Annexure P-III

Interest Rate Swaps

Description of the product

1. An Interest Rate Swap (the swap) is a financial contract between two parties exchanging or swapping a stream of interest payments for a `Notional Principal' amount on multiple occasions during a specified period. The swap is usually "fixed to floating" or "floating to floating" exchanges of interest rate. As per the contract, on each payment date during the swap period, the cash payments based on difference in fixed / floating or floating / floating rates are exchanged by the parties from one another. The party incurring a negative interest rate differential for that leg pays the other counterparty.

Permitted Product and Activity

2. Dealing in IRS is permitted in Pak Rupees only.

Bench mark Rate

3. The parties are free to use any domestic money market / debt market rate or interest rate implied in the foreign exchange forward market as a benchmark rate for entering into IRS, provided methodology of computing the rate is objective, transparent and mutually acceptable to counterparties and approved by the Financial Market Association (FMA). Initially the Karachi Interbank Offer Rate (Quoted on Reuters page KIBR) can be used as benchmark rate.

Size

4. There will be no restriction on the minimum or maximum size of `notional principal' amounts of Interest Rate Swaps.

Tenor

5. There will be no restriction on the minimum tenor, however the maximum tenor of the IRS is initially being restricted to 5 years. Any transaction, which exceeds this tenor, would require separate approval from SBP.

Risk Management

6. Authorized Derivative Dealer:

    a. Shall ensure that appropriate infrastructure and risk management systems such as ability to price the product, mark to market the positions, monitor limit exposures on an ongoing basis, etc., are put in place. The system must be able to calculate Price Value of Basis Point (PVBP) of the portfolio.

    b. Shall express internal trading limits on its activity in IRS in terms of Price Value of Basis Point (PVBP) of the portfolio.

    c. May employ more sophisticated methods of managing their exposure, such as Value at Risk ["VaR Limit"].

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7. Hedges entered against a particular exposure or part thereof for a given time period should not exceed the total principal / duration of the underlying exposure.

8. A customer may enter into an IRS with any authorized derivative dealer / non-market maker financial institution, irrespective of the exposure being booked with that entity or not.

9. Authorized Derivative Dealer / Non-Market Maker Financial Institution must ensure that its customer has Board / Head office / senior management approval to enter into derivative contracts for hedging.

Valuation

8. The valuation of any Financial Instrument is necessary from a control & business management perspective. Thus, the IRS portfolio must also be marked-to-market on a daily basis.

?? MTM / Pricing of IRS'

In more developed markets, "swap curves" exist that are published by major information vendors (Reuters, Bloomberg, etc.). These are used for valuing IRS transactions.

The swap curve usually trades at a premium or spread over the Treasury curve; these spreads vary across the tenor spectrum and fluctuate on a daily basis. The spread is driven by a number of factors, including credit spreads (the swap curve typically indicates the cost of fixed rate borrowing for an AA-rated borrower), liquidity in the swap market, a liquidity or funding premium that reflects investors' risk aversion levels and other market factors.

Since a swap curve does not exist in Pakistan, because Interest Rate Swaps are not actively traded and therefore market swap rates are not available, it needs to be developed for proper valuation.

FMA will coordinate with the major market makers to arrive at the zero, forward and the swap rates. Until then, the swap rate should be synthetically constructed using the following procedure:

a) Treasury Bill / Bond rates for relevant tenors are sourced from the standard sources (Reuters' page PKRV).
b) A swap spread may be loaded on to the Treasury yield curve.

The resulting swap yields should then be used to value and price IRS transactions. Due to an absence of an established market, the methodology used above involves an element of judgment. It is expected that once a swap market is developed, independent IRS prices will be available.

Netting Settlement

9. The following netting procedure shall apply:

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(a) All IRS payments to be exchanged will be net settled i.e. only the difference between the payable and receivable amount is exchanged.

(b) In case of insolvency, the claim of the counter party provides for the netting of the mutual transaction between the insolvent and the creditor. In such a case, the amounts payable by one party are set off against the amounts payable by the other party, and only the net balance is paid or received.

(c) Accordingly the provisions relating to close out would be in line with the statutory provisions and depend on the terms agreed between the two parties through automatic termination clauses and will eliminate the requirement of giving a notice and the fulfillment of other formalities in order to close out the transaction upon the happening of a specified event.