

**Draft.**  
**Financial Derivatives - Rules of Business.**

### **Invitation for Comments / Suggestions**

State Bank of Pakistan invites comments/suggestions on these draft guidelines by 30th July 2004. The comments/suggestions may be sent to Mr. Suleman Chhagla, Head of Risk Management Cell, SBP or Mr. Shaukat Zaman, Sr, Joint Director Risk Management Division, Banking Supervision Department, SBP

**State Bank of Pakistan (SBP)**  
**Financial Derivatives Business Rules (FDBR)**

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**General**

1. The Financial Derivatives Business Rules have been formulated to permit, regulate, and supervise financial institutions entering into derivative transactions.
2. State Bank of Pakistan is the supervisory authority for all Financial Institutions 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 Rules means Scheduled Commercial Banks, Development Finance Institutions (DFIs), 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 Rules 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 (beyond 1-year), 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 Rules 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 7(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**” as described in 7(b).
  - c. A Financial Institution may provide derivative trading services to customers and other financial institutions. Such institutions acts as an “**Authorized Derivatives Dealer**” and quotes prices to other institutions and customers and can take the **Market Risk** on its own books. 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 then prescribed by State Bank of Pakistan as described in 7(c).

**Eligible Entities and Permissible Activity**

6. No entity other than a financial institution as defined in Rule 3 shall enter into sale of derivative to its customers.
7. Entities eligible to undertake Derivative Transactions and types of transactions can be categorized as follows:

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**a. End User Entities**

Entities typically falling in the “End-Users” category include but are not limited to customers of Banks, DFIs, and Individuals. While dealing with such entities, Authorized Derivative Dealers should exercise due diligence to ensure that their Customers are undertaking 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 their underlying exposures only, and no derivative currently exist against such with any other Financial Institution. Customers are however allowed to split their exposures and hedge it with more than one Financial Institution, subject to that the total hedge does not exceed the total exposures hedged. Banks providing derivatives to Customers should obtain a Board Resolution or equivalent allowing it to enter into derivative transactions for hedging purposes.

**b. Non-Market Maker Financial Institution:**

A non-market maker Financial Institution will include all Financial Institutions , which do not have the approval by SBP to carry out Derivatives Business stated under Rule 5(c). 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 derivative transactions. A non-market maker Financial Institution, to be able to sell derivative transactions to End-User entities must demonstrate to State Bank of Pakistan that it has:

- i. 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.
- ii. A risk management framework to identify and address credit and operational risk arising out of derivatives selling activity.
- iii. The Financial Institution seeking the status of a Non-Market Maker Financial Institution must be able to demonstrate to the State Bank of Pakistan that individuals dealing in derivatives business have the requisite understanding of Derivatives transactions in front, middle and back offices.
- iv. A Derivatives Selling Policy & Guidelines document addressing issues from term sheet to code of conduct of dealers.

**c. Authorized Derivatives Dealer**

This category includes Financial Institutions that have been permitted under Rule 12 of FDBR by State Bank of Pakistan to carry on Derivatives Business as specified in Rule 5 (c) of these regulations. The basic purpose of permitting banks to undertake derivatives is to enable the market participants and/or corporate 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, at times, involve dealing in the market without underlying exposure.

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8. Derivative transactions currently permitted under the Rules 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 Rules. Any derivative transaction executed not permitted within these Rules by any entity without the express approval of State Bank of Pakistan will be contravention of these Rules and will be subject to action specified in Rule 30, at the discretion of State Bank of Pakistan.

9. When conducting Derivative Transactions financial institutions shall comply with all relevant regulations issued by the State Bank of Pakistan.

**Eligibility Criteria for becoming Authorized Derivative Dealer**

10. A Financial Institution may apply to the State Bank of Pakistan to become an Approved Bank to conduct Derivative Business. Financial Institutions applying to conduct Derivatives Business shall satisfy the following requirements:
- 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 automatically connecting front office, middle office and back office.
  - c. There must be an independent Front Office, Mid-Office and Back Office, with distinct/separate reporting lines and headed by different individuals. The detailed profiles of these individuals be submitted to State Bank of Pakistan along with the application.
  - d. The Financial Institution seeking the status of a Authorized Derivative Dealer must be able to demonstrate to the State Bank of Pakistan that individuals dealing in derivatives business have the requisite understanding of Derivatives transactions in front, middle and back offices.
  - e. It has proper premises and facilities for conducting transactions
  - f. In the case of a Foreign Bank branch applying to conduct derivative business, its home country regulatory authority has the supervisory framework in place and must be competent to supervise derivative business. It shall also obtain from its head office (regional headquarters) a formal authorization for conducting derivative business which includes transaction types and limits for such derivative business; and
  - g. Any other requirements stipulated by the State Bank of Pakistan.

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11. Financial Institutions applying to conduct derivative business shall submit the following documents and materials to the State Bank of Pakistan:
  - a. An application to become a 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 A to these Rules.
  - 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 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.
12. State Bank of Pakistan shall issue a reply within 30 days after receipt of the full set of application materials and documents submitted by a Financial Institution in accordance with these Rules.

