



THE Nigerian STOCK EXCHANGE

RC: 2321

SECURITIES LENDING AND BORROWING

Definition

Securities Lending refers to the lending of securities such as stocks and bonds by one party to another. Usually, the borrower will provide acceptable collateral to the lender in the form of cash or other acceptable securities of equal but often greater value than the lent securities in order to protect the lender against any default by the borrower. The borrower is obliged to return the securities at the end of an agreed period.

Who are the Parties to Securities Lending?

Borrowers: Market Makers, Broker-Dealer firms, Investment Banks, Hedge Funds and Intermediaries usually comprise this group.

Direct Lenders: These tend to be large institutional investors such as Pension Plans, Insurance Companies, Mutual Funds, Sovereign Wealth Funds, Investment Companies and some High Networth Individuals.

Agent Lenders: Custodians, Broker-Dealer firms and Asset Managers tend to play this role.

Contractual Agreements

In order to undertake a securities lending agreement, contracts between the lender and borrower must be in place, namely:

- The Global Master Securities Lending Agreement (GMSLA).
- The Securities Lending Authorisation Agreement (SLAA).

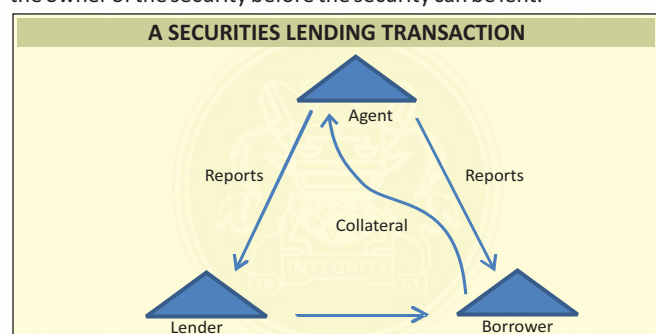
Industry participants usually adopt a standard GMSLA and this is the case with the Nigerian Stock Exchange program with an addendum to cater for the Nigerian Market.

The SLAA is only required when the lender (such as a custodian or broker-dealer firm) lends a security on behalf of the owner of the securities.

It is mandatory to have a GMSLA and SLAA (where applicable) in place prior to using any security for undertaking transactions on the floor of The Nigerian Stock Exchange.

Securities Lending and Recall Process

In simple terms, the transaction involves the temporary loan of securities from a lender to a borrower. Borrowers seeking to borrow securities would typically do this through a security lending agent. The borrower would need to enter into a Global Securities Lending Agreement with the securities lending agent, who is typically the custodian of the securities. The securities lending agent would need to have a Securities Lending Authorisation Agreement in place with the owner of the security before the security can be lent.



Once the security is lent, the legal title of the security passes from the lender to the borrower, but any benefits arising from corporate actions and/or dividend payments are retained by the owner. The lender regains title when the securities are returned by the borrower.

The securities recall process is stipulated by the terms and conditions of the securities lending contract. Main reasons for the recall of a security are:

- Need for the owner of the security to vote .
- Concern over the borrower's credit worthiness.
- Concern over market volatility.

Collateral Management

The collateral provided to the lender is a type of insurance against the borrower's default. Eligible collateral (taking into consideration criteria such as credit rating, market, type of security, etc.) is agreed between the parties subject to other aspects of the collateral:

- Notional limits – the absolute value of assets accepted as collateral.
- Concentration limits – the maximum percentage of any issue to be acceptable e.g. 5% of daily volume or maximum percentage of total market cap.
- Margin or haircut – the amount of over collateralization required by the lender to protect itself from price volatility of the underlying securities and counterparty risk. The value of the haircut will be determined by the size and term of the transaction, the type securities, maturity and credit worthiness of the counterparty.
- Initial margin required at the outset of the transaction
- The minimum margin to be maintained throughout the transaction.

As part of their risk management strategy, lenders would typically mark the collaterals from borrowers to market on a daily basis and make margin calls (collateral top up notices to the value of the haircut) on any day that the market value of the collateral is less than the agreed haircut.

Risk Management

There are five main types of risks arising in securities lending transactions, namely:

Counterparty Risk – To minimize the risk of defaults, lenders would only lend to high quality borrowers after carrying out appropriate credit risk checks on their counterparty.

Regulatory Risk – All participants should ensure that the regulatory stipulations and constraints of securities lending are well understood. This is provided in the Securities Lending Guidelines of The Nigerian Stock Exchange.

Market Risk – As markets are susceptible to price fluctuations, market liquidity and exchange rate volatility, it is essential for securities lenders to have adequate controls in place to ensure an effective risk management system for not just the non-cash securities but any cash collateral re-invested to protect against investment default.

Operational Risk - Adequate technology and processes should be in place to execute the movement of securities, monitor counterparties, generate reports and administer the lending and borrowing process in an efficient manner.

Delivery and Settlement Risk – It is essential for borrowers and lenders to ensure that the delivery of collaterals/securities as appropriate happens in a timely manner in line with the terms of the lending agreement.

Benefits of Securities Lending:

Lenders:

- Additional income from “idle” securities within an investment portfolio.
- Improves market liquidity by increasing the volume of securities potentially available for trading.

Borrowers:

- Provides market making opportunities.
- Additional income from increased trading volume.
- Improves liquidity and market depth.
- Provides covered short selling opportunities.

The Market:

- Improves market liquidity by increasing the number of potential “sell” and “buy” opportunities.
- Improves market depth and increases market efficiency through price discovery.
- Provides more competition in the market.

Agents/Intermediaries:

- Provides additional income.
- Increases business volume.

Issuers:

- Efficient pricing of securities.
- Improves liquidity by increasing the number of potential “sell” and “buy” opportunities in the market.

Depository:

- Increased assets (number and value) at the depository.
- Additional income generated from holding a larger volume of assets.

Regulators:

- Improves market efficiency.
- Improves market liquidity and market depth.
- Increase potential revenue.
- Market is more attractive to investors.

For more information please contact us at:
+234 (0) 700 CALL NSE (0700 2255 623)
contactcenter@nse.com.ng
