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The road to innovation and future proofing

RBC Investor & Treasury Services' Chris Barrand and Arthur Kolodziejczyk assess the outlook for global markets and how they are managing change across the securities finance ecosystem

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Innovation and future proofing: the state of play for global markets

RBC Investor & Treasury Services' Chris Barrand and Arthur Kolodziejczyk, co-heads of securities finance trading and product, map out the state of play for the US, EMEA and Canadian markets and reveal how the firm intends to future proof an ever evolving ecosystem. Carmella Haswell reports

How would you define RBC Investor & Treasury Services' securities lending performance for Q1 2023 and how has this been impacted by the state of Canada's economy?

Arthur Kolodziejczyk: Our securities lending performance across all regions has been positive since the start of the year. In North America, borrower demand for sovereign bonds continues to be strong as market participants adapt to a changing environment. Collateral transformation trades are back in focus, as well as increased interest in collateral optimisation, as borrowers look at new forms of revenue generation and balance sheet optimisation.

A number of financial institutions are now offering Dividend Reinvestment Plans (DRIP) to help raise their capital levels. The dividend option being offered has led to a steady income stream for lending clients that have chosen to elect the cash dividend, providing them with an opportunity to earn a premium on their lent positions.

As the rising interest rate environment adds pressure to credit, market participants have become more accustomed to using exchange-traded fund (ETF) instruments in more innovative ways to capitalise on new trade structures. High yield ETFs, such as iShares iBoxx $ High Yield Corporate Bond ETF (HYG) and SPDR Bloomberg High Yield Bond ETF (JNK), and broad-based ETFs, including SPDR S&P 500 ETF Trust (SPY) and iShares S&P/TSX 60 Index ETF (XIU), have been used for hedging, outright bets and spread trades, creating revenue opportunities which are facilitated by securities lending.

There is a strong correlation between merger and acquisition (M&A) activity and security demand as borrowers look to capitalise on arbitrage opportunities. Ongoing discussions with beneficial owners have given rise to lending opportunities when analysing optimal versus sub-optimal elections.

Chris Barrand: Outside of Canada and the United States, new markets and collateral expansion remain part of our strategy as we seek to capture high-spread revenue opportunities for beneficial owners. We continue to expand our lending parameters in Taiwan, while retaining an interest in opening other markets within the region, such as Malaysia. There is renewed interest from our beneficial owners to reassess these opportunities, understand the mechanics of each market and evaluate the potential revenues available. Furthermore, this presents us with the opportunity to expand our footprint within the region and engage new counterparts to provide a wider range of outlets to place client assets.

In EMEA, the equities landscape continues to be challenging. We expect borrowers will look to use their synthetic business and internal longs for fail and short coverage, as opposed to covering externally, given the internal pressures to reduce capital costs. However, we are challenging that status quo by being able to face our borrowers as principal, which alleviates these constraints and enables us to be competitive within automated trading platforms, given our continued focus to embrace technological advancements. For example, automated transactions accounted for more than 80 per cent of our global volumes in Q1 2023, demonstrating the importance of embracing automation.

How have the dynamics of the securities lending and financing marketplace shifted in the past 12 months?

Kolodziejczyk: The dynamics of securities lending from a fixed income perspective have changed over the past 12 months. Persistent inflation has caused central banks to rely on rate hikes to curb demand, slowdown the economy and put a lid on inflation.

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Arthur Kolodziejczyk
Co-head of securities finance trading and product

This, in a fixed income space, has created new shorts activity, as the inverse relationship between interest rates and bond prices have put pressure on bonds, especially in the investment grade and high yield space. The monetary environment caused market participants to return to source liquidity in term lending as we move from quantitative easing to quantitative tightening. For these reasons, demand for government bonds as well as corporate bonds remained strong in 2022 and continues to grow in 2023.

Initial public offerings (IPOs) have historically provided another revenue stream for early investor lending clients, but in the current inflationary and economic environment, companies have been hesitant to tap into public markets to raise capital and list on an exchange. As markets regain stability and investor confidence follows, the backlog of IPOs could start to dissipate, setting the stage for potential lending opportunities.

Barrand: In EMEA, we are experiencing similar trends with regards to corporate bonds. Borrower demand and lending fees have remained strong, in particular for those assets where short activity outweighs liquidity in lending. When the European Central Bank pulled back from the Corporate Sector Purchase Programme (CSPP) in 2022, it removed natural buyers from the market, resulting in an increased short interest. The continued interest rate hikes, coupled with falling asset prices, have further fuelled borrower demand.

One asset class that continues to provide upside for our clients is convertible bonds. In recent years, new hedge funds entering this space and limited market supply have led to an increase in demand and revenue returns. Some hedge funds choose to short because of the individual bond profile, while others use it as a portfolio hedge. Market supply is often scarce as some outright investors are not allowed to lend their bonds, or would rather avoid the administrative hassle given the structure of traditional convertible bonds (corporate actions, M&A and dividends). Therefore,

convertible bonds present an attractive opportunity for those willing to lend.

