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Securities Lending and Borrowing (SLB)

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- SLB Models
- Legal and Regulatory Framework.
- Who will participate in SLB.
- Eligible Securities and Collateral.
- SLB Process Flow
- Benefits
- Risk Management

SLB Models

- *There are two models through which SLB can be carried out.*
  - *Bilateral Model*
  - *Screen based model*

- *A hybrid Model will be adopted in Kenya which will entail both the bilateral model and the Screen-based Model*

What is the legal and regulatory framework for SLB?

- The overarching legal and regulatory framework for SLB is the Capital Markets Act and the Capital Markets (Securities Lending, Borrowing and Short selling) Regulations 2017.
- The SLB Regulations currently provide for the bilateral model of SLB. The Capital Markets Authority has given its 'in principle' approval for the implementation of a **Hybrid Model** of SLB in Kenya.
- The Screen-based SLB Model has been operationalized under the Central Depositories Act, the Central Depositories (Securities Lending and Borrowing) Rules and the Central Depositories (Securities Lending and Borrowing) Procedures.

Who can participate in SLB?

Securities Lending and Borrowing Agents are the authorized agents, appointed by CDSC, who can initiate and carry out SLB transactions for and on behalf of investors.

Central Depository Agents (CDAs) are eligible to be appointed as SLB Agents and they are required to make an application to CDSC to be appointed as SLB agents.

The appointment criteria is set out in the Central Depositories (Securities Lending and Borrowing) Rules.

Securities eligible for lending and borrowing

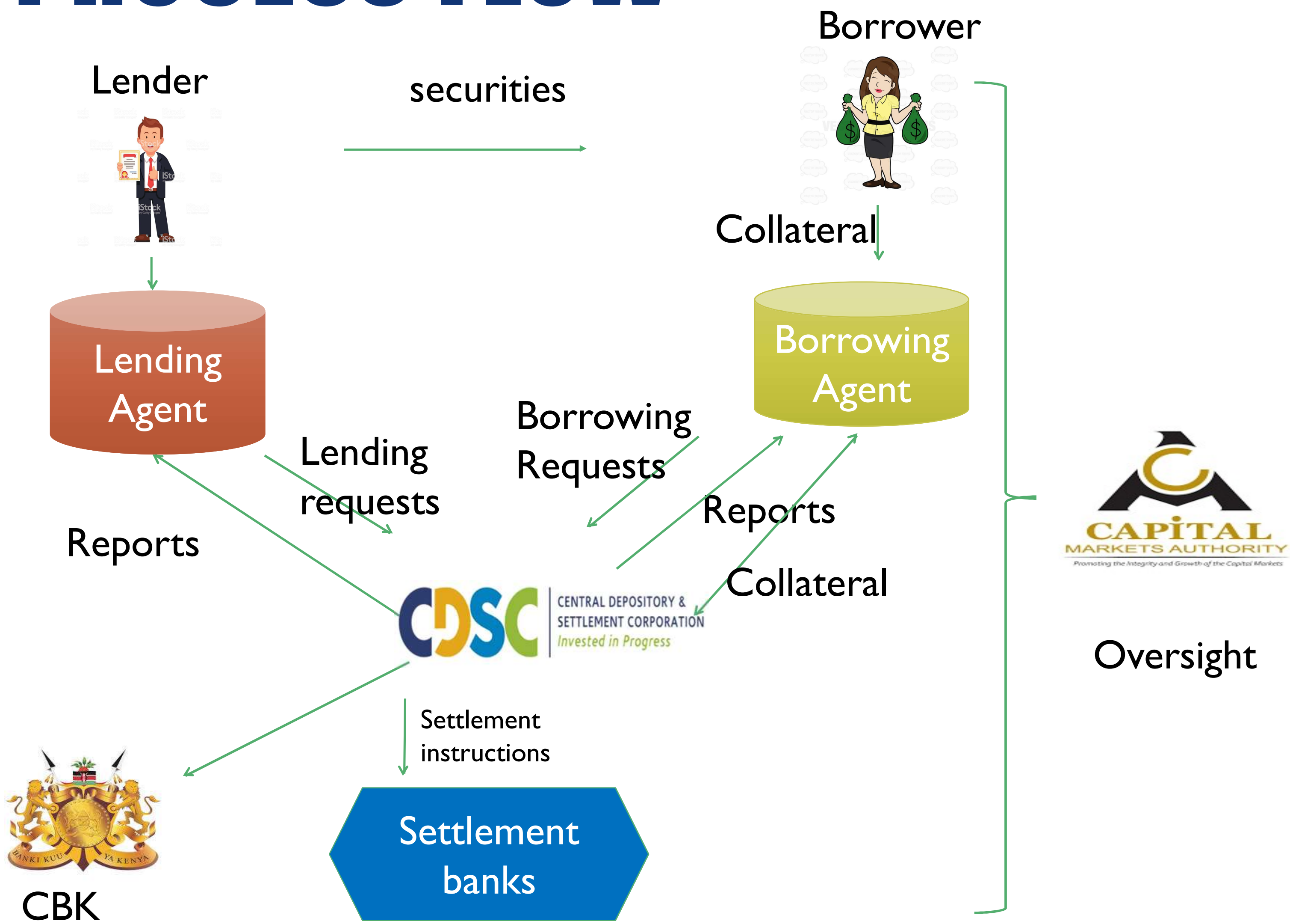
The NSE 20 share index securities as updated from time to time.

