General

1. The Financial Derivatives Business Regulations have been formulated in exercise of the power derived by State Bank of Pakistan under Banking Companies Ordinance 1962 and Foreign Exchange Regulations Act 1947, to permit, regulate, and supervise financial institutions entering into derivative transactions.

2. State Bank of Pakistan (SBP) is the supervisory authority for all banks and DFIs engaging in Derivative Business. Financial institutions engaging in derivative business shall obtain the approval of the State Bank of Pakistan and be subject to the supervision and scrutiny of the State Bank of Pakistan.

3. "**Financial Institutions**" as referred to in these Regulations means Scheduled Commercial Banks, Development Finance Institutions (DFIs), Non-Banking Finance Companies (NBFC), as well as branches of foreign banks, which are located in Pakistan (hereinafter referred to as "Foreign Bank Branch").

4. "**Derivative**" as referred to in the Regulations means a type of financial contract the value of which is determined by reference to one or more underlying assets or indices. The major categories of such contracts include forwards, futures, swaps and options. Derivative also includes structured financial products that have one or more characteristics of forwards, futures, swaps and options.

5. "**Derivative Business**" as referred to in these Regulations can be classified into three major types:

    a. Derivative Transactions for the purposes of hedging risks arising from its own assets or liabilities or for altering its risk profile. Entities generally engaging in such activity are regarded as **"End-User"** of derivatives, as described in 8(a).

    b. Derivatives Transactions executed by Financial Institution with its customers with the intention of making a spread. In this case, the Financial Institution does not take any **Market Risk** on its own books and covers the transaction the same day on a back-to-back basis. These institutions are regarded as **"Non-Market Maker Financial Institutions"** (hereinafter referred to as "NMI") as described in 8(b).

    c. A Financial Institution may provide derivative trading services to customers and other financial institutions and quote prices to other institutions and customers and can take **Market Risk** on its own books . Such institution acts as an **"Authorized Derivatives Dealer"** (hereinafter referred to as "ADD"). It is not necessary for this institution to cover its position on a back to back basis, however, it has to remain within its allowed limits when prescribed by State Bank of Pakistan as described in para 36 of these regulations.

6. **"Senior Management"** as referred to in these regulations includes but is not limited to Chief Executive Officer, Chief Financial Officer, or any other individual or body of

individuals designated by the Board of Directors to function as senior management for this specific purpose.

<u>Eligible Entities and Permissible Activity</u>

7. In each derivative transaction, one of the entity should be a financial institution as described in regulation 3.

8. Entities eligible to undertake Derivative Transactions and types of transactions can be categorized as follows:

   a. <u>End User Entities</u>
   Entities typically falling in the "End-Users" category include, but are not limited, to customers of Banks, DFIs, NBFCs and other entities. While dealing with such entities, Authorized Derivative Dealers should exercise due diligence to ensure that their Customers are allowed to enter into derivatives transactions as described in 5(a) against their underlying exposure. Authorized Derivative Dealers should obtain written confirmation from the authorized signatory/ signatories of such Customers to the effect that the transactions undertaken by them are meant for hedging/alter the risk profile of their underlying exposures only, and no derivative currently exists against such exposures with any other Financial Institution. Customers are, however, allowed to split their exposures and hedge it with more than one Financial Institution, provided the total hedge does not exceed the total exposures hedged. Financial Institutions providing derivatives to Customers should obtain an approval from its Board allowing it to enter into derivative transactions for hedging/altering risk profile purposes.

   b. <u>Non-Market Maker Financial Institution:</u>
   An NMI will include all Financial Institutions, which have been given the approval by SBP to carry out Derivatives Business stated under Regulation 5(b). These institutions can enter into derivative transactions with Authorized Derivative Dealers to hedge their own positions. While entering into transactions with their customers, these institutions must cover their positions on a back-to-back basis from an Authorized Derivative Dealer. These institutions must get a one time approval from its Board or Head Office / Regional Office to enter into such derivatives sale and provide a copy to SBP.

   c. <u>Authorized Derivatives Dealer</u>
   An ADD will include all Financial Institutions, which have been given the approval by SBP to carry out Derivatives Business stated under Regulation 5(c). The basic purpose of permitting banks to undertake derivatives is to enable the market participants and/or corporates to hedge their exposures in the financial markets. However, in recognizing the important role played by Market Makers in the development and creation of the market itself, Authorized Derivatives Dealers have been allowed to undertake market-making activity, which may include taking proprietary position.

