

Box 2.1: Derivatives Market in Pakistan

A derivative is an instrument whose value is determined from the value of underlying commodities, metal, index, currency, bond, stock etc. Derivatives are zero sum game (i.e. cost of one counter party is the benefit of other). Besides speculative motives, derivative also provides an opportunity to hedge against the potential risks.

A limited number of derivatives are permitted in Pakistan. For example, SBP has allowed few over the counter (OTC) derivative products for hedging purposes only subject to certain stipulated conditions and disclosure & reporting requirements.^{101,102} Only Authorized Derivative Dealers (ADDs) and Non Market Maker Financial Institutions (NMI) can carry out derivatives.¹⁰³ SECP has allowed futures of listed equities through Future Market Act, 2016 where National Clearing Company of Pakistan Limited (NCCPL) plays its role as a clearing house.¹⁰⁴ Pakistan Mercantile Exchange (PMEX) has allowed futures of commodities.

Through SBP's Financial Derivative Business Guidelines (FDBR) - 2004, four types of derivative instruments have been allowed i.e. (a) Interest Rate Swap (IRS), (b) Forward Rate Agreement (FRA), (c) Third Currency Option, and (d) Cross Currency Swaps.¹⁰⁵ Derivative deals are conducted over the counter (OTC). Although the derivative trading in Pakistan is thin with limited number of well-aware clients, and, that is too for hedging only, such deals do signal the risk perception of the counterparties. Such signals may be treated as Early Warning Indicators (EWIs) and used as input, proactively, in formulating policy toolkit (e.g. monetary policy, macro-prudential policy etc). However, the

underlying assumption holds that counterparties must have fundamental knowledge to understand the mechanics of the instruments in the context of their specific business needs.

The consolidated data of derivative transactions during CY17 depicts that major derivatives deals are carried out in Interest Rate Swap and Cross Currency Swaps. In IRS, the clients (generally corporate) enter into contract to either pay fix – receive floating (based on underlying loan) or vice versa on some notional amount.¹⁰⁶ The general trend of IRS deals in CY17 shows that clients have short (paying leg) the fix rate and long (receiving leg) the floating rate¹⁰⁷. This could be attributed to expectation of bottoming out of low interest rate in near future where clients intend to lock-in low cost of borrowing for the term of their obligations. The ADDs, generally, factor in several risks associated with such transactions (e.g. credit risk, risk of rate rise, rate volatility etc) while determining the fix rate to be paid by the client. The current deals reveal fixed rate incorporate premium of around 200 bps over the floating rate.

The other major component of derivatives in Pakistan is CCSs, which, generally, provide a cover against the exchange rate risk.¹⁰⁸ The prevalent exchange volatility and external sector pressures have increased the quantum of CCSs in CY17. The data reveals the ADDs carrying out deals amongst themselves as well as with other institutional and corporate clients, both, for hedging as well as market making. The deals are mostly done in USD and PKR for a wide range of tenors.

Besides, a few ADDs have FX options on their derivative portfolio, mostly European in nature, for both

(also called fix payer), expects the rate rise in future. At the same time, fix payer also know the stream of his payment outflows (i.e. cost) at the inception of contract. The fix receiver (float payer) expects rate changes in such a way that his receipt (fixed) would be higher than the payment (floating). IRSs are generally carried out for long tenor.¹⁰⁷ Mostly, 3-months KIBOR is used as benchmark for floating rate.¹⁰⁸ In CSS deals, counterparties exchange two different currencies at spot rate at the inception of the contract (also termed as borrowing and lending two different currencies). Both parties receive interest rates on lending currency and pay on borrowed currency, and exchange the original currencies at the end of the term with pre-specified exchange rate.

¹⁰¹ See BSD Circular No.17 of 2004

(<http://www.sbp.org.pk/bsd/2004/C17.htm>)

¹⁰² All derivative transactions are being reported through Derivative Transactions Reporting System (DTRS) to SBP on weekly basis (<http://www.sbp.org.pk/dmmd/2015/C6.htm>)

¹⁰³ See for ADDs and NMIs (<http://www.sbp.org.pk/DFMD/FS-Dom.asp>)

¹⁰⁴ Please see SECP's Future Market Act, 2016 (<https://www.secp.gov.pk/document/futures-market-act-2016/?wpdmdl=14687>)

¹⁰⁵ <http://www.sbp.org.pk/DFMD/FS-Dom.asp>

¹⁰⁶ The IRS may be used for both betting and hedging purposes (in Pakistan, only hedging is allowed). The party, which pay fixed rate

hedging and market making. However, FRA has been rarely seen in derivative contracts in CY17.

Besides the uncertainty arising from mark-to-market changes, the derivatives are prone to a number of other risks including liquidity risk (i.e. inability to unwind the deal at fair cost), legal risk due to ambiguous clauses in the deal etc.

Going forward, the size, number and types of derivative will depend upon the quantum of uncertainty in key economic variables, particularly, the exchange rate and interest rates. However, considering the lack of sophisticated customers and the fact that such instruments are only allowed to hedge the risks, the derivative deals are expected to remain limited in CY18.