The Securities to be lent must have been previously deposited in the CSD and must be balance free.

Accepted Collateral

Government Securities

PROCESS FLOW



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Matching the requests

All agents will be able to view all pending lending and borrowing requests

Automated matching of requests according to the following criteria;

1. Security
2. Quantity
3. Lending fee
4. Duration

After matching securities move from the lender’s CSD account to the borrower’s account and collateral is blocked.

Return of securities before the due date

The lender will have the option to recall securities earlier than the due date but will be required to give a 14 day notice.

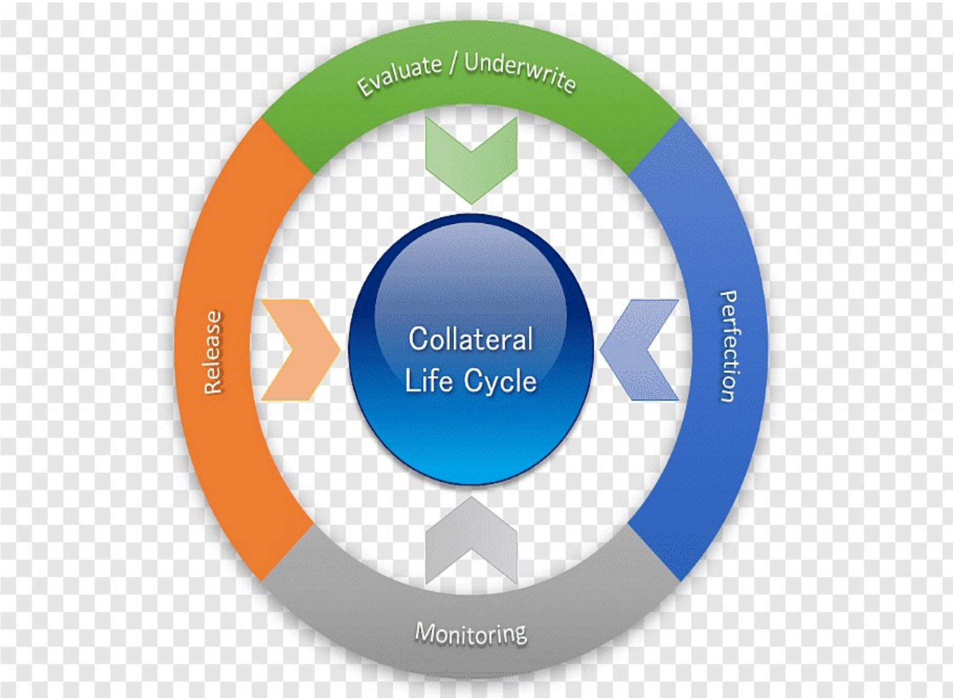
The borrower will be able to return the securities earlier than the return date.

Since the lending fee accrues daily, the lender will only receive the fee that will have accrued up to the point the securities are returned

Settlement of SLB transactions

- Advance notifications before due date
- Automatic return of securities at end of day on due date
- Settlement on the day after return date
- Settlement through settlement banks and CBK
- Guarantee fund to cover any funds shortfall
- Buy-in in case of failed delivery

Collateral management



- ✓ CDSC to manage collateral
- ✓ Cash collateral to be held in accounts to earn interest.
- ✓ Interest earned belongs to the borrower
- ✓ Securities collateral to be pledged in favor of CDSC

SLB Collateral and margins

Collateral of 100% of the value securities borrowed.

Initial margin of 10% to cover price movements.

Daily marking to market of securities.

Margin calls by CDSC.

SLB Reports and client statements

Reports for the agents and the settlement banks availed in the system.

Client’s statement to display outstanding balances of borrowed or lent securities.

