



Central to the debate

An expert panel discusses the merits of a central clearing counterparty, demand for ETFs, the health of the hedge fund industry and other key issues affecting securities lending in Canada

Craig Macdonald, chair: What's different from a year ago in the Canadian market?

Warren Maynard, State Street: From the standpoint of beneficial owners and lenders it's better. They've gained a better understanding of their overall programmes and taken action on their programmes so are better set for the future.

Patrick Avitabile, Citi Global: I agree. We've had new Canadian funds come into the programme that never lent before. Post-crisis, the education process has been a major focus for many new lenders. We've seen new funds performing a thorough due

diligence, a deep dive into the programme, and lending done in both developed and emerging markets. For the most part, clients that have never lent before are taking a conservative approach.

Robert Chiuch, CIBC Mellon: Right, and notably the risk and reward considerations in Canada are beginning to come back into balance. Post-crisis, the discussions are now less geared towards pure risk mitigation and containment. It's an environment where beneficial owners are again focused on securities lending as a product and how it can benefit them.

Yvonne Wyllie, RBC Dexia: If there were concerns a year ago from a beneficial owner's perspective, over the span of the year those concerns have been addressed as beneficial owners have taken the time to re-evaluate their lending programmes by reviewing the counterparty risk or collateral they're holding and some may have made adjustments to align with their level of risk tolerance. If the focus was specifically on risk last year, risk is still prevalent and a component to be considered, but it's the risk-adjusted return aspect they're now viewing as the basis for comparison.

Avitabile: What I found interesting about

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the new clients that have come into the programme is their view on collateral. They're electing to take cash as well as non-cash. One of the things lenders have learnt since the crisis is it's not the type of collateral, be it cash or non-cash, it's what you do with it. Clients are evaluating their appetite for risk and designing their programmes accordingly.

Chair: What are your thoughts on the topic of taking equity as collateral?

Chiuch: The experience through the crisis identified traditional views in collateral management – fixed income and 'cash as king' – that may not necessarily be universally true for all programmes. In fact, a basket of equities in an actively traded, highly liquid market is much easier to liquidate than a basket of long duration sovereign debt. Certainly, it's never prudent to put all your eggs in one basket and to have extraordinary concentrations in any asset class in a collateral pool. These days, it's important to have equities as a component of your acceptable collateral schedule.

Maynard: Especially if you are lending on equities. For the clients we talk to, using equities as collateral makes complete sense when you're lending out equities. Maybe when lenders are lending fixed income securities they might choose to restrict equities as collateral just because of the negative correlation between the two. Mutual funds in Canada are still not allowed to take equities as collateral. The regulations for mutual funds were put in place in 2001, and we've already had discussions with regulators about this. The regulators might be open to some modifications in the guidelines but they will want a mutual fund to approach them with this request as opposed to one of the providers in the business. The industry will also look to get expansion of the cash rules as well in the mutual fund securities lending regulations, which are currently very restrictive.

Wyllie: This would be something the Canadian Securities Lending Association (CASLA) could look at spearheading. As the industry association representing all securities lending participants, CASLA could present a united voice for the industry advocating expansion of collateral and the amendment of certain rules that are restrictive and competitively disadvantageous, as opposed to one individual firm or provider leading the initiative.

Avitabile: In the States, the Risk Management Association (RMA) commissioned

a research paper from RiskMetrics on the correlation between equities as collateral versus a loan of equities. Since the crisis started, the Fed and the SEC have wanted to understand how the securities lending business works as well as the trends in the industry. In the US you have different regulators regulating different client types. For example, the SEC regulates mutual funds and has specific requirements on what type of collateral that they can take, and equities are not one of them. Then there's Rule 15c3 that prohibits US brokers from collateralising a loan of securities with equities. Because there are various regulators governing different constituents in a securities loan the RMA has taken the approach to share the results of the 'equities as collateral project' with multiple regulators in an effort to gain a coordinated consensus. Two years ago the RMA started having quarterly meetings with the Fed to educate it on how the business works and from time to time the meetings have included other regulatory bodies such as the SEC and the Department of Labor, allowing the RMA the opportunity to keep all regulators up-to-date on trends in the industry and where we need to focus change. I would strongly suggest that CASLA adopts a similar approach with its regulators. Having an industry body promote education and changes that make sense for our lenders carries more weight than a single lending agent attempting to do this on its own.

