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The road to innovation and future proofing

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

State Street executes centrally cleared repo trades at Eurex

State Street has selected Eurex as its first clearing house outside of the US to trade and centrally clear repo transactions.

The first transactions have now been executed on Eurex through State Street's Munich-based subsidiary State Street Bank International (SSBI).

State Street says the power of multilateral netting aims to provide tangible risk management and collateral optimisation benefits to its client base. Through its Eurex membership, State Street intends to expand its European franchise and service offering.

Eurex's liquid and centrally cleared repo markets allow clients to trade repos with more than 160 registered participants, including commercial and central banks, as well as government financing agencies and a range of supranational organisations.

The platform aims to help market participants to raise or place cash efficiently and securely against more than 13,000 domestic and international securities.

With the current market environment of increasing interest rates, targeted longer-term refinancing operations (TLTRO) repayments, and further reduction of excess liquidity, Eurex has observed a "significant increase" in trading activities and has reached new record volumes in its cleared repo markets.

During the first four months of 2023, Eurex's total traded volume across all markets increased by around 120 per cent compared to the same period in 2022, driven by a 37 per cent YoY rise in traded volume in the repo market and an estimated 340 per cent YoY increase in GC Pooling, according to Eurex.

Frank Gast, member of the management board of Eurex Repo, says: "We welcome State Street Bank International as a trading and clearing member of Eurex Repo and Eurex Clearing. The opportunities in the European repo market are immense and Eurex is excited to facilitate SSBI's growth with our centrally cleared and innovative offerings."

Travis Keltner, global head of repo and alternative financing solutions at State Street, adds: "Eurex's ample access to stable market liquidity significantly enhances State Street's liquidity tool kit.

"With this membership, State Street can build upon the launch of this Eurex clearing foundation to further support our clients' needs, especially in capital efficient trading and clearing."

Key contents

MoraBanc selects Sharegain to support securities lending

MoraBanc has chosen Sharegain's Securities Lending as a Service (SLaaS) to deliver securities lending services to its private banking customers.

The Andorra-based banking group, with offices in London, indicates that Sharegain's SLaaS solution will enable it to connect all asset pools to one centralised securities lending solution and to generate new revenue from its assets under custody.

Carlos Salinas, MoraBanc's head of digital assets and fintech, says: "We always look for ways to add value to our clients and Sharegain's SLaaS solution will enable our private banking clients to benefit from a new source of income on their investment portfolio, through securities lending."

Sharegains's CEO and founder Boaz Yaari comments: "We are proud to collaborate with the outstanding team at MoraBanc and are excited by the opportunity to deliver greater value to them and their clients."

Global securities lending revenue jumps 27% YoY for April

The global securities finance industry generated US$1.05 billion in revenue for lenders in April 2023, a 27 per cent year-on-year (YoY) increase from April 2022, DataLend reports.

Global broker-to-broker activity, where broker-dealers lend and borrow securities from each other, totalled an additional US$279 million in revenue for the month of April, representing a 22 per cent YoY increase.

Month-over-month, the revenue generated for lenders in April (US$1.05 billion) amounted to a 3 per cent rise from the revenue accumulated in March 2023.

According to DataLend, the improvement in lender-to-broker revenue over 2022 was largely due to a continued increase in fees. Globally, across all asset classes, lending fees climbed 32 per cent YoY and 9 per cent from March 2023.

A strong market for global equities helped increase revenue by 45 per cent YoY in North America, the market data service of fintech EquiLend reports.

Revenue also increased 16 per cent in EMEA and 7 per cent in APAC YoY in April.

Securities trading "special," where fees meet or exceed 500 basis points (bps), generated US$525 million, a 52 per cent increase over the same period last year and up 10 per cent from the previous month.

The top five earners in April 2023 according to DataLend were AMC Entertainment Holdings (AMC), Upstart Holdings (UPST), Lucid Group (LCID), GameStop Corp (GME) and DNB Bank (DNB NO).

In total, the group generated US$151 million in revenue in the month — US$48 million more than the top five returned in March.

Performance was also strong for corporate and government debt, with YoY revenue improvements of 67 per cent and 5 per cent, respectively. However, revenue from lending government debt declined by 11 per cent from the previous month.

Eurex Repo volume up 77%

Trading volumes on Eurex Repo have risen 77 per cent YoY to €359.0 billion for April, also representing a significant month-on-month increase from the €296.5 billion average daily term-adjusted volume reported for March.

This year-on-year growth was driven by a 172 per cent YoY increase in GC Pooling average daily term-adjusted volume to €149.0 billion and 41 per cent YoY growth in special repo average daily volume to €210.0 billion.

For OTC derivatives clearing, notional outstanding volumes have risen 21 per cent YoY to €33,126 billion.

This growth has been driven by 13 per cent YoY expansion in notional outstanding for interest-rate swaps to €13,834 billion for April, of which overnight index swap clearing volumes have risen 52 per cent YoY to €2,917 billion.

Average daily cleared volumes through Eurex Clearing have contracted 32 per cent YoY for April to €159 billion.

This features a 5 per cent YoY decline in average daily cleared volume for interest rate swaps, although overnight IRS average daily cleared volume was up 88 per cent YoY for April to €15 billion.

OCC cleared securities lending volumes drop

Securities lending volumes cleared on the Options Clearing Corporation (OCC) platform declined 2.6 per cent year-on-year to 184,553 trades for April 2023.

The average daily loan value for securities lending trades cleared on the Chicago-based platform contracted 1.4 per cent YoY to US$132.3 billion.

For futures and options contracts, total volume for all futures and options cleared through OCC has dropped 2.4 per cent YoY to 764.3 million transactions for April 2023.

Year-to-date average daily volume for all futures and options cleared on the platform through April 2023 was 44.9 million contracts, up 7.2 per cent compared to YTD average daily volume through April 2022.

The platform experienced a 43.2 per cent YoY hike in index options contracts for the month to 67.2 million and a 19.1 per cent YoY decline in cleared futures contracts to 3.5 million.

ETF options contracts cleared on OCC rose 4.9 per cent YoY for April to 308.9 million.

In contrast, equity options contracted 12.0 per cent YoY to 384.6 million for April.

BoE amends schedule for 7-day US dollar repo operations

The Bank of England (BoE) has made changes to seven-day US dollar repo operations, which will commence from 1 May 2023.

Seven-day US dollar liquidity-provision operations will revert from daily to once per week, with operations expected to run on Wednesdays.

This change comes in light of improvements in US dollar funding conditions and the low demand at recent seven-day maturity US dollar liquidity-providing operations. The BoE, the Bank of Japan, the European Central Bank and the Swiss National Bank, in consultation with the Federal Reserve, will enact operational changes from 1 May 2023.

Alongside this update, the UK central bank will also revert from daily to weekly seven-day maturity operations which provide liquidity via the standing US dollar liquidity swap line arrangements.

The swap lines among central banks are available standing facilities and serve as an important liquidity backstop to ease strains in global funding markets, thereby helping to mitigate the effects of such strains on the supply of credit to households and businesses, domestically and abroad.

The update follows an announcement from a number of central banks in March that have started to unwind temporary changes to their liquidity-providing operations, through the US dollar liquidity swap line and repo operations, introduced in response to the Credit Suisse Group crisis.

The BoE says it continues to stand ready with other central banks to re-adjust the provision of US dollar liquidity as warranted by market conditions.

