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Healthy & Resilient

The RBC Investor Services' team offer their perspectives on recent demand drivers in the Canadian securities lending market

Left to right: Sophia Rizakos; Kellen Jibb; Kyle Kolasingh and William Yan

A healthy and resilient Canadian market

The RBC Investor Services' team offer their perspectives on recent demand drivers in the Canadian securities lending market, the current regulatory environment and important innovations planned for Canada's market infrastructure

What stood out for you in the first quarter of 2024?

Kyle Kolasingh: In previous first quarters, we have experienced heightened market activity driven by various systemic events. While the first quarter of 2024 was relatively muted, it still carried a significant impact. Q1 saw the S&P 500 achieve its twentieth record high in the span of three months, the NASDAQ 100 hit an all-time high, and the Bank of Japan end its 17-year run of negative interest rates.

Meanwhile, the upcoming transition to T+1 dominated conversations across the industry, as participants continued to take steps to ensure a clear and frictionless path forward. The ongoing integration of environmental, social and governance (ESG) factors into a well-functioning securities lending programme, remained a key requirement for beneficial owners and a mainstay of agent flexibility. After four years of suspended activity, Japan's Government Pension Investment Fund (GPIF) resumed lending in Q1. This bodes well for the sustainability of the financing marketplace, but arguably stimulated much debate and activity in the years following the GPIF suspension decision.

All in all, the RBC Investor Services' (RBCIS) global securities lending desks experienced a productive start to 2024, as we continued our journey of technological modernisation and preparations for T+1. This comes against the backdrop of a healthy and resilient securities lending sector in Canada, the second-largest financing market globally.

How has the North American securities lending market been performing?

Sophia Rizakos: The Canadian securities lending market continues to show strong revenue accretion and compelling portfolio optimisation opportunities for beneficial owners. 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.

Canadian equities demonstrated robust performance throughout 2023, generating positive year-over-year increases in revenue, loan balances and asset utilisation. Various sectors, including cannabis, artificial intelligence and crypto, created attractive lending opportunities. On the other hand, dividend reinvestment plan (DRIP) activity softened, with some of the major Canadian financials discontinuing their discount programmes in the face of a diminished need to raise additional capital.

In the US equities space, additional activity was attributed to corporate actions, which presented optional lending opportunities for beneficial owners. The most recent of these was an exchange offer with Cummins, which fully split off its remaining interest in Atmus Filtration Technologies. This followed notable events such as the Johnson & Johnson/Kenvue exchange offer, and the AMC conversion of APE shares in 2023.

Corporate action optimisation events continue to be fuelled by demand from arbitrage-seeking funds and, as a result, the US market saw a spike in borrowing fees. Looking further into 2024, we are keen to see how M&A activity develops following a relatively soft 2023, and whether this may translate into lending opportunities on both sides of the border.

Demand for fixed income remains strong, particularly for North American sovereign debt, due to the high interest rate environment coupled with central bank quantitative tightening. In February, the Bank of Canada (BoC) re-introduced the Receiver General auction to provide additional liquidity and align the Canadian Overnight Repo Rate Average (CORRA) closer to its target. The need for liquidity, combined with the search for higher yields, continue to stimulate borrower demand, particularly on an overnight basis. Demand for term lending, while still relatively high, has shown some signs of softening so far this year as structured trades, especially in the Canadian provincial bond space, have rolled off.

William Yan: Collateral flexibility and balance sheet optimisation remain relevant to borrowers and beneficial owners alike. In 2023, RBCIS was the first Canadian agent to accept Canadian pension paper as a standalone form of collateral, providing further flexibility to borrowers and unlocking additional balances for beneficial owners. As we enter Q2 2024, our securities lending desks are seeing demand to pledge an array of collateral, including equities, convertible bonds and corporate bonds.

What is new on the regulatory front for securities lending?

Yan: The BoC's planned introduction of a settlement fail fee on Government of Canada bond and bill trades, underscores the growing emphasis on improving market functionality and efficiency within a low-rate environment. In an approach similar to the implementation of the US Treasury Market Practices 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 inevitably aid in promoting optimisation of the borrower settlement process through the introduction of punitive costs, while minimising operational risk. As it stands, the proposed timeframe for the first trial period is set to begin in Q4 2024. While the trial will include fails tracking, fail fees will not be exchanged by participants.

Another notable regulatory update is the Securities and Exchange Commission's (SEC) Rule 10c-1a. The rule, which awaits final guidelines from the Financial Industry Regulatory Authority (FINRA), is intended to enhance transparency and oversight in governing the securities lending market, bolster investor confidence and promote more informed decision making. Based on available information, a beneficial owner using an agency lending model would not have a reporting obligation.

