

ACHIEVING EARLY IMPACT IN KENYA

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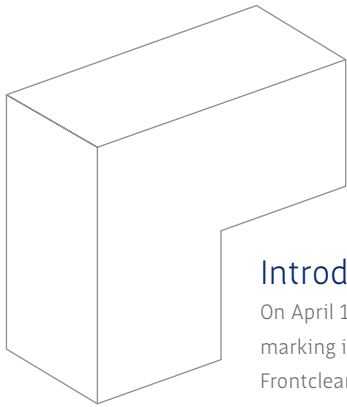
confidential



frontclear

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A financial markets development company



## Introduction

On April 15th 2015 the Frontier Clearing Corporation issued its first notes to the value of USD 31.1 million, marking its first financial close and the launch of a new global financial markets development company. Frontclear is entirely focused on establishing more stable and inclusive interbank markets in developing and emerging economies. This report is Frontclear's first Impact Report and covers the 8 months to 31 December 2015.

## Frontclear impact strategy

The financial crisis revealed to all the importance of having stable and inclusive interbank markets. When these markets froze because of counterparty default fears in the wake of the Lehman bankruptcy, the global financial system stood momentarily at an abyss and was only saved due to swift and massive central bank interventions that continue to today. Since then, establishing robust financial market infrastructure that can withstand credit risk shocks has been a central policy in the efforts to reform the global financial system. Mandatory central clearing of certain markets and mandatory OTC collateral rules have come into effect in advanced markets, whilst banks have been subjected to higher capital requirements for uncollateralized interbank transactions. The latter has had a particular impact on emerging market based banks, who have limited ability to post high quality collateral.

## Why do interbank markets matter?

Interbank markets are the core transmission mechanism of any financial system and are critical to its overall functioning. Stable and inclusive interbank markets:

- Provide an important source of liquidity for financial intermediaries, allowing them to fund temporary shortages and reduce funding risk;
- Optimally allocate funding among intermediaries in the financial system, and is by extension key to effective monetary policy transmission;
- Can unlock cross border comparative funding advantages and thereby reduce the cost of capital for all market participants, and by extension, to the real economy;
- Are critical to the liquidity of primary and secondary bond markets (see box on why title transfer matters)

“An important policy measure that has been proposed to stabilize interbank markets — especially in emerging economies — is to collateralize transactions in the interbank market.”

World Bank 2013 Financial Development Report

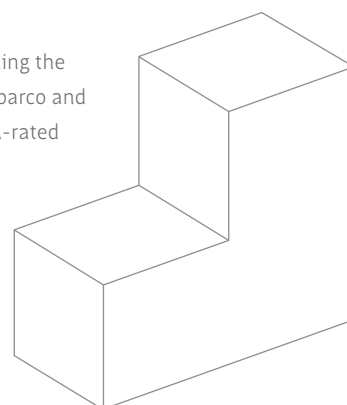
The crisis also sorely reminded us of the impact the financial system can have on the real economy. Global GDP declined by 2 percent in 2009. It has been estimated that between 50 million and 100 million people around the world either fell into, or were prevented from escaping extreme poverty due to the crisis.<sup>1</sup> Access to financing continues to be one of the most significant challenges for the creation, survival and growth of SMEs, especially innovative ones. Evidence suggests the problem is strongly exacerbated by financial and economic crises. SMEs and entrepreneurs suffer a double shock: a drastic drop in demand for goods and services and a tightening in credit terms because financial intermediaries themselves experience funding and liquidity difficulties.<sup>2</sup>

The policy goal is thus to establish more inclusive and stable interbank markets. This means that all financial intermediaries should have cost effective access regardless of size, and that markets should continue to function in times of crisis. How does Frontclear seek to contribute to the establishment of more stable and inclusive interbank markets?

First, Frontclear directly facilitates access to interbank markets for local financial institutions through the issuance of credit guarantees. Second, Frontclear works with local and international partners to establish financial market infrastructure. Third, Frontclear strategically deploys technical assistance funds to build capacity among market participants and to promote an enabling legal and regulatory environment. Together these elements allow Frontclear to establish the building blocks that move markets forward.

