



ISO 27001 Certified

## National Clearing Company of Pakistan Limited

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

NCCPL/CM/OCTOBER-16/11

October 20, 2016

### Concept Paper – Islamic Financing System

Dear Clearing Members,

We are enclosing herewith a draft concept paper to introduce Islamic Financing for shares in securities market for the consultation of market participants. Clearing Members are requested to review the same and provide us your feedback/comments on the same in writing till October 26, 2016.

For any further queries or concerns, please feel free to contact the Customer Support Services of your respective locations.

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Karachi	021-32460811-19 Ext. 209, 214, 217, 218 & 224 Dir. 021-32438531-32-33	021-111-111-622	021-32462825
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Regards,

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**Rehan Saif**  
**Head of PD & CSS**

CC:

1. Executive Director - Policy, Regulation and Development Department - SMD  
Securities & Exchange Commission of Pakistan - Islamabad
2. Managing Director - Pakistan Stock Exchange Limited
3. Chief Executive Officer - Central Depository Company of Pakistan Limited
4. Chief Executive Officer - Mutual Fund Association of Pakistan
5. Chairman - Pakistan Banking Association

# Concept Paper

Islamic Financing System - a proposal to introduce  
Islamic financing for shares in securities market

This concept paper is prepared by National Clearing Company of Pakistan Limited (NCCPL) for consultation purposes. Comments/feedback on the same may be provided to NCCPL through email or post at the following address.

## **A. Introduction**

In Pakistani securities market, there are two regulated share purchase financing products which are being provided through a platform established and operated by the National Clearing Company of Pakistan Limited (NCCPL) under the Securities (Leveraged Markets and Pledging) Rules, 2011 (**the “Rules”**) and NCCPL regulations made pursuant to section 26 of the Securities Act, 2005 with prior written approval of the Securities and Exchange Commission of Pakistan (SECP). One of product is called Margin Financing System (MFS) which is a counter-party risk based product where financier may extend financing against purchase of almost all the listed shares under an agreement with the financee and take counter-party risk. In the second product which is called Margin Trading System (MTS), a financier may extend financing for purchase of only eligible securities (only highly liquid securities) to an unknown financee and take risk on the shares it financed. Operational model of both these products is based on conventional financing principles whereby financier charges interest on money.

It is also important to note here that the Rules prohibit any other form of financing for purchase of shares listed on a stock exchange. In absence of any Shariah compliant mechanism for financing share purchases, investors interested to transact in securities market in a Shariah compliant manner, are being deprived and are unable to purchase shares on credit.

In order to facilitate such investors as well as those financiers who are interested to extend financing through Islamic modes, a proposal for financing share purchases at stock exchange through Murabaha is envisaged under the guidance and support of renowned Shariah Scholars namely Mufti Hassaan Kaleem from Dubai Islamic Bank, Mufti Irshad Ahmed Ijaz from Bank Islami Pakistan Limited, Mufti Najeeb Khan from Summit Bank and Mufti Bilal Qazi from Meezan Bank. The product will be called Islamic Financing System(IFS) and will work parallel to MFS and MTS, if approved.

In light of the guidance provided by Shariah scholars and assistance provided by the representatives of the NCCPL, CDC and Pakistan Stock Exchange, this concept paper is prepared for consultation purposes.

## **B. Proposed Financing Model**

In the proposed IFS, financing may be provided by a securities broker to its customer using its own funds or by an Islamic Financing Institution (IFI) to a securities broker and its customers. For extending financing, a broker may use its own funds or funds arranged from a financial institution. The financing will be based on Murabaha contract entered into by the contracting parties hence securities broker or IFI will be taking counter-party risk and will be responsible for credit risk assessment of the respective financee.

## **C. Eligibility Criteria for Securities**

In IFS, financing will only be allowed for securities enlisted on all shares Islamic Index of Pakistan Stock Exchange Limited.

## **D. IFS Participants**

### **1. Finanee**

A securities broker or its customer may avail financing against ready market purchases. However, in case of a customer, the securities broker shall be responsible for completion of all formalities, where required. Such securities broker has to be an active member of NCCPL.