9. Derivative transactions currently permitted under the Regulations include:
    a. Foreign Currency Options
    b. Forward Rate Agreements
    c. Interest Rate Swaps

   The type, tenor, structure, and specifics of derivatives permitted are contained in the Annexure P-I to P-III of these Regulations. No derivative transaction other than those permitted within these regulations shall be undertaken except with the express prior approval of State Bank of Pakistan.

10. When conducting Derivative Transactions, financial institutions shall comply with all relevant regulations, such as Foreign Exchange Regulations and other regulations issued, from time to time, by the State Bank of Pakistan.

Eligibility Criteria for becoming Non Market Maker Financial Institutions

11. An NMI to be able to sell derivative transactions to End-User entities must demonstrate to State Bank of Pakistan that:

    a. It has a sound risk management system and internal control system in relation to derivative transactions. The system should be able to accurately reflect/evaluate the credit / counterparty risk at the end of each day.

    b. There must be independent Front Office, Mid-Office and Back Office, with distinct/separate reporting lines and headed by different individuals. The detailed profiles of these individuals should be submitted to State Bank of Pakistan along with the application of the financial institution wishing to become an NMI.

    c. It has a risk management framework to identify and address credit and operational risks arising out of derivatives selling activity.

    d. The individuals dealing in derivatives business have the requisite understanding of Derivative transactions in front, middle and back offices.

    e. The derivative business unit is located in the Treasury's main dealing room from where it will carry out all derivative business.

    f. In the case of a Foreign Bank branch applying to conduct derivative business, its home country regulatory authority has the appropriate supervisory framework in place. It shall also obtain from its head office or regional headquarters, a formal authorization for conducting derivative business which includes transaction types and limits for such derivative business.

    g. It has a Derivatives Selling Policy Manual addressing issues from term sheet to code of conduct of dealers; and

    h. It fulfills any other requirements stipulated by the State Bank of Pakistan.

12. Financial Institutions applying to conduct derivative business as NMI shall submit the following documents and materials to the State Bank of Pakistan:

    a. An application to become a Non Market Maker Financial Institution to conduct derivative business;

    b. A copy of its Derivatives Selling Policy Manual. The minimum requirements of the Derivative Selling Policy Manual are set out in Appendix A to these guidelines.

    c. Accounting treatment / policies in relation to derivative transactions.

    d. Risk measurement and management framework.

    e. Organization structure of the derivatives trading unit in relation to the Treasury

    f. Name lists and resumes including qualification, experience of personnel trading in derivative transactions.

    g. Other documents and materials required by the State Bank of Pakistan as per the Product Specific Annexure of the General Guidelines.

<u>Eligibility Criteria for becoming Authorized Derivative Dealer</u>

13. A Financial Institution to be able to obtain the status of Authorized Derivative Dealer must demonstrate to State Bank of Pakistan that:

    a. It has a sound risk management system and internal control system in relation to derivative transactions. The system should be able to accurately reflect/evaluate the overall risk at the end of each day.

    b. It has a sound derivative transaction processing system.

    c. There must be independent Front Office, Mid-Office and Back Office, with distinct/separate reporting lines and headed by different individuals. The detailed profiles of these individuals should be submitted to State Bank of Pakistan along with the application of the financial institution wishing to become an ADD.

    d. The individuals dealing in derivatives business have the requisite understanding of Derivative transactions in front, middle and back offices.

    e. The derivative business unit is located in the Treasury's main dealing room from where it will carry out all derivative business.

    f. In the case of a Foreign Bank branch applying to conduct derivative business, its home country regulatory authority has the appropriate supervisory framework in place. It shall also obtain from its head office or regional headquarters, a formal authorization for conducting derivative business, which includes transaction types and limits for such derivative business; and

g. It fulfills any other requirements stipulated by the State Bank of Pakistan.

