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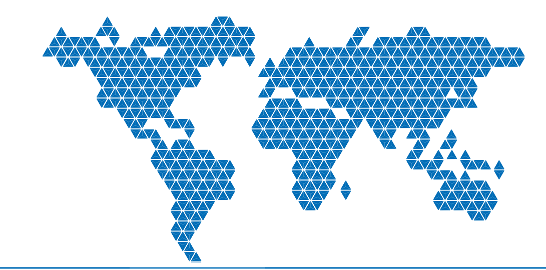
# Canadian in character

The prospects for the market remain bright



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## Industry calls for change to US federal funds open rate

ICAP's federal funds open rate (FFOR) should be replaced by the the Federal Reserve Bank of New York's new overnight bank funding rate (OBFR) as a benchmark for pricing and performance reporting, industry associations have argued.

The Risk Management Association (RMA) and the Securities Industry and Financial Markets Association (SIFMA) have backed the OBFR as an alternative because it would better address the benchmark standards recommended by the International Organization of Securities Commissions (IOSCO).

ICAP will cease to publish the FFOR from 27 July, at which point the new rate will be adopted.

Fran Garritt, director of securities lending and market risk at the RMA, said: "Choosing the OBFR makes sense at a time when industry participants are focused on the IOSCO guidelines and other standards that are attempting to confirm the accuracy and transparency of benchmarks."

Rob Toomey, associate general counsel at SIFMA, added: "As the market transitions away from the FFOR, we look forward to working with all market participants to ensure a smooth changeover as they move to implement this recommendation."

The proposed benchmark alternative was endorsed by the Treasury Market Practices Group (TMPG), which initiated the process of finding a suitable alternatives to ICAP's FFOR following IOSCO's recommendations were published in 2013.

TMPG chair Tom Wipf added: "Using benchmarks that comply or are consistent with the IOSCO principles is a TMPG best practice. The TMPG appreciates the leadership of the RMA and SIFMA in identifying a benchmark for pricing and performance reporting purposes that is consistent with the IOSCO principles."

In a brief on the proposed amendment, the TMPG outlined the reasons behind the need for a change, stating: "ICAP, the publisher of the FFOR, does not consider the FFOR to be a benchmark under the IOSCO principles yet it is utilised by market participants as if it did have the attributes of a benchmark."

"Since then, the TMPG has worked with the RMA and SIFMA to advance the replacement of the FFOR with benchmarks that are compliant or consistent with the IOSCO principles."

SIFMA expanded on this, stating: "As the TMPG noted in its case study of the use of benchmarks in TMPG covered markets, because the FFOR is based on a limited volume of transactions it may be less reflective of the underlying financial interest it is trying to measure than if it were a calculation based on a large volume of data points."

The RMA and SIFMA clarified in a joint statement that the proposal should only be viewed as a recommendation for their members "in order to promote the smooth functioning of the market".

"The recommendation does not and should not restrict the flexibility of counterparties to negotiate the specific terms of any particular transaction or contractual relationship."

The OBFR, which the Federal Reserve Bank of New York began publishing on 2 March, includes overnight federal funds and certain eurodollar transactions, and is published on most days at approximately 9am New York time.

## Saudi Arabia opens door to securities borrowing and lending

Saudi Arabia's Capital Markets Authority (CMA) has approved the introduction of

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securities lending and covered short selling to the Saudi Stock Exchange from H1 2017.

In a statement on the regulatory reform, the CMA stated: "The CMA aims for these measures to provide greater stability to the overall capital market environment, through applying ... best practices, incentivising investors in an environment that supports the national economy."

In addition, the CMA has approved the Saudi Stock Exchange's request to amend the transactions settlement cycle of listed shares from T+0 to T+2 in order to align it with other international markets. The shift will also take effect in H1 2017.

The incorporation of securities lending and short selling comes as a part of an extensive overhaul of the Saudi Stock Exchange's framework in a drive to encourage foreign investment into the country.

The initiative began on 15 June 2015 with the approval of regulatory amendments to allow qualified foreign financial institutions to invest directly in Saudi Arabia-listed shares.

This latest review is now set to loosen rules further to enable foreign investors to own larger stakes in listed companies, with a new cap of 10 percent of the shares outstanding of a single issuer for each investor.

All foreign investors in a Saudi Arabia-listed company, including residents and non-residents, may own no more than 49 percent of the shares of any listed company, unless a company's bylaws states this must be lower.

## Consistent regulation key to avoiding business disruption

The International Securities Lending Association (ISLA) and International Capital Market Association (ICMA) have submitted comment letters to EU regulators offering industry responses to regulatory proposals.

The associations agreed that consistency of terms is essential to streamlining reporting and avoiding inconsistencies across the various regulatory requirements of the Securities Financing Transaction Regulation (SFTR) and the Financial Stability Board's (FSB) crackdown on 'shadow banking'.

The potential pitfalls were highlighted by ISLA in its response to the FSB's call for industry comment ahead of its final proposal on ways to reinforce stability within alternative financing.

ISLA's comments, which reflect the view of its approximately 100 members, were largely supportive of the FSB's analysis of the growing shadow banking industry.

In particular, ISLA acknowledged that two of the three options offered by the FSB for monitoring collateral reuse would be viable, allowing for a "reasonable approximation" of the collateral reuse market.

ISLA also praised the FSB's focus on the practical issues around implementing systems to track collateral reuse and the potential cost impact on industry participants.

The response letter did raise concerns that the FSB's definitions of reuse and rehypothecation are different to those of the European Securities Markets Authority (ESMA), as seen in the SFTR.

ISLA commented: "In order to achieve any level of global data aggregation there needs to be a consistent definition of the applicable elements that represent reuse and rehypothecation."

ISLA highlighted the limited capabilities of its members to discern between collateral held and their own assets. The association stated: "There is no legal or practical distinction between own assets and collateral assets. Both belong to the firm and are likely to be held in a single firm depot."

"Due to the fungibility of the securities in the account, it is not currently possible to link specific securities to any particular source or transaction."

Questions were also raised by ISLA's members regarding the potential accuracy of the "reuse reliance rate" and the "collateral circulation length".

At the same time, ICMA offered its opinion on ESMA's SFTR reporting requirements.

The association advised that reporting requirements must be concise and focused only on essential data that will aid greater transparency in order to avoid redundant reporting requirements.

The review came as part of a response letter from ICMA's European Repo and Collateral Council ahead of the second draft of ESMA's regulatory and implementing technical standards for SFTR reporting.

ICMA commented in its letter: "In order to avoid any ambiguities, these definitions should be explicitly set out in the SFTR technical standards."

"Importantly, the terminology used needs to be consistent with established market practice and the applicable legal documentation, such as the global master repurchase agreement."

As well the issue of inconsistencies, ICMA raised concerns regarding an overlap in reporting between the SFTR and the Markets in Financial Instruments Regulation (MiFIR), stating: "While we acknowledge and welcome the explicit exemption from MiFIR reporting requirements of all transactions that will be reported under SFTR, we also note that this exemption does not extend to securities financing transactions (SFTs) that have been explicitly exempted from SFTR reporting, in particular SFTs with European System of Central Banks counterparties."

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"We strongly disagree with this approach as we believe that the SFTR provides the only appropriate framework to report SFTs and that the inclusion of the aforementioned transactions in MiFIR transaction reporting goes against the clear political decision to exempt these trades from SFTR reporting obligations," ICMA explained.

On reporting, ICMA also highlighted the importance of not overburdening firms with unnecessary data requirements that did not directly further ESMA's aim on improving transparency in the market.

At the same time, ESMA should, wherever possible, request data from the trade repositories as opposed to from the firms themselves in order to minimise the chance of inconsistencies or errors.

## No bid for LSE, confirms ICE

Intercontinental Exchange (ICE) has confirmed it will not place a counter-bid to Deutsche Börse's offer for a merger with the London Stock Exchange Group (LSEG).

ICE, which already operates 11 global exchanges and six clearinghouses, stated that, following due diligence on the information made available, there was "insufficient engagement to confirm the potential market and shareholder benefits of a strategic combination".

The decision comes three months after ICE first announced it was considering making an offer for LSEG.

That news followed the revelation that the exchange was engaging in talks with Deutsche Börse for a potential 'all-share merger of equals' in February.

ICE clarified that it reserves the right to reconsider making a bid for LSE within the next six months if the ongoing talks with Deutsche Börse eventually collapse.

## Tradition launches collateral platform

Swiss broker-dealer Tradition is launching a new peer-to-peer collateral trading platform.

The platform, known as Elixium, aims to tackle the impact on balance sheets caused by Basel III for those in the repo and collateral financing markets.

Elixium's tools and analytics will allow institutions to qualify credit slippage, view depth and liquidity across all tenors and baskets, and offer varied execution methodology.

The platform will be rolled out in stages over the next few months.

It will be run by Nick McCall, co-founder of DBV-X, which recently split from Tradition.

McCall said: "The repo and collateral market is a critical source of funding for many institutions but is balance sheet intensive."

"As institutions come under pressure as a result of regulatory changes such as the liquidity coverage ratio and net stable funding ratio, a reduction in balance sheets has impacted the depth of liquidity available," McCall added.

"By establishing a peer-to-peer network and offering full counterparty control, we are enabling greater access and price discovery for many non-bank institutions such as asset managers, central counterparties, corporates and insurance firms, which are increasingly being seen as key sources of liquidity in the repo market."

The new platform will also be managed by Roberto Verrillo as head of strategy and markets, Gabrielli Frediani as chief business development officer, Nick Van Overstraeten as director of product development, and Iona Levine as special adviser.


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Verillo led Nomura's GBP rates desk, while Overstraeten brings more than 13 years of experience as a senior interest rates trader at Citibank. Levine previously served as general counsel for LCH.

The new platform will hold 40 collateral baskets covering fixed income and equities in GBP, EUR, USD, CAD and JPY, along with emerging market currencies.

Elixium is available to corporates, central banks, sovereign wealth funds, asset managers, pension funds, insurance companies, government institutions, hedge funds, broker-dealers and banks.

Verrillo added: "Legacy trading models are no longer as relevant in today's market as they once were. Financial institutions are restructuring their product offerings and businesses in light of regulatory and structural shifts in the dynamics of how markets operate. Elixium is designed as a direct result of these changes and we hope to be at the forefront of this evolving market over the coming years."

Frediani said: "I'm delighted to join Elixium at a time when the market is ripe for ambitious change. Regulators and central banks are demanding a move towards transparent markets, while market participants want standardised access to collateralised liquidity on a short-term and long-term basis."

"Elixium addresses these complex issues and offers a choice of execution protocols that is urgently required by the market."

## Nomura rolls back EMEA equity financing business

Nomura Holdings has confirmed it will be stripping back its equity financing operations throughout Europe, the Middle East and Africa (EMEA).

The Japanese bank plans to close its EMEA equity derivatives, delta one trading and equity futures and options business. Equity underwriting and equity research will also be wound down.

Nomura will maintain a presence in London from which it will continue to offer repo, stock loans and total return swaps services to its EMEA clients.

The Japanese bank also reassured customers that its global prime brokerage service "will remain intact".

The confirmation comes shortly after Nomura initially announced plans for widespread closures of some business lines in the EMEA and the Americas in order to consolidate its position in Asia.

