Launch of Kibor Futures

The start of 2009 has brought in a quiet revolution in interest rate trading in Pakistan. A very significant milestone has been achieved by the listing of Kibor Futures Contracts on National Commodity Exchange Limited (NCEL). Commencement of trading in Kibor Futures brings such an innovation to the financial sector and rest of the economy that it will take some time for key stakeholders to fully benefit from it. Launching of this new product was an essential prerequisite for Banks, Brokers, Financial Institutions and Corporates to start familiarising themselves with it. The coming weeks and months will see these key market participants catching up with the learning curve and actively begin to use Kibor Futures for their business planning and risk management.

Kibor Futures were first proposed and developed by NCEL over 3 years ago and during the past 2 years numerous consultations with SBP, SECP and FMAP have resulted in the regulatory approval of a contract designed to meet the needs of maximum number of users in the economy.

Interest rate risk is ubiquitous

Interest rate risk is the one fundamental risk that no one can escape from. Be it a company or an individual. Depending on the nature of business, a company may or may not be exposed to currency fluctuations, commodity price volatility or equity market risk but it will always be affected by interest rate movements. This is true not only for businesses that have borrowings but also for cash-rich, debt-free companies where invested funds are affected by changes in interest rates. Same goes for individuals as

their savings, investments, borrowings and the value of future cash flows are impacted by variations in interest rates.

Similar to changes in prices of other assets, interest rate changes also create uncertainty for businesses. Like all other futures, interest rate futures also provide the essential service of reducing risk and uncertainty and help in better business planning and management.

Kibor as a benchmark

Karachi Inter-Bank Offer Rate (Kibor) represents the consensus rate at which banks are willing to lend funds to each other. This benchmark rate is an important reference point as most lending transactions are linked to this rate. In addition to bank lending to customers, many debt instruments and commercial contracts also use Kibor as a benchmark rate. All parties to these transactions are directly exposed to changes in the Kibor rate. Even if someone is not directly exposed to Kibor, e.g holder of a T-Bill, he is still exposed to changes in interest rates. Since Kibor rates have a correlation with other interest rate measures like yields on government T-Bills and PIBs, holders of government securities can also hedge themselves to a significant level using Kibor futures.

Benefits

Since the value of all future cash flows is affected by the changing levels of interest rates, every business either profits or loses from rising or falling interest rates, depending on whether it is receiving or paying cash in the future. Everyone has a need to protect themselves against adverse moves in rates and it is logical to expect

that most entities, given the opportunity, will make use of available hedging instruments. Since banks are the primary participants in borrowing and lending, it is natural to expect them to be the leading providers of liquidity in the futures markets as well. However, as NCEL is a national exchange providing equal access to all, companies and individuals also have an opportunity to come straight to the market to hedge their positions.

Potential to help reduce interest rate spread

Numerous explanations and solutions have been put forward over the past few years regarding the huge spread between deposit and loan rates in Pakistan. Most of these reasons may be valid in their own context but NCEL Research has also maintained for a long time that one of the main reasons for this huge spread is the need for banks to cushion themselves against adverse interest rate moves. In the absence of any hedging instruments, a bank will be inclined to pass on the risk of adverse movements in interest rates to its customers in the form of higher lending rates and lower deposit rates. If a bank is able to better hedge its assets and liabilities by using the futures market, it will reduce the need to keep a huge spread without impacting the bank's profitability. Surely, this is a much more efficient way for banks to fulfil their essential role as providers of capital and saving instruments to the economy.

These are not just theoretical observations but have also been proved in practice by other countries that have taken steps to improve the efficiency of their interest rate markets.

To help Banks create better products for customers

Interest rate futures have very fundamental benefits for financial markets. The chief advantage is to have a tradable yield curve which provides information about the market's consensus view regarding the future path of interest rates. This information is extremely valuable for banks and other institutions as it allows them to develop, price, sell and hedge a variety of financing and saving products tailored to the needs of their customers. Customers benefit from a range of better priced products suited to their needs and banks benefit by better managing their risks, leading to lower reserve requirements which in turn results in higher returns on capital.

Kibor futures will allow banks to perform their lending function efficiently by taking the burden of interest rate risk away from the corporate and industrial sector. Banks are best capable of handling interest rate risk as opposed to their customers. Industry should be allowed to focus on its own area of expertise and leave interest rate risk for banks to manage. In the absence of good hedging instruments, borrowers are not able to fix their debt cost. This is because their banks themselves are not able to efficiently fix the price of debt for their customers. Most debt remains floating and fully exposed to interest rate moves and the burden is borne by the end issuer. As an example, the textile sector over-invested during the low interest rate period and is now suffering due to higher rates. Ideally, banks should have been efficient enough to have structured the debt in a way which would have provided some protection to the sector. Having interest rate futures is one necessary tool for banks to be able to perform this essential risk-transfer function for the economy.

Interest rate futures have a history of almost 30 years ever since they were first launched in the US. They have proved to be a fundamental building block of interest rate markets and have shown their strength and usefulness in every jurisdiction. With the launch of Kibor futures, banking and financial sector as well as the rest of the Pakistani economy will be able to benefit in the same way as the rest of the world has. It may take some time for full benefits to start accruing to all stakeholders, but the launching of the contract is a huge achievement in itself. The challenge now is to get banks and brokers to participate in the market actively so that they start using the contract for the pricing, hedging and positioning needs of their customers.

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