CIBC MELLON

Stewarding Stability, Security and Revenue Growth

AUGUST 2023

ROB FERGUSON

Chief Capital Markets Officer

Rob is responsible for CIBC Mellon's capital markets functions, including global securities lending, treasury services and foreign exchange processing, and settlement services. He is also responsible for bringing advanced capital markets solutions from BNY Mellon's Markets Group and CIBC's Capital Markets group to support Canadian asset servicing clients in navigating today's complex market environment.

Explore with us

We would be pleased to discuss these themes further, including exploring them in the context of our ongoing Canadian and global research efforts. Please don't hesitate to contact your relationship manager to arrange a discussion.

I was pleased to be featured in an article on the Canadian securities lending market for Issue 327 of Securities Finance Times Magazine. The article entitled, "Stewarding Stability, Security and Revenue Growth," covered how Canada's securities lending market is poised for continued growth in 2023, driven by improved demand, advances in technology and a progressive regulatory environment.

The Canadian securities lending market maintained high standards of risk management and service delivery during 2023. During the past year, the industry has negotiated the challenges of adapting to new regulations and market changes, evolving technologies and the push for further integration and transparency into environmental, social and governance (ESG) principles.

Last year, we saw a number of the large Canadian banks take advantage of their strong balance sheets to shop for acquisitions. BMO took over the Bank of the West, RBC agreed to acquire HSBC Canada, and TD Bank Group acquired Cowan and recently terminated the previously announced purchase of First Horizon.

With the regulators boosting capital requirements, the Canadian banks also issued discounted Dividend Reinvestment Plan (DRIP) programs which have been a major driver in the Canadian equity space. On this note, we continue to see vibrant loan demand in the natural resource sector, specifically pertaining to energy and rare earth minerals necessary for electric vehicle (EV) battery production.

More broadly, collateral flexibility continues to be key. There is continuing demand for collateral transformation trades in the fixed income space, with demand rising around quarter ends. There has been an uptick in term loans in Canada, including transformation trades in our program as the federal banking regulator, Canada's Office of the Superintendent of Financial Institutions (OSFI), introduced a requirement for the Canadian chartered banks to start reporting their Net Stable Funding Ratio (NSFR). Canadian dealers are also solving for Liquidity Coverage Ratio (LCR). These regulatory requirements have resulted in an increased reliance on securities lending activity as a liquidity tool.

Furthermore, Large Exposure and Counterparty Credit Limit (SCCL) requirements have prompted agent lenders to continue to diversify their borrower base, as well as exploring other routes to market such as via a CCP. These regulatory drivers have also highlighted the cost of indemnification for agent lenders.

Monetary tightening and geopolitical drivers

The Canadian financial services market is known for its strength. Typically, we see global investors looking to Canada as a source of stability during times of global uncertainty and volatility. With increased volatility comes increased securities lending volume. Securities finance plays a role in supporting clients and providing a solid infrastructure for Canada's capital markets. We recognize that financial stability through market cycles is essential.

Recent central bank rate increases have been beneficial for clients that participate in a cash collateral program. With the increase in rates, spreads have widened and this has generated more in incremental revenues from a cash reinvestment program. Cash has been king over the past year. Rising interest rates have also placed additional pressure on companies that are looking to refinance maturing debt, resulting in higher demand in the high yield and distressed corporate bond space.

ETF demand has increased from firms wishing to build exposure to certain asset classes and from some portfolio managers as a hedge for their long portfolios, protecting their positions from volatile short term swings in the market. Recent pressures on US regional banks have resulted in stronger demand for financials, particularly in the US market. This said, the Canadian financial ecosystem has a well-earned reputation for stability. This reflects the structure of our banking system, together with sound risk management and an emphasis on governance and robust regulation in our financial institutions.

Technology, innovation and automation

For our global enterprise, clients have been looking to take advantage of integrated capabilities across our parent companies — bringing in global data solutions or local market correspondent banking, for example, while extending and streamlining clients' access to markets.

Against this backdrop, the securities finance industry has continued to apply technology to deliver automation across the lifecycle of a securities financing transaction. Participants are seeking further automation, greater transparency into investment activities, and flexible and timely access to data, all the while respecting and navigating a rapid rise in regulatory and market complexity.

The impact of greater automation and technological innovation is consistent with promoting more efficient, effective and transparent investment operations and, ultimately, better optimization outcomes for clients. These objectives have underpinned the industry's development planning for decades, from the first straight-through processing (STP) to today's data-driven investment operations. Stewarding stability and security Regulatory factors continue to drive and influence borrower requirements, with agent lenders adjusting to their constantly changing needs. As we mentioned in our introduction, liquidity coverage ratio (LCR) requirements are currently top of mind — referring to the proportion of high-quality liquid assets (HQLA) held by financial institutions to ensure their ongoing ability to meet short term obligations — along with the net stable funding ratio (NSFR), which is the liquidity standard requiring that banks hold enough stable funding to cover the duration of their long-term assets. As a result, we have seen an influx of term loans, including Government of Canada bonds, US treasuries and provincial debt. We have also witnessed stronger demand for transformation trades as borrowers look to upgrade lower-grade collateral, such as equities, for HQLA.