Tradeweb Markets expected to acquire Yieldbroker

Tradeweb Markets is expected to acquire Yieldbroker, an Australian government bond


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and interest rate derivatives trading platform for AUD125 million (US$85 million).

Yieldbroker covers the institutional, wholesale and primary markets. Tradeweb is a marketplace for rates, credit, equities and money markets.

The mandate is expected to draw on both firms' trading solutions and industry experience to create more liquid, transparent and efficient fixed income markets.

Tradeweb customers would also benefit from pre-trade transparency and coverage of the Australian and New Zealand debt capital markets, the firm says.

It adds that the acquisition would provide Yieldbroker's domestic client network, including superannuation funds, with access to its global multi-asset platform, liquidity and technology.

A spokesperson for Tradeweb says: "Australia is home to the fifth-largest pension fund market globally, and we believe that this acquisition would help grow Tradeweb's Asia Pacific footprint and provide meaningful opportunities for domestic and global clients.

"Tradeweb can offer no assurance that a definitive agreement will be entered into, or if entered into that a transaction will be consummated. The potential deal remains subject to Yieldbroker stockholder approval, final definitive documentation and would be subject to customary closing conditions and regulatory reviews."

Software firm Regnology acquires Metadata Technology

Software and regulatory reporting solutions provider Regnology has acquired Metadata Technology to enhance its technology offering.

Regnology says the acquisition marks a step forward in its ambition to serve the community of regulators and regulated financial institutions.

Regnology adds that it aims to serve organisations by providing solutions designed to address “the data conundrum” and regulatory complexity with streamlined workflows and increased efficiency.

As part of the acquisition, Regnology will take over UK-based firm Metadata, which provides Statistical Data and Metadata eXchange (SDMX) solutions for central banks and national statistics authorities.

SDMX is an ISO standard designed to describe statistical data and metadata while improving sharing across statistical organisations and institutions.

Metadata’s software solutions are built on open-source technology, in particular, the Fusion Metadata Registry (FMR), which currently empowers more than 450 statistical agencies globally with structural SDMX metadata registries.

Commenting on the acquisition, chief revenue officer at Regnology Maciej Piechocki says: “The team at Metadata has built a stand-out technology trusted by central banks and statistical agencies across the globe.

“We are committed to pursuing the effort to foster widespread SDMX adoption to alleviate the strain of reporting and further increase statistical processing efficiency.

Through the deal, we are pleased to be able to bring an enhanced offering to our existing community of regulators and authority bodies.”

Chris Nelson, CEO of Metadata and founder of the SDMX protocol, adds: “Looking back to 2005, the ambition behind the introduction of SDMX was to reduce the cost and time-to-market of statistical data and metadata.

“Fast-forward to today, we help empower a vibrant and ever-growing global SDMX community with better-quality statistics. We are confident this acquisition will pave the way for more benefits in the future.”


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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The benefits of tokenisation cannot be understated. We recognise

"One asset class that continues to provide upside for our clients is convertible bonds. In recent years, new hedge funds entering this space and limited market supply have led to an increase in demand and revenue returns"

Chris Barrand
Co-head of securities finance trading and product

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

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

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

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

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

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

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

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

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

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

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

Canada securities lending panel

Securities lending specialists reflect on the drivers of performance in the Canadian market over the past 12 months, key changes in technology and market practice and how the future looks for the rest of 2023 and beyond

Panellists

Kyle Kolasingh, head of market services solutions, **RBC Investor & Treasury Services**

Lori Paris, head of client management, North America, **Northern Trust**

Mary Jane Schuessler, managing director, Global Equity Products, **BMO**

Ahmed Shadmann, head of agency lending trading, Toronto, **State Street Global Markets**

Mathilda Yared, managing director, Global Securities Finance, **National Bank Financial Inc.**

How do you assess the performance of the Canadian securities lending market over the past 12 months?

Mathilda Yared: The Canadian securities lending market fared relatively well in the past 12 months, despite challenging market conditions marked by a higher interest rate environment, reduction in funding needs and stress in the US and EU banking sectors. Balances shifted to lenders that could support wide collateral schedules, with a focus on access to liquidity, stability of trades, diversification and automation of execution.

We expect names that make up the TSX60 index to make their way into the top 10 revenue generators for Canadian equities, with a corresponding increase in utilisation. Increased short interest for names in the cannabis and cryptocurrency sectors, including Canadian exchange-traded funds (ETFs), also acted as a driver of utilisation and revenues.

The Canadian market experienced an upturn in Canadian-bought deals across various sectors, together with demand from retail clients and hedge funds, resulting in increased loan balances, utilisation, and revenues on names that otherwise would not have been on our radar.

Finally, US securities in the electric vehicle space and meme stocks have also been revenue generators for Canadian banks.

Kyle Kolasingh: There has been positive momentum in the securities lending market here in Canada over the past year. Overall fees, utilisation of assets and returns have seen double-digit growth during this time. Growth on the equity side has been primarily fuelled by erratic market conditions and ongoing usage of exchange-traded funds (ETFs) in hedging. Several cannabis names have rejoined the list of top equity earners, while financials and energy names continue to round out the top borrowed stocks. Like equities, the demand for fixed income assets has also increased.

In addition to directional plays, we have noticed a direct correlation between an environment of rising interest rates coupled with quantitative tightening and the demand for government assets and corporate bonds — particularly sovereigns and high yield, non-investment grade instruments.

Lori Paris: In the Canadian marketplace, average fees, utilisation and overall returns have increased year-over-year in Northern Trust's agency securities lending programme, driven primarily by demand for fixed income assets. Canadian government, provincial and corporate bond demand was spread across both the open and term loans. Canadian equities also experienced higher demand, with an overall marginal revenue increase in the asset class as on-loan market values were down compared to the previous year. Hedge funds continued their net-long bias, however. The Canadian equity specials environment saw a slight increase in relevance as measured by average fees over the previous year, as several equities continued to produce significant gains overall.

General collateral (GC) — those securities that have the least amount of demand and are typically used for financing — were in less demand, while there was an increase in demand for exchange traded products (ETPs) such as

ETFs because they are an efficient way to hedge or gain exposure to an entire index. The energy, specialty healthcare, pharmaceuticals and raw materials or mining sectors were prominent in driving revenue in Canada's securities lending markets. In addition, holdings in Canadian Dividend Reinvestment Plan (DRIP) names saw healthy utilisation year-over-year and continued to generate positive returns across the programme.

In the fixed income securities lending market, the collateral upgrade trade was a large driver of revenue for the past 12 months as demand continues for high-quality liquid assets (HQLA) and financial institutions look to optimise their balance sheets by pledging a wider array of non-cash collateral including equities, corporate and convertible bonds.

Ahmed Shadmann: The past 12 months have been a roller coaster ride, with the shadow of recession looming over the economy the entire time. The Canadian market experienced the fastest central bank rate tightening regime since the 1980s on the back of decades-high inflation and a tight labour market, which set the stage for market uncertainty and unease. This came in the form of a market sell-off south of the border in the first half of 2022 and that contagion spread into the Canadian market. We noticed short-interest pick up across multiple sectors, but particularly technology, crypto, cannabis, mining, and electric vehicle and related industries.

