Canada weathers the storm

RBC I&TS' Don D'Eramo and Kyle Kolasingh discuss the impact of the pandemic on Canadian securities finance and the ongoing role ESG, ETFs, data and automation are playing in the industry

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Where do you think Canada's market fits into the picture globally for ESG-focused investments?

Kyle Kolasingh: The increased focus on environmental, social, and governance (ESG) in Canada is generally consistent with the rest of the world as we continue to see more ESG funds launched by local providers. ESG has been embedded in the corporate citizenship activities of major Canadian corporations and institutions for a number of years. For example, RBC's corporate social responsibility mandate and environmental initiatives have existed for well over a decade. Actions that support ESG activities are an enduring fixture of the securities finance market, including the ability to vote proxies—a longstanding securities lending practice available through loan recalls. However, we have recently been engaging in more integrated ESG conversations with beneficial owners, extending beyond governance to align lending programmes with broader ESG goals and integrating such factors into their investment strategies and lending activity.

Don D'Eramo: The Canadian securities lending market also aligns with global initiatives to standardise ESG principles. RBC Investor & Treasury Services (RBC I&TS) continues to work closely with two groups that are leading ESG discussions for securities lending, The Global Principles of Sustainable Securities Lending and the International Securities Lending Association. These international groups have been instrumental in raising awareness of the alignment between ESG and securities lending, helping to reinforce the message that ESG and securities lending can co-exist.

Do you think that Canadian beneficial owners have a different view of ESG than their peers in the US and EU?

D'Eramo: Broadly speaking, the views of beneficial owners on ESG are similar across geographies. However, opinions may vary on a case-by-case basis where lenders have incorporated different ESG applications within their investment strategies. As Kyle mentioned, up until recently, the ESG focus was on governance. However, beneficial owners are beginning to develop a broader understanding of ESG. This includes a discussion of how securities lending promotes liquidity, price discovery and transparency across global capital markets, contributing to the efficient operation of these markets.

Let's move on to another initialism — ETFs. Canada has a number of progressive ETFs, including Bitcoin and cannabis. How do you think they will impact securities lending in Canada, compared to other countries that don't have those types of ETFs?

Kolasingh: Historically, ETFs have been a popular segment of the securities lending market but demand for ETFs—in Canada and globally—has grown significantly over the past year primarily due to increased liquidity and hedging requirements. Given the suppression in specials over the past 12 months, ETFs are currently a significant revenue driver for beneficial owners across equity and fixed income classes. We anticipate that the recent introduction of cryptocurrency ETFs in Canada will open new opportunities for beneficial owners and borrowers.

When it comes to ETFs, Canada is really no different than the US or Europe. We tend to align with Europe on many facets of securities lending, including ETF penetration. In terms of liquidity, Canada lags the US due to the sheer size of the market but as progressive ETFs continue to evolve and more of these funds launch within Canada, we expect to see a positive impact on the securities lending market.

How are the effects of the pandemic different from the financial crisis of 2008 in relation to the Canadian securities lending market?

D'Eramo: A calmer approach seems to have prevailed during the pandemic compared to the global financial crisis of 2008, which saw many securities lending clients run to the sidelines. This time round, lenders generally maintained an air of focus, conducting comprehensive risk reviews in response to the market shocks caused by COVID-19 and adjusting their securities lending programmes accordingly. I think that beneficial owners generally felt more at ease with the increased transparency of our securities lending programme, and this facilitated an enhanced understanding of their programme and its risk parameters.

The cash reinvestment component was a particular pain point for many lenders during the 2008 global financial crisis globally, but especially in the US where cash collateral was most prevalent. At the height of the pandemic, it was much easier to adopt a changing risk appetite given the predominately non-cash environment in

Canada. The ability to avoid dislocation, particularly around failing transactions, added to the sustainability of the Canadian securities lending market.

In addition, COVID-19 was the catalyst for above-average market volatility, which caused a number of lenders to review certain risk decisions, resulting in a flight-to-quality that provided opportunities for Canadian beneficial owners. The securities lending business has generally proved to be significantly more resilient than 20 years ago and this is very much a testament to the growing maturity of the industry.

How do you see automation and data playing out at RBC in terms of securities lending?

D'Eramo: RBC I&TS is a Canadian market leader in securities lending automation. From an execution perspective, we optimise clients' lending programmes through a high degree of market connectivity and by leveraging various Fintech platforms. We also continue to digitalise our client experience, including the development of robust client dashboards that enable beneficial owners to access the necessary data and make results-driven decisions. This is particularly important as markets become increasingly complex, the regulatory landscape continues to evolve and beneficial owners introduce more sophisticated financing strategies that extend beyond traditional agency lending.

Kolasingh: Access to data, whether in the form of interactive visualisations or via automated delivery channels, is key to helping clients achieve their securities lending goals and overall investment strategy. For example, one of the noticeable trends during the onset of the pandemic was beneficial owners' use of structured derivatives within their investments. Readily understanding the dynamics of one's securities lending portfolio through enhanced access data enables such timely and informed decision-making. This connectivity requirement will continue to drive our digitalisation strategy.

We also leverage data internally, tapping into our custody platform to identify lending opportunities for beneficial owners who are not part of the agency lending programme. Historically, a number of such beneficial owners, particularly non-institutional investors, have been under the impression that they are unable to participate in securities lending. This is not necessarily the case. A single name within a portfolio may actually derive comparatively larger revenues than a much larger portfolio because of that one name. Our data mining capabilities have enabled beneficial owners to realise such latent opportunities quickly, often within two to five days from data discovery to execution.

What do you think is going to drive revenue in 2021 as we near the tail end of the pandemic?

Kolasingh: Securities lending revenue profiles have undergone significant change over the past year, especially within the Canadian market. Looking back, legalisation of the cannabis industry was driving much of the revenue in 2018 through to early 2020, providing a number of opportunities for beneficial owners. Coming out of 2020, Canada and the global market experienced a notable suppression in hard-to-borrow securities, a dip in special fees and a tapering of overall demand. This was partially due to a lack of demand as hedge funds closed directional positions and deleveraged, thereby reducing the need to borrow. On a positive note, there are promising signs south of the border where hedge fund assets have increased over the past year, particularly during the previous six months. This is an encouraging indicator for the securities finance industry and we hope to see a resultant increase in demand.

We also witnessed lucrative event-driven opportunities, including initial public offerings (IPOs) and corporate actions, and believe that these types of opportunities will continue throughout 2021. IPOs have historically created opportunities for beneficial owners, and the recent uptick in upcoming Canadian IPO activity bodes well for the industry. In April, we experienced higher activity in the cannabis industry, largely driven by increased mergers and acquisitions. As market improvements materialise, we expect specials to come back to the market and we are closely monitoring the situation.

On the fixed-income side, the demand to borrow high-quality liquid assets (HQLA) on an overnight basis has remained fairly stable over the past 18 months. In 2020, we encountered a suppression in demand for structured term lending opportunities on HQLA but some of this activity has returned. As markets continue to improve and stabilise, we expect these types of opportunities to drive revenue for the remainder of 2021 and into next year.