



National Clearing Company of Pakistan Limited

8th Floor, Karachi Stock Exchange Building, Stock Exchange Road, Karachi

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Margin Financing System

Dear Clearing Members

We are pleased to inform you that the **Margin Financing ("MF") System** as proposed by the Consultative Group on Capital Market has been approved by the Securities and Exchange Commission of Pakistan. Since the said **MF System** has been proposed to be operated through the portal of National Clearing Company of Pakistan Limited ("NCCPL"), we have initiated necessary system development and regulatory amendments in NCCPL Regulations.

In this respect the implementation date of the said MF System will be communicated soon to all market participants. However, in the mean time the detailed Concept Paper on the proposed system is attached herewith for your review and basic understanding.

For any clarification, queries and information please feel free to contact us.

Regards,

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Badiuddin Akber

Head of Operations

Encl: Concept Paper of MF System

CC:

- Securities and Exchange Commission of Pakistan (SMD Islamabad / Karachi)
 - Karachi Stock Exchange (Guarantee) Limited
 - Lahore Stock Exchange (Guarantee) Limited
 - Islamabad Stock Exchange (Guarantee) Limited
 - Mutual Fund Association of Pakistan
 - Pakistan Banking Association
 - Central Depository Company of Pakistan Limited
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MARGIN FINANCING (MF)

CONCEPT PAPER

Contents

OBJECTIVES	3
A. MARGIN FINANCING THROUGH BROKERS.....	3
Scope	3
Working mechanism	3
Risk Management	5
Default procedures	6
B. DIRECT MARGIN FINANCING THROUGH BANKS	6
C. DISCLOSURE	7
D. OTHER CONSIDERATIONS.....	7

OBJECTIVES

1. Introduce a product to cater to the financing needs of the brokerage houses and their clients
2. Monitor and regulate the overall credit extended to and by the brokerage houses
3. Provide funding access to retail investors
4. Introduce a financing mechanism based on the principles of counterparty credit risk, whereby the lending terms are defined by the respective parties involved.

A. MARGIN FINANCING THROUGH BROKERS

Scope

This product will cover the following types of financing:

1. To use 3rd party funding to finance the Ready Market purchases, both proprietary and client
2. To use Broker's own funds to finance the Ready Market purchases of its clients

Working mechanism

1. Following information is required to be provided to the NCCPL which will be entered by NCCPL in the MF system and shall be updated at least on a monthly basis:
 - All brokers will be required to provide the Credit lines provided to them by non broker financiers and the same shall be confirmed by the financier. Notification will also be required in case of any change.
 - All broker financiers will be required to provide the details of financing to clients against own funds
2. Exchange shall prescribe with the prior approval of Commission a list of eligible securities on the basis of a pre-defined criteria. The list shall be reviewed on a six monthly basis. A 30 days notice shall be given in advance before making changes to the list.
3. The agreement between the financier and the brokerage house for the credit line will address the following matters:
 - List of securities acceptable for margin financing which shall not be changed unless giving a notice of at least two weeks in advance.
 - Financier Participation Ratio (FPR) for each security, which is acceptable to the financier with minimum of 25% or Var whichever is higher (FPR represents the extent to which the Ready Market purchase will be financed by the financier; remaining funds shall be arranged by the financee)
 - Mark-up rate shall be capped on KIBOR+8%
 - Length of contract

- Form of acceptable collateral for margin and MtM losses (cash, securities etc) Treatment of corporate actions.
4. The above particulars shall also be covered in the agreement between the broker and its finance client.
 5. This MF facility will only be available against Ready Market purchases for that day. The brokerage house intending to finance a Ready Market purchase by itself or by its client, will initiate the funding request to an eligible financier which has given a credit line for such purpose to the brokerage house. The funding request shall be initiated on the date of purchase. This funding request will contain the following details:
 - Scrip symbol
 - Number of securities
 - Financier Participation Ratio (FPR)
 6. The financier will have the option to affirm the whole or part of the funding request. Once affirmed, the financier will be obligated to settle the Ready market transaction on behalf of the financee on the settlement date only to the extent of FPR. The remaining portion of the Ready Market purchase shall be settled by the broker itself, using that client's funds. Upon settlement, all the securities will move to the MF Blocked account of the financier.
 7. Where the financee sells the securities or arranges his own funds, the brokerage house will initiate a Release transaction. The financier will affirm the Release transaction. The Release transaction will only include the amount of principal, and not the amount of mark-up. The financier will recover the mark-up directly from the brokerage house. In case if the reversal is not linked to the ready market sells transaction the only effect upon affirmation by the financier will be the unblocking of securities in the financier account.
 8. Where the broker acts as a financier to lend from its own resources, the broker will initiate the funding request against its client purchase. The funding request will be affirmed by the brokerage house. The transaction will, however, be settled by the NCCPL, whereby the funds will be paid by the brokerage house, and the securities will move to the separate MF blocked account of the brokerage house. It should be noted that the brokerage house will be allowed to provide financing only to its own clients. A member of one stock exchange can provide to member of another stock exchanges as its client. Further, the brokerage house will not be allowed to use the funds of its clients for providing MF and can only provide MF out of its own resources.
 9. The MF system will allow partial release of open MF positions.
 10. The financier will determine the form of acceptable collateral against margins and MtM losses; however, securities shall only be allowed to be pledged in favour of the financier from the House Account of the brokerage house. It should also be noted that direct pledge from client's sub-account or free delivery of client's securities from its sub-account to the House Account for the purpose of pledge shall not be allowed. However, the financier may