The increasingly high interest rate environment saw the street position itself for corporate bond defaults, particularly those dwelling in the high yield space. That drove the borrow rates higher for companies that had piled on their balance sheet with debt in the easy money era. We also continued to experience high demand for borrows of government bonds across the yield curve, but that focus shifted to the front-end as the Bank of Canada continued on its rate hike path.

Generally, the above-mentioned factors have contributed to a year-over-year increase in earnings throughout our Canadian lending programme into 2023.

Central bank monetary tightening has been accompanied by significant geopolitical instability over the past 12 months. What challenges and opportunities is this presenting for your securities lending business?

Mary Jane Schuessler: The second quarter of fiscal 2023 has certainly brought its fair share of challenges between the heightened risk environment, cash and balance sheet concerns as well as deeper counterparty risk analysis and reviews. Unfortunately for the securities finance business, most opportunities exist when the market is healthy and fully functioning. As the central banks raise interest rates globally, there has been a general contraction in cash and therefore less financing opportunities exist as well. Volatility, however, can be good for the specials markets and we have seen some very interesting opportunities and new entrants to the lending space. Cannabis shorts have made a comeback, with some M&A activity in the space as well. The meme stock craze has also continued, with heavily shorted names in crypto and the electric vehicle space creating attractive lending revenue.

Shadmann: Record high inflation, tight labour markets, decades-high interest rate and the ensuing stock and bond market

rout resulted in market participants stepping into unknown and unchartered waters. Add continued geopolitical tension to the mix and we seem to have all the ingredients to create the perfect storm. This heightened uncertainty across both the equity and bond space made our clients pause in the second half of last year to re-evaluate their risk appetite for types of acceptable collateral. The concerns were quickly alleviated as clients became comfortable with the robust internal risk mechanism we have in place for collateral management. Once that challenge was put to rest, we found opportunities to deploy client assets in the short-interest driven space and to satisfy liquidity needs. Further, State Street's Direct Access peer-to-peer lending and Venturi peer repo platforms have helped further to alleviate our client risk concerns as they provide additional distribution routes to market.

Kolasingh: Market volatility has become a somewhat "colloquial" term of late. For the fourth consecutive year, the first quarter experienced market disruption on a global scale: the onset of the pandemic, the meme stock craze, the Russia-Ukraine crisis and now an unfolding banking crisis. The challenge over the past 12 months, and historically, has been to continue to drive alpha — the fire that fuels our industry's engine — with a potential risk-reward trade-off. The securities finance industry has a proven ability to pivot and our resiliency is without question. That said, each scenario brings unique opportunities, whether it be new areas of directional interest or increasing demand for HQLA. The dominating drivers of Canadian HQLA have traditionally been liquidity and regulation. To this end, increasing interest rates, combined with quantitative tightening, have resulted in a noticeable uptick in utilisation of government securities, both sovereign and provincial.

Paris: A number of risk events in the past few months have led to souring sentiment and a flight-to-quality bid which saw investors pivot to the front-end of sovereign yield curves. In addition, the Federal Reserve continued to fight surging inflationary pressures, lifting the Federal funds range to 4.75-5.00 per cent by March. This has created an environment that has led to robust demand in the securities lending markets over the past 12-month period with on-loan volumes and fees remaining elevated.

With the 2-year US treasury yielding up to 5.00 per cent during the period, investors continued to pivot to the relative safety of the US government and parked cash in the short-end while waiting for greater economic and monetary policy certainty. This situation was amplified in the first quarter of 2023 as regional US mid-size banks Silicon Valley and Signature came under significant pressure, forcing government intervention to secure depositors across the sector. The demise of European giant Credit Suisse added to market stress and flight-to-quality activity in securities finance markets. These events further increased borrowing appetite for US treasuries and other highly rated sovereign bonds.

It has been a similar story in international sovereign markets, with global bonds remaining heavily sought. In a continuation from last year, European sovereign debt, notably core countries such as Germany, France and the Netherlands, were all in high demand, with fees widening accordingly. There were further signs of collateral scarcity emerging such as the overwhelming demand for bonds. It was a similar story in the UK, with surging gilt yields providing robust shorting activity along the curve and significant demand to source gilts. The situation was intensified in September given the volatility and disorder in the liability-driven investment (LDI) fund construct, which triggered forced sales and a series of emergency interventions by the Bank of England.

These events also impacted corporate and emerging market bond prices with increasing yields, higher funding costs and economic uncertainty weighing on sentiment and market performance. This resulted in ongoing wider fees than is typical from a securities finance perspective.

Yared: The past year highlighted the benefits of National Bank's robust and resilient risk management approach and the collaboration of each desk within its Global Securities Finance team as the industry navigated a market environment that led to increased overall regulatory scrutiny.

National Bank has continued to focus on automation of its securities lending business, utilising technology to facilitate the optimisation and refinancing of its securities lending book. Collateral management and diversification of borrow sources were also key to sustaining, and further developing, our Canadian securities lending activities.

What investments and adaptations to working practices have you made to sustain and grow your Canadian securities lending activity in this environment?

Schuessler: Optimisation is the name of the game for all firms in a year like 2023. With the looming recession, most firms are reviewing expenses and looking to squeeze revenue out of existing products before expanding or investing to achieve revenue targets. There is a major focus on optimisation within BMO, which sometimes results in a contraction in the amount we are borrowing. We are, however, very invested in growing our securities lending activity as we advance into the second year of our US Prime offering expansion.

Paris: Northern Trust is committed to Canada with a dedicated trading desk located in Toronto that works closely with both borrowers and lenders in the marketplace. Our Canadian trading team works with our global trading teams located in Sydney, Hong Kong, London and Chicago to bring local expertise to our clients globally. Northern Trust looks to bring global demand for client portfolios to the local market by offering a number of cross-asset and cross-currency trades. For Canadian clients, some of the most significant opportunities lie in lending Canadian government bonds (HQLA) against other global assets such as US Equities or Japanese Government Bonds. We continue to prioritise investments in our global infrastructure to support our local Canadian clients.

Shadmann: Two regulatory initiatives come to mind that garner the majority our attention. First, the move to T+1 settlement in Canada and the US. T+1 implementation requires that we are even more robust across our post-trade settlement activities — particularly with the

issuance of recalls moving from a manual to automated process, requiring that we integrate our internal system with vendors, TMX and the broker-dealer community. We are already active participants in CASLA's T+1 sub-committee, which is working to identify and implement industry best practices. Internally, we have established a T+1 task force which is evaluating T+1 implementation to deliver a smooth transition for both pre and post-trade services.

Second, implementation of the proposed penalties regime will impose a fee for settlement fails for Government of Canada bond and T-bill trades. Although still in its consultation phase, we feel that the proposed model currently lacks clarity around securities lending market fails. However, we believe this will be a positive development for the market when issues identified during the industry consultation phase have been addressed.

Which regulatory initiatives will consume most attention for your teams over the coming 12 months? And which initiatives that focus on standardisation, digitisation and technology enhancement?

Shadmann: The use of technology in a prudential and cost effective manner continues to be key to our growth strategy. By automating previously manual processes, this has allowed us to increase the size of our book this year and to venture into more nuanced pricing of our holdings. We continue to invest into our IRIS platform, which will continue to replace our legacy systems. This platform has the benefit of making our internal system more flexible in connecting with third-party platforms across the street, thereby making pre and post-trade settlement more seamless. At the same time, it provides us with greater flexibility in offering highly customised client programmes, for instance by offering versatility in the form of hybrid or insurance indemnity.