The Japanese bank cited "extreme volatility and a significant decline in liquidity, triggered by heightened uncertainty in the global economy" as the driver behind the closures.

Tetsu Ozaki, COO of Nomura Group, said: "We are taking decisive action to refine the services we offer to our clients, while continuing to leverage our dominance and unique strengths in Asia, providing tailored solutions to our clients globally and continuing our 90 year legacy of putting clients at the heart of everything we do."

## CCPs in ESMA stress test success

European central counterparties (CCPs) are generally well equipped to manage extreme negative developments in the market, according to the European Securities and Markets Authority (ESMA) EU-wide stress test report.

In the first EU-wide stress test, ESMA assessed the resilience of CCPs to severe market shocks, and the potential impact this could have on their clearing members.

Under the European Market Infrastructure Regulation (EMIR), ESMA is required to identify any events that could exhaust the resources of CCPs, and to estimate whether such an event could have an adverse effect on the economy.

According to the report, CCPs would only struggle in the case of a number of clearing members defaulting at once during a period of severe market volatility.

The test included components of member default, historical variants, hypothetical variants and reverse stress testing. The reverse stress test explored the number of entities that would have to default to exhaust the total resources of a CCP, also taking in to account the other three variants.

Although central counterparties were set up to reduce the systemic risk of bilateral counterparty relationships, because CCPs are highly connected through common clearing members, a default in a large member group could trigger default for other entities, exacerbating systemic risk.

According to ESMA, its tests in this area focused only on counterparty credit risk, and so were not necessarily adequate to establish the level of resilience. ESMA has pledged to improve its methodology in this area in future tests.

A high degree of concentration of mutualised resources was only found in one CCP, and in specific cases where high concentration resulted from small overall exposures to limited members.

At a general EU level, however, ESMA found no sign of a high concentration either at a clearing member or group level.

The test found that pre-funded resources would be sufficient to cover losses, considering hypothetical and historical stress scenarios. In the case of these stress scenarios combined with the default of the top two clearing members, a CCP would

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have to call in additional resources up to an estimated €1.4 billion.

This would leave uncovered losses of about €100 million.

But this scenario is an extreme, unprecedented and implausible scenario, and the system was deemed, overall, to be resilient to such stress scenarios.

Reverse stress testing involved the hypothetical default of an extremely high number of entities, both EU-wide and at an individual CCP level.

The actual effect of this would not be limited to CCPs, ESMA said, and therefore cannot be accurately estimated. However, it assessed that the theoretical shortfall CCPs could withstand is around €40 billion.

Finally, ESMA found that some CCPs were not applying stress price shocks representing the most extreme historic price changes given. For some institutions that are sensitive to volatility shifts, some CCPs did not apply volatility stress scenarios.

The authority recommended that national competent authorities should ensure CCPs assess clearing partners for their creditworthiness and the amount of losses other clearing members could be exposed to, because of participation in multiple CCPs.

ESMA also suggested that national competent authorities should supervise a review of price shocks applied in testing, and that CCPs should review their own stress tests, tailoring them to their specific offering based on historical and hypothetical scenarios.

The European Association of CCP Clearing Houses (EACH) welcomed the results. In a statement, EACH said: “The results indicate that, for the reporting dates, the system of European CCPs can overall be assessed as resilient to the scenarios used to model ‘extreme and plausible market developments’.”

Eurex Clearing has also welcomed the results. A spokesperson highlighted the findings around concentration and shortcomings in individual stress tests, saying: “The low level of concentration highlights the stability of the financial system. Based on our own calculations, Eurex Clearing shows one of the lowest concentration levels among all European CCPs.”

The spokesperson continued: “Eurex Clearing discussed minor inconsistencies with the minimum shifts with ESMA and the national competent authorities and took mitigating actions in order to be in line with the proposed minimum stress scenarios. The impact of these actions is not noticeable.”

ESMA chair Steven Maijoor said: “CCPs play a significant role in financial markets by reducing the exposure risk of clearing members. Therefore, ensuring that CCPs are resilient to shocks is an important supervisory tool to mitigate systemic risk.”

“ESMA’s first EU-wide stress test shows that European CCPs are overall well equipped to face the counterparty risk associated with the considered stress scenarios.”

## IBM tackles blockchain concerns

US technology giant IBM is working with securities borrowing and lending participants such as BNY Mellon to create a “tamper-resistant” blockchain solution for the trade and transfer of assets.

The industry collaboration comes after IBM highlighted the fact that concerns around the security of blockchain as an emerging technology are holding back many participants, such as those involved in securities lending, from investing fully.

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Suresh Kumar, chief information officer at BNY Mellon, commented: "At BNY Mellon, we are actively exploring blockchain's potential to better serve our clients and our company."

"With this new initiative, IBM is providing an environment that will allow companies like us to collaborate more easily and more securely and in a more standardised way, which is critical to advancing meaningful use cases for blockchain."

In a brief on the blockchain initiative, IBM explained: "Blockchain networks are built on the notion of decentralised control, but some cloud environments leave back doors open to vulnerabilities that allow tampering and unauthorised access."

"Working with teams of security experts, cryptographers, hardware experts and researchers, IBM has created essential new cloud services for tamper-resistant, trusted blockchain networks."

Jerry Cuomo, vice president for blockchain at IBM, said: "While there is a sense of urgency to pioneer blockchain for business, most organisations need help to define the ideal cloud environment that enables blockchain networks to run securely in the cloud."

Eiji Ueki, director and executive vice president of NTT DATA, an IBM client, added: "Blockchain is a highly innovative and promising technology. However, there are a lot of issues to be solved for enterprise systems."

"IBM's new blockchain cloud service is directly trying to address those issues. We believe this will help accelerate the maturation of blockchain technology."

IBM revealed it is addressing these concerns directly by forging cloud services with the highest federal information processing standards (FIPS 140-2) and evaluation assurance levels in the industry to support the use of blockchain in government, financial services and healthcare.

IBM is also making it easier to use its code, based on the Linux Foundation Hyperledger Project, in any environment, and offering services on Bluemix, IBM's cloud platform, to help developers quickly build applications.

## Blockchain in proxy voting prototype

The National Settlement Depository (NSD), the Russian central securities depository (CSD), has completed testing on its blockchain e-proxy voting platform.

NSD has been working with DSX on the projects, and the prototype is based on the NXT distributed cryptographic platform, using the ISO 20022 international messaging standard.

The platform uses distributed ledger technology to submit instructions for corporate actions, making information available to all members of the chain at the same time.

The distributed database contains a full history of updates, and once data is entered

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it cannot be edited, meaning it should be impossible to tamper with.

It is also designed to make information easily traceable, and to ensure optimum integrity at every point of the voting process.

Regulators and auditors can also access all necessary information by becoming members of the network.

Securities holders vote using digital signatures. Once votes are entered in to the blockchain, holders are issued with identification numbers.

Once votes are passed to the CSD, the system calculates the results and NSD publishes them on the blockchain.

The system then keeps a record of any changes made throughout the voting procedure, and stores the results.

Eddie Astanin, chairman of the executive board at NSD, said: “Over the past 10 years, the global financial infrastructure has faced the challenges that make us review the approaches to reliability, security and performance of information systems.”

“It is obvious for us that ignoring the rapid development of fintech and upgrading the out-dated platforms could hinder the stable development of the Russian financial system.”

Astanin added: “Fortunately, Russian specialists are among the most experienced in the global fintech industry, and we have proven this fact by implementing a fully functional prototype of e-proxy voting system based on blockchain.”

“After testing blockchain for bondholder meetings, we can extend the use of this technology to other business areas of NSD.”

During the testing period, the working group achieved a submission speed of 80 voting instructions per second. According to Sergey Putyatinskiy, IT director at NSD, the CSD is now working to improve capacity and to enable support for more voting types.

## Cyber risk and Asia top DTCC’s systemic risk survey

Fear of cyber attacks has dropped significantly in the past year thanks to sustained investment in prevention, according to the Depository Trust & Clearing Corporation (DTCC).

Only a quarter of survey respondents, made up of DTCC’s clients, cited cyber risk as the single biggest systemic risk to the broader economy. Just over half, 56 percent, placed it in their top five.

Notably, these percentages fell steeply from 46 percent and 80 percent, respectively, just one year ago.

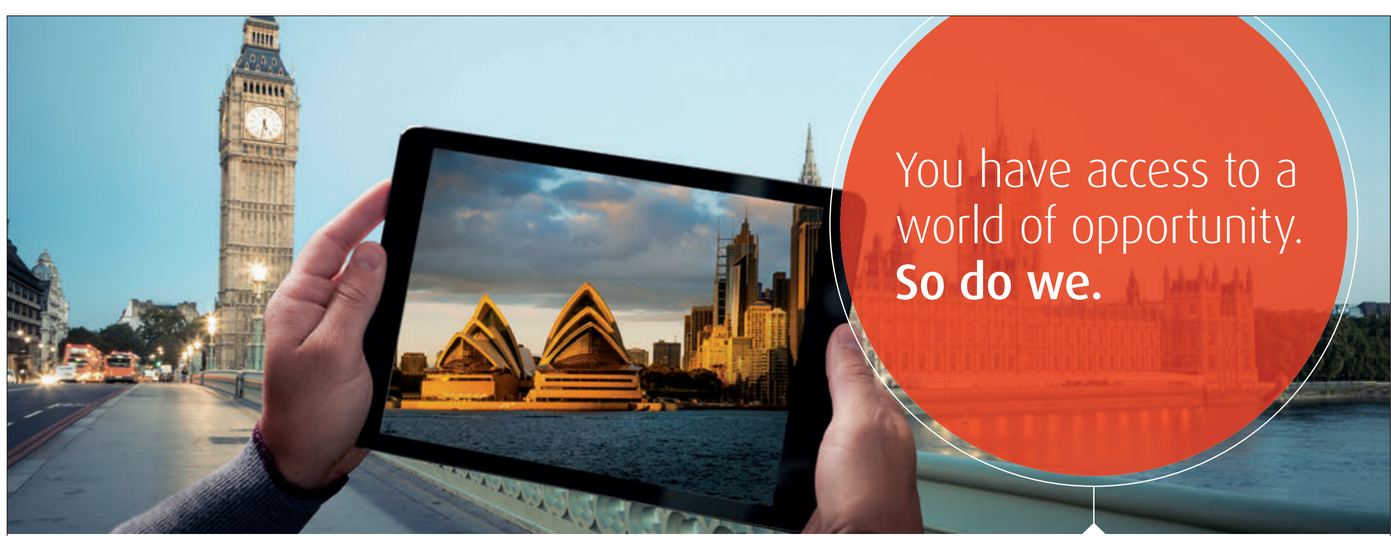
One respondent offered some context to the drop off, stating: “Cyber [risk] is never going to go away, but it seems the major players are investing heavily in prevention.”

The survey results come as Hermes Investment Management warned that a potential worst-case ‘cybergeddon’ scenario places as much as $3 trillion of global economic value at risk by 2020. Hermes also predicted a 250 percent increase in the global cyber security solutions market, currently valued at $75 billion.

In stark contrast, fear of an economic slowdown in Asia has leapt to the fore in the minds of industry participants over the past year, DTCC found, as 22 percent of respondents now rank it number one, compared to only 1 percent the year before.