James Treseler, Societe Generale Americas: But it's not without risk. It goes back to your point when you said it's not so much about taking the cash, it's what you do with it. The same thing holds for equity collateral. You have to understand the equity collateral and the risks of the collateral. If you put out a lender portfolio XYZ and take in ABC as equity collateral, you have to look at the beta risk between those two portfolios to make sure it's pulling in the right direction. If you have beta risk that goes in the opposite direction and something goes wrong – and don't forget in the Lehman scenario some markets were moving as much as 10% – you're going to wish you were in dollars.

Chiuch: That's why CIBC Mellon doesn't take ETFs – especially ETFs that have a long or short bias in the marketplace. In terms of the generic equity model, we choose to model this through the tri-party service providers because they offer an effective method for managing sector risk and, in fact, down to individual security risk. You can monitor concentration limits, daily trading volumes by issuer,



Craig MacDonald



Yvonne Wyllie, head, securities lending market products and services, RBC Dexia Investor Services



Patrick Avitabile, global head of equity trading for global securities finance, Citi



Robert Chiuch, co-head, global securities lending, CIBC Mellon



Warren Maynard, vice president, account management and sales, State Street Securities Finance division, Canada



Peter Hayes, partner and national director, alternative investments practice for Canada, KPMG



James Treseler, managing director, equity finance and synthetic prime brokerage, SG Americas



“Year-over-year we’ve seen a 10% increase in securities lending activity done to-date ... it’s a positive trend and conditions appear to be improving” ROBERT CHIUCH

and more. In addition, you can outsource that risk segment to a provider that has the risk engine in place to build in your specific requirements. You can create buckets, if you like, or you can have an omnibus model.

Wyllie: Even when managed in-house it requires a dynamic collateral management infrastructure with capabilities to measure both the correlation and liquidity between the loan and collateral portfolio. But it goes back to the demand for transparency and what information is being provided back to the lenders so they truly understand the composition of their portfolios and the risk associated with it. We’re not advocating 100% equities in any one portfolio, it’s about diversification. Equities should be a portion, corporate bonds could be another portion, and of course high quality government securities.

Avitabile: Clients realise today that to effectively optimise their return on a portfolio they need to have a wide variety of collateral types. There won’t be a specific concentration in any one, but it will depend where the opportunity is and where the economics make sense. Cash may be the preferred form of collateral in one trade whereas non-cash may be preferred in another.

Chair: What is the status of Canadian and global ETF market demand?

Maynard: We’re starting to see funds come

to market, but there’s not a huge amount of supply available right now in the ETF space. Globally we’ve seen some demand for ETFs and some excellent returns for loans of ETFs but supply now in Canada is very low.

Peter Hayes, KPMG: There have been certain providers in Canada growing fairly quickly. The suite of products is quite extensive but launch sizes have generally not been huge. Claymore, for example, had nothing in Canada a few years and now has several billion. All the ETF providers are bringing products to the market, but I’m not sure if they’re billion dollar launches. They’re going to be in the tens of millions or hundreds of millions and then slowly ratchet up.

Treseler: In 2008 the ETF market measured just over \$500m globally, and since then it’s growing at a rate of about 40% a year. So it’s just enormous. What concerns me is whether ETFs are being collateralised today. Back in the day, through a mutual fund you’d just buy physical shares, such as in the S&P 500. Now, they’re being backed by derivatives which means your ETFs have counterparty risk. I think Mom and Pop investors buying an ETF think it’s just an alternative mutual fund, not realising they’re getting credit risk.

Hayes: Like any product, including investment products, it’s buyer beware. If anyone reads the prospectus for a bull/bear ETF there’s some strong language

about the risks involved. The regulators in Canada have been pretty strong about that, especially once leverage is added to the mix.