Paris: The most significant regulatory initiatives on the horizon include T+1 settlement in the US and Canada, securities lending trade reporting, clearing of secondary transactions in US Treasuries and US implementation of Basel III — also called the Basel III Endgame. Each of these proposed rules has the potential to dramatically shift the way securities lending operates today; some are expected to have beneficial impact for the industry and others may take the industry some time to digest. The key US industry groups have been actively engaged in consultative initiatives with the regulators to preserve the market efficiencies offered by securities lending, while also adapting to the regulatory objectives of delivering improved market stability and transparency. We expect to have a busy 18 to 24 months owing to these regulatory initiatives.

Yared: The T+1 Securities Settlement initiative will consume most of the industry's time and attention over the next 12 months. Moving from a T+2 to T+1 settlement cycle is a significant change and requires investment in technology, operations, internal synchronisation and coordination across the securities lending industry. With a go-live date of 27 May 2024 for Canada and 28 May 2024 for the US, most of the operational and IT focus is on implementation at this time. We expect this initiative to be a priority in the coming year for all market participants. For the securities lending community, it will be interesting to note whether new market practices will emerge as the result of a shortened settlement cycle, especially as it relates to recalls.

We are also following the developments of the US Securities and Exchange Commission's (SEC) proposed 10c-1 rule, which would require lenders of securities to provide the material terms of trade for securities lending transactions to a registered national securities association, such as the Financial Industry Regulatory Authority (FINRA). When comparing the SEC's proposed 10c-1 rule in its current form to the European Securities Financing Transactions Regulation (SFTR) rules, it is noteworthy that despite the moderate number of required reporting fields (i.e. 12), 10c-1 implementation is expected be more onerous since it requires that securities lending trades are reported within 15 minutes of execution, In contrast, the EU reporting requirement is on T+1. A final version of the SECs proposed 10c-1 rule is expected later this year.

Kolasingh: The move to T+1 and implementation of a "fails regime" on Bank of Canada government securities — both planned for 2024 — will drive the regulatory change agenda for the next 12 months and beyond. Similar to the recent adoption of the Central Securities Depositories Regulation (CSDR) in Europe, we expect T+1 to drive significant technology enhancements into the securities lending value chain, as well as more efficient execution and settlement processes across the market. The move to a shorter settlement cycle may also present various opportunities as demand for fail coverage is likely to increase.

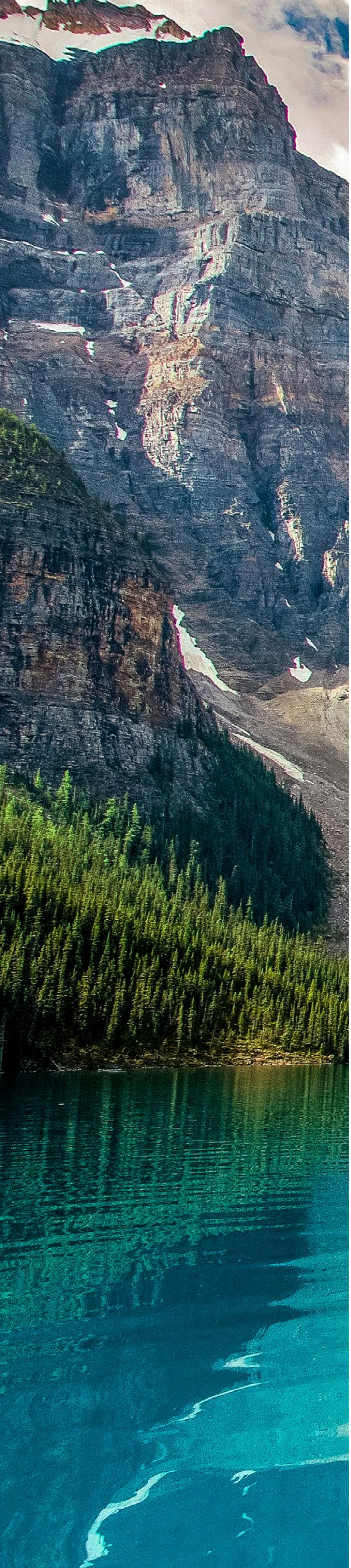
Regardless, changes to processes, systems and behavioural patterns will be required by all stakeholders, including agent lenders, borrowers and beneficial owners. While the proposed changes may be challenging to implement in a matter of 12 months, the resulting benefits will be substantial. Improved trade submission, recall management and security returns will only add to the sustainability of the financing market and its importance as a source of liquidity to the capital market system.

Schuessler: At BMO, we concentrate efforts on post trade services — marking, returns, recalls etc. The upcoming migration to T+1 has forced many to take a closer look at their post-trade service enhancement. Canada has very little automation for recalls and returns when compared to the US and this must be drastically improved before T+1 takes effect!

What programmes are ongoing within CASLA, and at industry-level more broadly, to support this change agenda?

Yared: CASLA has put in place a T+1 working group (CASLA T+1 WG) that includes agent lenders, Canadian pension funds and Canadian banks. The CASLA T+1 WG is working closely with CDS/TMX, as well as vendors such as Equilend and Pirum, to discuss the challenges the Canadian securities lending industry will face under a shortened settlement cycle, along with potential solutions. CASLA's role will be key in clarifying market practice for Canadian securities lending participants in a T+1 settlement cycle environment.

Kolasingh: One of CASLA's key objectives is to ensure the long-term viability of the Canadian securities lending industry, with a focus on efficiency and security of the marketplace. In this vein, CASLA continues to be engaged on several regulatory and market infrastructure



initiatives. As the CASLA coordinator over the past 12 months, I have had the opportunity to work closely with our members as we navigate changes in the Canadian marketplace. We currently have a T+1 sub-committee with representation from more than 10 member firms, working hard to ensure the smooth application of shorter settlement cycles within the securities lending value chain — domestically and in partnership with fellow associations in the US. We have also been engaged with the Government of Canada Market Functioning Steering Group, which recently published a consultation paper on the proposed fails regime. As the market evolves, CASLA will continue to be a key voice for our member firms.

As a collective global voice for the securities lending industry, GASLA seeks to enable positive engagement with stakeholders, including regulators, policymakers and standard-setting bodies in all regions. How has CASLA identified benefits through its participation in GASLA?

Kolasingh: It will be two years this September since the Global Alliance of Securities Lending Associations (GASLA) was formed and released its first joint publication. How time flies! CASLA's participation in this important industry forum has enabled our members to play an important role in the global dialogue, along with our fellow associations. In particular, I cannot stress how beneficial it has been for GASLA to be at the forefront of the ESG discussion and for the Canadian view to be part of formulating industry guidance on this important topic. I fully expect that ESG is only the first of numerous other industry-wide topics that will be moving to the forefront in times ahead, including the Common Domain Model, digital assets, and diversity, equity and inclusion. I am looking forward to meeting some of my GASLA colleagues on stage at this year's CASLA conference to discuss industry trends, opportunities and challenges — and the importance of our collaborative efforts.

How do you assess the outlook for the Canadian securities lending markets for 2023-4?

Schuessler: There are so many tools when it comes to optimisation, revenue concentration, collateral management as well as customisation. Those with the ability to implement quickly, adapt to the trends quickly and be agile in their offerings will no doubt have a successful 2023-4.

