SECURITIES LENDING AND BORROWING (SLB)

VS

DERIVATIVES

COMPLIMENTS OR SUBSTITUTES

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SECURITIES LENDING & BORROWING (SLB) AND DERIVATIVES

SLB (CDSC) and the Derivatives market (NSE) are both fairly new products in the Kenyan Capital Markets. We take a look at how similar/different these two products are and whether there is a case for both complimenting each other while meeting the needs of different investors.

MARKET STATISTICS

Global Revenues

SLB	2020	2021	Growth
Americas Equity Securities Lending Annual Revenues	$3.7B		
Q1 2021 Total Global Secuities Finance Industry Revenues	$1.88B	$2.07B	10%
Broker-Broker Activity (Where Brokers and Dealers Lend and borrow securities from each other)	$223.4M	$248M	11%

DERIVATIVES	2019	2020
Volume of Exchange Traded Derivatives contracts	32.36 billion	46.28 billion
Volume of Futures Contracts	18.27 billion	25.32 billion

$2.07B
Global Securities Revenue in Q1, 2021

$1.4B
2020 EMEA Equity SLB Revenues

$46.28B
2020 ET Derivatives Contracts

$25.32B
2020 Volume of Futures Contracts

***Source**: Data Lend (Market Data Division of Fintech, EQUILEND), IHS Markit December 2020 securities finance snapshot, World Federation of Exchanges 2020 Market Highlights*

INTRODUCTION: Securities Lending and Borrowing

Securities Lending and Borrowing (SLB) is the temporary transfer of shares from one party *(lender)* to the borrower, with an agreement to return the shares either on demand, or at a future date. The lender can be an individual or an institution that holds a substantial number of shares on a long term basis.

How to Lend

1. Contact an SLB Agent.
2. Submit your lending instructions (The shares you are willing to lend, the lending fees and the period you wish to lend)
3. The SLB Agent upon confirmation of the availability of shares in your account, shall capture the lending request in the CDS
4. The securities shall then be reserved and your lending request added to the lending pool or matched with an existing borrowing request

How to Borrow

1. Contact an SLB Agent.
2. Provide 100% collateral and 10% Initial margin.
3. Submit your borrowing request (The shares you are want to borrow and the borrowing period)
4. The SLB Agent captures the borrowing request in the CDS
5. The request is added to the pool or matched with an existing lending request

In case matching does not happen within the set time (expiry date), the requests will be automatically removed from the pool and the shares and collateral released.

INTRODUCTION: NSE Derivatives Market

Derivatives are financial instruments whose characteristics and value depend upon the characteristics and value of an underlying asset which is typically a commodity, bond, equity or currency.

The NSE derivatives market (NEXT) offers futures contracts. These are agreements to exchange a pre-agreed amount of an asset at a pre-agreed price on a pre-agreed date in the future.

Types of Derivatives Markets

1. **Over the Counter (OTC):** Parties trade directly with each other without going through an exchange or other intermediary.
2. **Exchange Traded Derivatives (ETD):** Trading is conducted via specialized derivatives exchanges or other exchanges.

Investors buy or sell derivatives to manage the risk associated with the underlying security, to protect against fluctuations in value, or to profit from market movements.

Features of NEXT Futures

1. **Single Stock Futures:** Based on SCOM, KCB, EQTY, ABSA, EABL and BAT.
2. **Index Futures:** Based on the NSE 25 Share Index
3. **Contract Duration:** Quarterly expiry dates - March, June, September and December
4. **Settlement:** Cash settled
5. **Profits and Losses:** Valued and settled on a daily basis

Securities Lending and Borrowing (SLB) Vs Derivatives
SIMILARITIES: Trade on stocks as the underlying asset

Securities Lending and Borrowing (SLB) allows lenders to transact in shares that would other wise be idle and gives borrowers the opportunity to take advantage of bear market conditions and make money from declining prices

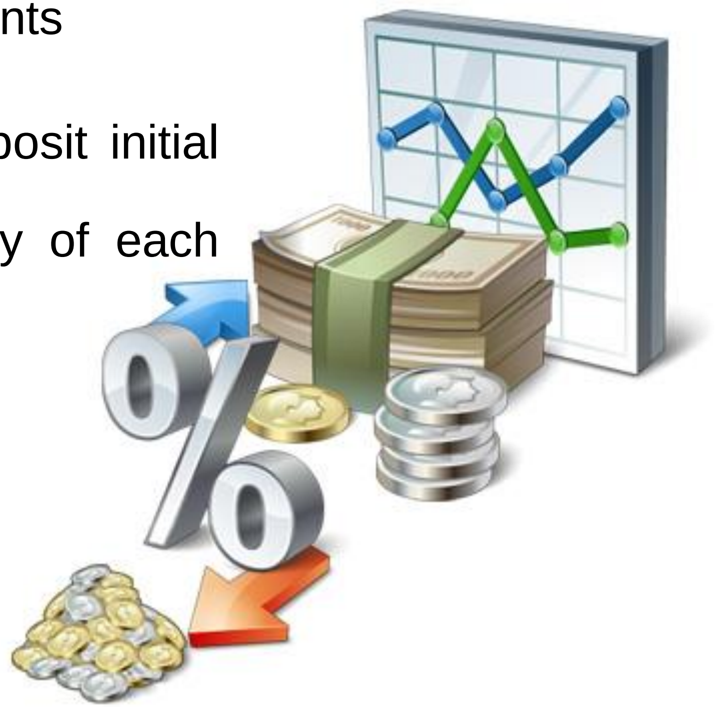
Derivatives Market (NEXT) allows investors to gain exposure to various counters and the broad market by trading Single Stock Futures and Index Futures. Investors can take advantage of both bull and bear markets by going long or short.