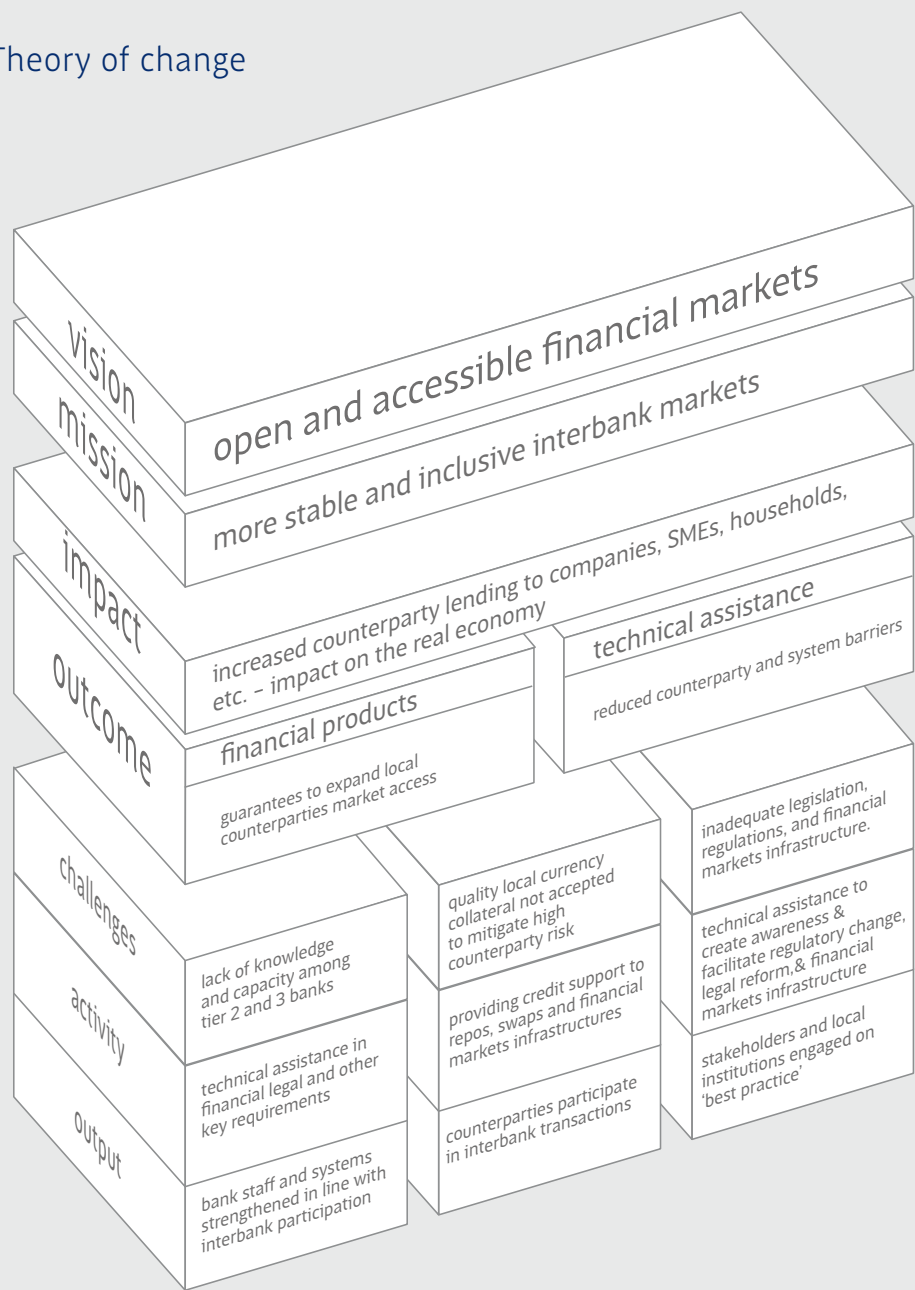
A key goal of Frontclear is to facilitate the better use of local currency assets as collateral in interbank markets. In this regard, Frontclear only supports secured interbank transactions where collateral is exchanged between market participants. Frontclear diversifies its collateral risk exposure through global diversification, thereby absorbing collateral risk more efficiently than if market participants hold the risk on a bilateral basis.