Yared: The past three years have taught us to expect the unexpected and we remain cautiously optimistic with regards to the outlook of the Canadian securities lending market for 2023-2024. Firms with a solid liquidity profile, sound balance sheet management, automation, optimisation and refinancing will be well positioned in 2023-2024.

A key trend to keep an eye on is Fully Paid Lending, which is still in its infancy. Historically, the securities lending market has been limited to large institutional players. National Bank will continue to develop its Fully Paid Lending programme, which allows retail investors to participate in the securities lending market. We see an active and robust Fully Paid Lending programme as a significant value-add for the client and potential key differentiator in the future.

We anticipate that the hard-to-borrow space will continue its current trend, driven by bought deal names with two to three weeks durations and sustained short interest in the Canadian cryptocurrency and US electric vehicle space. With interest rates remaining high and the potential for a market downturn, retail supply may diminish, leading to stronger short interests across sectors.

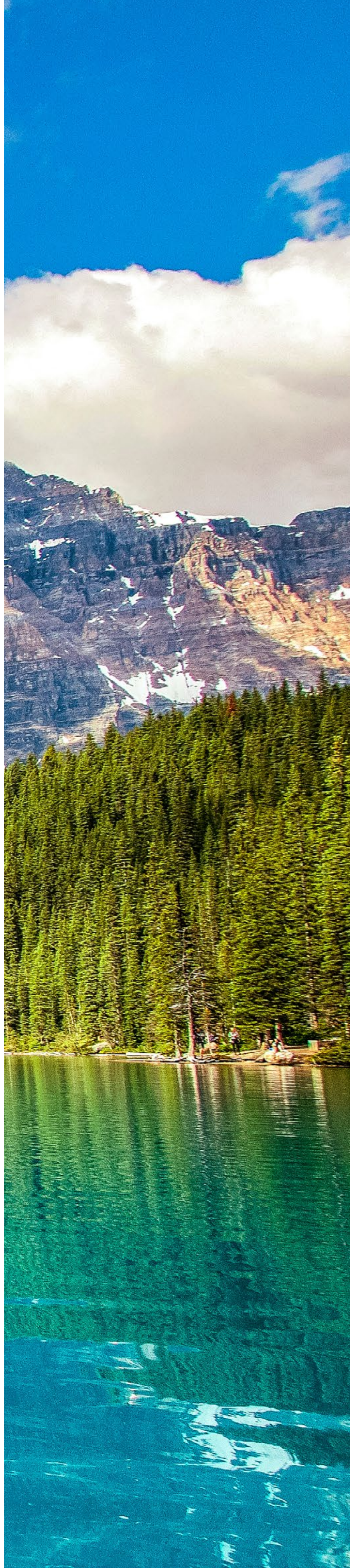
Paris: The Canadian securities lending market continues to show steady demand and resilience despite the headwinds and uncertainty in the global markets. As a leading provider of securities lending and securities finance solutions for our clients, Northern Trust has a global presence that provides clients with access to more than 51 securities lending markets. Canada remains a primary focus for our clients located in Canada and for those that hold Canadian assets.

Looking ahead, we expect overall demand will remain robust for securities lending in Canada. Demand for HQLA and Canadian government bond benchmark issues will provide opportunities in both the term and open lending markets. Also, financial institutions need to optimise and manage their balance sheets more efficiently, which will drive demand for lenders to accept a wide range of collateral. The expectation of continued volatility in global commodity prices would drive demand for specific equity securities in the materials and energy sectors, given Canada's key role in these industries. We also expect dividend reinvestment trades to continue to provide a steady revenue stream throughout the remainder of the year with the proliferation of Canadian banks' stock purchase plans.

Clients that employ collateral flexibility take a key step to enhancing their programme performance. Clients are also taking a more hands on approach to generating alpha; this may be reflected in programme internalisation, peer-to-peer lending or directed trades. We also see securities lending moving from a back-office operations function to a front-office, investment-oriented job title.

Kolasingh: I remain optimistic about the Canadian securities lending market as we hit mid-year and consider what is beyond 2023. Despite a volatile first quarter, growth has continued in equity and fixed income borrowing, with specials popping up in each area. This, along with strong beneficial owner participation rates and engagement, suggests that we will be in for a fruitful second half of the year. While there is a challenge with T+1 and the associated changes that will be required, the benefits to be realised as part of a more automated and efficient value chain will undoubtedly be worth the effort.

Shadmann: We continue to face extreme market conditions. 2021 brought the covid pandemic and in 2022 we experienced decades-high inflation and fast paced monetary tightening policies implemented at unpreceded speed. These events allowed us to evaluate and tighten up our lending programme, both in terms of the efficiency of asset deployment into the market and in keeping our clients' risk appetite front and centre. The events of the past two years highlighted the importance of engaging with our clients and forming a deeper understanding of their needs. This positions us well to be better stewards and agents of our clients' assets into 2023-4. We expect short-interest themes will continue in sectors driven by market events and we are hopeful that our clients will continue to benefit from the positive revenue stream that is provided by the securities lending programme.



Rob Ferguson
Chief capital markets officer
CIBC Mellon

Stewarding stability, security and revenue growth

Canada's securities lending market is poised for continued growth in 2023, driven by improved demand, advances in technology and a favourable regulatory environment, according CIBC Mellon's chief capital markets officer Rob Ferguson

The Canadian securities lending market has maintained high standards of risk management and service delivery during 2022. 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) programmes 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 programme 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 recognise that financial stability through market cycles is essential.

Recent central bank rate increases have been beneficial for clients that participate in a cash collateral programme. With the increase in rates, spreads have widened and this has generated more in incremental revenues from a cash reinvestment programme. 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 optimisation 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) finalised 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 standardisation, digitisation and high governance standards. Canadian and US market stakeholders — including US 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.

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 US 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 optimise 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 organisations adjusted their capital planning to the revised requirement, we saw greater activity in dividend reinvestment programmes. 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.

"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"

Rob Ferguson
Chief capital markets officer
CIBC Mellon

Native digital assets in securities finance

In the second of two articles, Dr Ian Hunt notes that, at some point, a major jurisdiction will provide a venue where native digital assets can be issued within a single issuance model and transacted under a single operating model. At that point, securities finance will change profoundly for the better

Native digital assets offer the prospect of profound benefits to securities financing. These encompass cost reductions for lenders and borrowers, a radical simplification of operational processes, a very high degree of automation and the roll-back of regulation. These benefits are not delivered by doing what we do now, but by applying sexier technology to do things very differently.

Native digital assets model

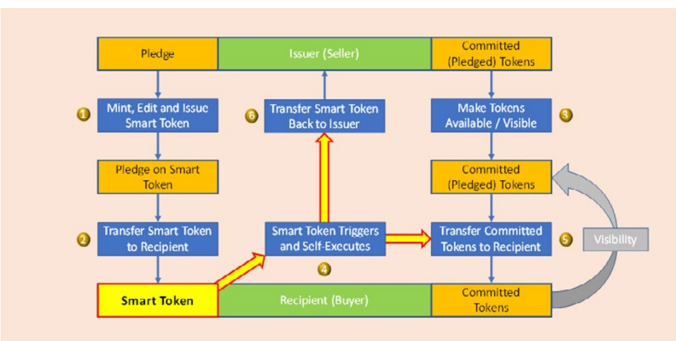
In a purely digital financial structure, all transactions are processed in exactly the same way, irrespective of the nature of the transactions or the assets and cash that are being traded. In the digital world, securities finance trades are not unique.