14. Financial Institutions applying to conduct derivative business as authorized derivatives dealer shall submit the following documents and materials to the State Bank of Pakistan:

   a. An application to become an Authorized Derivative Dealer to conduct derivative business;

   b. A copy of its Derivatives Business Policy Manual. The minimum requirements of the Derivatives Business Policy Manual are set out in Appendix B to these Regulations.

   c. Internal trading limits set-up for the derivatives activity, duly approved by the respective Board of Directors {in case of Locally incorporated entities} or Head Office / Regional Office {in case of entities incorporated outside Pakistan}. These limits should be in line with the capital structure of each institution and it's risk appetite on such positions. At a minimum, the position limits may be expressed in terms of Price Value per Basis Point (PVBP) or Value at Risk (VaR) of the portfolio, and supplemented by stop loss levels on a monthly basis.

   d. Accounting treatment / policies in relation to derivative transactions

   e. Organization structure of the derivatives trading unit in relation to the Treasury

   f. Name lists and resumes including experience, qualification of personnel trading in derivative transactions.

   g. Other documents and materials required by the State Bank of Pakistan as per the Product Specific Annexure of the General Guidelines.

<u>Application and Approval Procedure</u>

15. Applications to obtain the status of the either an NMI or ADD will be sent to Banking Supervision Department of State Bank of Pakistan. The application should be supported by a full set of application materials and documents submitted by a Financial Institution in accordance with these Regulations.

16. State Bank of Pakistan shall issue an acknowledgement of receipt of application, and will respond within 30 days with the approval, rejection or seek further information from the applicant.

17. State Bank may, at its discretion, carry out an on-site inspection of the treasury related units/offices (front office, middle office, back office) to assess the readiness and suitability of the applicant as either an NMI or ADD.

Operational, Dealing, and Risk Standards for ADD/NMI

18. A Financial Institution shall establish a Risk Management System, Internal Control System, and Processing System commensurate with the nature, scale, and complexity of its derivative business, based on the classification of derivative business provided in Regulation 5.

19. Senior management of a financial institution shall understand the risks of engaging in derivative transactions. They shall review and approve the policies, procedures, organization and authorization of the business operation system and risk management system. They shall have access to information at any time in respect of such risks through an independent risk management function and a sound examination and report system, and shall supervise and manage derivative business accordingly.

20. Senior management of a financial institution shall adopt the standards and methods for measuring the risks of its derivative business which are appropriate for such institution, and shall periodically review and update the risk exposure limits, stop loss limits and contingency plans for derivative transactions pursuant to the overall strength, amount of tier-1 capital, profit-making ability and the operations policies of such institution, as well as the estimation of market risks. Accordingly, senior management shall also establish procedures for supervising and handling these limits.

21. A financial institution shall formulate clear standards on the qualifications of dealers, analysts and other staff, and shall provide the sales staff and other relevant staff with training that corresponds to the complexity of derivative transactions and risk management, so as to ensure that they possess the necessary skills and qualifications.

22. A financial institution shall formulate relevant policies to assess the suitability of its counterparties, including the assessment of whether its counterparties fully understand the terms of the contracts and the counterparties' obligations under the contracts, to ascertain whether the proposed derivative transactions are consistent with the objectives of the counterparties and to assess the credit risks of the counterparties.

23. A financial institution shall be entitled to rely in good faith and in a reasonable manner on formal written documents provided by its counterparties for the purposes of these Regulations.

24. When conducting derivative transactions with institutions and individuals (the end users), the financial institution shall disclose the risks involved in derivative transactions, and shall obtain a written confirmation from such institutions or individuals in order to ensure that they have understood and have the ability to bear the risks in these derivative transactions.

25. The information to be disclosed by the financial institution to such institutions or individuals shall include at least the following:

a. The contents of the derivative contracts and a summary of the risks involved; and

b. Significant factors that may affect the potential loss arising out of the derivative transaction.

26. A financial institution may properly and reasonably use collateral or other credit risk reduction techniques to reduce the credit risk of its counterparties, adopt proper measures and models to assess the credit risk and adopt risk control measures accordingly.

27. A financial institution shall use proper risk assessment methods or models to assess the market risk of derivative transactions, and manage the market risk based on marked-to-market principles. It shall also adjust the scale of its derivative business, the types of transactions and the level of risk exposure accordingly.

28. A financial institution shall, based on the scale and types of the derivative transactions, make adequate arrangements for liquidity to ensure its ability to perform contractual obligations even under extraordinary market conditions.