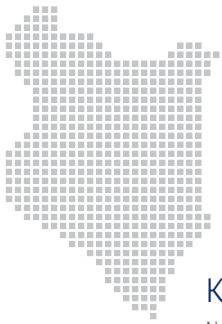
Frontclear is funded by European governments and development finance institutions, including the Financial Sector Deepening Africa, European Bank for Reconstruction and Development, Proparco and The Currency Exchange Fund. Frontclear's guarantees are counter-guaranteed by KfW, a AAA-rated German development bank.



1- For further reading see: Goodwin, N., Harris, J., Nelson, J., Roach, B and Torras, M. (2015). Principles of Economics in Context, Chapter 15.  
2- For further reading see: OECD. (2009). The impact of the global crisis on SME and entrepreneurship financing and policy responses.

Theory of change

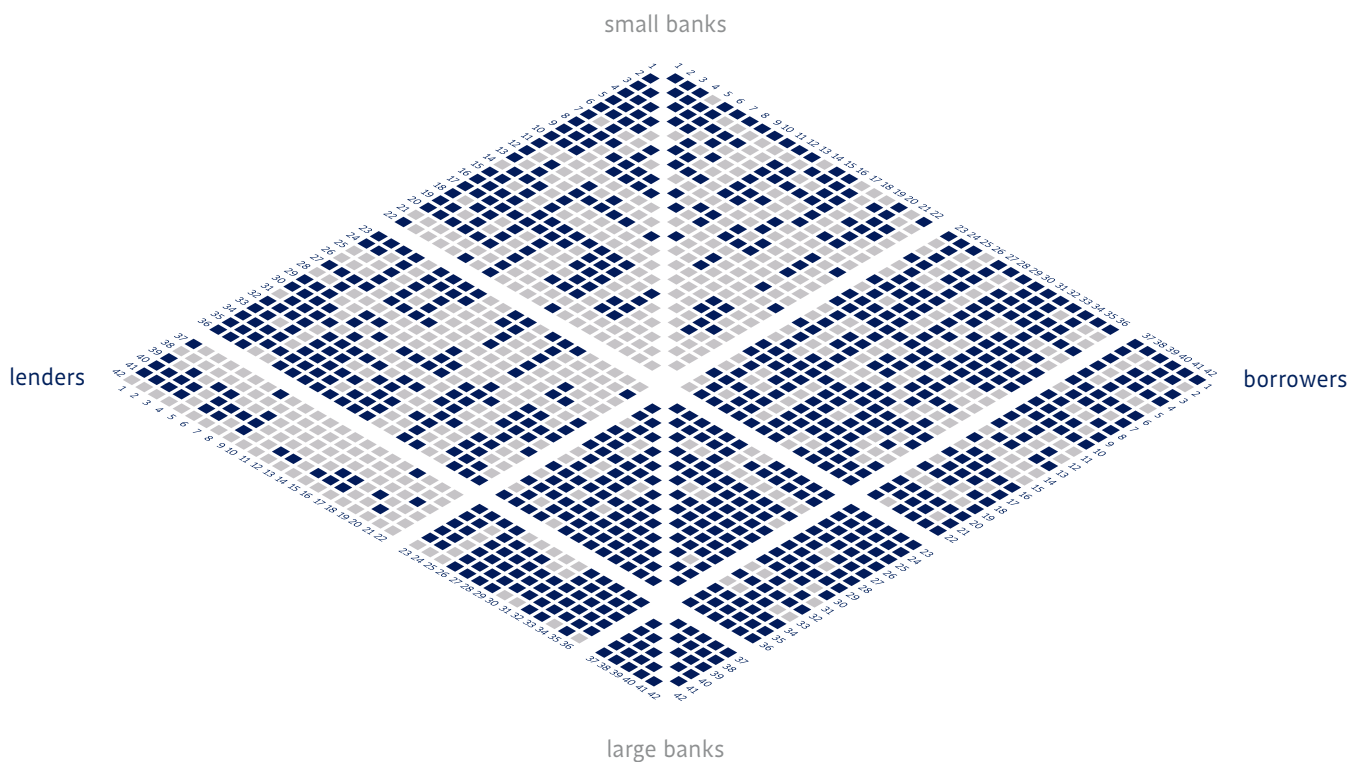




## Kenya case study: Building true repo markets

Nowhere better than to start in Kenya. The diagram below shows that the Kenyan unsecured interbank market is segmented. That is, smaller banks have limited access to the market. This occurs because of the high perceived credit risk of smaller banks. Repo markets are an important element in interbank markets, precisely because they mitigate this imbalance as loans are fully collateralized with government securities. This offsets credit risk on the borrower thereby making the interbank market more inclusive. Again, where smaller banks have expanded access to interbank markets, they are in turn better able to serve the needs of their client base.

## The problem with interbank markets in East Africa



The diagram show the unsecured interbank trading relationships among all banks in Kenya. The banks are ranked in the matrix from small to large (where bank 1 is the smallest, and bank 42 the largest). Blue blocks show active trading relationships, gray blocks means no active relationship exists. The matrix clearly demonstrates that smaller banks have limited access to the market, and in particular, cannot borrow from large banks.

Source: 2014. African Development Bank. Segmentation and efficiency of the interbank markets and their implication for the conduct of monetary policy. Working paper series 202.

"There are no true repo markets in East Africa," says Richard Commotto of ICMA.<sup>3</sup> "In Kenya, Rwanda, Tanzania and Uganda, there is an interbank instrument called a 'horizontal repo'. In Burundi, there is the 'pension livrée' (the French name for repo). In Ethiopia and Malawi, there is nothing as yet. However, neither horizontal repo nor pension livrée are true repos, that is, neither is secured by the transfer of title to collateral by means of a true sale."