All pots of value are in token form, held at addresses on the ledger. All transactions are flows of tokens between addresses. Native digital assets are just tokens which commit future flows of value and therefore flows of tokens. Smart tokens are just native digital assets which implement and manage the flows that they commit: including flows in securities financing.

The operating model has a tiny number of steps, entities and interactions. There are only five or six steps in the whole process:

1. The issuance of the smart token (if the smart token is newly minted, rather than being sold-on by a previous recipient).
2. The transfer of the smart token to its recipient.
3. The earmarking of the committed tokens by the issuer, making them visible to the recipient.
4. The self-initiation of the smart token and the computation of its terms.
5. The transfer of the committed tokens from the issuer to the recipient.
6. The transfer of the smart token back to the issuer.

Fig 1: Use of smart tokens in securities finance transactions



This process works not just for the settlement of any transaction on the ledger, but also for the other key constituents of our current financial ecosystem: for example, for indications of interest, orders, executions, income payments, corporate actions, collateral transfers and securitisations. It supports not just trading, but also asset servicing, financial engineering and securities finance.

Why securities finance fits the model

The smart token model is based on the self-execution of pledges. The pledges are coded on tokens held on a digital ledger and represent commitments to future flows of value. As outlined above, all value on-ledger is represented in the form of tokens, so those value flows are just flows of tokens between addresses on the same ledger. The pledge tokens are smart, because they have the capability to implement the flows that they commit: they are self-executing, native digital assets. The tokens committed may be cash tokens of some form, may be asset tokens giving title to off-ledger conventional assets or may themselves be native digital assets.

At a superficial level, this set of principles is clearly applicable to securities finance transactions, which are all about commitments to future flows of cash and assets. Those future flows may be the initial movements of cash and collateral in a repo, the exchange of the lent asset for collateral in a stock loan, the periodic adjustment of deposited collateral through valuation and calls, or the return of the lent asset, cash or collateral on termination of a loan or repo.

Why securities finance is different

In most financial transactions, the value exchanged is known and fixed in the trade. In deciding to buy an equity, it would be highly unusual not to have a particular equity specified in the stock leg, and a particular currency specified in the cash leg of the trade. Even in bond trades, where the trading decision may be based on a specification of target terms, conditions and credit quality, a specific bond is identified and baked into the trade order prior to execution. The exact security to be delivered is locked at the point of agreement of the trade, well in advance of settlement.

In securities finance, and generally in collateral agreements, there is a notion of eligibility and substitution. Until the actual delivery of the collateral, the security to be delivered may not be precisely defined. We know its characteristics, defined in an agreement on eligibility, but we do not know its identity. Clearly in stock loans, the lent security itself is known and fixed in the loan agreement. However, the collateral may not be so precise.

In most financial transactions, once the trade is agreed and confirmed contractually, the buyer has a right to the asset and the seller has a right to the cash: the seller can't pull the sold security back and the buyer can't claw their cash back.

> *"The smart token model is based on the self-execution of pledges. The pledges are coded on tokens held on a digital ledger and represent commitments to future flows of value"*

In securities finance, however, the deliverer of the security sometimes has the right to recall it and to substitute an alternative asset, provided that replacement asset passes the criteria of eligibility. In securities lending, the loaned security can be recalled to enable the lender to benefit from income, corporate actions, voting rights etc. In repo agreements, where there is a termination open specifically agreed between the parties then, again, the deliverer of collateral can recall it at their discretion.

A model based on native digital assets

A typical loan transaction in the smart token model includes three pledges from the lender:

- A commitment to transfer the relevant asset token(s) from the lender to the borrower at the inception of the loan.
- A commitment from the lender to transfer excess collateral tokens back to the borrower on a defined frequency, where the value of the collateral exceeds the value of the lent asset by a defined fraction.
- A commitment from the lender to return the collateral for the lent assets at the termination of the loan or when the lent assets are returned to the lender.

There are four pledges from the borrower:

- A commitment from the borrower to transfer eligible tokens as collateral for the lent assets, at the inception of the loan, in an amount defined as a multiple of the value of the lent assets.
- A commitment from the borrower to transfer the shortfall in collateral tokens to the lender on a defined frequency, when the defined multiple of the value of the lent assets exceeds the value of the collateral.
- A commitment from the borrower to return the asset tokens to the lender at the termination of the loan, or on a defined prior event (such as a recall).
- A commitment from the borrower to pay cash tokens as a fee, in a specified amount and at specified times.

These clusters are exchanged when the loan is agreed, so the lender holds the borrower's pledges and the borrower holds the lender's pledges. All of these pledges are issued as smart tokens on the digital ledger and act just like IOUs. There may be other pledges, depending on the nature of the agreed loan. For example, there may be a pledge to deliver cash tokens representing manufactured dividends from the borrower to the lender. In any case, the pledges are all just smart tokens like any other and will self-activate and will implement their own terms.

In a fully digital system of finance, ownership is a simple construct: it is the location of a token. If the token is held at your address on the digital ledger, then you own the token. Any lien, mortgage, claim, charge or encumbrance on the token is represented simply by a pledge to deliver it in future, and under defined conditions, to the holder of the charge. As a result, a repo is very similar to a loan in the smart token model.

However, there are some differences between a native digital loan and a native digital repo. The fee pledge in the loan does not exist for the repo and the primary tokens transferred in the repo are always cash tokens. The collateral in a loan is often, but not always, cash tokens while the collateral in a repo is generally a set of asset tokens; these may be tokenised conventional assets or may be native digital assets. On termination of the repo, the asset tokens are returned, but the cash tokens returned are inflated by the repo rate agreed for the transaction and the time over which the cash tokens have been held. The termination date of the repo is generally fixed and short-term, but undefined if it is an open repo. For stock loans, the tenor is generally unlimited and termination is on recall or return of the loaned stock.

Handling the differences in securities finance

The differences outlined above for securities finance and collateral management require some extension of the native digital assets model. In the simplest form of the model, each smart token implements the transfer of tokens whose identity is pre-defined. The availability for transfer of those committed tokens is exposed across the ledger: the recipient has visibility of the committed tokens on the issuer's node. The recipient can confirm both the identity and the quantum of the tokens earmarked for delivery and this can enhance trust as a result.

In a securities finance context, the identity of the tokens to be delivered may not be known until they are earmarked for delivery. The smart token that manages their delivery therefore needs to carry the eligibility criteria, rather than the identity of the tokens to be transferred. When the committed tokens are made visible to the recipient, then the smart token (on behalf of the recipient) needs to check that the tokens satisfy the eligibility criteria.

To accommodate recalls, substitutions and upgrades, additional pledges are required from both the issuer/lender and the recipient/borrower. The issuer needs to pledge the return of the collateral on request from the recipient and the recipient needs to pledge the delivery of replacement eligible collateral on receipt of the recalled collateral.

The benefits of a native digital model

The parties to a securities finance transaction deploying native digital assets will benefit from a very high degree of automation. Once issued by an issuer and held by a recipient, the smart tokens do all the work: they calculate, validate, trigger and manage the movements of assets and cash which implement the transaction throughout its lifecycle. The tokens do this within a very simple operating model that is shared across asset types and products. With a single, simple operating model, the complexity of technology reduces markedly, even though the level of automation goes up.