Chiuch: That goes back to my earlier point about accepting them as collateral. Many of us have been asked to accept ETFs as collateral. The issue is the amount of transparency in the underlying activity of the ETF or the underlying holdings, which in some cases may not actually be approved or qualified securities for securities lending purposes in Canada.

Chair: What is the status of the hedge fund market now in Canada?

Hayes: The Canadian hedge fund market is where it was just before the credit crisis, in a sort of ‘about to take flight’ stage. You can make more money when you run a hedge fund, frankly, so the pedigree of the people we see are very senior people from banks, trading desks and asset managers that have enough capital backing to launch with \$50-100m. There are numerous examples of start-up managers within the last year that raised over \$100m in short order. Those are great numbers anywhere in the world right now. Another difference is the strategies we’re seeing and it’s not just long/short TSX. You’re seeing credit strategies, credit arbitrage, a little bit of fund-of-funds. Global macro is very hot right now and institutional investors are looking for absolute return products. The industry is very positive right now. The bil-



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lion dollar shops five years ago would have numbered under 10, and now there’s probably 15. I think the industry is at the start of a growth spurt.

Chair: What’s the average size of the start-ups?

Hayes: Three years ago the average size would have been \$10-20m. Now you’re seeing the \$25-50m launches again and the \$100m-plus. In Quebec there’s recently been institutional interest in seeding Canadian hedge funds, and that’s fantastic, not something we have generally seen. Canadian institutional investors historically have not invested in Canadian hedge funds, they’ve gone elsewhere for it. Perhaps they had enough exposure to the Canadian market, but now we see strategies being launched by Canadian managers that aren’t just Canada strategies. The money is also coming from high net worth investors, which in Canada is a bit different, you can almost call it retail. You’re not talking about the \$250,000 to £1m dollar tickets, you’re talking about \$25,000 to \$150,000 tickets, most often through the bank broker networks.

Chair: Do the new funds use local prime brokers or the big US brand names?

Hayes: It’s a mix, but generally local brokers, at least at first. One difference is it used to be that a Canadian fund manager would launch Canadian funds, build a record for two years, then launch an off-

shore fund. We see them going dual track now, doing onshore/offshore at the same time, sometimes not even going to the Canadian market because frankly it can be more challenging to run a hedge fund in Canada than other jurisdictions from a regulatory and tax perspective.

Chiuch: Global providers of prime brokerage services have suggested to me there’s growing demand for onshore servicing for their product, so they’re either revisiting previous operations in Canada or looking at launching new operations in Canada.

Wyllie: From the fund side they’re also looking for counterparty diversification in light of the market crisis two years ago. They’re not necessarily just looking for the biggest, they’re looking for providers that can offer and demonstrate best practices such as segregation of assets or collateral and the ability to use and accept managed accounts. So that’s where, from a Canadian perspective, we’ve seen some inflow into our market – from onshore and offshore accounts.

Hayes: Most of the prime brokers are telling us that a few years ago a hedge fund would have one or two prime brokers at most and now it’s very common to have four or five, or even more. It was the flight to quality right after the crisis, into Canada.

Treseler: And that actually opens up a problem within itself, doesn’t it? Because the hedge funds now have to pay these five prime

brokers, and how does one do that? Especially when leverage is a fraction of what it used to be, inflows are completely gone.

Chiuch: That dynamic may be affected by larger constraints regarding regulatory and compliance issues that might be dampening some of the enthusiasm to expand the number of service providers. The cost of compliance and administration are going through the roof, so maybe now hedge funds are thinking about consolidating again, not necessarily because any of the people that do the administration are any better or worse than each other, but because coordinating all the administrative responsibilities between, say, five providers to get consistent reporting can be a burden.