Michael Leibrock, managing director and chief systemic risk officer at DTCC, commented: “We’re not surprised to see an increase in concerns about the global economy, especially in Asia where we have seen the economy slowdown in China sharply in recent years compared to three decades of mostly double digit growth.”

“Interestingly, while cyber risk remains very much top of mind, concerns have decreased over the last year, raising a red flag that firms need to remain vigilant in the face of this persistent threat.”

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# Canadian in character

## Rob Ferguson of CIBC Mellon offers local insights on commodity trends and their impact on Canadian securities lending

With the sixth Canadian Securities Lending Association annual conference taking place on 2 June 2016, securities lending market participants and stakeholders from Canada and across the globe will come together to take stock of the current trends, opportunities and changes facing one of the world's largest lending markets.

Long hailed as a global safe harbour in turbulent markets, the stability and transparency of Canada's banking and regulatory environment, along with its AAA debt rating and status as a stable and mature market, have helped Canada's securities lending market maintain its position among the world's largest and most active. Nonetheless, macro trends in the global and Canadian economies do mean a changing market with both challenges and opportunities for participants.

Being a resource-focused market, the Canadian economy has experienced dampened growth with the low level in energy prices and other commodities, which are well below historical averages. The per-barrel price for West Texas Intermediate has recently averaged US $38 per barrel, according to the Bank of Canada—significantly less than the US $93 per barrel average of 2014. The resulting contraction of business investment seen by the Bank of Canada in the energy sector has been a significant drag on economic activity and we are seeing more consolidation in the sector. On the other hand, securities lending activities have seen an uptick in resource-based Canadian equities and corporate bonds and thus has benefitted from this trend.

Simultaneously, we have also seen the Canadian dollar dip to lower levels. The Bank of Canada has been noticeably proactive in its commodities correction and announced on 21 January 2015 that it was lowering its target for the overnight rate by a quarter of a percentage point to 0.75 percent, which the street was not expecting. The Bank of Canada noted that it made this decision in response to Canada's sharp decline in oil prices. Some market participants have nonetheless benefitted from interest rate cuts, particularly those who are well positioned with respect to cash reinvestment programme participation set out across longer horizons with a favourable interest rate differential. Further to that rate cut, on 15 July 2015, the Bank of Canada announced that it was lowering its target for the overnight rate by a quarter of a percentage point to 0.5 percent. The Bank of Canada cited further downgrades of business investment plans in the energy sector, as well as weaker-than-expected exports of non-energy commodities and non-commodities for the downward revision.

From a securities lending perspective, borrowers in Canada have benefitted from weaker commodity prices, specifically in companies that have exposure to the oil or resource sector. Business in Canada over the last couple of years has been heavily-weighted towards general collateral lending and in Q3 2015, with correction in commodities and specifically in energy, we've seen a shift towards the warm special space as many of the resource companies have come under pressure, as well as secondary markets with exposure to Western Canada or the commodities industry, such as mortgage and financing companies.

Usually with a market downturn, affected companies may choose to offer dividend reinvestment plans (DRIPs), even at a discount, to preserve cash while maintaining their dividend payment. But over the last year in Canada, we've noticed a different trend with affected companies eliminating their discounted DRIP offers and reducing or suspending dividends as their method to preserve cash. Given this strategy, it just shows the negative pressure that the energy sector has been under.

Uncertainty continues around whether energy producers and related firms will be able to maintain their activity levels at the current low prices. We are seeing a decrease in capital expenditure spending by the energy sectors, along with reduced exploration and product development. Meanwhile, healthier companies are looking for opportunities to purchase distressed assets and improve efficiencies. This should keep energy and resource-based securities in focus for securities lending.

Mergers and acquisitions (M&A) activity in Canada is moving at a brisk pace, given the lower Canadian dollar and opportunities to grab discounted assets. We've seen record M&A activity that involved Canadian companies in Q1 2016. There is demand for good quality assets for sale, including undeveloped oil reserves and physical properties. We could expect to see increased M&A activity in the energy sector as assets in companies continue to trade at

a discount. This bodes well for securities lending as the steady pressure on the resource sector will likely mean continuing specials in the Canadian equity space.

In the non-energy commodity sector, lower prices are expected to add to constraints on mining activity, according to the Bank of Canada. Declines in base metals, from iron ore to zinc, have lowered the Bank of Canada's non-energy commodity price index, which fell below the central bank's levels that were assumed in October 2015. This trend in Canada is part of a wider global trend with excess supply of base metals. In Canada, the current excess supply of base metals suggests that prices may continue to fall modestly until either production is substantially decreased or demand picks up. In terms of securities lending, we have seen a pick-up in demand for companies relating to base metals and drilling over the past year.

In recent quarters, we have seen lower oil prices come against a backdrop of more wide-ranging growth in Canada. Outside the energy sector, we are beginning to see the economy rebound and the Bank of Canada attributed this to foreign demand, stronger exports, improved business confidence and investment, and employment growth. With the weaker Canadian dollar, we've been seeing the manufacturing sector bolster the economy, given that for many exporters, the exchange rate depreciation has boosted margins on sales in US dollars. This cash flow denominated in Canadian dollars allows for price competitiveness and additional funding for firms to increase their investment spending.

Overall, investment outside the resource sector is expected to strengthen. Canadian companies that are involved in the manufacturing sector have benefitted over the last few months, which has benefitted securities lending from a mark-to-market perspective. Prices of energy and other commodities remain well below historical averages, but there are some signs of improvement and stabilisation. Even with energy specials existing today, we're seeing commodities prices rebound. It remains to be seen if the current rebounds will materialise into a bull market for the commodities space with a true correction in the marketplace.

At the end of the day, the market of course retains its fundamental 'Canadian' character, marked by stability, strength and a culture of prudent risk management. For that, even Canadians should be unapologetic. **SLT**

***"Borrowers in Canada have benefitted from weaker commodity prices, specifically in companies that have exposure to the oil or resource sector"***

**Rob Ferguson,** Senior vice president, capital markets, business development and relationship management, CIBC Mellon

# A league of its own

Experts on Canada’s securities lending industry discuss the market’s qualities compared to others, finding it to be a strong source of HQLAs

## How has the securities lending industry in Canada fared over the past 12 months?

**Dave Sedman:** The Canadian securities lending business has continued to show strong demand over the past 12 months. Beneficial owners have received a steady stream of earnings and continue to see value from the securities lending product. Although spreads continued to tick upwards, utilisation has remained stable. With the collapse in commodity prices, 2014 saw heightened demand in the oil and gas sector and mortgage finance companies, particularly Home Capital Group and Genworth Financial.

The dividend reinvestment plan continued to produce attractive returns and was a large contributor to revenues for our clients. Non-cash collateral continues to be preferred over cash collateral because beneficial owners are rewarded for taking an expanded set of collateral such as equities.

Non-cash collateral is used in Canada more than other regions and accounts for approximately 80 percent of collateral pledged for Canadian securities lending transactions. Cash collateral can provide additional diversification, and in some cases, incremental revenue, however, very low interest rates have continued to support the benefits and simplicity of taking non-cash collateral. There has also been an increased focus on capital usage and continued demand on collateral alternatives and trading structures.

**Alexa Lemstra:** On the market data front, in 2015 we saw relatively steady on-loan balances and utilisation as well as some upward movement in fees. More recently this year, we have seen overall utilisation increase along with higher fees in the market in the healthcare, information technology and materials sectors.

Canada's on-loan balances are following the global trend of increases. In Canada specifically, we are seeing balances increase primarily in the financials, utilities and telecommunications sectors. From a business perspective, we are also seeing firms allocating more resources to technology and enhancing systems. Balance sheet, regulation and collateral flexibility are key topics for our clients.

**Charles Murray:** The strength of both the borrower and lender base in Canada has ensured sound growth in the securities lending industry over the past 12 months as the needs of both sides of the street have been well aligned.

**Don D'Eramo:** During the past year, volatility and strong corporate activity within the Canadian market led to increased demand from global borrowers for Canadian equities. Evolving financial regulation continued to be a factor influencing borrower behaviour, including a heightened focus on balance sheet management. As a result, demand for high-quality liquid assets (HQLAs) remained strong especially on a term basis.

**Phil Zywot:** The Canadian securities lending industry has performed well over the last year, despite the low level of oil prices and other commodities—and the associated negative impacts to Canadian equities. Being a resource-based market, the Canadian economy has experienced dampened growth, similar to other energy-producing countries. In terms of securities lending, borrower interest for Canadian fixed income has remained strong and we continue to notice high demand for HQLAs. We have also seen a resurgence in Canadian equity specials, specifically in companies that have exposure to the oil patch or the resource sector.

**John Loynd:** Overall, 2015 was a pretty steady year, even with the Canadian Stock Exchange down 11 percent and the Canadian dollar down 19 percent. Deal flows were down in Canada and hedge funds continued to de-lever, but the volatility in the markets created great trading opportunities as firms took shorter term views on positions.

We took advantage of the markets and diversified our businesses to capture more US activity, along with more fixed income business via our prime brokerage platform. With Canadian hedge funds outperforming their peers this year, we see great potential in balances continuing to head in the right direction.

## Canada is already the world's second largest securities lending market. Is it still growing?

**Zywot:** The stability and transparency of Canada's banking and regulatory environment, combined with its AAA debt rating and status as a stable and mature market, has helped Canada maintain its position as the second largest securities lending market in the world. The Canadian federal government's deficit spending plan is intended to bolster the Canadian economy, and one way it plans to fund fiscal stimulus is by increasing the supply of new Canadian government issues. The government is reintroducing three-year bonds, and Canada's gross bond issuance is expected to be CAD 133 billion (US $102.2 billion), representing an increase of approximately CAD 41 billion (US $31.52 billion) from the previous year's levels.

Those developments should help contribute to the growth of the Canadian securities lending market, given market demand for HQLAs. On the equity side, we have noticed a surge in merger

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**Dave Sedman,** Head of securities lending trading, Canada, Northern Trust

and acquisition activity involving Canadian companies in Q1 2016 and this trend also contributes to further growth in our space.

**Murray:** The market is growing as demand for funding and term trades increases. Historically, Canada has not been an especially attractive market for specials in both the fixed income and equity space for a variety of reasons, but mainly due to size and regulatory oversight.

Our market continues to grow largely due to the sophistication and high credit quality of its participants. These qualities allow for innovative initiatives, such as term structures and various collateral upgrade trades, as well as client-driven initiatives, to take root and grow.

**Lemstra:** According to DataLend data, Canadian on-loan balances were fairly steady in 2015 with a slight trend downward. However, in Q1 this year, as in much of the rest of the world, they are trending higher again and are back to April 2015 levels. Lendable values have followed the same trend.

General collateral volumes are holding steady, and we are seeing small increases in specials activity in the healthcare, information technology and materials sectors. Canada is a very established market. While the market may see some gradual shifts in on-loan balances and fees, as a whole it tends to be a very steady market.

**Loynd:** The Canadian market continues to evolve and grow. The exchange-traded fund market keeps hitting new asset under management highs every quarter, boosting borrowing needs. Legislation on liquidity rules from Basel and the Investment Industry Regulatory Organization of Canada have created a need for higher-quality collateral, driving demand for collateral optimisation trades and moving balances significantly higher over the past year. This will continue to grow as more liquidity and funding regulations come online in coming years.