3- For further reading visit <https://icmacentre.wordpress.com/2015/12/22/repo-markets-in-east-africa>

In the absence of a market based on outright title transfer, Kenya's interbank market has failed to perform the function of making the market more inclusive. Large banks largely avoid participation in the horizontal repo market due to the legal risk since the collateral is pledged rather than transferred. Moreover, the horizontal repo market is very short-term in nature and does not facilitate cross currency transactions. The box below provides a further explanation on the role of title transfer.

## Why is title transfer so important?

Title transfer of collateral means that full legal title of the collateral in a repo transaction is transferred to the collateral receiver / cash lender. In the horizontal repo market in Kenya, collateral is provided by means of a pledge registered at the central bank. This means the collateral provider / cash borrower retains legal ownership and that the collateral receiver / cash lender cannot resell the collateral in the open market. Title transfer is fundamental to the economic role of repo interbank markets in the wider financial system:

- Title transfer brings legal certainty that the collateral is truly free of encumbrances and readily accessible by the collateral receiver / cash lender and can be readily sold in the open market without reliance on the borrower. This is critical to the role of repos in mitigating credit risk and making the market inclusive;
- Title transfer facilitates market liquidity as the collateral receiver / cash lender can sell the collateral in the open market for cash during the life of the transaction, as it only has an obligation to return similar securities at trade termination. The collateral thus becomes fungible.
- Title transfer is key to ensure repo markets can play their role in supporting liquidity in the bond market by making it easier for dealers to commit to 2-way prices at all time. Why? Higher liquidity in the repo market means dealers can reduce their inventory holding of bonds as they can source bonds quickly to honor executed transactions. It also reduces the cost for primary dealers as purchases of new issuances can be funded by repo'ing existing stock. Finally, the repo market allows dealers to hedge their interest rate risk, reducing their risk of dealing significantly. All this is only possible if title transfer is achieved.

