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Eyes on the market

Supplying flexibility across trading conditions

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Kyle Kolasingh, associate director for securities finance at RBC Investor & Treasury Services, speaks to Bob Currie about the evolution of the bank's securities finance programme and how it provides flexibility to meet clients' lending and financing needs under a wide range of trading conditions

The dynamics of the securities lending and financing marketplace have shifted dramatically over the past 12 months. After a challenging 2020, when market participants were confronted with high market volatility and sharp liquidity fluctuations triggered by the COVID-19 pandemic, 2021 has provided renewed opportunity for lenders to focus on optimising their portfolios and seeking out new opportunities for revenue generation — while still keeping a watchful eye on changing macro-economic conditions as central banks make changes to their emergency stimulus programmes.

The fallout from the pandemic has hit the securities finance markets in multiple ways, says Kolasingh. In Canada, for example, strong intrinsic value lending opportunities witnessed during 2019 contracted sharply during the pandemic and are yet to recover to pre-COVID levels.

Cannabis stocks were a strong driver of equity lending revenues in the Canadian market through to Q2 2020, following legislative changes in Canada in October 2018 which liberalised rights of adults to possess legal cannabis and for pharmaceutical companies to manufacture cannabis-based medical products. Given the emergent nature of this product sector, this has also proven attractive from a directional demand perspective, driving 'specials' activity in cannabis stocks.

However, these high intrinsic value opportunities have declined since Q2 2020, prompting beneficial owners to review their lending strategies and to seek out new yield opportunities as loan demand strengthens during COVID recovery.

One response — for lenders with global portfolios and an appropriate risk appetite — has been to look to emergent lending markets for revenue opportunities. Taiwan, for example, has experienced a 119 per cent year-on-year increase in year-to-date loan revenues, according to IHS Markit data, and Malaysia has also similarly experienced strong growth in equities lending revenues for foreign institutional investors.

While event-driven opportunities have been limited in Canada through H2 2020 and into 2021, the US market has benefited from the return of IPO activity and capital raising from special purpose acquisition companies (SPAC) since the start of the year.

A number of 'meme' stocks, for example GameStop and AMC, have also provided pockets of intrinsic value for lenders in the US market — as buy-side firms with short exposure to these companies moved to close out positions in the face of coordinated activity from retail investors attempting to support the share price.

Subsequently, however, some hedge fund managers have been reluctant to commit to the high conviction strategies that sustained the long-lasting 'specials' activity that we saw prior to COVID. The meme stock short squeeze in early 2021 has reinforced this caution, prompting some hedge funds to reduce leverage and exercise vigilance when taking short-interest positions in listed companies.

Beyond equity, demand from financial institutions remains strong for high-quality liquid assets to meet liquidity coverage requirements (Liquidity Coverage Ratio, Net Stable Funding Ratio) and regulatory capital commitments under Basel III, both through overnight borrowing and longer duration transactions.

"While fixed income lending opportunities were suppressed in North American markets during 2020, given the liquidity impact of central bank interventions, these are now starting to return. We see extended term trades for Canadian provincial bonds and Canadian government bonds, for example, with demand to borrow extending out to 95 days," says Kolasingh. This demand for HQLA, and for term-based collateral transformation trades, is likely to persist as the Federal Reserve and the Bank of Canada make changes to their asset purchase programmes.

To support these activities, Kolasingh says that RBC I&TS aims to be the provider of choice for its counterparties, refining the product to offer greater collateral flexibility and extending its tri-party network to broaden the range available to borrowers.

"We also continue to work on GMSLA pledge structures to make it easier for counterparties to do business with us — thereby extending the capital efficiency benefits that this range of borrowing options can deliver to banking counterparties," he adds.

Client pipeline

Given this amelioration in lending conditions, 2021 has driven a strong pipeline of new and returning lenders seeking to optimise market opportunities. Beneficial owners that temporarily suspended lending with the arrival of the COVID crisis have now, in many cases, returned to the market — and RBC I&TS has been enrolling new institutional lenders onto the programme, seeking to add incremental returns which are particularly attractive in a low interest rate environment and achieved in a risk-controlled framework.

"Against this background, we have maintained close dialogue with new and existing lenders to help them tailor their lending parameters to current market conditions, to communicate our views on key risks and to guide them on how these can be mitigated within a well-managed lending environment," says Kolasingh.

RBC I&TS has also been working with institutional lenders to provide greater flexibility in how they access the markets and realise value from their asset portfolios. Traditionally lenders have been encouraged to enrol their full portfolio of lendable assets into the programme. However, it also offers opportunities for asset owners to lend single lines of securities — which may offer potential to deliver high intrinsic value — without requiring that they enrol their full asset portfolio in the lending programme.

