retailers has fuelled demand for specific companies in those market segments."

According to Sedman, another pocket of demand relates to the lack of liquidity in certain securities around proxy voting periods. "In Canada specifically there tends to be cyclical demand based on the proxy voting. This can be attributable to a number of investors that want to ensure they have access to their securities to vote the proxy."

In addition, a large portion of the revenue generated from Canadian equities is driven by dividend yield enhancement trades, coupled with the dividend reinvestment plan trade.

"Continued demand from borrowers to pledge various forms of non-cash collateral – equities and corporate debt – has dominated the securities lending market, providing opportunities for beneficial owners that can accommodate this collateral within their risk parameters," Sedman explains.

HQLA demand

BNY Mellon's Zywot says demand for US treasuries and Canadian government bonds continues to play an important role in securities lending. "With Canada being one of the few remaining AAA-rated countries, demand for Canadian government bonds, and other AAA-rated sovereigns remains very high and we expect this trend to continue."

RBC's D'Eramo adds that financing trades, collateral upgrades and term lending are dominant and increasing trends in the Canadian fixed income space which has approximately $860bn+ in lendable assets with $130bn+ on loan. "In managing risk-weighted assets, liquidity and funding continue to be at the forefront for regulated financial institutions globally, securities lending is an increasingly important function to supply HQLA and transform collateral to address evolving needs," D'Eramo says.

Another area that is generating securities lending demand is the evolving Basel rules and the regulator's interpretation of them. "Liquidity rules under Basel require banks to hold higher levels of HQLA. This in turn has strengthened demand for Government of Canada issuances, especially structured on a term basis and, again, where a variety of collateral can be accepted by the lender," Sedman adds.

Given the current low interest rates, BNY Mellon's Zywot believes there is a greater focus for lending participants to generate alpha to meet funding requirements and elevate returns. "More Canadian beneficial owners are turning to securities lending programmes as a vehicle to generate incremental returns on their portfolios," he said. "As lending programmes become more targeted, agent lenders are looking for portfolios that are more alpha-generating in terms of holding specials and are pursuing those accordingly."

RBC's D'Eramo adds that enhanced transparency, greater automation and more efficient collateral management solutions are the leading market trends. "Transparency and greater beneficial owner engagement are contributing to beneficial owners being open to new lending opportunities and being able to make calculated risk/reward decisions. "Securities lending is not immune to the changing financial services landscape. Maintaining strong client relationships and understanding trends will ensure we can continue to produce solutions our clients need to be successful."