**D'Eramo:** Participation and supply within Canada continue to grow as new lenders and borrowers enter the market.

**Sedman:** The Canadian securities lending model is straightforward and transparent, underpinned by strong financial institutions that participate both on the borrowing and lending side of the transaction. Given the strength of the borrower counterparties and the continued growth in the Canadian capital markets and fund management business, we expect that Canada will see continued growth throughout the year.

What may have an impact on the securities lending market is a general slowdown in the natural resource-rich Canadian economy which could be impacted by a global slowdown. However, the securities lending market has historically benefitted in a variety of economic cycles and we expect continued growth going forward.

## What is the supply-to-demand ratio like in Canada and how does that affect your day-to-day business?

**D'Eramo:** Canadian equities enjoy one of the highest utilisation rates globally. Supply and demand are dependent on a number of factors including the volume and quality of lendable assets, as well as the risk appetite and type of lender. In Canada, regulation plays a significant role in relation to supply and demand. For example, mutual funds governed by national instrument 81-102 are unable to accept equity collateral, while pension and insurance funds, which are governed by the Office of the Superintendent of Financial Institutions Guideline B-4, are able to do so.

**Sedman:** As the fund management business grows and more beneficial owners enter the market, there has been a larger shift globally towards a more specials-driven market. Increases in supply are met with greater demand for specific securities which can dramatically boost a client's earnings. What has become increasingly difficult is predicting which securities will trade special and produce the greatest revenue.

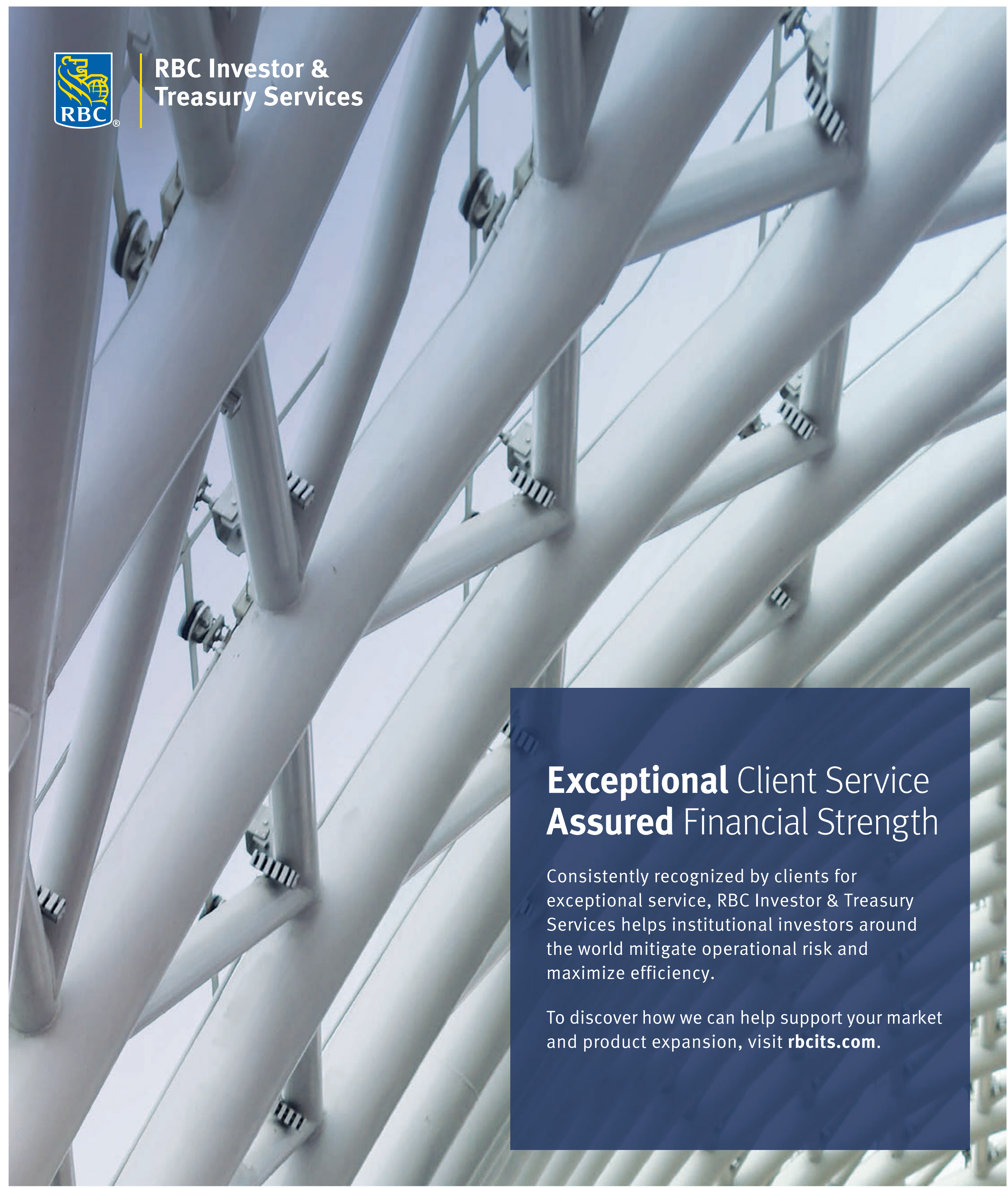
Northern Trust encourages clients to participate fully, but have the technology and client service expertise to customise each client's programme to meet their specific requirements.

**Lemstra:** Canadian banks see demand for inter-listed securities, dividend-related activity, HQLAs such as Canadian government bonds, non-cash collateral borrowing and collateral upgrades. We are seeing lots of supply, with a steady 13 to 14 percent utilisation averaged across all asset types in this market.

**Murray:** There is a big variance depending on the type of transactions in question. As we continue to move into an increasingly funding-centric marketplace, demand continues to grow for collateral upgrade trades. Depending on how esoteric the collateral offered is, we could often see demand outstrip supply.

> ***The recent market downturn in the commodity space—specifically for oil—has sparked more interest in Canadian equities and corporate bonds***

**Phil Zywot,** Managing director, securities finance, BNY Mellon

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Due to the growing trend to accept equities as collateral, the market has witnessed a supply bump with a slower paced increase in demand. For general collateral trades, government for government as an example, we will often see a situation where supply far exceeds demand.

**Loynd:** On an overall basis, supply has kept up with demand in most asset classes. Certain sectors in the equity space came under duress as the markets took a downturn. Where we have seen the largest deficiency in supply is on the debt side. With so much demand for government bonds in the collateral optimisation space, supply is lagging behind.

However, the regulatory changes that came into effect late last year, which reduced the need for financial disclosure from certain types of funds, gave borrowers the ability to approve principals otherwise untapped by the investor. We have started to see supply catch up to demand. Along with traditional avenues for borrowing, we have branched out to look at alternative ways to get supply in-house with non-traditional securities lenders either via a swap or repo.

**Zywot:** Supply in the Canadian marketplace has remained relatively steady over the last year. The recent market downturn in the commodity space—specifically for oil—has sparked more interest in Canadian equities and corporate bonds.

As such, we've seen increased demand in specials in this sector along with more borrower interest in the secondary markets that are exposed to the Canadian oil patch such as mortgage and financing companies, and the housing sector in Western Canada.

In terms of day-to-day impacts, the result of this market activity has contributed to higher fees and revenues in the Canadian equities and corporate bonds space.

### How are Canadian lenders and their agents innovating to keep pace with the US?

**Zywot:** Innovation has been a big focus—Canadian lenders are investing heavily in technology, whether it be upgrading their front-end systems or implementing efficiencies such as new and advanced AutoBorrow capabilities and collateral management systems.

Canadian lenders and beneficial owners have also been widening their collateral capabilities in an effort to capture greater returns, follow global best practices of collateral diversification, and position themselves to respond to emerging regulatory and market demand for expansion in the use of collateral.

**Murray:** Based on size alone, the US outpaces Canada, but in terms of innovation and creativity in the securities finance business, the opposite holds true. Our strong regulatory regime allowed us to persevere through the crisis in 2008, which made a critical contribution to our ability to strengthen our business and innovate with momentum.

A great deal of the innovation and evolution in our business has been centered on collateral. The Canadian market has historically been a non-cash market, and by that we are not referring to just government securities. Canadian borrowers and lenders have always been pioneers of various types of collateral innovation from convertibles to various types of corporate securities. This innovation is a function of the market leading sophistication of our clients, from pension plans, provincial asset managers, private asset managers, and mutual funds—all thought leaders in our business.

**Sedman:** The biggest innovations are on the trading desk. The past 10 years saw the emergence of the customised programmes for beneficial owners. The technology and efforts to allow clients to be able to be specific about their participation and provide transparency has really helped strengthen and attract supply to the securities lending market.

Now the focus is on increasing trade automation and maximising the distribution of the supply to the borrowers and end users. For example, the use of EquiLend's Next Generation Trading (NGT) system has allowed easier access for borrowers and more customisation around the distribution of securities. This is important for our clients because it ensures their securities have the best opportunity to go on loan as supply continues to enter the market.

**Loynd:** Over the years the lending community has been asking us what we want. The answer has been the same for quite some time: better collateral schedules, term borrows and cross asset trades. It seems that over the past couple of years the conversations have been paying off.

As lenders have seen spreads compress these new avenues into more diverse collateral, cross-asset trades and term borrows have moved the Canadian lenders ahead of a lot of their US counterparts, creating better returns for them and their clients. Lenders that adapted their programmes and conveyed the added revenue to their clients with little to no extra risk are now the first phone call for many borrowers.

**Lemstra:** While the Canadian market may be smaller than our neighbour to the south, it is still the second largest market in the

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**Alexa Lemstra,** Director, EquiLend Canada

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world and is a strong player in the global securities finance market. Market participants here have been focused on investing in systems and leveraging automation to achieve straight-through processing for their businesses. The EquiLend client base continues to expand, with firms expressing increased interest in data, trading and post-trade reconciliations as our clients look to us to do more for them in the current environment.

Canadian banks have been very engaged in NGT discussions, testing and builds. In some cases, they are ahead of the curve in adopting trading changes and leveraging technology to do it. It is an active and dynamic market that very much embraces new technology to benefit the business.

**D'Eramo:** Canada has a longstanding reputation as a highly successful and robust securities lending market. While the US is seeing a trend toward the acceptance of non-cash collateral, non-cash lending has been standard practice in Canada for many years. Securities lending is generally becoming more transparent in Canada. Rigorous disclosure and monitoring requirements are driving heightened engagement between lenders and their agents. In addition, lenders are engaging with their agents on a more frequent basis as the demand for alternative collateral types and term loans increases.

## On the global regulatory front, what is demand like for HQLAs? Is Canada proving to be a valuable source of these?

**Loynd:** HQLAs and the liquidity coverage ratio (LCR) have been on the scene now for a few years. Firms are always looking for different solutions to ensure that its LCR is on side. With the continuing creation of central funding teams across the street, the need for optimisation has gone to the front of the line.

Canada as a whole has seen huge demand from US clients looking to improve their LCR but for the most part they will only look at US assets. So even though Canada is doing lots of business to satisfy demand for HQLAs, it is somewhat limited to US collateral. As firms have become more efficient and capable of handling alternative currencies, we have started to notice a little more willingness to take Canadian assets.

