PAKISTAN EQUITY DERIVATIVES MARKET

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This paper features results of a survey on the Pakistan Equity Derivatives Market to understand the reasons for low activity and investors' interest in this market. A standard questionnaire was utilized. This questionnaire was filled by 29 renowned institutions of Pakistan (Annexure 1). One to one interviews were also conducted.

The questionnaire sought to identify:

1. Reasons for low participation by financial institutions in the equity derivatives market.

2. Specify the use of derivatives in existing market infra structure to hedge existing portfolios.

3. Whether trading of equity derivatives are suitable for the Pakistani institutions.

4. Measures to increase the usage of exchange traded equity derivatives.

Rise of Equity derivatives in Pakistan:

Data on Futures Volumes Released by NCCPL

Month	Volume in Contracts	Companies	Banks/DFIs	Mutual Funds	NBFCs	Foreigners	Others
	Contract size = 500 shares						
Jan-10	160175	789	0	0	4981	889	153516
Feb-10	120538	4217	33	0	1768	27	114493
Mar-10	302759	21923	13433	88	12042	426	254847.26
Apr-10	250120	2814	366	311	4002	35	242592
May-10	179829	3867	336	186	504	413	174522.658
Jun-10	255450	14202	0	0	1674	437	239137
Total	1268871	47812	14168	585	24971	2227	1179107.92
Avg contract per month	211,479	7,969	2,361	98	4,162	371	196,518
% of total contracts traded		3.77%	1.12%	0.05%	1.97%	0.18%	92.93%

Pakistan equity derivatives products were launched on the Karachi Stock Exchange in 2001. Initially one month deliverable single stock futures were introduced. Nine years later this market is still considered to be underdeveloped when compared to India. Exchange traded financial derivatives were introduced in India on the National Stock Exchange and the Bombay Stock Exchange in June 2000. Index futures contracts based on S&P CNX Nifty Index (Nifty) and BSE Sensitive Index (Sensex) were initially launched. Since then, the turnover of derivative contracts has risen immensely on the India National Stock Exchange.

In most developed or developing markets investors prefer to take positions and derivatives instruments are often preferred over underlying assets in the spot market. In Pakistan the is not the case. In the first two quarters of the calendar year 2010 (i.e. from Jan to Jun) futures market constituted 3% and 8% in terms of volume and value of the spot market. However, during late 2004 and early 2005 the deliverable future contract were picking up in volume terms. During that period, futures volumes constituted 30 to 40% of the spot market volumes. But unfortunately due to weak market infrastructure and risk management measures of that time the market could not sustain the outgoing leverage position in the market thus leading to the 2005 March crisis. After the crisis several risk management measures have been taken to reduce systematic risk.

The National Clearing Company of Pakistan has recently started releasing data on the futures market. Accordingly in the first two quarters of the calendar year 2010 on an average 211, 000 equity derivatives contracts were traded per month. Institutions have not been heavy users of exchange-traded derivatives. In the said period banks, NBFC's and companies contributed 1%, 2% and 4% of the future volumes respectively. Individuals and other investors contributed 93%of the total volumes in exchange traded equity derivatives.

Market Review, Product-Line History

Product	Settlement Basis	Since
Ready Market	Initially on T+3. Now settles on T+2 basis	2001
Deliverable Futures	30 days	2001
Cash Settled Futures	30, 60 &90 days contract	2007
COT (Stopped in 2006)	22 days	1994
CFS (Replaced COT) and discontinued in May 2009	22 days	2005
Stock Index Futures	90 days contract	2008
7 Days Cash Settled Futures	7 days	2010

Derivatives Users in Pakistan:

In Pakistan many Banks, DFIs, Mutual Funds, Non Banking Financial Institutions trade in the derivatives market. However, the use varies with the nature of the organization. Mutual Funds manage funds of the general public and they work under the supervision of their respective trustees. Mutual Funds mostly trade in equity derivatives to reap arbitrage opportunities; they first take a long position in the spot market and then sell in the derivatives market to lock in confirmed profits. Mutual funds cannot take positions in future trade to create leverage. Islamic mutual funds are not allowed to buy or sell in the existing equity derivatives market. However, the Karachi Stock Exchange is working on the launch of Islamic derivatives.

As far as banks / DFI's are concerned according to Prudential Regulations for Corporate / Commercial banking (1. B): "Banks/DFIs may take exposure in future contracts to the

extent of 10% of their equity on an aggregate basis. In this connection, the 10% exposure limit for future contracts will include both, positions taken in future buying and selling." Despite this regulatory support, Banks / DFIs participation is very low.