29. A financial institution shall set up a sound operational risk control mechanism and system to strictly control any operational risk.

Reporting, Disclosure, and Other Requirements

30. A financial institution shall submit to the State Bank of Pakistan such reports and related statements in respect of its derivative transactions as prescribed by the Banking Supervision Department from time to time.

31. A financial institution shall disclose the risks, losses, profit variations of its derivative business and any extraordinary situations according to the financial disclosure requirements in force.

32. In the absence of any specific requirements of the State Bank of Pakistan, or the Institute of Chartered Accountants of Pakistan, accounting treatment and disclosure of derivatives transaction will be, in accordance with International Accounting Standards.

33. No derivative transaction will be executed by the Authorized Derivative Dealer / Non-market Maker Financial Institution unless International Swaps and Derivatives Association (ISDA) Agreement has been exchanged with the other entity.

34. State Bank of Pakistan can examine the materials and statements of the financial institution in relation to derivative business at any time, and periodically examine whether the categories of derivative transactions in which a financial institution is engaged are appropriate in the context of its risk management systems, internal control systems and business processing systems.

35. A financial institution shall properly maintain all transaction records and relevant documents, accounts, original receipts, telephone recordings and other information in relation to its derivative transactions. Telephone recordings shall be maintained for no less than half a year. A financial institution shall retain other materials for at least five years after the termination of contracts for review purposes unless any law / regulation requires a longer period.

36. Authorized Derivative Dealer permitted to undertake derivative business shall include its net open exposure in the calculation of limit on exposure against contingent liabilities under Prudential Regulation R-2 for Corporate / Commercial Banking. A financial institution attaining the status of ADD shall have its maximum contingent liabilities limit under Prudential Regulation R-2 increased from 10 times to 12.5 times of equity. This increase in limit will continue in force as long as it maintains the status of ADD and will restore back to its original limit upon losing the status of ADD.

Powers of State Bank of Pakistan

37. These Regulations shall be interpreted by the State Bank of Pakistan.

38. Any Financial Institution, as described in Regulation 3, conducting derivative transactions as NMI or ADD, without first obtaining the status of NMI or ADD on approval from SBP, shall render itself liable for punitive actions under the Banking Companies Ordinance 1962 / other applicable laws, which may lead to the cancellation of its license under such laws.

39. The State Bank of Pakistan may suspend or withdraw the status of a Financial Institution as an NMI or an ADD to carry out Derivative Business if it has found that the financial institution is in violation of these regulations.

Appendix A

Minimum Requirements of the Derivatives Selling Policy Manual

a) Scope of Derivatives activities, types of services & products to be offered to clients.

b) Procedures for evaluating client suitability

c) Authorities and responsibilities of;
- Board of Directors
- Management Committees
- Chief Executive Officer
- Other Senior Officers
- Department Managers, and
- Trading or Dealing Room Officers / Staff

d) Policies and procedures to govern selling & documentation

e) Policies and procedures for controlling and measuring risk including, as a minimum;
- Counterparty and Gap Limits
- Mark-to-Market policies & procedures

f) Internal Control and Audit Policies

g) Policy review frequency

h) System of Financial and Regulatory reporting

i) Job Descriptions of and minimum qualification standards for key positions, and

j) Technical competence of key officers / traders responsible for derivatives

Appendix B

Minimum Requirements of the Derivatives Business Policy Manual

a) Scope of Derivatives activities, types of services & products to be offered to clients.

b) Authorities and responsibilities of;
- Board of Directors
- Management Committees
- Chief Executive Officer
- Other Senior Officers
- Department Managers, and
- Trading or Dealing Room Officers / Staff

c) Policies and procedures to govern trading & documentation

d) Policies and procedures for controlling and measuring risk including, as a minimum;
- Trading, exposure, counterparty and Gap Limits
- Earning / Capital at Risk (EaR / CaR) and Value at Risk (VaR) Limits assumptions, calculators and limits
- Mark-to-Market policies & procedures

e) Internal Control and Audit Policies

f) Policy review frequency

g) System of Financial and Regulatory reporting

h) Job Descriptions of and minimum qualification standards for key positions

i) Procedures for evaluating client suitability

j) Data processing capability commensurate to the volumes and complexity of the Bank's derivatives business, and

k) Technical competence of key officers / traders responsible for derivatives