**Sedman:** Regulation has an impact on the business and Canada is in a position to be a net beneficiary as HQLAs and other collateral continue to be in demand and valued by the marketplace. Since Canada is one of the last AAA-rated sovereigns, it is likely that demand will continue to grow for Canadian government and government-backed collateral. What remains to be seen is the impact of the increased cost of capital on borrowers and lending agents, which we feel already has slowed demand in certain segments of the market.

**Murray:** The Canadian securities lending market has remained resilient in the past 12 months. Demand for Canadian fixed income securities remains relatively strong. As a result, demand for HQLAs has remained robust. Specifically, as Canadian government securities have retained their AAA rating, demand has remained strong for borrowing this asset class. Regulatory forces as well as an active repo market have kept demand stable for Canadian federally issued debt, as well as federally guaranteed agencies. With demand increasing for Canadian government debt from non-traditional borrowers, other classes of fixed income have benefitted and experienced increased demand from these forces as the traditional borrowers have had to source alternate forms of debt.

Provincial debt has seen an increase in overall demand as a result of Canada government debt being redeployed for new sources of demand. Overall, those lenders with the widest array of flexible collateral options have benefitted the most as borrowers seek to optimise the use of available assets into upgrade trades. Beneficial owners of HQLAs that have the ability to enter into term trades have also seen robust demand this year and that demand is only expected to increase, as pressures from regulatory requirements such as LCR and the net stable funding ratio (NSFR) come more into focus.

**D'Eramo:** There has been a steady increase in the demand for HQLA over the past several years. Highly rated Canadian debt continues to attract significant demand from financial institutions looking to manage their capital ratios, such as the LCR and NSFR. Collateral flexibility remains an important driver of borrower demand in Canada.

**Zywot:** In the current regulatory environment, the demand for HQLAs continues to remain steady, especially with Canada being one of the beneficiaries. Given that Canadian government bonds are one of the few AAA-rated instruments remaining, these HQLAs are in high demand as a form of collateral for market participants. Canadian bond balances have benefitted over the past couple of years and are expected to continue to do so.

## What's in store for the rest of 2016 as far as your business is concerned?

**Murray:** The year ahead is expected to remain stable for the Canadian securities lending market. It's expected that the theme of

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**John Loynd,** Director, global equity finance, BMO Capital Markets

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**Charles Murray,** Head of securities finance in Canada, State Street

regulation will continue to drive the need to source HQLAs, with an emphasis on securing that supply for a term. Alternative and non-traditional collateral, such as equities, will continue to remain an important driver in the market as participants feel further pressure to optimise their collateral usage.

**Zywot:** We expect merger and acquisition activity to continue to increase through 2016, driving demand and revenues in the Canadian equity space. The steady pressure on the resource sector should result in continued specials in Canadian equity and corporate bonds. New regulatory requirements and the cost of capital should continue to gain focus. Finally, we expect to still see strong demand for HQLAs such as Canadian government bonds, which should remain steady for the remainder of the year. Overall, we believe the prospects for the Canadian market remain bright.

**D'Eramo:** In 2016, corporate activity is expected to continue driving increased demand for securities lending. During the coming year, RBC Investor & Treasury Services will continue engaging with our clients to match their lender profiles (such as term trading, collateral flexibility and risk tolerance) with borrower demand. In addition, we are working with clients that traditionally have not utilised securities lending to capture high-value revenue opportunities through a transaction-based approach.

**Sedman:** At Northern Trust, our focus is on trade automation and client customisation. The Canadian market continues to provide a stable source of income for our clients and we are committed to providing our world class securities lending service to meet our growing demand in Canada. We expect to see demand for general collateral trades to continue to decrease as borrowers and lenders alike remain focused on efficient capital and balance sheet usage. Borrowers are expected to focus on seeking balance sheet friendly trades and use a broader range of non-cash collateral types, in order to keep pace with new regulatory requirements. The expansion of collateral sets should also continue to evolve within the Canadian securities lending market.

**Lemstra:** EquiLend continues to work with firms to launch trading workflows on the NGT trading platform. We are also responding to clients wanting to gain more efficiency by offering more services in our new post-trade paradigm. Furthermore, we continue to provide market data to assist clients in their trading decisions.

**Loynd:** Fiscal 2016 is off to a great start. Market volatility has definitely helped the book and we feel very well positioned to have a strong financial result in the global prime finance group. BMO is in the midst of a multi-year project where we have invested wisely in our technology platform by implementing many tools that will help us automate many of our flows for years to come. We still believe there are excellent opportunities in servicing our Canadian clients in terms of foreign securities, as well as European-based clients who are actively trading US and Canadian securities. We continue to offer clients a one-touch approach as our securities finance, prime brokerage and delta one team can offer a suite of products together as one. **SLT**

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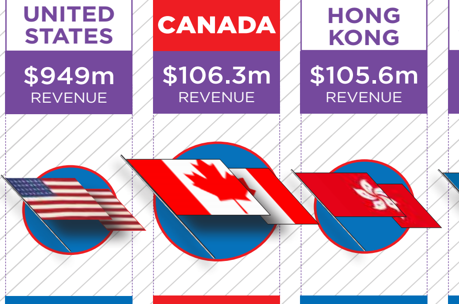
**Don D'Eramo,** Head of securities lending, RBC Investor & Treasury Services

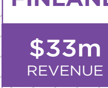
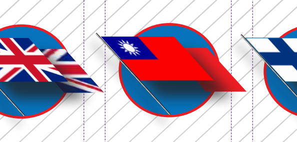
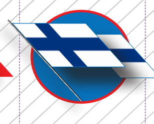
# DATALEND CANADA

## EQUITY SECURITIES LENDING SPOTLIGHT Q1 2016

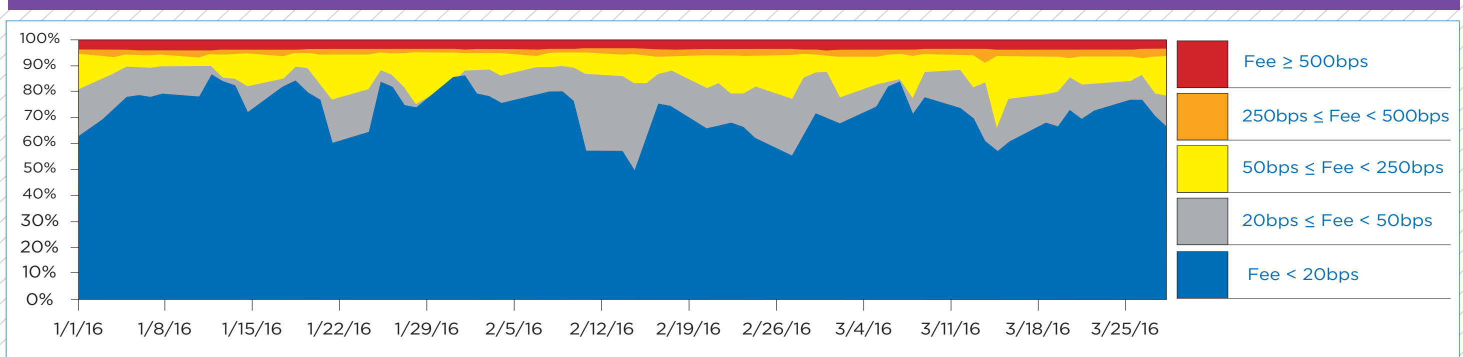
### TOP COUNTRIES BY EQUITY SECURITIES LENDING REVENUE

| Country | Revenue | On Loan |
|---|---|---|
| UNITED STATES | $949m REVENUE | $553bn ON LOAN |
| CANADA | $106.3m REVENUE | $51bn ON LOAN |
| HONG KONG | $105.6m REVENUE | $25bn ON LOAN |
| SWEDEN | $95m REVENUE | $12bn ON LOAN |
| JAPAN | $94m REVENUE | $62bn ON LOAN |
| KOREA | $86m REVENUE | $10bn ON LOAN |
| FRANCE | $81m REVENUE | $20bn ON LOAN |
| UK | $70m REVENUE | $41bn ON LOAN |
| TAIWAN | $43m REVENUE | $9bn ON LOAN |
| FINLAND | $33m REVENUE | $7bn ON LOAN |

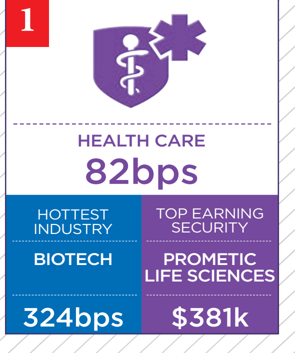
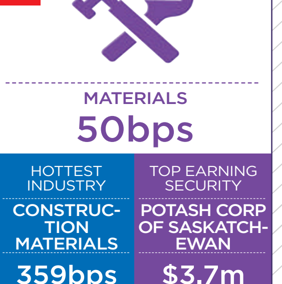
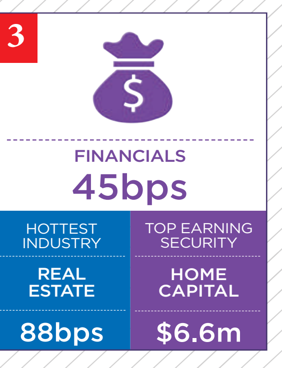
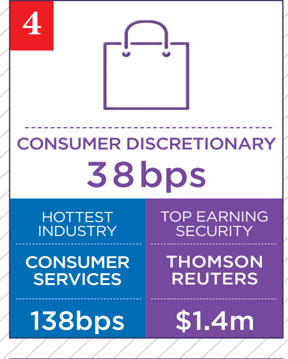
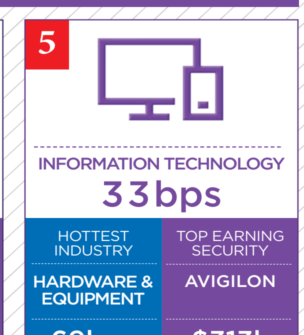
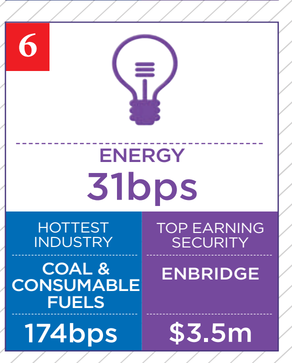


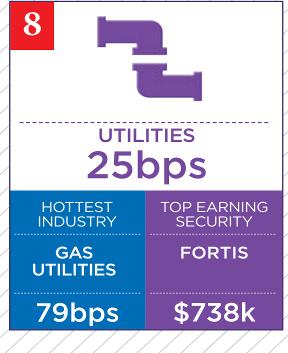
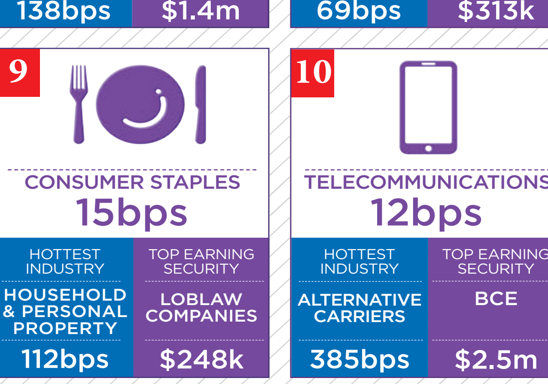