### **2. Financier**

Following may be financiers in IFS:

- All Broker Clearing Members (“BCM’s) of stock exchange;
- a banking company within the meaning of the Banking Companies Ordinance, 1962 (LVII of 1962)
- a company, corporation or institution to which Section 3A of the Banking Companies Ordinance, 1962 (LVII of 1962).
- an investment company and a closed-end scheme registered with the Commission under the NBFC Rules.
- an open-ended scheme of any kind constituted under the NBFC Rules.
- any other person about which the Board (subject to final approval by the SECP) is satisfied that it has a good financial standing.

## **E. Agreements Between Participants**

A Master Murabaha Agreement (MMA) has to be executed before entering into any transaction in IFS between the financier and finanee detailing at least the following:

- List of securities acceptable for financing
- Financing Participation Ratio (FPR) for each security
- Profit margin (mark-up) rate
- Length of contract
- Form of acceptable collateral etc
- Margin requirements
- Provisions relating to default by either party

## **F. Modus Operandi- IFS**

NCCPL will provide a system to facilitate IFS participants for recording and settlement of IFS transactions based on counterparty risk through its National Clearing & Settlement System (“NCSS”) in the capacity of an Authorized Intermediately. For this purpose, appropriate amendments will be made in the Rules and the regulations of NCCPL.

Some other features of the IFS system are listed below:

- Reversal of IFS transactions (on maturity/default or with mutual agreement) will also be recorded on such IFS system.
- Facilitation without any obligation will be extended for risk management purposes i.e. management of securities held as collateral
- Collection of marked-to-market losses, profit and corporate entitlements will be managed by the IFS Participants privately outside the system.

In IFS, financing may only be extended against ready market purchases. A securities broker may extend financing to its customers or an IFI being clearing member of NCCPL may extend financing to a securities broker against its proprietary or customer purchase position. Prior to entering into a transaction in IFS, a financier and financing have to enter into MMA and record the same on IFS system. Financing in IFS can be obtained by an investor through the following options:

1. Financing by securities brokers to its customers
2. Financing by IFI to a securities broker
3. Financing by IFI to a customer of securities broker

## **1. Financing by securities broker to its customers**

### **I. Murabaha Recording on Settlement Date**

- a. A customer of a securities broker has to sign and submit MMA and an irrevocable promise to buy shares from the securities broker based on a contract of Murabaha.
- b. The securities broker will purchase the required shares from the ready market using UIN of the respective customer through a specific key to be introduced by the stock exchange to identify such trades.
- c. Obligation to provide margins will rest with the securities broker however in order to secure the Murabaha transaction, the securities broker shall collect required margins from the customer.
- d. Before the end of trade date, the securities broker will intimate NCCPL through IFS its intention to enter into sale transaction with the customer based on contract of Murabaha on the respective settlement date after assuming ownership of the purchased securities. In case the customer agree to pay complete settlement amount before the settlement date, the

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securities broker will not charge any mark-up in Murabaha transaction. In other cases, the securities broker can charge agreed mark-up.

- e. NCCPL, on the settlement date and upon receipt of money from the securities broker record Murabaha transaction in IFS.
- f. The securities broker will be obliged to collect from the customer an amount of settlement obligation to the extent of customer's FPR.
- g. The customer through its securities broker communicate its standing instruction to NCCPL to make arrangement for transfer its securities purchased through Murabaha transaction to the designated blocked account of the securities broker as collateral.
- h. NCCPL will deliver purchased shares to an IFS Blocked account maintained in the name of securities broker. The shares will be held in this account in block status on behalf of the customer to secure IFS transaction. However, the securities broker will have recourse to these shares in case of default by the customer.
- i. Any right including right to dividend, right to vote etc. in respect of shares held in IFS blocked account will vest with the customer. NCCPL and CDC will make suitable arrangement to ensure the same.
- j. **Risk Management:** Till settlement date, the securities broker will be responsible for margin requirements. After settlement of trade on settlement date with NCCPL, the securities broker as IFS financier will be responsible to collect margins from customer as per terms and conditions of Murabaha transactions.
- k. **Default Management:** Since the securities broker will be responsible for settlement of the ready market trades, hence in case of default to meet settlement obligations on the settlement date, NCCPL will carry out default management procedures as per the existing default mechanism.