accept pledge from client's sub-account provided that specific authority is provided to the financier. Brokers will be obliged to collect margins from their clients through the MF Regulations. a reporting mechanism shall be prescribed in the Stock Exchanges Regulations for the margins deposited by the brokers, specifying the exposure of client and the margin collected against the same.

11. No special treatment will be provided for corporate actions. Corporate actions shall be handled by the financier and brokerage house as per their mutual agreement.
12. Eligible financiers shall include:
 - Banks/ DFIs / Investment Banks
 - Brokerage houses from their own funds (for their clients only)

Risk Management

1. VaR margins will initially apply on the financee on the Ready Market purchase. The financier, upon affirmation, shall pay VaR based initial margins and MtM losses on the Ready Market purchase only to the extent of FPR; the remaining margins and MtM losses shall be recovered from the financee. Such VaR margins on the Ready Market purchase will be released upon settlement.
2. Upon settlement of the Ready Market purchase, all the securities will move to the MF Blocked account of the financier.
3. Upon settlement of the Ready Market purchase, Mark-to-market losses will be collected from the financee by the financier.
4. Where a Ready Market sale is available against the Released MF transaction of the financee, the financier shall be required to affirm the Release transaction. Upon affirmation, VaR margins on the Ready Market sale from the financee shall not be collected. No margins are required from the financier, since the securities will be delivered from MF blocked account of the financier on the settlement date.
5. Where the financee intends to take delivery of financed securities, it will initiate a same-day Release Request. Upon affirmation by the financier, the financed securities will be unblocked in the CDC Account of the financier. The settlement between the financier and financee shall take place outside the system.
6. Free float based position limits shall be applicable on financees as follows:
 - Market level: 40% of free float
 - Broker level: 1% of free float
 - Client level: 0.5% of free float

7. Exposure to MF shall not exceed 10 times NCB of the broker. Exposure to a single client shall not exceed 5% of the total permissible exposure. Exposure in single scrip shall not exceed 20% of the total permissible exposure.
8. The brokerage house will develop a credit risk assessment system, whereby it will evaluate the credit worthiness of its clients.
9. A financier will be allowed to provide financing in scrip only to the extent of 5% of its free float.

Default procedures

Since the margin calls are being directly managed between the financier and the brokerage house, any default will be directly handled by the financier. For this purpose, the financier will be authorized to notify CDC for unblocking of MF financed securities.

Where the financier or the financee defaults in payment of the Ready Market purchase, the MF deal will be cancelled, and normal default procedures of NCCPL shall apply in order to compensate the Ready Market seller.

The broker shall execute a margin agreement with a person who intends to be his client for the purpose of margin financing. Such agreement shall clearly specify that the client takes the risk that his securities may be liquidated by the financier, if the brokerage house defaults on any margin call made by the financier. The agreement will also specify the responsibility of the brokerage house for protection of interests of those clients, which have complied with their respective margin calls.

B. DIRECT MARGIN FINANCING THROUGH BANKS

This product will facilitate banks to provide direct credit facilities to clients for obtaining financing against securities. The client will directly approach the bank for credit line to obtain finance against securities.

C. DISCLOSURE

A comprehensive disclosure framework should be developed to provide information to the investors / regulators in a fair and transparent manner. Such disclosure should include:

1. Scrip wise margin financing value and volume and percentage of free float to ensure compliance with MF limits of scrip in terms of free float. (public information)
2. Total MF credit lines available to a brokerage house (non-public)
3. Total MF utilized by a brokerage house, showing separately MF utilized for propriety account (non-public)
4. Total MF un-utilized by a brokerage house (non-public)
5. Total MF provided by the brokerage house out of its own resources (non-public)
6. Scrip-wise Total MF availed during the day (public disclosure)
7. Credit lines utilized by a brokerage house, other than MF.(non-public)

D. OTHER CONSIDERATIONS

1. The SECP and stock exchanges will specify the minimum net capital which a brokerage house must have to be eligible for providing Margin financing facilities.
2. Margin Trading Rules 2004 and the regulatory framework of exchanges, NCCPL and CDC should be reviewed for necessary changes.
3. Necessary changes in SE / NCCPL / CDC will be required.