Hayes: If you have a £100m of one-prime or you have \$20m five primes, the direct costs typically aren’t that much more for a fund. There are the additional costs of having to administer and reconcile five portfolios and obviously legal agreements, etc. The other trend in the hedge fund space indirectly is that in the last five years there’s been a strong movement of hedge fund administrators from elsewhere opening up offices in Toronto. Names like Goldman Sachs, UBS and SS&C moved in over the last few years and others like State Street and Citco have been here for longer. The increased availability of service providers can only be good for Canadian hedge funds. Merlin Securities is a recent addition to the prime broker selection in

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“The Canadian hedge fund market is where it was just before the credit crisis, in a sort of ‘about to take flight’ stage” PETER HAYES

Canada, expanding from strong growth in the US.

Chair: Is there a need for a central clearing counterparty (CCP) in the Canadian market?

Chiuch: Everybody’s open to the notion of creating a model that provides incremental transparency and makes the marketplace more robust. But when you look at the issue in the context of the Canadian market specifically, you have five major banks and bank-owned broker-dealers, 10 major counterparts, and if one of them goes down there’s going to be a significant systemic problem regardless of whether or not there’s a CCP in place. People that maybe aren’t directly involved in this business often fail to consider that a CCP doesn’t eliminate risk. You’re transferring risk from the industry to the CCP with the underlying assumption that the CCP can manage credit and risk better than anyone else. When you add in the administrative burden of managing that, the margin top-ups, the incremental fees that you’re paying into the clearer, I’m not sure where the value is. I’ve yet to see a compelling model I can deliver to my internal stakeholders that says, ‘this makes absolute sense in its current manifestation’. I think the CCP as a concept is something that will drive forward and evolve into something of value to the industry, but in its current form there’s still a lot of work to do.

Avitabile: I think that’s one model. In other models you have a clearing broker

in between the lending agent and the CCP, so your risk is concentrated against the clearing broker. They’re no different than any other broker you lend to today. As a matter of fact, they could possibly be a tier two or tier three broker in terms of lower credit. This would create the need to have several clearing brokers in order for you to diversify your counterparty risk. That said, you still have the issue of a systemic problem if a clearing broker goes down.

Wyllie: It will take some time for the CCP model to evolve. Canada will probably follow suit with the US or Europe, and the emergence of CCPs in general. It will be just another route to market as I don’t think the market itself will be solely structured on a CCP model. There are advantages to it, especially from a regulatory standpoint, but we’re still in the phase of obtaining a better understanding of some of the benefits and how it will actually play out within the securities lending arena. Canada over time will adapt to that but it won’t be the single model that will be prominent within our market.

Hayes: It depends who’s driving it. If the regulators drive it then it probably has to be an all or nothing. But if it’s something the industry ends up building, then perhaps not.

Maynard: That’s the problem, there’s just not enough clarity right now. Like you said before, I don’t think we’ve seen a

model yet that is compelling. If it’s going to bring operational efficiencies to the market, then yes, but we’re still struggling to see how it’s going to work out. And with regards to risk you’re still going to have it, so I agree, if it comes about in other parts of the world, Canada may possibly come under pressure to adopt some type of central clearing facility.

Chair: Are the regulators pushing it?

Chiuch: To some extent it’s been sold to the regulators, or attempts have been made to sell it to regulators as a panacea for all things that went wrong with sub-prime – and I don’t think that’s true. There’s a lot more due diligence that has to be done to determine the appropriate model and getting the industry associations involved and having open dialogue where all the stakeholders are engaged is really important.

Maynard: When the central clearing counterparty has been discussed in the past it was more of a discussion around efficiencies of netting to some participants in Canada, as opposed to really looking at the overall securities lending business and what impact it would have on that.

Wyllie: Going back to the end of 2009 into 2010, the Bank of Canada was an advocate for the CCP model and welcomed the move by the Investment Dealers Association of Canada to develop a central counterparty for the Canadian repo market as a means of mitigating counterparty default risk. If this progresses then you will possibly see securities lending follow suit, but again it’s an evolution.



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Treseler: Understand that you are not forced to use a CCP. In the US it’s not a regulation that you have to use it. For equities in the US, you have to be a member of the Options Clearing Corporation to directly participate with the CCP. However, this is a general collateral (GC) market, it’s not where lenders want to make you money – you guys make your money in specials. I don’t want to take a security with a high repo value from someone who’s anonymous to me and then give it to a client. It’s dangerous, it’s toxic. But that’s what’s going on there. Actually, I think it’s a very smart model but it’s not the cure-all.