**Operational, Dealing, and Risk Standards of Authorized Derivative Dealers**

13. 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 Rule 5.
14. 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 department and a sound examination and report system, and shall supervise and direct derivative business accordingly.
15. 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 risk exposure limits, stop loss limits and contingency plans for derivative transactions pursuant to the overall strength, amount of

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self-owned capital, profit-making ability and the business operation 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. There shall be appropriate separation between the senior management in charge of derivative trading and those in charge of risk management.

16. 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.
17. A financial institution shall formulate relevant policies to assess the suitability of its counterparties, including the assessment of whether its counterparties understand fully 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.
18. 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 Rules.
19. When conducting derivative transactions with institutions and individuals, the financial institution shall disclose the risks involved in derivative transactions, and shall obtain a written confirmation from the institutions or individuals in order to ensure that they have understood and have the ability to bear the risks in derivative transactions.
20. 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.
21. 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 risks and adopt risk control measures accordingly.
22. A financial institution shall use proper risk assessment methods or models to assess the market risk of derivative transactions, and manage 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.
23. 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.
24. A financial institution shall set up a sound operational risk control mechanism and

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system to strictly control any operation risk.

25. A financial institution shall submit to the State Bank of Pakistan accounting, statistical reports and related statements in respect of its derivative transactions as required.
26. A financial institution shall disclose the risks, losses, profit variations of its derivative business and any extraordinary situations according to the disclosure requirements.
27. State Bank of Pakistan shall be entitled to 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.
28. 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 three years after the termination of contracts for review purposes unless the accounting rules require otherwise.

**Powers of State Bank of Pakistan**

29. These Rules shall be interpreted by the State Bank of Pakistan.
30. The State Bank of Pakistan may suspend or withdraw the status of a Financial Institution as an Authorized Derivative Dealer to carry out Derivative Business if it has found that the financial institution is unable to effectively implement the necessary risk management system and internal control system for conducting derivative transactions.

**Disputes and Arbitration**

31. [To be discussed in full committee]

**Effective Date**

These Rules shall be effective from \_\_\_\_ \_\_, 2004. Any financial derivative transaction approved by State Bank of Pakistan and executed by the Financial Institution shall be deemed to be executed within this Regulation.

**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, and
- 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

**Foreign Currency Options****Foreign Currency Options General Guidelines**

These set guidelines are being issued as an annexure to the Financial Derivatives Business rules issued via circular No. XX dated XX.

**Description of the product**

1. Foreign Currency (FX) options are contracts that give the buyer the right, but not the obligation, to buy or sell one currency against the other, at a predetermined price and on or before a predetermined date. The buyer of a call (put) FX option has the right to buy (sell) a currency against another at a specified rate. If this right can only be exercised on a specific date, the option is said to be European, whereas if the option can be exercised on any date prior to its maturity, the option is said to be American.

**Permitted Product and Activity**

2. All Authorized Derivative Dealers and Non Market Maker Financial Institutions are permitted to carry out derivatives business in Foreign Currency Options as follows:
  - a. Trading and Selling of FX options are permitted in G-7 currencies only.
  - b. No entity may offer any PKR / USD or PKR / Other Currency option unless specifically permitted by State Bank of Pakistan.

**Size**

3. There will be no restriction on the minimum or maximum size of 'notional principal' amounts of FX Options.

**Tenor**

4. Maximum tenor of the Option may not exceed 1 year. Any transaction, which exceeds this tenor, would require separate approval from relevant approving authority.

**Risk Management**

5. All positions entered into by whosoever will be covered on a back-to-back basis and the banks will not be allowed to carry any market risk in this respect.
6. Authorized Derivative Dealer must cover all exposures on a back-to-back basis from a foreign bank or their branches abroad.

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**Foreign Currency Options**

7. Authorized Derivative Dealers, which have their Head Offices in Pakistan, may cover their position with their branch abroad, however they must ensure that their branch also covers its position on a back-to-back basis offshore. Local Banks may also cover their position through another Authorized Derivative Dealer, which has its Head Office outside Pakistan, who will be required to cover their exposure with a branch abroad.
8. Banks may enter into packaged products involving cost reduction structures for customers provided the structure does not involve customers receiving a premium.
9. Banks may quote the option premium in US Dollars or in the currency of the underlying option and will be allowed to remit abroad the premium required to cover the transaction on a back-to-back basis.
10. 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.
11. A customer may enter into FX Option hedge with any bank irrespective of the exposure being booked in that bank or not.
12. 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.

**Settlement**

13. Option contracts may be settled on maturity either by delivery on spot basis or by net cash settlement as specified in the contract. In case of unwinding of a transaction prior to maturity, the contract may be cash settled based on the market value of an identical offsetting option.
14. Options can be booked against all existing FX exposures e.g. trade, loans and other remittances. In cases where exposures are against PKR the customer will either run their USD/PKR exposure or cover this separately in the interbank forward market.

**Accounting and Disclosure**

15. 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 generally accepted accounting principles specified by recognized international accounting bodies.

**Documentation**

16. No derivative transaction will be executed by the Authorized Derivative Dealer / Non-market maker Financial Institution unless the necessary documents e.g. ISDA or other equivalent documentation have been exchanged with the other entity.