That was all true until Frontclear's closed its first transaction, a USD25m cross currency repo between the Standard Bank of Southern Africa and the Commercial Bank of Africa. In cooperation with the regulatory authorities and the counterparties, the transaction achieved settlement on the basis of full title transfer of the collateral through private title transfer under section 31(1) of the Capital Markets Act. The transaction is considered highly demonstrative and lays the foundation for future work to build a robust, stable and inclusive interbank market in Kenya. The box below provides further detail on the transaction.

## The first repo in Kenya

Frontclear brokered and facilitated a USD 25 million cross currency repo transaction between Standard Bank of Southern Africa (SBSA) and the Commercial Bank of Africa (CBA). In this transaction, CBA receives USD 25 million in 1 year funding from SBSA and provides Government of Kenya Infrastructure Bonds as collateral. The transaction was executed under an ISDA agreement between the two counterparties. Frontclear guarantees the Early Termination Amount to SBSA. In return for the funding, CBA pays a repo rate to SBSA. The diagram illustrates the transaction structure.

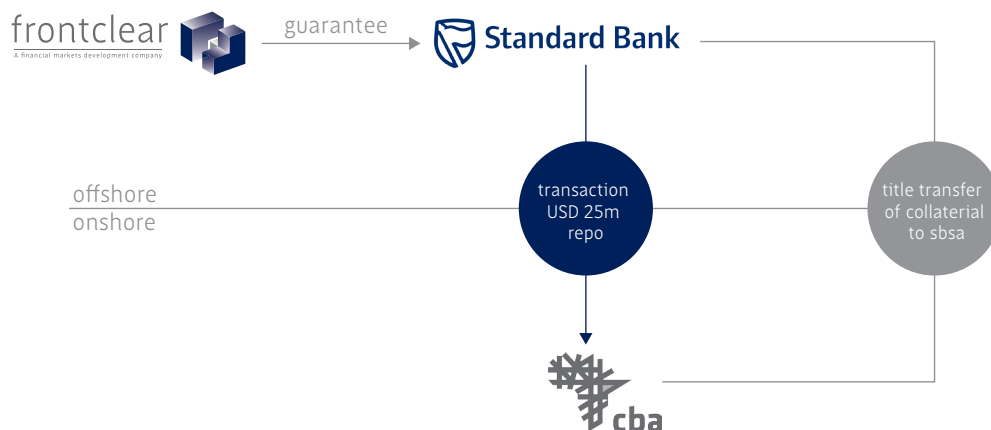
“With this transaction, Standard Bank, Commercial Bank of Africa and Frontclear worked together as partners to develop Kenya’s domestic financial markets. The market development initiative and focus of Frontclear assisted with lobbying the various regulating bodies in Kenya as a collective. We were able to transact under global industry-standard documentation. We see this type of transaction as key to developing deep and liquid financial markets in Kenya and across Africa as a whole.”

Reggie Mlangeni, Regional Head East Africa, Client Solutions at Standard Bank

“This repo transaction has allowed us to term out our funding by a considerable magnitude thereby infusing the much needed stability to our balance sheet.”

Raphael Agung, Head of Treasury at CBA

## The transaction structure



## Frontclear Kenya Technical Assistance Program

To support its demonstrative transaction capacity, Frontclear has launched a 2 year training program in Kenya under the Frontclear Technical Assistance Program (FTAP) funded by Financial Sector Deepening Africa and the Department for International Development of the United Kingdom. The training program, implemented in cooperation with ICAP and ICMA, aims to strengthen knowledge and capacity among smaller banks in the areas of repo and swap markets. The first training took place in Q1 2016 and saw the participation of 13 banks, the Nairobi Stock Exchange and Capital Market's Authority. Frontclear is also looking to further its engagement with the regulatory authorities to formalize the title transfer mechanism for future transactions and for the establishment of a vibrant, stable and inclusive repo market based on outright title transfer of collateral.

## Conclusion

Frontclear's first transaction – being the first true repo based on title transfer executed in East Africa – strongly demonstrates the development impact rationale of Frontclear: risk bearing capacity can catalyse demonstrative transactions to move markets forward. Combined with smart deployment of technical assistance, Frontclear can trigger the establishment of the fundamental building blocks for development of stable and inclusive interbank markets in the target markets.