From a client perspective, the ESG discussion has continued to remain prominent among our client base, with the core objectives centred on proxy voting and collateral eligibility. As an agent lender, we are able to ensure their assets are recalled and held away, which demonstrates good governance to shareholders and enables them to participate in annual general meetings.

How do you see technology trends regarding DLT, automation and digital assets playing out at RBC in terms of securities lending?

Kolodziejczyk: When it comes to tokenisation of securities, distributed ledger technology (DLT) presents a revolutionary step forward, if the core ecosystems in which securities lending function today can be integrated in a practical manner for the benefit of all. As a single institution, we stand ready to use DLT where it meets the securities lending market's operational and technical elements.

Automation of existing processes, enhancements and transformation of our technology stack is key for us to capture efficiencies, gain new capabilities and future proof against the evolving ecosystem and regulatory requirements.

Barrand: We continue to monitor the evolution of the digital asset ecosystem and are making investments in our technology stack that allow for innovation and future proofing. As highlighted within the Digital Assets in Technology paper published by the International Securities Lending Association (ISLA), tokenisation has the potential to enable the full use of all available assets across multiple custodial accounts through the use of DLT.

The benefits of tokenisation cannot be understated. We recognise

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its potential to allow the industry to overcome some of the bottlenecks experienced today. Besides the obvious benefits DLT would introduce to collateral management capabilities, DLT would give us the ability to improve access to those assets that are currently inaccessible, improving both industry liquidity and settlement times with the reduction of fail risk and associated costs, while also mitigating clients' ESG requirements.

Where India slowly phased into a T+1 settlement cycle, the US and Canada are expected to face a 'big bang' approach in May 2024. How is RBC preparing for this and how do you expect the market will handle this approach when enacted?

Kolodziejczyk: We are working closely with our financial market infrastructure partners to design new tools to allow for greater automation of these lifecycle events, so that we can capture efficiency including reduced latency, both from direct engagement and from our contributions as part of the Canadian Securities Lending Association (CASLA) T+1 Working Group.

Shortening the settlement cycle to T+1 has provided the opportunity for the industry to review their processes and look to leverage automation where possible. Areas that need further attention are the ability of lenders or their investment managers to provide complete and timely sale instructions; especially for hard-to-borrow assets that, by definition, are higher yielding from a securities lending perspective. A compressed settlement cycle could create additional fails in the market, which would provide securities lending opportunities in the short term as the industry looks to adapt.

Barrand: These required changes in market behaviour can be challenging from the outset and T+1 will be no different, particularly given that the industry will have less than 12 months to comply with the 'big bang' approach. However, increased settlement efficiency and reduced fails are achievable with the right risk management tools in place and continued collaboration across market participants. A shorter settlement cycle can boost market liquidity while reducing counterparty risk.

With the introduction of the Central Securities Depositories Regulation (CSDR) in Europe last year, we have seen many improvements including standard settlement instructions (SSIs) being reviewed and updated more regularly, revised mapping within automated trading platforms, timely settlement of collateral prepays and increased detailing of pre-matching processes. If T+1 was to be introduced in Europe and the UK, the transition could potentially be smoother than in Canada and the US, given the work that has already been undertaken to improve settlement behaviour.

What are the key drivers of your product development strategy and what can the financial sector expect next from RBC?

Kolodziejczyk: Our product development strategy has a few key anchors. These include creating increased efficiencies and developing solutions for upcoming regulatory changes, while protecting existing revenue and capturing new business through automation. This will improve our client and counterparty experience. To do so, we start with looking at the future state and moving backwards to problem solve for known market challenges, while considering the environmental factors that will evolve the business in coming years.

RBC I&TS continues to develop our non-cash collateral parameters through conversations with our beneficial owners and market participants. Although Canada has been viewed traditionally as a non-cash collateral market, rising rates have brought a renewed focus on reinvestment opportunities to capture spreads. After the recent announcement by the federal government to enter a consultation period for retiring the Canada Mortgage Bond programme, RBS IT&S has been working with market participants, including beneficial owners, to identify other assets that could fill the void.

Barrand: From an international perspective, we continue to see borrower interest for pledge collateral as opposed to title transfer. Besides the obvious capital cost savings for the borrower, there are operational efficiencies given that the collateral remains in the name of the collateral giver. Being able to offer a pledge model ensures we can retain and attract new business.

Another key driver is to use technology to further streamline operational processes, enhance efficiencies and align our business for the upcoming T+1 transition and proposed Bank of Canada fail regime. Being an active participant of industry working groups, while working closely with market vendors, means we can react to market change quickly and put in place the required solutions.