Finally, from a global perspective, the industry continues to assess Basel's revised market risk framework. The Canadian space is well positioned to adopt this updated framework following the implementation of Basel III in Q2 2023.

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William Yan
Associate
RBC Investor Services

What are some of the key innovations planned for the Canadian market infrastructure?

Kolasingh: The transition to a T+1 settlement cycle in Canada and the US, during May 2024, is a milestone event which has driven significant advancements in automated and outsourced technologies. Both lenders and borrowers are currently in various implementation phases of their technology solutions to prepare for the changing settlement landscape, as they look to optimise recall management processes and minimise operational risk.

In Canada, the TMX Group is developing its securities lending recall hub, which is intended to simplify the communication of recall notices for market participants. Similar to the Depository Trust and Clearing Corporation's (DTCC) SMART/Track recall messaging services, the facility provides for interoperability among participants and fintechs — a welcomed enhancement to the financial infrastructure. This additional facility will greatly simplify electronic messaging across multiple fintech and bilateral relationships. As a result, firms will be able to utilise their existing post-trade providers and avoid a patchwork of connectivity, thereby furthering operational efficiencies across the industry.

At RBCIS, we have partnered with our fintech providers to implement a recall service that leverages the TMX facility. This is designed to automate communication of the sending and receipt of recall notifications between agents and borrowers. The streamlined approach will assist in expediting the recall process, increase operational efficiency and reduce timelines.

In tandem with T+1, the TMX Group and Clearstream have launched the Canadian Collateral Management Service (CCMS) — Canada's first domestic triparty capability. CCMS aims to optimise collateral management by enhancing liquidity and minimising exposure risk as market participants navigate increased collateral requirements from regulations, the transition to T+1 and the cessation of bankers acceptances in the Canadian market.

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Kellen Jibb
Associate
RBC Investor Services

Collaboration between stakeholders will continue to be paramount in addressing emerging challenges such as T+1, while seizing opportunities for innovation and growth. Such a spirit of industry-wide cooperation bodes well for market participants, who can continue to operate with confidence.

How are the other market-facing activities being impacted by T+1?

Kellen Jibb: Similar to securities lending, the foreign exchange (FX) world is well prepared for T+1. The USD/CAD FX trade is already on a T+1 standard settlement cycle, and T+0 trading is supported by most market participants. Issues may still arise, particularly in the 'holiday mismatch' scenario, where there is a US holiday but no Canadian holiday (or vice-versa). In this situation, it will be necessary for traders to fund their foreign security purchases on the trade date, to ensure that funds are available to settle security trade purchases. Also, T+0 FX trades cannot be settled via Continuous-Linked Settlement, and this could potentially result in more bilateral trading between the client and counterparty for T+0 trading.

Furthermore, much like securities lending, clients may need to review their trade management and cash projection procedures on the cash and funding side to ensure stakeholder alignment with the shorter settlement cycle. Keeping an additional cash buffer to cover any potential overdrafts might also be necessary, at least until the market is back to a steady state.

How is DEI being integrated into the securities lending sector?

Kolasingh: Over the past 24 months, I have seen a structural change in the securities lending industry, which is increasingly embracing diversity, equity and inclusion (DEI) practices. As chair of the International Securities Lending Association's (ISLA) DEI Steering Group, I work closely with ISLA lead Tina Baker and a group of industry colleagues to further

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Sophia Rizakos
Analyst
RBC Investor Services

the association's goals of building and fostering a more diverse securities lending sector. One of our initiatives — ISLA Connects — provides individuals who do not have the opportunity to interact via traditional means, such as industry conferences and working groups, with access to various networking and educational opportunities.

This type of foundational work not only cultivates long-lasting collaboration and inclusivity within the industry, but also encourages change and embraces diversity, ultimately contributing to a successful and sustainable securities financing marketplace. That said, much remains to be done across the industry in raising awareness of our unconscious biases and furthering the appreciation for diversity.

What is RBCIS doing to prepare its securities lending offering for the future?

Kolasingh: The ongoing evolution of global securities financing markets — driven by regulatory change, new markets coming online, expanded forms of collateral management, and the integration of digital assets — makes the need for enhanced automation and a revitalised infrastructure even more important for the business going forward. This is in parallel with increasing demand for greater flexibility in offerings and capabilities from both beneficial owners and borrowers.

As such, RBCIS is continuing to modernise our technology and operational flows. This will enhance trading capabilities, enabling us to optimise client assets and streamline procedures within a compressed settlement infrastructure. In partnership with trusted fintech vendors, our advanced technology architecture and capabilities will future proof the RBCIS securities lending solution. At the end of the day, it is all about ensuring that we continue to meet the needs of our lending clients in today's ever-changing market landscape, generating yield and unlocking the full potential of their investment portfolios.

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Kyle Kolasingh
Head of Market Services Solutions
RBC Investor Services