In terms of the growth of the derivatives market, and the variety of derivative users, the Pakistan equity derivatives market has shown subdued performance as compared to India. In local bourses, retail investors remain the major users followed by private sector institutions and large corporations. State-owned institutions have participated minimally. The variety of derivative instruments available for trading is expanding slowly.

There remain major areas of concern for Pakistan exchange traded equity derivatives. Large gaps exist in the range of derivative products that are traded actively. In equity derivatives, only single stock deliverable futures are traded and account for almost 100% of the total volume in exchange traded derivatives. Trading in cash settled Futures and Stock Index Futures is virtually absent. A lack of market liquidity may be responsible for inadequate trading in these instruments.

Why do institutions not participate to a greater extent in the derivatives markets?

In Pakistan, some institutions such as banks and mutual funds are only allowed to use derivatives to hedge their existing positions in the spot market, or to rebalance their existing portfolios. Moreover, in case of most institutions internal policies prohibit them from traing in equity derivatives. In our survey we found that out of the 29 institutions 41% are not allowed to trade in equity derivatives due to their internal policies. The remaining 59% (17 institutions) participate minimally. *(See Annexure A for survey results)*

The main reason is the lack of knowledge and expertise followed by tight risk management measures mandated by the Securities and Exchange Commission of Pakistan. In the survey more than 72% of the institutions claimed that lack of knowledge

is the reason for low activity in equity derivatives products. Also, cash margin requirements and Unique Identification Number (UIN) based margin collection are also key concerns for institutions. Previously the executing broker used to deposit margins with the Exchange on behalf of their clients. The broker used to act as a collecting agent between the exchange and his client. But in some cases the broker, to facilitate his important clients, used to meet regulatory margin requirements without collecting the from the end user thus initiating unnecessary risk in the market. Since the increased regulatory vigilance and introduction of UIN based margins along with the launch of Institutional Delivery System (IDS), margins are largely collected directly from the end user. Therefore, now, even where institutional internal policies allow them to trade in exchange traded derivatives, institutions have reservations in depositing margins with the exchange.

Moreover, 9 out of 17 institutions in our sample which are allowed to trade in equity derivatives rarely trade in this market. Only one institution claimed that they participate regularly in this market. Also, 10 institutions allowed to trade primarily traded to capture arbitrage opportunity to mitigate spot and future market inefficiencies and 6 to hedge their existing portfolios. (See Annexure A & B for survey results)

Further we asked institutions to rate the derivative market in Pakistan in terms of efficiency and convenience on a scale of 1-5 with '1' being 'excellent' and '5' being 'very poor'. 76% of the respondents' institutions ranked it 4th and 5th.

To our surprise a large number of institutions in our sample believed that the regulatory authorities are successful in safeguarding the interest of the investors in the derivatives market.

Policy Initiatives;

Pakistan equity derivatives markets require initiatives by the regulator and the Exchange to create investor awareness about existing products and about how they can use these products to hedge their existing portfolios and to reap benefits from existing market inefficiencies. The Exchange should launch new programmes to inform and educate brokers, dealers, traders, and market personnel. In addition, institutions will need to devote more resources to develop the business processes and technology necessary for derivatives trading. Moreover, fund managers should be motivated to participate more actively to take advantage of existing market inefficiencies. The front and back office salary and appraisal should be directly linked to the performance and creativity of trading officers. Lack of proper return reward and appraisal systems always reduce creativity. Institutions should try to build competent staff at all levels.

Furthermore, market development reforms will help these markets grow faster. For example, the development of the shares lending and borrowing market and presence of market makers will help increase the liquidity in spot and future markets. Moreover, state owned institutions like Employee Old Age Benefit Fund and National Investment Trust should be encouraged to participate in the derivatives market. This will help increase liquidity.

A managerial structure should be designed in each organization which clearly defines roles, responsibilities, and accountability of top management, front desk and back desk. Each department should be given enough authority. Back office staff should be trained and experienced enough to facilitate front desk operations.

Also, local investor education must also be focused upon. For this purpose, media coverage, seminars and publications should be made on basic concepts of equity and derivative products ethical standards of transacting in markets on the rights of investors and brokers.

SECP in association with the Karachi Stock Exchange board and members should design some mandatory study guidelines for traders, fund managers, settlement officers and other related parties. This will facilitate blending of professionalism into the capital market and will eventually increase market depth.

However, some efforts have already made in this regard. SECP, exchanges of Pakistan and other renowned institutions like the CFA Association of Pakistan and Mutual Funds Association of Pakistan have established the Institute of Capital Markets in 2009. ICM has been established as a platform to develop human capital which may be capable to meet the emerging professional knowledge needs of capital markets and create standards among market professionals. The institute envisions offering various licensing examinations leading to certifications for different segments of the capital markets. However, up till now, by large no enthusiasm is seen among the audience as the pace of registering is very slow.

Appendix