Both have shares as the underlying asset.

Securities Lending and Borrowing (SLB) Vs Derivatives
SIMILARITIES: Margin requirements

Securities Lending and Borrowing (SLB) requires the borrower to provide 10% initial margin on top of collateral to cover for fluctuations in price movements

Derivatives Market (NEXT) requires both the buyer and seller to deposit initial margin. This margin is calculated by the NSE based on the volatility of each security and ranges between 8% - 20% of the value of the position.



Margin is applied to cover for price movement

Securities Lending and Borrowing (SLB) Vs Derivatives
SIMILARITIES: Regulator and Exchange

Both **Securities Lending and Borrowing (SLB)** and the **Derivatives Market** are regulated by the Capital Markets Authority (CMA) and trade on a regulated Exchange (**NEXT** and **NSE)**

CAPITAL MARKETS AUTHORITY
Promoting the Integrity and Growth of the Capital Markets

CENTRAL DEPOSITORY & SETTLEMENT CORPORATION
Invested in Progress

next NSE Derivatives Market

Securities Lending and Borrowing (SLB) Vs Derivatives
DIFFERENCES : Settlement

In **Securities Lending and Borrowing (SLB)** transactions, borrowers receive actual shares to transact in and lenders expect back their shares at the end of the lending period.

In the **Derivatives Market (NEXT)** futures contracts are settled in cash. Physical settlement (delivery of shares to settle contract obligations) will be introduced at a later stage.

Securities Lending and Borrowing (SLB) Vs Derivatives
DIFFERENCES: Clearing and Settlement Platform

Securities Lending and Borrowing (SLB) clearing and settlement is carried out through the Central Depository System **(CDS)** managed and by CDSC

Derivatives Market transactions are cleared through Clearing Members and a Clearing House - **NSE Clear**.

Securities Lending and Borrowing (SLB) Vs Derivatives
DIFFERENCES: Transaction Facilitation

Securities Lending and Borrowing (SLB) transactions require appointed SLB Agents. Appointment is done by CDSC. (Not all approved CDAs are appointed SLB Agents)

Derivatives Market has approved Trading Members (Brokers and Investment Banks) as the entities facilitating trade execution. (Not all Brokers and Investment Banks are derivatives Trading Members)

A CASE FOR BOTH

next NSE Derivatives Market

Securities Lending and Borrowing (SLB) Vs Derivatives
How SLB and Derivatives can Compliment Each Other

When fulfilling **Physical settlement** of a derivatives contract obligation, the party with the obligation can engage in an SLB transaction and borrow the securities in order to settle the Derivatives contract ensuring they do not default on their obligation on maturity. This applies to jurisdictions that require settlement in shares for single stock futures.

Securities Lending and Borrowing (SLB) Vs Derivatives
How SLB and Derivatives Compliment Each Other

SLB and Derivatives exist to help **similar** customers achieve **different** goals.

Investors trying to hedge risks by limiting their exposure to stocks can take up different positions in a derivatives contract.

Consider a case where an investor engages in SLB by borrowing shares to execute a short selling trading strategy. They can hedge their risks and enter into a futures contract to buy the shares in future at the expected low price to minimize risk of losses should the SLB contract mature with the shares trading at a high market price.

Derivatives and SLB help investors meet different needs

Securities Lending and Borrowing (SLB) Vs Derivatives
How SLB and Derivatives Compliment Each Other

Security	SCOM	
Trade	Short Sale	Buy
Asset	Shares	Futures
Quantity (Shares/Contracts)	2,564,103	2,564
Exposure	100,000,000	99,996,000
Funds Required Upfront	110,000,000	10,717,520
Entry Price	39.00	39.00
Exit Price	41.00	41.00
Gross Profit/Loss	-5,128,205	5,128,000

If the share price rises, the investor would suffer losses on their short selling strategy but would also make a profit on the futures contracts they had bought. This effectively mitigates the overall risk on the combined portfolio.

Market makers can also take advantage of this strategy to reduce their risk and subsequently provide more liquidity to both markets.

THANK YOU!