Corporate Actions

Borrower to pay lender any dividends that accrue during the duration of the contract

Borrower to provide additional securities in case of a bonus or split.

Suspension and Delisting

All SLB transactions will be closed when a suspension or delisting is announced.

Where it is not possible for the borrower to acquire the securities, CDSC will initiate a cash settlement process.

The last average price obtained from the NSE shall be used to determine the value of outstanding securities.

BENEFITS

Benefits to the lender

- Additional income.
- The lender does not have to look for borrowers in order to lend securities.
- The lender does not have to manage the collateral since CDSC will perform this function.
- Automated transfer of securities.
- The lender will receive all corporate actions that take place during an SLB transaction.
- No counterparty risk as transactions are guaranteed by CDSC.

Benefits to the borrower

- Additional income to the borrower.
- Supports trading and investment strategies e.g. short selling.
- Screen based model ensures that borrowers can view securities on offer to enable them to quickly take advantage of opportunities that arise.
- No counterparty risk as transactions are guaranteed by CDSC.
- Immediate automated transfer of securities ensures that borrowers receive securities in a timely manner.

Benefits to the market

- ✓ Increased liquidity
- ✓ Enables participants to cover temporary shortfalls or overall net debit positions in CDSC at settlement time.
- ✓ Market makers are enabled to borrow securities in order to make two-way quotes.
- ✓ Additional income for the market (Commissions and transaction levies).

EXAMPLE SHOWING HOW THE LENDER AND BORROWER EARN MONEY IN SLB TRANSACTIONS

Assumptions

- Borrowing Date 3rd September 2020
- Return date 6th November 2020
- Number of days 65
- Security EABL
- Number of shares 100,000
- Lending rate 10%
- Share Price at borrowing 172.99
- Share Price at return 150.65
- Required Collateral + Margin (Kes) = 17,299,000 + 1,729,900 = 19,028,900

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LENDER

Lender earnings

100,000* 172.99*10/100*65/365

= Kes 308,064.00

Lender expenses

SLB Levies = 16% * 308,064.00 = **49,290.24**

Earnings – Expenses = 308,064.00- 49,290.24 = **258,773.76**

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BORROWER

Borrower Earnings

Borrowed and sold 100,000 shares on 6th Nov 2020 @ 172.99 = 17,299,000

Bought back shares @ 150.65 = 15,065,000

Difference = Kes 2,234,000

Interest earned from cash Collateral = 5%* 19,028,900 = 951,445*65/365= 169,435

Total Earnings= 2,234,000+169,435 = **2,403,435**

BORROWER CONT…

Borrower expenses

Commissions and levies at time of sale = 2%* 17,299,000 = 345,980

Commissions and levies at time of purchase = 2%*15,065,000 = 301,300

Lending Fee paid to the lender= 308,064.00

SLB Levies = 0.55* 17,299,000 = 95,144.50

Total Expenses = **1,050,488.50**

- Difference between revenue and expenses = 2,403,435- 1,050,488.50 = **1,352,946.50**

RISK MANAGEMENT

Risk Management

Risk	Mitigation
Credit Risk	Collateral to be maintained at 110% of the value of the securities borrowed
	Daily mark-to-market of the lent securities and collateral (non-cash) with daily margin calls.
	Borrower to provide collateral before placing a borrowing request and this collateral is reserved immediately an SLB transaction is executed/matched.
	Borrower may request for return of excess collateral
	Settlement Guarantee Fund in place
	Buy-in and Cash equivalent compensation for failed return of securities paid by the collateral provided
Liquidity Risk	The Authority has proposed to prescribe that only liquid securities (constituents NSE20 index) may be lent/borrowed
	The quality of the collateral required in a securities lending or borrowing transaction restricted to cash in Kenya shillings; and Government securities.
	SLB regulation restricts reuse of collateral
	A notice of up to 14 days by the lender to the borrower when recalling lent securities.

Risk Management

Risk	Mitigation
Collateral Investment Risk	SLB Regulations limit reinvestment of collateral to interest bearing deposits for cash and overnight repo for GoK securities.
	Collateral to be held with credit worthy tier I Banks
Operational Risk	Rules and Operational Procedures
	The new system ability to support the SLB framework have been tested and noted to be adequate
	Indemnification mechanisms by the agents and CDSC provided for in the SLB Rules and contracts.
Market Risk	Daily Mark-to-Market, Initial Margin requirement, restriction on collateral reinvestment
Legal Risk	Admission in CMA's Regulatory sandbox for piloting of screen-based SLB
	Standardized Master Agency Agreements