## annex A: Frontclear portfolio metrics

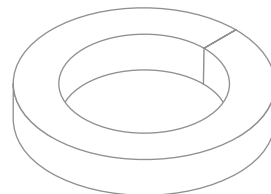
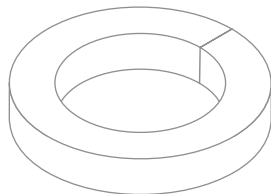
In the 8 months from operational launch on 15 April, Frontclear closed one transaction in October 2015.

The following metrics report an overview of the guarantee portfolio as at 31 December 2015, though it should be noted that the Kenyan transaction was finally settled on 23 February 2016.

### portfolio metrics

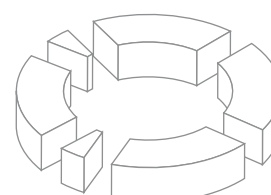
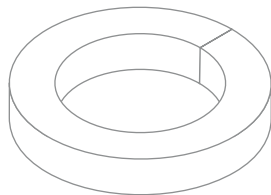
### impact metrics

by region  
sub saharan africa | 100%



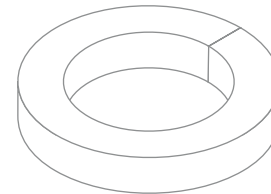
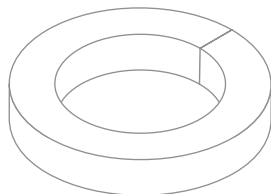
financial inclusion  
tier 2 | 100%

country income level  
other low income | 100%



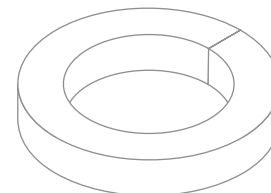
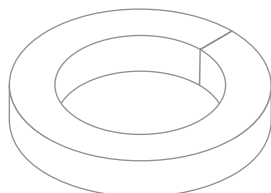
use of proceeds  
manufacturing | 23%  
private individuals | 21%  
government / parastatals | 7%  
commercial | 21%  
transport & communications | 7%  
other | 21%

obligor type  
financial institutions | 100%



connectivity  
onshore-offshore | 100%

financial instruments  
cross currency repo | 100%



currency  
USD | 100%



## annex B: Frontclear FTAP report

Frontclear's guarantee capacity is complemented by an essential role for technical assistance, which seeks to remove the market barriers stemming from a lack of relevant knowledge and skills among counterparties and systemic actors. Specifically, its purpose is twofold:

1. Obligor development: Developing specific skills and knowledge, required to realize transactions; and
2. System development: Contributing to improved knowledge and institutions required to realize a more conducive financial markets system.

The reporting period has largely been dominated by start-up activities. The FTAP achievements to date heavily reflect the building of key FTAP processes. Primary technical assistance achievements aimed at obligor and system developments include:

- a. Country selection: Kenya and Zambia country strategies have been approved by the Donor Committee. Based on expected impact potential, Ghana, Ivory Coast, Rwanda and Uganda will be developed next. Beyond Africa, Mongolia, Kazakhstan, Kyrgyz Republic, Armenia, Georgia are selected in the CIS region and to date, Paraguay for the Latin American region.
- b. Local beneficiary: In each country, the role of a local beneficiary is essential to market outreach and local follow-up. For all three active country programmes a local party has been or will shortly be on-boarded to take-up this active role.
- c. FTAP Approach and analytical framework: An overall FTAP Approach was developed and approved, in accordance with the requirements stated in the FTAP Agreement. A detailed analytical framework has been developed in order to identify context for relevant OD and SD technical assistance. Each active FTAP Country Strategy is based on said framework.

Supporting process developments include:

- a. Suppliers: Thirty technical suppliers were scored following an open market invitation, from which 5 have developed into strong relationships.
- b. Procurement process: the full procurement workflow supported by all required standard documentation in template form, has been established by the close of 2015.
- c. Funding process: Funding targets for the additional regions of CIS and LATAM are in place for 2017. In 2015, 2 funding proposals were submitted with decision-making expected in 2016.



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