Chair: It’s been sold to the regulators as a cure-all though. In the UK it hasn’t happened yet, and I’m not sure it will, but there was a huge push that it may help.

Treseler: I remember when EquiLend came out, and EquiLend was going to give price transparency for everybody. It was evil and, look, it’s an important part of the market today. Data Explorers – nobody wanted it. Look at Data Explorers, very important to the industry today. This is just another branch growing on the tree.

Chiuch: Yes, but EquiLend wouldn’t work if I was told I had to deal with blind counterparts. It’s apples and oranges. It’s a different product. For me the notion that a CCP removes the bilateral nature of the business, where potentially I’m dealing with counterparts with whom I have no interest in dealing, and you’re actually giv-

ing up the relationship management side of it to some extent.

Treseler: You’re not forced to use it. I don’t know a single clearing counterparty in repo and securities lending that you’re forced by your regulator to use.

Chiuch: I’m hearing comments around the table that if other people do it Canada could follow. I disagree with that notion and I don’t think that should be the case without a lot of due diligence on what is appropriate for our market. You have to take a very careful look at the absolute cost of doing business, and remember why you’re here as an agent lender. Our primary focus is to look after client assets, the second is to earn risk-adjusted returns. You as a borrower, James [Treseler], I don’t think you’d be too thrilled if my lending fees went up by some material amount because I decided suddenly that the costs of doing business have risen incrementally to the point where I’m going to have to pass those fees along to the borrowers. At some point, the spreads are so thin in the securities lending market that I’m not going to eat the cost of dealing through another counterparty, adding incremental layers, because it’s not just about plugging in a system. It’s the incremental reporting and administration. It’s all the logistical stuff, and the margining and risk management that goes with it is not inexpensive. There’s an element of the GC business that will either become more expensive for the

underlying borrowers or will just dry up because we won’t lend at any cost.

Avitabile: The goal for the hedge fund is to get a better price, so basically he’s disintermediating the prime broker. As an example, it’s possible in the US to lend GC at Fed Open minus 5 or 10. So let’s say you’re doing it at Fed minus 5. Why would a hedge fund borrow through the central counterparty if they’re going to get Fed minus 5? They’re going to want something better than that. If the lending agent pays a better rebate he will need to make up the shortfall in volume. In the case of a broker, who is sitting on long positions and has a funding cost of Fed plus 25, he has the opportunity to reduce his cost by lending below his funding cost and above the levels on the street from the agent banks. All the issues that the broker is long become eligible for the funding trade. The GC trade for the broker-dealer would give him the opportunity to reduce his funding cost.

Treseler: It’s negative spread repo, but it makes the market more efficient. Why should someone go to a custody bank to borrow at Fed Open minus when you can get Fed plus?

Chiuch: In its current manifestation as being offered by the vendors that are out there, it’s not a compelling argument and it’s cost prohibitive. People might say, ‘Why don’t you just ramp up your volume?’ but that’s not going to happen with someone whose responsibility it is to earn



risk-adjusted returns for the beneficial owners in a prudent, skilful manner.

Treseler: Unless you are actually trying to raise money you wouldn't participate in a CCP. It's a place to trade collateral, it's not about securities lending anymore.

Wyllie: But even within Canada I don't think it can be avoided because it's already happening. The central bank has already supported it for the intra-dealer repo market, so I don't think you can say Canada won't develop a CCP framework similar to other markets.

Chair: What are the concerns of lenders today?

Avitabile: Understanding where the risks are and the controls that are in place to mitigate them. They want customisation, more control over their programme and transparency. In fact, some clients who have decided to explore lending for the first time have created project teams to become educated on lending in order to successfully perform due diligence on a lending programme. Today, more and more clients are focused on intrinsic value lending and want benchmarking to ensure they're achieving the best results for their portfolios. Equally important is the need for optionality. They want to be able to adjust and make changes to their programme as and when markets change. Programme changes can include adjusting holdbacks, restricting or adding borrowers, collateral types and guidelines, to name a few. They may not want to lend in emerging markets today, but once they feel more comfortable and confident with the lending process and the programme

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parameters they've established they're likely to expand their programmes to include emerging markets.