Sustainable lending and financing

Beyond the focus on high-yield opportunities and prudent risk management, asset owners have been looking closely at the 'sustainability' of their securities lending arrangements, ensuring that their lending programme aligns with their ESG commitments across the organisation and their stewardship responsibilities as an investor.

"The focus and content of these discussions can vary substantially," Kolasingh notes, depending on the type of client and where they are located. In North America, the discussion to-date has centred particularly on proxy voting and shareholder engagement — on managing loan recalls to ensure that beneficial owners can vote stock that is currently on loan.

While this remains a primary consideration in Europe, the focus has widened to include application of ESG screening to collateral schedules and counterparty lists — ensuring that assets accepted as collateral, and a lender's list of eligible counterparties, align with its overarching ESG strategy. This, notes Kolasingh, is a trend that is likely to be replicated in North America and other regions.

In supporting these commitments, Kolasingh believes that is an area where a high-quality agent lender can deliver significant value. “We have focused for many years on ensuring that investors can meet their stewardship responsibilities, particularly in voting stock that they own,” he says. “The current industry focus on sustainable securities lending is an extension of that dialogue.”

As asset owners and buy-side lenders extend their demand for ESG screening across collateral lists, this will require application of sophisticated optimisation engines to ensure efficient collateral mobilisation and allocation across the client’s collateral inventory, which may bridge multiple product silos and geographical locations. While few beneficial owners have the size or commercial motivation to meet this commitment in house, the agent lender is well placed to invest in this innovation and to scale this across the community of lenders and borrowers that it supports.

Product Development

As a prominent driver of its product development strategy, RBC I&TS identifies greater use for its client base of new digital channels to execute securities lending transactions.This reinforces the need to support connectivity to leading electronic execution platforms, but also to meet the data requirements of clients around their lending and financing activity.

Responding to this need, RBC I&TS continues to invest in enhancing data transparency to lender and borrower clients, providing detailed analytics relating to loan performance, revenue attribution and opportunities for maximising risk-adjusted returns on securities lending assets. This includes an extension of its visualisation tools and data dashboards, enabling the client to generate customised analytics and reporting, as well as data delivery via automated channels.

The securities finance team also identifies growing demand from asset owner and asset management clients for bespoke financing solutions. This caters particularly for the needs of buy-side firms for securities borrowing to support their trading and investment activities. With this development, a rising number of clients are using RBC I&TS’ services to support both their securities lending and financing requirements.

Looking geographically, RBC I&TS has been expanding the network of markets in which it supports securities lending activities. Over the past 18 months, the focus has been on extending its securities lending coverage in Taiwan, Poland, Israel and the Czech Republic. “This geographical expansion will extend into 2022 when we expect to add more emergent lending markets to our global footprint in line with demand from our clients,” says Kolasingh.

In expanding its trading network, the securities finance team continues to add new lenders and borrower counterparties. “The borrower network has been growing year-on-year and now extends globally to more than 100 borrower organisations, all highly-regulated financial institutions,” says Kolasingh. “We also continue to extend the flexibility of our lending programme, for example by adding additional collateral sets including convertible bonds and a wider range of equity indices.”

Concluding thoughts

In closing our discussion, SFT asked Kyle Kolasingh to highlight the most important lessons that his team has learnt over the past two years — a period characterised by liquidity tightening during the Q3 19 US repo spike followed, inter alia, by the COVID-19 pandemic and the meme stock short squeeze.

“Nothing beats conversation with clients,” responds Kolasingh. The key, he says, is to have an open dialogue on an ongoing basis. “It is an obvious point, but we do not only discuss risk factors with clients when a risk event develops. Sound risk management is fundamental to all discussions, in planning new avenues for revenue generation, monitoring risk hotspots and ensuring clients understand how these will impact lending volumes and yield opportunities.”

Indemnification continues to play an important part in these conversations. In the past 24 months, these have been an important component of nearly every client conversation. In the past, RBC I&TS sometimes saw lender clients opting out of indemnification, preferring to receive a higher share of revenue. Over the past 18 months, however, it has noted no instances of clients passing up access to indemnification to receive a higher fee share.

Importantly, this is just one component of a risk management framework that extends well beyond indemnification — including value at risk (VaR) stress testing across the loan and collateral book, alongside detailed counterparty credit risk assessment and full collateralisation of outstanding loan positions with an additional haircut. “With this framework in place, secured lending provides an attractive source of risk-adjusted return, while aligning with the stewardship responsibilities borne by beneficial owners” concludes Kolasingh.