### CANADIAN EQUITY FEES




### TOP CANADIAN SECTORS BY AVERAGE FEE

| Rank | Sector | Average Fee | Hottest Industry | Hottest Industry Fee | Top Earning Security | Top Earning Security Revenue |
|---|---|---|---|---|---|---|
| 1 | HEALTH CARE | 82bps | BIOTECH | 324bps | PROMETIC LIFE SCIENCES | $381k |
| 2 | MATERIALS | 50bps | CONSTRUCTION MATERIALS | 359bps | POTASH CORP OF SASKATCHEWAN | $3.7m |
| 3 | FINANCIALS | 45bps | REAL ESTATE | 88bps | HOME CAPITAL | $6.6m |
| 4 | CONSUMER DISCRETIONARY | 38bps | CONSUMER SERVICES | 138bps | THOMSON REUTERS | $1.4m |
| 5 | INFORMATION TECHNOLOGY | 33bps | HARDWARE & EQUIPMENT | 69bps | AVIGILON | $313k |
| 6 | ENERGY | 31bps | COAL & CONSUMABLE FUELS | 174bps | ENBRIDGE | $3.5m |
| 7 | INDUSTRIALS | 25bps | CAPITAL GOODS | 34bps | CANADIAN NATIONAL RAILWAY | $1.2m |
| 8 | UTILITIES | 25bps | GAS UTILITIES | 79bps | FORTIS | $738k |
| 9 | CONSUMER STAPLES | 15bps | HOUSEHOLD & PERSONAL PROPERTY | 112bps | LOBLAW COMPANIES | $248k |
| 10 | TELECOMMUNICATIONS | 12bps | ALTERNATIVE CARRIERS | 385bps | BCE | $2.5m |

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# Steady as she borrows

## Matthew Chessum of Aberdeen Asset Management discusses the firm's recent challenges and their impact on its securities lending programme

**Aberdeen has endured some difficult market conditions recently. What effect are these negative events having on Aberdeen's securities lending programme, if any?**

As a firm it has been a challenging three years for Aberdeen Asset Management given the weakness in emerging markets. However, we are fortunate in that we have a strong balance sheet and are a globally diversified business.

The securities lending programme within Aberdeen is designed to generate incremental revenues in a risk averse and flexible manner. It is a tool used by Aberdeen to ensure that a fund's assets are constantly put to work for the benefit of our clients. Market conditions do not have any direct impact upon the programme from a risk/reward perspective as securities lending is always managed to ensure that risk management is of paramount importance.

Despite this, the programme remains open to change as long as any modifications meet our risk appetite (which is relatively low). Changes have been made to the collateral schedule and the funds now accept main index equities against equity loans with an increased haircut. The decision to modify the collateral schedule followed intensive research and stress testing of how

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equities behave versus our on-loan positions during periods of market stress.

Due to the strong positive correlation between the underlying loan and the collateral held, it was discovered that the fund was always covered with the haircut remaining pretty much intact. The decision was therefore taken to accept them on a trial period with continued monitoring. This trial period is now over and main index equities form an integral part of our collateral schedule. Revenues have increased as a result, as our funds are now more attractive for the selected borrowers that we agree to lend to.

### How would you describe the health of Aberdeen's securities lending programme? How would you rate its importance during times of stress?

Securities lending within Aberdeen is never going to be at the very top of any fund manager's agenda even during times of market volatility. Securities lending is used as a tool to generate incremental revenues for our clients in a very risk-controlled manner.

The revenues are incremental in relation to the size of most funds so while being another tool in the fund management box, there are many others available that contribute to the funds' overall performance. During periods of stress, as long as the lending revenues continue to justify themselves in relation to any implied risk, as they do during normal market conditions, then the message is very much steady as she goes.

### European markets are being described as difficult in general. Would you agree, and why?

In respect to securities lending, it is true that there does seem to be less demand than in previous years. We have never been a large lender of European securities as we have never lent our securities for general collateral rates. Therefore, we have always been more skewed to the specials end of the market.

Given the composition of our fund ranges, we have always therefore seen more borrowing activity from our Asian, emerging market and small and mid cap funds. European markets from a specials perspective still have pockets of value. Scrip dividends are always in high demand and there are generally one or two specials that we hold in Europe. Given that we are value-driven investors, however, we tend to find that we do not hold too many securities that are special in Europe as they are outside the limited amount of corporate activity that has been going on. Currently, most European specials seem to be directionally driven and we very rarely hold them.

### What do you think lending and repo desks need to do to adapt to these conditions?

Flexibility is key but beneficial owners should not be scared to stick to their guns if any proposed changes from their agents are clearly outside their risk parameters. Given the ongoing cost and increasing scarcity in government bonds, we have found that accepting main index equities as collateral at an increased haircut has worked out well. We insist upon full collateral segregation, daily reporting and quarterly stress testing to ensure that any risks inherent to accepting equities are well monitored. Up until now, despite running the stress test scenarios over several market events and several different time periods, all results have shown that we have remained over collateralised and within applicable tolerances.

Prevailing market conditions helped to nudge us into making this decision but the main driver was to ensure that the funds continue to hold good quality and above all liquid collateral. We were able to make these changes as we only lend to good quality brokers who are monitored daily and because we are still operating firmly within our agents indemnification remit.

### How important is Asia proving to Aberdeen, in terms of securities lending and the wider firm?

Asia is important for Aberdeen from both a firm and securities lending perspective. Some 34 percent of all equity investments are in Asian securities and given that Aberdeen uses intensive first-hand research to find quality companies at the right price, Asia definitely seems to be providing a number of opportunities.

Aberdeen has had a presence in Asia since 1992 with our first office opening in Singapore. Today, the group now has offices in Hong Kong, Thailand, Malaysia, Australia, Japan, Taiwan, Indonesia, China and South Korea. As mentioned previously, our lending programme is more focused on intrinsic lending so owning securities in some less generic markets allows us to ensure that all loans generate meaningful returns as demand to borrow is usually greater or at larger spreads.

Asian securities have always provided a significant portion of our lending revenues in the past and given recent corporate and economic activity are likely to do so in the immediate future. Asia holds many opportunities for lending in relation to new markets and new, more intense pockets of demand. It's an exciting place to be but it has its challenges as information flows and market structure means that securities lending is not as passive as it once was. **SLT**

*Flexibility is key but beneficial owners should not be scared to stick to their guns if any proposed changes from their agents are clearly outside their risk parameters*

**Matthew Chessum,** Investment dealer, Aberdeen Asset Management

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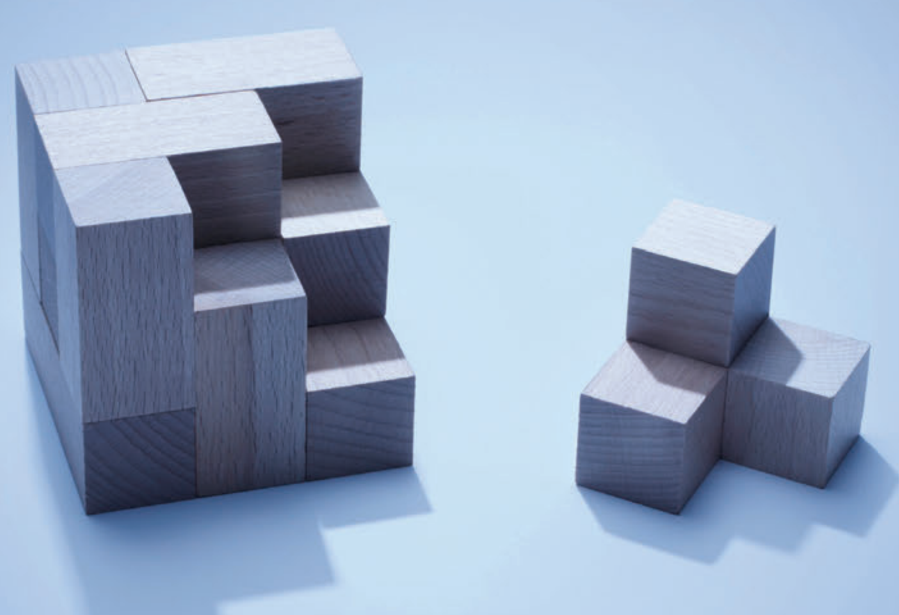

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# Something bold, something borrowed

## Arizona's state pension fund is an old-hand when it comes to securities lending. Director Paul Matson reveals how its programme works

### How long has Arizona's pension fund been open to securities lending and what initially drove the decision?

The Arizona State Retirement System (ASRS) has been involved in securities lending for more than 20 years. The key reasons behind the ASRS's involvement are opportunities for periodic arbitrage-like sources of return, in areas such as tax differentials, as well as a recognition of high-value fundamental (intrinsic) demand for securities, which can generate incremental risk-adjusted income.

### Can you outline the terms of the Arizona pension fund's securities lending programme?

The primary objective in our securities lending program is to generate a relatively high risk-adjusted return from fundamental or intrinsic market demand factors rather than from reinvestment strategies, while being able to preserve principle, ensure adequate liquidity to meet loan redemptions without realised losses, and not significantly encumber the management of the underlying portfolios.

The ASRS runs a modified 'specials only' lending programme with both a non-cash as well as an extremely conservative cash collateral investment strategy intended to provide high risk-adjusted incremental income.

The pension fund accepts both cash (US dollars only) and non-cash collateral, such as US and other developed market securities. Our collateral parameters also allow us to accept both fixed income and equity, with certain restrictions to ensure adequate daily mark to market of the collateral held.

Any cash collateral received is invested in triparty repo agreements that are in turn collateralised at 102 percent. Our repo collateral rules allow for US government securities, including bills, bonds or notes, and US agency securities, such as agency debt and agency mortgage-backed securities.

The margins for the collateral depends on the securities on loan and the type of collateral. Initial and maintenance margins range from 102 percent to 115 percent of the market value of securities on loan with collateral marked daily and maintenance margin adjusted the subsequent business day.