Maynard: We're seeing clients that are more engaged. If anything, going forward the challenge may be to keep lenders as engaged as they have been through the financial crisis period. We're having a lot more regular discussions with our lenders. Also, the theme of customisation is now popular with lenders as they look to customise their lending programme to their own internal risk parameters. The conversations we're having a lot more now are along the lines of, 'Is there anything that my counterparties are doing that I'm not doing? Show me all my programme options.' Part of our job as well is to understand what our clients' goals and objectives are for their programme and ensure these are being met.

Wyllie: There are probably less challenges on the beneficial owner's side in comparison to what we're seeing on the demand side as over the last year a significant amount of work has been allocated to satisfy the concerns of our underlying clients. Lenders are asking for additional reporting, more transparency and regular reviews, as opposed to a number of years ago when there were beneficial owners within programmes that didn't even realise they were in those programmes. Demand hasn't quite returned to pre-crisis

levels but there are still opportunities now that we're seeing in the market. The emergence of term trades has increased in popularity whereas that wasn't necessarily something that clients might have had an interest in a number of years ago.

Maynard: It's much easier to upsell clients on new product opportunities and options that are engaged in their programmes already and up to speed about the particulars of their current lending programme than it is to upsell somebody who doesn't know a lot about their current lending programme. What we're finding now when we're out there trying to win new business is lenders are well versed about their current lending programmes and are looking for other opportunities available to them over and above what they're currently doing. Securities lending is a value-added programme for our clients and in some cases we compete with other value-added services like swaps and repos.

Chair: What's the outlook for securities lending in Canada?

Avitabile: An increase in supply as we see clients re-engage and new clients who have never lent before participate in lending for the first time. The beneficial owners are better positioned than ever to make a decision to participate in a securities lending programme because they're better educated on the product. One of the



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challenges we face as an industry is on the demand side, as you may see demand for Canadian equities somewhat flat through year-end while markets in Asia are experiencing significant growth.

Maynard: The growth in demand from borrowers is certainly a challenge going forward for the foreseeable future given lending supply continues to grow. Another challenge is interest rate markets in the US. Interest rates being so low, you don’t have as much ability to undertake GC lending as you once did as you don’t have room to make a lot of spread on your cash reinvestment. That will hamper some of the day-to-day volume and returns until interest rates go up. In Canada we continue to see demand from borrowers to accept cash as collateral and are working with our lenders to offer cash collateral products that meet their risk tolerances.

Maynard: A rising rate environment in Canada is always a challenge and that’s why it will be critical to manage your investment parameters, effective durations and weighted average maturities in short term funds when you’re investing cash collateral in this type of environment.

Wyllie: If we look at year-over-year balances they’re trending up, but it might be some time before we hit pre-crisis levels.

We’re unlikely to see similar volumes in the near future but current activity is a good indicator of a positive outlook. On the supply side we’re at pre-crisis levels as most lenders that temporarily suspended their programmes have since returned and markets have improved in general, but on the demand side challenges remain.

Chiuch: Some of the spreads have evaporated because the higher margin businesses like M&A and event-driven trades just aren’t there. Rising balances are also a function of rising asset values. Markets have risen significantly, and it’s difficult to see a clear picture of how much of the market growth is real and how much is attributable to the rise in underlying asset values.

Treseler: We’re witnessing an increase in flows of ETFs because of the general unwillingness of investors to take a short position on an individual security. As well, some firms like SG are taking a more technical view of corporate actions and possible opportunities. It’s just about having the proper partner in the marketplace who has all the tools to execute such transactions properly.

Chiuch: Year-on-year we’ve seen a 10% increase in securities lending activity, so overall you could say it’s a positive trend and conditions appear to be improving. ■
By Luke Clancy, freelance Journalist

