

Need of the Time: Margin Financing and Hedging Tools

The global financial crisis led to the current credit crunch in the international markets. This impacted all asset classes across the board including the equity and debt markets. Many pundits are blaming leveraging across the institutional and consumer markets for the fall in current investor and consumer sentiments. The U.S. consumption habits are also being questioned as the global economy will need more than a cash injection and change in monetary policy to stimulate its revival.

The KSE-100 index witnessed over 68% decline from its peak. The campaign for de-leveraging of the equity markets can be countered with the launch of a proper “live” margin financing system. The existing CFS system to finance equity shares is fairly being criticized. We have witnessed its failure over the past several years despite the efforts to improve the product. A margin financing system is the need of the time since the equity market needs proper Value at Risk based margin limits for each stock on a separate basis. These limits will then enable us to determine the allowable leveraging limits for the investors. This pre-trade margin based buying-limit allocation system will enable the equity markets to trade efficiently without any major liquidity crunch in the future leading to higher investor confidence.

The KSE management along with its BOD members is diligently working on the launch of new and innovative products to strengthen its product menu. The relevant “New Product Committee” is working on the launch of Cash Settled Futures as a new product. This needs to graduate into a separate equity options exchange over time. Equity options are a tool that provides investors a right to purchase or sell a security on a pre-determined future date. This right is usually traded with a basic intrinsic value along with time premium. Equity options markets are a source of providing investors hedging tools across the globe. It also reduces the speculative element from the normal trading market leading to lower volatility risk. The need for equity options in Pakistan have been advocated for years but this is an opportune time to launch this product providing fund managers professional hedging tools leading to lower turnover ratios of the equity based mutual funds in the country. This lower turnover of equity based mutual funds will lead to further reduction in the volatility of the normal trading market increasing long-term investment approach. It will also discourage short-term trading habits of both retail investors as well as institutional investors. Investors will be enabled to invest utilizing

long-term investment horizon. Investors willing to purchase “Leaps” (Long-term equity options) will also provide an opportunity to attract a new class of investors in the country. Similarly KIBOR linked hedging products need to be introduced for the fixed-income and money market fund managers to hedge their portfolios in their respective categories.

The margin financing system and equity options can both help bring back the investor confidence leading to a better financial market system in the country.

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