Because there is a single operating model, the sharing of infrastructure and people across a financial organisation becomes wholly practical. Securities finance is no longer an island of custom process and technology. Neither are funds, derivatives, income or corporate actions: all of these apparently disparate assets, activities and products are managed in exactly the same way, under the same operating model and deploying the same platform.

To implement a new contract type, accommodate a new asset class, create new terms or new eligibility criteria, all that the parties need to do is to issue and code the appropriate smart tokens. No infrastructural, technical, operating model or security data changes are necessary. As a consequence, change is very quick and very cheap.

The fact that there is only one digital operating model, and the tiny number of entities, objects and processes that it deploys, reduces the required regulation by multiple orders of magnitude. As a result of the very high level of automation, the reduction in the number of intermediary entities and the simplification of regulation, costs to both lenders and borrowers are reduced substantially.

At some point, a major jurisdiction will provide a venue where native digital assets can be issued within a single issuance model and transacted under a single operating model. At that point, securities finance will change profoundly, permanently and much for the better. Other jurisdictions will have no choice but to follow suit.

Dr Ian Hunt is an authority on buy-side business process and technology. He is an industry consultant to multiple leading asset managers, recognised for his work in promoting innovation in technology for investment. He was the designer of FundAdminChain's digital funds ledger, and recently published a major set of papers on Digital Issuance and Native Digital Assets, launched at the Investment Association in London. Hunt has worked with a number of large asset management companies on their strategies for distributed ledger technology. He has also been active in securities finance, helping BNP Paribas to implement their outsourced repo process and Threadneedle with their stock lending operations.

TradFi and DeFi should be used in tandem, Securities Finance Technology Symposium panellists say

Industry participants examine the benefits and challenges presented by the adoption of DeFi-based structures and how these will evolve alongside traditional trading, lending and financing arrangements. Lucy Carter reports

Traditional finance (TradFi) and decentralised finance (DeFi) can and should exist in tandem, speakers on the 'TradFi vs DeFi' panel at this year's Securities Finance Technology Symposium in Boston affirmed.

Panellists noted that there are many benefits to adopting more DeFi systems, with Mike Norwood, head of EquiLend trading solutions, suggesting that traditional finance should consider applying DeFi strategies to TradFi problems to "remove inefficiencies and accelerate velocity".

"It's not an 'either or' situation, and we don't have to move one way or the other," he went on. Instead, firms should "look for what fits the purpose, look at a problem holistically and take bits and pieces to find the most appropriate solution."

Another speaker added that smart contracts can be an effective way to reduce risk and improve control over assets. They urged market participants to research DeFi and find ways that it can improve their operations, predicting that those who fail to move with the market and understand DeFi will be left behind.

"You have to take the bull by the horns," they stated, suggesting that firms work ahead of regulators and start using DeFi technology and solutions now. One speaker acknowledged that regulations can be slow and complex to develop, but argued that this is something that the industry should welcome — "they can't make mistakes". Market participants should find ways to operate DeFi technology within existing rules as they wait for specific regulation to be introduced, they advised.

One speaker maintained that there does not need to be a tension between what is interesting and what is compliant — elements of DeFi technology can and do operate within existing rules. However, "you can't move faster than the regulators," they affirmed.

Another panellist agreed that although a specific regulatory framework is necessary, technologies such as smart contracts are already able to operate within existing regulatory norms. They advocated for “using all the tools we have at our disposal” to enhance risk management, compliance and operations, reassuring that we don’t need to upend the entire infrastructure” to start using DeFi technology. The transition will be “an incremental process,” they predicted.

“It doesn't have to be TradFi versus DeFi,” one panellist explained. “They can commingle and coexist quite easily.” Another speaker added that this is not only a possibility but a necessity — the two must coexist to be successful.

Continuing the argument for coexistence, one panellist reflected on the perception of many that crypto and blockchain are a “solution without a problem”. He argued that this is not the case, with the possibility of tokenising real estate something that could “solve impending regulation problems in the investment management world.”

Considering benefits for the securities lending world, Norwood explained that a shared ledger, implemented by a technology vendor, could allow for a golden source of contract information, updated in sync, which would reduce the operational challenges around contract lifecycles. However, while it makes sense in certain market sectors and use cases, he suggested that there is not an argument for a total move to decentralised finance.

One speaker went on to say that the biggest barrier to adoption is not regulatory hesitancy but rather a lack of education and a fear of the unknown. They predicted that market participants will be inclined to experiment more in the DeFi space as they learn more about it.

Looking to the future, Norwood stated that “we need to reimagine what the industry should look like,” embracing elements of DeFi to solve specific problems. However, he warned that there should be a focus on improving, rather than only making digital versions of, existing systems.

The industry has a reliance on outdated legacy technology, Norwood said, with a lot of responsibility falling to technology vendors to drive change. However, he concluded that for progress to be made, clients must be open to change in technology as well as behaviour.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Supporting the industry through Libor cessation

From 30 June 2023, securities that reference LIBOR will not have a published index to use for interest rate calculations, pricing or valuation and will need to be updated. Ann Marie Bria, DTCC's managing director for Asset Services Business Management, explains how the New York-based financial infrastructure specialist is helping the industry to manage this transition

There has never been a wholesale discontinuation of a benchmark index. The London Interbank Offered Rate (LIBOR) has been the basis for the pricing of most debt instruments for more than 35 years and its cessation is a first for financial markets. While regulation stated that there should be no new securities issued after the beginning of 2022 that leverage the LIBOR benchmark, legacy contracts pose an issue. In fact, there could be more than 150,000 securities that have legacy contracts based on the LIBOR rate. On 30 June 2023, securities that reference LIBOR will not have a published index to use for interest rate calculations, pricing or valuation and will need to be updated.

> "To prepare, firms should determine how they will identify and update securities that are impacted by LIBOR cessation by 30 June"

Client segments such as the fund accounting industry could be most impacted by this change. Those providers must account for interest to bondholders and address questions concerning the sourcing of accurate alternative benchmark rate information for pricing purposes. Market data vendors may also experience challenges since this information is not expected to flow through traditional data channels. As a result, these vendors are now partnering with the Depository Trust and Clearing Corporation (DTCC), allowing them to access the data on many of the USD LIBOR-impacted debt securities.

What must firms do to be ready for the June deadline?

The LIBOR cessation compliance date is fast approaching. Therefore, the industry must prioritise preparations to ensure its readiness. The cessation of a benchmark rate is unprecedented, as we have noted, and The Federal Reserve Bank of New York created the Alternative Reference Rate Committee (ARRC) in the US to identify challenges and solutions to address the new requirement.

