SECURITIES LENDING AND BORROWING (SLB)

UNDERSTANDING SLB, RISK EXPOSURES AND MITIGATION MEASURES

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Overview of Securities Lending and Borrowing

Securities Lending and Borrowing (SLB) is the temporary transfer of shares from one party *(lender)* to another (*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 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. Submit your borrowing request (The shares you are want to borrow and the borrowing period)
3. The SLB Agent upon receiving your collateral and 10% initial margin, shall capture the borrowing request in the CDS
4. 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.

Overview of Securities Lending and Borrowing

Benefits of SLB to Participants

Lenders

- ❖ Additional Income through Lending Fees
- ❖ Automated transfer of Securities
- ❖ Lender receives all corporate actions that take place during an SLB transaction

Borrowers

- ❖ Additional income in bear market conditions
- ❖ Supports investment strategies like short selling
- ❖ With screen based model, borrowers can view securities on offer and take advantage of opportunities that arise

Lenders and Borrowers

- ❖ No Counterparty risk as transactions are guaranteed by CDSC
- ❖ Lenders and borrowers transact in a common platform (Central Depository System)

CENTRAL DEPOSITORY & SETTLEMENT CORPORATION
Invested in Progress

APPROVED SLB AGENTS

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CDSC Risk Management Framework

CDSC's Risk Management Framework is based on globally recognized standards

Governance

- Oversight through the Board's Risk Committee & ExCo.
- Framework benchmarked on international standards – CPMI-IOSCO, COSO, ISO
- Organization-wide Risk-aware culture

Strategy & Objectives

- Analyzing Risk and Business context
- Defined Risk Appetite and Tolerance

Risk Assessment

- Risk Identification
- Risk Analysis
- Risk Evaluation and Prioritization
- Risk Mitigation

Review & Revision

- Annual Risk Policies review
- Continuous assessment of risk performance

Information & Reporting

- Periodic reporting of risk posture

Settlement Risk	Cyber & InfoSec Risk	Credit Risk	Regulatory Risk	InfoTech Risk
Operational Risk	Strategy Risk	Market & Liquidity Risk	Compliance Risk	Agency Risk

Securities Lending and Borrowing Risk Management

1 Credit (Default) Risk

The risk that a party (Borrower, Lender, CDSC), will be unable to meet fully its funds and securities obligations when due

Risk	Mitigation Measure(s)
Collateral and Securities Settlement: Borrower could fail to provide collateral or the lender may not avail the lent security at the beginning of the contract.	❖ Borrower is required to **provide collateral before** placing a borrowing request and this collateral is reserved immediately an SLB transaction is executed/matched. ❖ The lender to ensure that securities are **unencumbered** before CDSC can approve the lending order/request. ❖ DVP-3 settlement of the matched SLB orders with **simultaneous blocking of collateral and transfer of borrowed securities** from the lender to Borrower.
Margin: Failure by the borrower to deposit the additional margin calls.	❖ Daily mark-to-market of the lent securities and non-cash collateral with daily **margin calls** and **Prompt contract closeouts**. ❖ SLB transaction to be **terminated** a day after borrower default to limit exposure to the lender of securities.

1 Credit (Default) Risk…

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Risk	Mitigation Measure(s)
Failed delivery: Failure by the borrower to return securities to the lender at the end of the contract period	❖ Buy-in and Cash equivalent compensation for failed return of securities paid by the collateral provided. ❖ Centrally Cleared SLB Contracts with Collateral to be maintained at 110% of the value of the securities borrowed.
Lending Fees: The borrower's inability to settle outstanding lending fees at the end of the contract.	❖ Provided collateral to be used. ❖ Settlement Guarantee Fund in place.

Liquidity Risk

The risk that a counterparty will not settle an obligation for full value when due. Liquidity risk does not imply that a counterparty or participant is insolvent since it may be able to settle the required debit obligations at some unspecified time thereafter.

Risk	Mitigation Measure(s)
Illiquid stocks: Inability of the Borrower/CDSC to get securities (shares) in the open market.	❖ Only liquid securities (**constituents of the NSE 20-Share Index**) can be lent/borrowed. ❖ A **notice of 14 days by the lender** to give the borrower adequate time to source for the securities. ❖ SLB Rules/procedures allows for **cash settlement** (compensation to the lender) incase of failure to get securities.
Collateral: Inability to liquidate borrower's collateral on default by the borrower.	❖ Collateral required in a securities lending or borrowing transaction is restricted to **Cash (in Kenya shillings)** and **Government securities**. ❖ SLB regulation **restricts reuse of collateral** to: interest bearing accounts in case of cash and overnight repo transactions for GoK Securities.

Loss to SLB participants resulting from inadequacy in internal processes, people and systems

Processes

- SLB **Rules and Procedures are in place** and approved by CMA.
- **Periodic communication** with the SLB parties, their agents and the regulator on SLB transactions including daily reporting on executed SLB transactions.
- **Indemnification mechanisms** by the agents and CDSC provided for in the SLB Rules and contracts.
- **Accounting Treatment** for SLB Transactions already provided for in IFRS 9.

Systems

- A **CDS system** in place to support the SLB framework has been tested and noted to be adequate.
- **Benchmarking** of the Screen-Based SLB Model done.

People

- **Training** and **capacity development** for staff and participants conducted and continuing.

Uncertainty in application of regulations or contractual terms, unfavorable regulatory changes, freezing or delay in recovery of assets because of a court orders, or voiding of contracts resulting from non-compliance to laws and regulations

Uncertainty in Regulations - SLB Regulations, Rules and Procedures have been exposed to stakeholders and approved by CMA. CMA has admitted CDSC to deploy SLB in the regulatory sandbox.

Regulators support - SLB to be carried out by regulated entities who may act as intermediaries (SLB Agents) for securities borrowers and/or lenders with CMA conducting continuous compliance monitoring.
RBA issued a Letter of No Objection to allow Retirement Benefit Schemes to participate subject to their IPS

SLB Master Agreements - SLB Master Agreements are in place (between lender and borrower, Lender/Borrower and the SLB Agent and CDSC and SLB Agents) spelling out obligations, responsibility, dispute mechanism etc.

5 Other Risks and Mitigation Measures

Custody Risk

Loss of collateral due to insolvency of collateral custodian

- CDSC is limiting the custodian of borrower collateral to Tier I banks with a low credit risk rating
- Collateral is distributed among various commercial banks

Settlement Risk

Delay in receiving securities or collateral

- Transfer of security to the borrower is simultaneous with the blocking of collateral
- SLB Guarantee Fund in place

Market Risk

Loss arising from price fluctuation in security lent/borrowed

- Marking to Market,
- Initial Margin requirements,
- Limitation on collateral re-use

While there are adequate risk mitigation mechanisms provided in the Rules and Operational Procedure, the Borrowers, Sellers, and their Agents need to note the following

Borrowers

- Market can go against borrower
- Increased cost due to manufactured dividend
- Premature wind-up of contract on call by lender or default on margin calls
- Illiquidity in the market when return is due
- Impact of delisting and suspension of securities in an open SLB contract

Lenders

- May lose control when the borrower fails and compensation is made on cash basis
- Inability to promptly exploit opportunity due to the 14 days notice period
- Premature return of securities
- Impact of delisting and suspension of securities in an open SLB contract

THANK YOU!

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