### Is the ASRS able to engage in both open and term lending?

The overwhelming majority of securities loans are standard agency loans that are cancellable or recallable by either the ASRS or the borrower on any given business day with a normal settlement period for the type of security on loan. The ASRS also engages in 'term'

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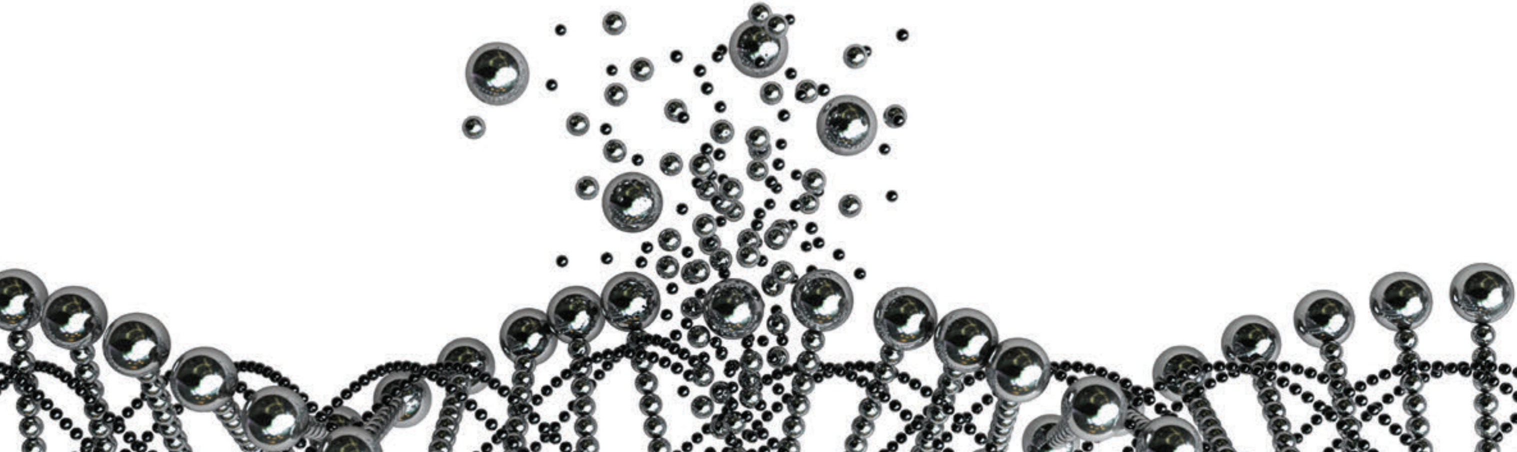

loans and would engage in dedicated programmes as opportunities arise. Term loans are analysed on a case-by-case basis as tactical lending transactions and market condition warrant.

### If Rule 15c3-3 were to be amended to allow equities to be accepted as collateral, would you incorporate that into your programme?

Yes. In essence, we are supportive of collateral that is price correlated with the borrowed securities, which can often be accomplished with equity collateral.

### Who is your agent lender and how active is Arizona in the day-to-day lending process?

State Street acts as our agent lender, with the ASRS setting higher level lending guidelines and overseeing the entire process. For example, on term loans, meaning those that are not immediately recallable, the ASRS actively decides to engage with a borrower and participates in the negotiation of the terms of the loans.

As our custody bank and also our securities lender, State Street is viewed as the agent lender that should bring term and fixed portfolio opportunities to the ASRS. The ASRS does not have an internal lending desk, but does internally manage fixed income and equity portfolios, which assists in market insight.

### What would you say to another state that is considering securities lending?

It appears that the majority of US state pension funds participate in securities lending in one form or another, although during the global financial crisis a number of funds exited securities lending. Most funds have subsequently resumed lending, generally in a more conservative manner.

Should the ASRS be asked, we would respond that we view securities lending in terms of overall portfolio construction, and therefore include securities lending in our asset allocation studies similar to how an asset class would be included.

### Did the ASRS withdraw from securities lending during the economic crisis?

Yes, effectively the ASRS did withdraw in large part from securities lending post-2008 while we reviewed our guidelines and ensured that the market had the requisite liquidity.

### Have your lending terms changed significantly, following the ASRS's decision to return?

Our lending terms have changed somewhat, mainly in two areas. First, we are focused even more on the intrinsic value of the demand side, and second, we are more conservative with our cash reinvestment guidelines.

We are, however, flexible when demand-side opportunities arise.

### Are there any circumstances that could cause you to close down your programme again?

Yes, the ASRS would consider closing its securities lending programme under a number of scenarios, including if the arbitrage-like and intrinsic demand sides for securities were to be eliminated, if the risk of the universe of allowable reinvestment assets were to rise significantly, if over-collateralisation rates were to be notably reduced, or if the overall market liquidity became structurally less liquid.

Quite simply, the ASRS would consider closing its securities lending programme under a scenario where many issues were to occur that resulted in a higher risk/return ratio. For example, if the arbitrage-like demand caused by such things as tax differentials were significantly reduced, possibly via greater global tax harmonisation.

Moreover, if the intrinsic demand side for securities, such as the demand to facilitate shorting, were to be significantly reduced, or the risk/return ratio of the universe of allowable reinvestment assets were to rise significantly, the ASRS would be forced to reconsider the viability of its lending programme.

Finally, if the over-collateralisation rates, which are typically from 102 percent to 105 percent, were to be significantly reduced, or the overall market structure became too cumbersome or became structurally less liquid, then again ASRS would consider leaving the market.

### If the ASRS were to leave, are there other similar revenue streams that you might consider engaging in?

There are no revenue streams that we consider to be direct substitutes to securities lending, but we are always looking for additional return streams, whether it is private market debt opportunites, in-house portfolio management, cash drag minimisation, or any other areas that come to our attention. **SLT**

> ***On term loans, meaning those that are not immediately recallable, the ASRS actively decides to engage with a borrower and participates in the negotiation of the terms of the loans***

**Paul Matson,** Director, Arizona State Retirement System

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# Two steps forward, one step back

## James Burgess, returning chair of the South African Securities Lending Association, discusses the development of the South African market

### How is the securities lending industry doing in South Africa?

The market is very much alive, but it's probably going through what Europe went through between 2008 and 2014. In Europe during that period lenders pulled away, liquidity dropped and prices moved up. That's not exactly what's happening here at the moment though, because we haven't lost lenders by absolute numbers, we have lost volume by those lenders scaling down their portfolios.

Much of the time this is because they have either gone offshore or moved into passive funds. Passive investments can mean, for example, exchange-traded funds, which has taken stock away from the lending pool.

The South African market isn't as deep or sophisticated as we would like at the moment, but we are working hard to change that. To put it in context, for Europe and the US, general collateral runs at anything between 10 and 20 basis points (bps), but in South Africa it's 40 bps. From a European point of view, we look twice as lucrative, but if you look at the market and what's actually out on loan, it's not huge. The South African Securities Lending Association's (SASLA) members only make up about 10 lending desks, working with just under $10 billion of fixed income and equity.

In terms of fee splits, 40 bps is not a great deal of fee to share and so it has to be a service and volume game.

### What is the next big step for South Africa?

We are in an interesting situation because, currently, the Johannesburg Stock Exchange (JSE) guarantees settlement, which is something even Europe doesn't offer. However, the JSE must find a way to continue this feature while migrating from a T+5 to a T+3 settlement cycle, which is happening on 11 July.

The only way that's realistically happening is if the exchange has ample access to sufficient liquidity in stock borrowing, and in this

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regard we need to encourage more lenders in to boost liquidity. The coverage may only be needed for a few days or a week, but, across the market, it's still a huge amount for the exchange to borrow at any one time. The JSE suggests that this may be a couple of thousand trades a day that need to be covered.

The JSE is about to start testing auto-borrow and auto-distribution capabilities, which will be essential to allowing this guarantee to continue in a T+3 environment.

### How is SASLA involved in making this happen?

Our job is to serve our current lenders and make it as simple as possible for them to continue lending, and to provide education that we might encourage new lenders to make their holdings available and making sure they know what's in it for them.

Most of the time, it's a case of explaining the benefits of incremental gains on their portfolio, but sometimes we are still having to explain to market participants why allowing stocks they are long in to be sold short is not actually damaging to their portfolio. Besides the international literature, we have our own study in South Africa that shows that's not the case in our marketplace.

### Are there any opportunities for SASLA to expand to cover the rest of the African continent?

There are SASLA members that are encouraging and supporting the development of securities lending in Africa. I'm sure that they'd be happy to share their thoughts and experiences.

When this develops and they look for guidance in the likes of an industry body, then we will be happy to provide support. But for the moment we will remain South Africa-focused.

### What are your goals as chairman of SASLA for the next 12 months?

SASLA's main aim is to keep the regulator properly educated on the ramifications of the regulation it proposes and enacts. But that doesn't mean we go running to the regulator's office to complain every time something increases our costs.

We are focused on the regulation that affects more than just cost and actually makes it structurally difficult to continue our business.

Another issue is that, although we have been a cash collateral market for years, global trends towards non-cash have reached us and we're finally starting to see a greater move to non-cash collateral. However, the regulatory framework we have in place really isn't set up for non-cash.

Haircut requirements have been created for certain lenders where they require somewhere between a 5 and 15 percent haircut depending on collateral type, which is expensive and would incline a borrower towards cash.

At the same time, Basel III has made it punitive for banks to place cash collateral from a balance sheet perspective. If a bank borrows and gives cash collateral, it is exposed to counterparty risk and therefore must hold capital against it.

This means we have two regulations that are in complete contradiction of each other.

### Do you find regulators in South Africa are sympathetic to these issues and open to negotiation with SASLA?

Yes, to their credit they are very open and always considered in their responses. In South Africa, it is our understanding that they have made the conscious decision not to be the first mover, although not to be the last one either, when it comes to regulation.

This method allows us as an industry to learn the lessons from Europe and the US before deciding upon our own framework.

### Do you find that South Africa is modelling itself on either the European or US regulatory models?

We are happy to be led by the G20's Financial Stability Board. We are a G20 signatory so we have to apply its rulings—but maybe not be first.

Having said that, for our industry we feel that the European Securities and Markets Authority is the most vocal body and so naturally we are more inclined to look to Europe to get an idea of market trends and regulation than we are the US.

### What's your understanding of the South African regulator's thoughts on CCPs?

I think that's a question for the regulator. Even in our industry there is a difference in opinions in this regard. My immediate concern would be the extent of the cost impact and a possible knock-on effect on liquidity. **SLT**

> ***SASLA's main aim is to keep the regulator properly educated on the ramifications of the regulation it proposes and enacts***

**James Burgess,** Chair, South African Securities Lending Association

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# Energy rally breaking bears' conviction

## Fuelled by a recovery in energy markets, high-conviction short trades have turned sour as crowded positions deliver the worst performances since the financial crisis. Markit analyst Relte Schutte reports

Underpinned by rising energy prices, a rally in equities during April has proven quite costly for short sellers.

High-conviction names recorded the biggest spike (losses) in shares seen since the financial crisis, with shorts subsequently covering positions aggressively.

Markit's Research Signals Implied Loan Rate (ILR) factor captures and gauges the demand or 'conviction' among short sellers. By ranking stocks according to prices, shorts are willing to pay to borrow shares. The ILR is able to indicate which names see relatively higher demand, implying more negative sentiment.

Historically, with a 75 percent or more hit rate, short demand has indeed provided valuable signals into which stocks are expected to fall—shorting the top 10-percent of in-demand stocks on a monthly basis has returned close to 120 percent in excess returns since 2007 (underperforming the market on a cumulative basis).

However, the recent rally has interrupted the relationship between conviction and subsequent price declines. The most in-demand names in the US posted the second-highest monthly rise in prices since 2009, jumping by 5.8 percent on an excess returns basis.

This is only the third occasion where the top percentage of in-demand names have posted a monthly excess return above 3 percent, in almost 10 years.

Year-to-date, the most in-demand names are now in positive price performance territory.

More disheartening, however, is that the least-targeted 10 percent of names have in fact posted consecutive price declines since February, falling by 2.8 percent in April.

Not surprisingly, a quarter of names that make up the top 10 percent conviction shorts are energy firms, followed by 19 percent of names in the biotechnology sector.

Showing the extent to which energy names have rallied in the past two months, the most demanded energy names moved on average 27 percent higher in April after already rising some 16 percent in March.

The transportation and materials sectors were the next highest rising sectors on a price basis in April. However, these sectors were less represented among the top 10 percent of conviction trades.