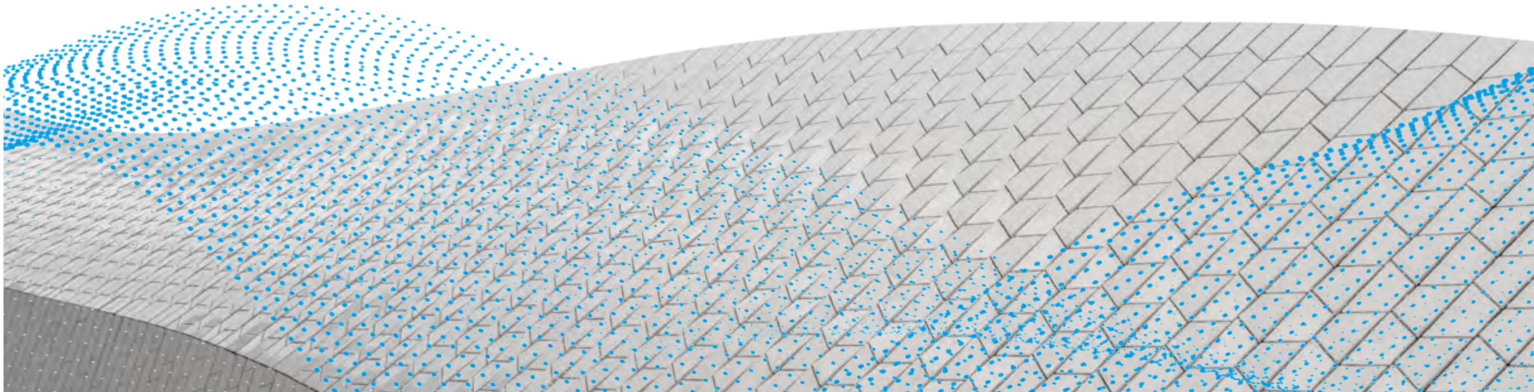
To prepare, firms should determine how they will identify and update securities that are impacted by LIBOR cessation by 30 June. While firms can update this information themselves, the ARRC has outlined best practices that market participants can follow, such as leveraging DTCC's updated LENS solution or new data feeds being offered by market data providers.

How ready are firms for the June deadline?

There could be some challenges with meeting the June deadline, primarily due to the sheer volume of work that will be required to update legacy contacts. According to our records, with more than 150,000 contracts to be updated and only 5000 being updated so far and communicated utilising LENS, there is much work still to be done. We are committed to helping our clients to navigate this unique industry requirement.

DTCC has been an active member of the ARRC since the committee was formed to help the industry find solutions to challenges posed by the LIBOR cessation. As part of this initiative, DTCC has been working with the ARRC, industry bodies and market participant firms to create a centralised process for capturing and disseminating standardised benchmark replacement information.

DTCC's LIBOR Benchmark Replacement Index Solution delivers an efficient process for issuers, agents and any parties responsible for the dissemination of new benchmark replacement data to communicate with investors and the market. The solution is built utilising DTCC's LENS portal, providing users with access to information disseminated by issuers or agents of current USD LIBOR debt securities whose rate is transitioning to an alternate benchmark. Alternatively, DTCC Data Services is providing the disseminated data on these USD LIBOR-impacted debt securities to market data vendors and other subscribed users via automated data feeds.



Senior management changes at Blackrock, Margin Reform and Scotiabank

Scotiabank Global Banking and Markets has promoted Robert Dias as managing director, head of global prime services, collateral management and funding.

Based in Toronto, Dias has served at the bank for more than eight years. In his new role, he will report to Pruyn Haskins, managing director, global head of prime services, collateral management and funding.

Dias previously served as managing director, global head of collateral management and funding, a role he held for almost four years. In this position, he led teams across Toronto, New York, London, Dublin and Singapore.

Prior to joining Scotiabank in 2014, Dias was director of securities lending and equity finance trading at Bank of America Merrill Lynch (now Bank of America and BofA Securities) from 2010 to 2014.

Margin Reform, a practitioner-led management and IT consultancy firm, has appointed Jonathan Adams to head the firm's securities finance practice.

The appointment comes as part of Margin Reform's expansion, which will see Adams take on the practice involving repo and securities borrowing and lending, to support its portfolio of sell- and buy-side clients.

Adams brings more than 25 years of securities finance experience to the London-based role. He will report to Shaun Murray, CEO of Margin Reform.

EquiLend's Allen appointed WISF New York chapter lead

Women in Securities Finance (WISF) has welcomed Nancy Allen as lead of its New York chapter.

Open to all members of the securities finance community, the WISF group was formed to create a community to foster connections and promote the advancement of women.

With more than 20 years' experience in the global securities finance market, Allen is currently head of data and analytics solutions at EquiLend, where she is responsible for the strategic development and growth of the product suite.

Allen joined EquiLend in 2016 from Northern Trust, where she was most recently senior vice president and head of international fixed income securities lending trading at the firm's London office.

Earlier in her career, Allen held a number of positions at State Street and Deutsche Bank.

Commenting on the appointment, the WISF chairs Elaine Kim Benfield, Arianne Collette and Jill Rathgeber, say: "On behalf of the global leadership team of Women in Securities Finance, we are thrilled to have Nancy join as a New York chapter lead.

"Nancy is an outstanding leader in the industry and has contributed immensely to the growth of WISF since we launched. Her knowledge and experience in the securities finance industry are unmatched, and we are thrilled for Nancy to continue to serve as an integral part of the success of Women in Securities Finance.

"Nancy is our first addition to the New York chapter, and we look forward to continuing to formally expand the New York Chapter leadership team. We have come so far in our five plus years and it is exciting to see how we keep growing and evolving."


Don’t mind the gap
Our repo markets bridge liquidity gaps. More than 160 European financial institutions are currently active on our Repo, GC Pooling, HQLA^x and eTriParty markets. They benefit from trading opportunities with fully integrated clearing and settlement.
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He joins Margin Reform after his recent departure from Delta Capita, where he was head of securities finance and collateral management at the firm's London office between 2016 and 2023.

Global asset manager and technology provider BlackRock has promoted Andy Orr as head of international equity trading within the firm's securities lending business.

Based in London, Orr will also take on a broader regional management role for securities lending trading for the EMEA region.

He will continue to report to Yoshi Aoyama, managing director and co-head of global trading at BlackRock.

Orr first joined BlackRock in 2006 as a systems developer, before taking on a number of roles within the firm including equity finance trader and head of the EMEA securities lending trading desk.

After almost 30 years in the securities lending industry, financial veteran Edward Marhefka is to retire from his position at S&P Global Market Intelligence.

Marhefka is currently managing director, head of equities data and analytics at S&P Global Market Intelligence's New York office. In his current role, Marhefka is responsible for managing these parts of the business, which encompass securities finance, exchange-traded funds (ETFs) and benchmark services, to name a few.

The equities data and analytics businesses were transitioned to Paul Wilson and Alessandro Ferretti earlier this year.

He first joined the firm, formerly known as IHS Markit, in 2013 as managing director and co-head of the Markit Securities Finance business in North America.

Prior to his decade-long tenure with the financial information services firm, Marhefka spent 15 years at Morgan Stanley managing the global equity finance and repo sales teams.

Earlier in his career, Marhefka worked in the prime finance business at Lehman Brothers in a sales capacity. Previously, he served in the custody and clearance business at Bank of America and Bankers Trust.

Marhefka is to retire from S&P Global Market Intelligence on 31 May 2023. His future plans include travelling, golf and enjoying the New Jersey shore with family and friends.

Commenting on his retirement, Marhefka says: "I am grateful and thankful to the many people who supported, trusted and worked with me during my career. There are too many to list, but I will never forget the impact they made on my career and me and my family."

Euroclear has appointed Melwin George Mathew as treasury back-office controller in its banking division, based in Brussels.

Mathew has six years of experience in Mumbai's financial services industry, beginning his career with State Street as a business analyst for middle- and back-office transaction management.

He later moved to Nomura, where he was an analyst for trade settlements, and Morgan Stanley, where he was an associate.

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