Furthermore, market participants await the US Securities and Exchange Commission's (SEC's) finalized proposal for SEC 10c-1, requiring lenders of securities to provide the material terms of securities lending transactions to a registered national securities association. In February 2022, the Commission proposed Rule 13f-2, which is designed to provide greater transparency through the publication of short sale related data to investors and other market participants. These initiatives aim to promote financial stability, mitigate systemic risk and protect market participants. On 8 September 2022, the Canadian Securities Administrators announced the introduction of a new prospectus exemption, the Listed Issuer Financing Exemption, to provide a more efficient method for issuers listed on a Canadian stock exchange to raise capital. With this, reporting issuers trading on a Canadian exchange that have filed all required timely and periodic disclosure documents will be able to use this exemption to distribute freely tradable equity securities without preparing a prospectus. In doing so, they will be able to rely on their existing continuous disclosure record, supplemented with a short offering document.

The road to T+1 settlement

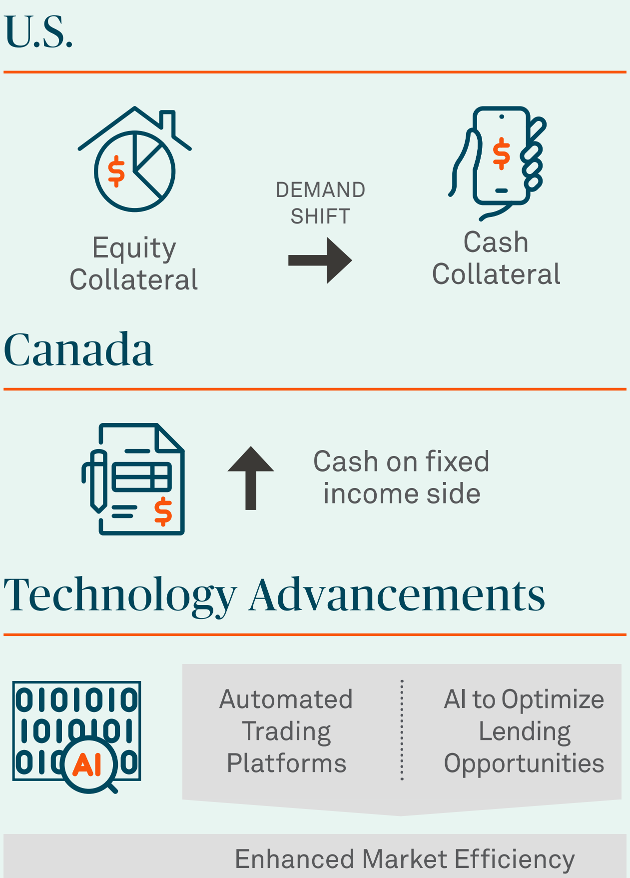
As an industry, we are continuously looking to improve the efficiency and resilience of our markets, with a particular focus on standardization, digitization and high governance standards. Canadian and U.S. market stakeholders — including U.S. and Canadian central securities depositories, the Canadian Capital Markets Association (CCMA), and industry participants such as CIBC Mellon — have begun preparations designed to shorten the settlement cycle in Canada to T+1. With this development, we anticipate more pressure particularly in the warm and hard-to-borrow space. Often the agent lender will receive the sale notification either late in the day or on the following day, resulting in the recall being processed a day late. Under T+1, this would result in the recall being sent out on a T+0 basis, without giving the borrower time to source additional supply elsewhere or to buy back the position. Potentially, agent lenders may need to hold larger buffers to accommodate late sales in less liquid names, thereby reducing maximum potential revenue on the total position. Consequently, the industry may need to consider modifying deadlines for accepting and processing recalls, for example, with deadlines potentially extending into the evening. Beneficial owners will need to look at ways to provide notifications to their agent lender more efficiently, whether that is through automation or an improved batch facility.

For our global enterprise, clients have been looking to take advantage of integrated capabilities across our parent companies – bringing in global data solutions or local market correspondent banking, for example, while extending and streamlining clients' access to markets.

Aligning for the future

The Canadian securities lending market has remained resilient and continues to show encouraging signs of growth, driven particularly by stronger demand from institutional investors seeking to enhance returns. In particular, we have seen a demand shift out of equity collateral and into cash collateral from U.S. players. In Canada, we have seen a pickup in demand for cash on the fixed income side. Alongside this, advances in technology have been key in enhancing the market's efficiency, with automated trading platforms, and use of artificial intelligence to optimize lending opportunities, contributing to the market's expansion. The Canadian government's commitment to promoting a stable and secure financial market has further bolstered the outlook for the securities lending sector. Its proactive regulatory measures and efforts to improve transparency and risk management practices have garnered the confidence of investors and facilitated a favourable investment climate. In February, Canada's Office of the Superintendent of Financial Institutions raised its Domestic Stability Buffer requirement 50 basis points to 3 per cent. As organizations adjusted their capital planning to the revised requirement, we saw greater activity in dividend reinvestment programs. Looking ahead, we anticipate that this activity may subside as domestic banks readjust to the macroeconomic environment.

Overall, the Canadian securities lending market is poised for continued growth in 2023, driven by increased demand, technological advancements and a favourable regulatory environment. With a reputation for stability, efficiency and transparency, the industry is well-positioned to attract a diverse range of investors and its outlook remains positive for the foreseeable future.



The impact of greater automation and technological innovation is consistent with promoting more efficient, effective, and transparent investment operations and, ultimately, better optimization outcomes for clients.

Regulatory factors continue to drive and influence borrower requirements, with agent lenders adjusting to their constantly changing needs. Liquidity coverage ratio and net stable funding ratio considerations are currently top of mind.

For more information

CIBC Mellon is pleased to engage with clients on this front and continue the conversation. Please contact your Relationship Manager if you would like more information.

CIBC MELLON

A BNY MELLON AND CIBC JOINT VENTURE COMPANY℠

www.cibcmellon.com

000 - KL53- 05- 23