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**Reporting**

17. Each Authorized Derivative Dealer / Non-Market Making Financial Institution / End user Banks should report the derivative transactions and outstandings to State Bank of Pakistan on a monthly basis as specified in Annexure \_\_\_\_.

**Forward Rate Agreement****Forward Rate Agreements (FRA) General Guidelines**

These guidelines are being issued as an annexure to the Financial Derivatives Business rules issued via circular No. XX dated XX.

**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 (fixed) rate for a "Notional Principal" amount. On the settlement date, the transactions are "Net Settled" against a pre-determined "Benchmark" (section 3) 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. All Authorized Derivative Dealers and Non Market Maker Financial Institutions are permitted to carry out derivatives business in Forward Rate Agreement as follows:
  - a. Dealing / Selling of 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 following can be used as benchmark rates:
  - ⇒ Karachi Interbank Offer Rate (Quoted on Reuters page KIBR)
  - ⇒ Karachi Interbank Repo Rate (Quoted on Reuters page KIBRR) - To be introduced
  - ⇒ GoP securities Revaluation Rate (Quoted on Reuters page PKRV)
  - ⇒ GoP reserve eligible security rates.

**Size**

4. There will be no restriction on the minimum or maximum size of 'notional principal' amounts of Forward Rate Agreements.

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**Forward Rate Agreement**

**Tenor**

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

**Permissible Entity**

6. All institution entering into FRA transactions must follow the guidelines set out in Circular No. XX on the Financial Derivatives Business Rules. Banks must also abide by such reporting requirements as prescribed by the State Bank in this Annexure.

**Risk Management**

7. Derivatives are new products for the Pakistani market therefore all Authorized Derivative Dealer shall:
  - a. 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. Set internal trading limits on their activity in FRAs, must be expressed in terms of Price Value of Basis Point (PVBP) of the portfolio.
  - c. Who can employ more sophisticated methods of managing their exposure, such as Value at Risk [“VaR Limit”] may do so.
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 bank irrespective of the exposure being booked in that bank 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.

**Accounting and Disclosures**

12. 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 generally accepted accounting principles specified by recognized international accounting bodies.

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**Valuation**

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

- MTM / Pricing for Swaps  
MTM (Mark-to-Market) of all swaps should be carried out independently by the Back Office or the Middle Office. The Middle Office should carry out reconciliation of Front/Back Office positions and MTM.
- MTM / Pricing for FRAs  
The MTM and pricing procedure for FRAs is described below.

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.

**Legal and Documentation**

14. As interest rate derivatives are new to our market, banks need to develop and agree upon standard documentation, procedures and terms & conditions that will govern these transactions. To achieve this objective, banks should sign a suitable master agreement before entering into these transactions with each other.

- (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.

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**Reporting**

15. Banks are also required to report their outstanding FRAs to the Banking Supervision Department, State Bank of Pakistan, on the format attached at annexure, on a monthly basis.

**Interest Rate Swaps (IRS) General Guidelines**

These guidelines are being issued as an annexure to the Financial Derivatives Business rules issued via circular No. XX dated XX.

**Description of the product**

6. 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**

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

**Bench Mark Rate**

8. 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 following can be used as benchmark rates:
- ❖ Karachi Interbank Offer Rate (Quoted on Reuters page KIBR)
  - ❖ Karachi Interbank Repo Rate (Quoted on Reuters page KIBRR) – To be introduced
  - ❖ GoP securities Revaluation Rate (Quoted on Reuters page PKRV)
  - ❖ GoP reserve eligible security rates.

**Size**

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

**Tenor**

10. 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 relevant approving authority.

**Risk Management**

11. Derivatives are new products for the Pakistani market therefore the following risk

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management guidelines are to be followed by all Authorized Derivative Dealers:

- a. 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. All Authorized Derivative Dealers internal trading limits on their activity in IRS, must be expressed in terms of Price Value of Basis Point (PVBP) of the portfolio.
  - c. Bank who can employ more sophisticated methods of managing their exposure, such as Value at Risk ["VaR Limit"] may do so.
16. 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.
  17. The 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.
  18. 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.

### **Accounting and Disclosure**

19. 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 generally accepted accounting principles specified by recognized international accounting bodies.

### **Valuation**

20. 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 established 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

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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 established, independent IRS prices will be available.

### **Legal and Documentation**

21. As interest rate derivatives are new to our market, banks need to develop and agree upon standard documentation, procedures and terms & conditions that will govern these transactions. To achieve this objective, banks should sign a suitable master agreement before entering into these transactions with each other. One such standard legal agreement has been developed by ISDA (International Swaps and Derivatives Association). This agreement can be signed with the counterparties to provide uniformity, standardization and legal protection to the IRS transaction. FMA along with local legal counsel will prepare a standard ISDA Schedule Agreement to cater to the market needs that may be used, however each bank is free to negotiate amendments in this document to suit their internal requirements.

- (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 happening of the specified event.

### **Reporting**

22. Banks are also required to report their outstanding IRS to the Banking Supervision Department, State Bank of Pakistan, on the format attached at annexure, on a monthly basis.

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