Description of the product

1. A Forward Rate Agreement (FRA) is an interest rate contract between two parties that allows an entity to position itself in the interest rate market. Economically, FRAs are similar to forward borrowing or lending transactions, however in the case of FRAs, the actual lending / borrowing does not take place. The parties enter into a contract at a rate for a "Notional Principal" amount. On the settlement date, the transactions are "Net Settled" against a pre-determined "Benchmark" or Reference rate. The party incurring a negative interest rate differential under the transaction settles this by paying the counterparty the difference amount. FRAs are off-balance sheet transactions. The payment of the interest differential is usually settled "upfront", i.e. at the settlement date, with the interest differential "discounted back" to the present value. This discount is calculated by using the settlement interest rate. The party quoting the Future Rate Agreement is called the "quoter" and the party receiving the quote is called the "receiver". Either party can be called the "seller / lender" or the "buyer / borrower".

Permitted Product and Activity

2. Dealing in FRAs 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 FRAs, 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 is no restriction on the minimum or maximum size of `notional principal' amounts of Forward Rate Agreements.

Tenor

5. There is no restriction on the minimum tenor, however the maximum tenor of the FRAs is initially being restricted to 24 months on the far leg. Any transaction, which exceeds this tenor, would require separate approval from relevant approving authority.

Risk Management

7. 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 its internal trading limits on its activity in FRAs 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"].

9. 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.

10. A customer may enter into FRA hedge with any Financial Institution irrespective of the underlying exposure being booked in that Financial Institution or not.

11. 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

12. The valuation of any Financial Instrument is necessary from a control & business management perspective. Thus, the FRA portfolio must also be marked-to-market (MTM) on a daily basis as follows:

FMA will provide the implied rates on Reuters for revaluation. The relevant yield curve must be used to mark-to-market the position i.e. a FRA booked against KIBOR must be revalued against the KIBOR revaluation rates.

The MTM of FRAs should be done using the relevant tenor yield curve. For instance, if the original tenor of a transaction is 3 v 6, then after 2 months the instrument tenor is effectively a 1 v 4 and it is marked to market on that basis.

The complication arises when pricing for "broken" dates – i.e. when valuing contracts that do not mature on standard maturity dates. For instance, in the example above, after 1 ½ months the transaction is effectively a 1 ½ v 4 ½ FRA. Since market rates for such tenors are not readily available, the spot (and therefore the forward) yields need to be interpolated.

Netting Settlement

13. The following netting procedure shall apply:

(a) All FRA 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 amount payable by one party is set off against the amount 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 happening of the specified event.