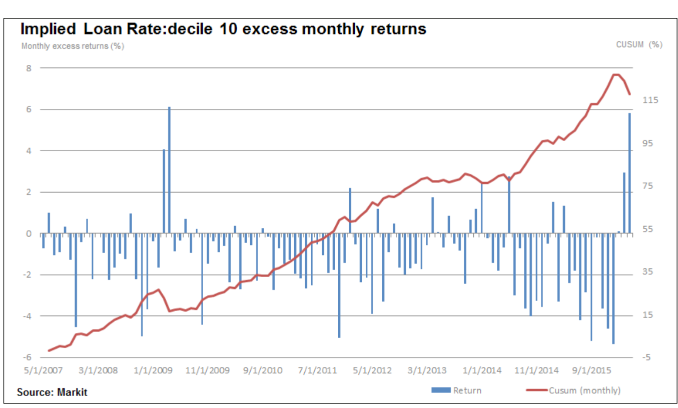
While broad covering in April occurred across a universe of more than 3,000 US stocks, significant covering was seen in the top 20 percent of the most in-demand stocks, which, at the same time witnessed the strongest price increases. In terms of single names surging in April, the top 10, which increased by an average of 85 percent, include some familiar names but were overwhelmingly energy stocks, with an average cost to borrow that was just shy of 20 percent. **SLT**

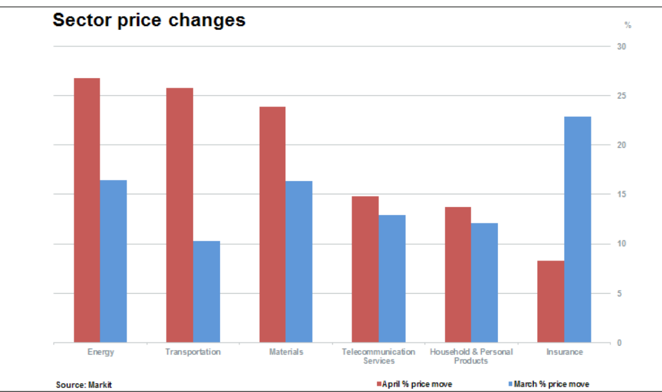
**Implied Cost to Borrow: decile ranks**

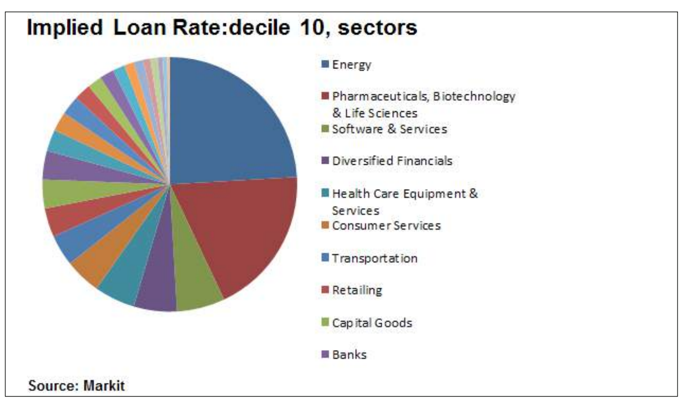
US Total Cap: April change

Source: Markit

Average short interest · price change · Covering



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**Date:** 02-03 June
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**Date:** 21-23 June 2016
**Location:** Vienna
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# Industry **Recruitment**

## Securities Lending Trading (Associate/Vice President)

**Recruiter:** BlackRock
**Location:** London

BlackRock is one of the world's preeminent asset management firms and a premier provider of global investment management, risk management and advisory services to institutional, intermediary and individual investors around the world. BlackRock offers a range of solutions—from rigorous fundamental and quantitative activemanagement approaches aimed at maximising outperformance to highly efficient indexing strategies designed to gain broad exposure to the world's capital markets.

## Systems Analyst Role

**Recruiter:** EquiLend
**Location:** London

EquiLend is seeking a systems analyst for the London office to work closely with the EquiLend product owners and scrum team to execute projects from inception through production release.

## Senior SoftwareEngineer

**Recruiter:** EquiLend
**Location:** New York

EquiLend is seeking a Senior Software Engineer (.NET) to participate in all stages of development for several applications within the enterprise.

## Business Analyst, Prime Finance

**Recruiter:** Citi
**Location:** Dublin

Investor services is a business line within markets and securities services, it includes products across prime finance, delta one, futures, OTC clearing, collateral management, global custody, fund administration, and agency lending.

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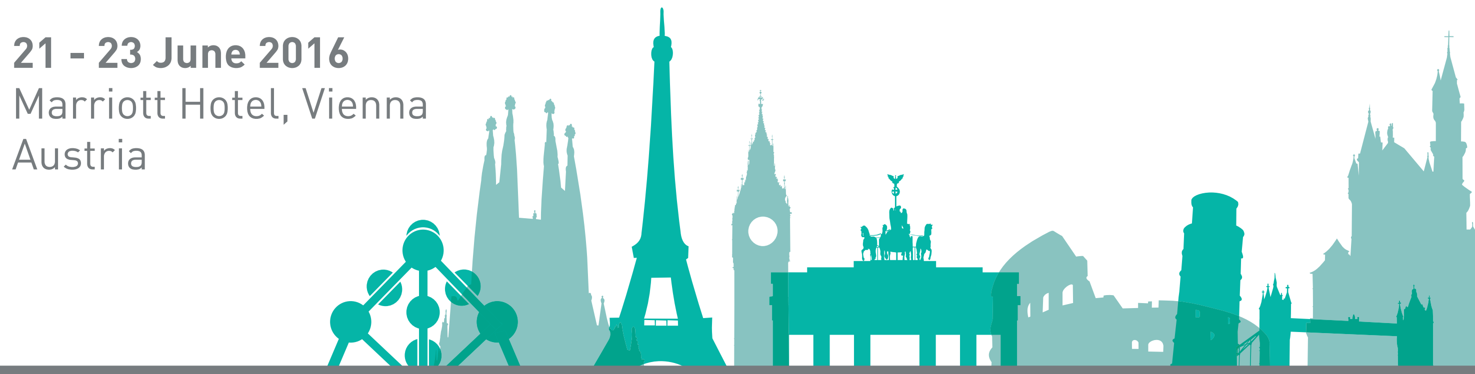

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ISLA is delighted to announce its keynote speakers for this year's **25th Annual Securities Finance and Collateral Management Conference**.

## SPECIAL KEYNOTE ADDRESSES

**Steven Maijoor**
Chair
***European Securities and Markets Authority (ESMA)***

**Harald Müller**
Deputy Head of Treasury Strategy Division
***Oesterreichische Nationalbank (OeNB)***

**Lord Evans of Weardale KCB DL**
*Former Director General of the British Security Service MI5 from 2007 to 2013*

**FOR ALL CONFERENCE INFORMATION**

Email: isla@eventrock.co.uk
Tel: +44 (0) 208 288 7738
Web: **www.isla.co.uk/isla2016**

**FULL AGENDA LIVE**

Moderators and speakers have now been announced! For all the latest agenda developments join our linkedin group.

# EquiLend, Societe Generale and Wilmington Trust all feature

EquiLend has appointed **James Moroney** as director and trading product specialist.

Moroney, who will be based in New York, will liaise with clients and work on the continued rollout of the Next Generation Trading (NGT) platform.

Moroney said: "I have been an EquiLend user for many years and am intimately familiar with the efficiency and benefits of its broad service offering as the leading provider of securities finance technology."

"I am very excited to join EquiLend and help bring NGT, which is truly transforming the way securities finance industry trades, to the global marketplace."

He brings more than two decades of experience in securities finance and related industries to the role.

Prior to joining EquiLend, Moroney was managing director and head of North American equities trading within State Street's securities lending business.

Brian Lamb, CEO of EquiLend, commented: "Jim Moroney's many years of experience in the securities finance industry, especially his broad trading expertise, are a great asset to EquiLend. We are thrilled to welcome Jim to the team."

The NGT platform, which launched in April 2015, has shown strong growth in trading volume and client use over the past 12 months.

Currently, 62 of EquiLend's more than 100 clients are onboarding to NGT and an average of 31 are already using it for daily trading.

The latest NGT data valued the daily average notional traded on the platform at $1.4 billion, with 77 percent of trades considered 'warm' and 'hot' versus 15 percent AutoBorrow.

There are also 14,000 indication of interest trade requests received and processed daily.

Societe Generale has appointed **Charlie Day** to run the bank's equity prime brokerage business.

Day is now head of equity prime brokerage for Societe Generale Prime Services. Previously, he was global head of synthetics prime brokerage and head of prime services for Europe and Asia at Scotiabank.

Day will continue to be based in London and report to Frederic Colette, deputy head of prime brokerage and clearing sales.

Societe Generale has also created a new digital office within its global banking and investor solutions division and appointed **Alain Fischer** to run it as chief digital officer.

In the newly-created position, Fischer will be responsible for defining digital strategy and for encouraging the use of digital solutions in global banking and investor solutions. He will report to Didier Valet, head of global banking and investor solutions.

Fischer has been at Societe Generale since 2007, when he joined the corporate and investment banking cash equity team as global head of operations and technology. He later became global head of operations and technology for the research and strategy department, and in 2013, was made global head of e-business for global markets.

The new digital office will coordinate on products related to digital transformation, will contribute to investment strategy in working with external platforms, and promote consistency in digital initiatives.

Valet said: "Digital technology is impacting the way we interact with clients and serve them, providing a world of opportunities to innovate while deeply transforming our businesses. In order to bring more value to our clients and maintain our competitiveness, we are accelerating our digital transformation to be more agile in a changing environment."

Fischer said. "The digital office will enable us to go further in simplifying our architecture and tools, and delivering customised web services with unique access points and optimised interfaces to all users."

"With these key principles, we will enhance the user experience and deliver innovative tailored services to our clients while monitoring technological developments which could support the transformation of our businesses."

Wilmington Trust has hired **Scott Linden** as product leader for its collateral management business within its global capital markets division.

Linden will oversee collateral management as part of the institutional custody business.

He is responsible for administration of the business, as well as product development and growth.

According to Wilmington Trust, Linden will prepare the trust for compliance with new regulations coming into force over the next 12 months.

He will also launch an outsourcing product that covers margin functionality across products for clients experiencing significant growth in volumes.

Prior to joining Wilmington Trust, Linden was director of collateral management consulting at Perficient. Before that, he worked at BNY Mellon as collateral management product manager.

Amy Stengel, managing director of institutional administrative services at Wilmington Trust, commented: "We are thrilled to add Scott Linden to our team."

"Scott Linden's expertise will help position Wilmington Trust to be very competitive in the collateral management space, particularly as the financial markets prepare for the upcoming regulations for derivatives transactions."

**Lauren Gaspar** has joined Charles Schwab as managing director of securities lending.

According to Charles Schwab, Gaspar will allow the US broker to offer additional market insights, enhanced relationships with counterparties and improved short sale and fully paid products for its clients.

The firm's securities lending team is based in San Francisco but Gaspar will remain in New York to provide a "feet on the street presence" for the company.

Gaspar spent the past 11 years at SunGard Securities Finance, now FIS, focused on data analytics and reporting products. **SLT**

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