In case of a default by a customer to meet its obligations, such default shall be managed by the securities broker privately without any obligation of NCCPL. However, based on specific request of the securities brokers, NCCPL will assist the securities broker to retrieve shares held in IFS Blocked Account and other securities collaterals

## **II. Murabaha Recording on Future Date**

- a. A customer of a securities broker shows its intention to purchase securities from the securities broker based on contract of Murabaha within a specified time period mutually agreed by the contracting parties
- b. A customer of a securities broker has to sign and submit MMA and an irrevocable promise to buy shares from the securities broker based on a contract of Murabaha.
- c. The securities broker will purchase the required shares from the ready market using UIN of the respective customer through a specific key to be introduced by the stock exchange to identify such trades.
- d. Obligation to provide margins will rest with the securities broker however in order to secure the Murabaha transaction, the securities broker shall collect required margins from the customer.
- e. On the trade date, the customer through its securities broker will communicate to NCCPL regarding its intention to purchase securities, which the securities broker has purchased using customer's UIN, from the securities broker based on Murabaha on a future date.
- f. On the settlement date, the purchased securities shall be delivered to the house account of the securities broker based on the above communication whereas payment is to be made by the securities brokers from its own account to the extent of agreed FPR and on behalf of the customer for the remaining amount.
- g. On the agreed date, the securities broker shall request NCCPL through IFS to record Murabaha transaction. NCCPL will record the Murabaha transaction and arrange for transfer of relevant securities from the house account of the securities broker to the designated IFS blocked account of such securities broker. The shares will be held in this account in block status on behalf of the customer to secure IFS transaction. However, the securities broker will have recourse to these shares in case of default by the customer to meet obligations of Murabaha transaction.
- h. Any right including right to dividend, right to vote etc. in respect of shares held in IFS blocked account will vest with the customer. NCCPL and CDC will make suitable arrangement to ensure the same.
- i. Upon meeting obligations of Murabaha transaction by the customer, the securities broker shall intimate to NCCPL through NCCPL which shall make arrangement for transfer of securities from IFS blocked account to the customer designated account.
- j. Broker, as per the terms and conditions set out in the Murabaha Agreement, will record Murabaha Sell transaction to Finanee at cost + profit. Such sell transaction will be recorded

after the settlement of ready market purchase where shares are made available in the Brokers house account.

- k. **Risk Management:** Stock Exchange will apply margin on ready market purchases as per existing risk management regime till settlement date. Upon settlement of the Ready Market purchase, Mark-to-market losses will be collected from the client by the financier outside IFS.
- l. **Default Management:** Till settlement of ready market transaction, in case of default by either the customer or the securities broker, normal default proceedings shall be initiated by the NCCPL against the securities broker.

In case of default by customer on obligations arising out of Murabaha transaction, such default shall be managed by the securities broker outside IFS. However, upon request of the securities broker through IFS, NCCPL shall make arrangement for transfer of relevant securities from IFS blocked account to the house account of securities broker.



## 2. Financing by IFI to a securities broker

### I. Murabaha Recording on Settlement Date

- a. IFI will be admitted as IFS Financier (clearing member) of NCCPL
- b. A securities broker and IFI have to sign and submit MMA. The securities broker also has to make an irrevocable promise to buy shares from IFI based on a contract of Murabaha.
- c. The securities broker as an agent of IFI will purchase the required shares from the ready market using its proprietary UIN through a specific key to be introduced by the stock exchange to identify the trade.
- d. Obligation to provide margins will rest with the securities broker however the securities broker may collect required margins from IFI to meet its obligation as his agent.
- e. Before the end of trade date, the securities broker on behalf of IFI will intimate NCCPL through IFS its intention to sell the purchased shares; and purchase the same on its own account based on contract of Murabaha on the respective settlement date after assuming ownership of the purchased securities on behalf of IFI. Once affirmed by IFI, the transaction will be recorded in IFS.

In case the securities broker agree to pay complete settlement amount before the settlement date from its own resources, no mark-up will be charged in Murabaha transaction. In other case, agreed mark-up rate will be applied.

- f. NCCPL, on the settlement date and upon receipt of money from the IFI, record Murabaha transaction in IFS.
- g. The securities broker communicate its standing instruction to NCCPL to make arrangement for transfer its securities purchased through Murabaha transaction to the designated blocked account of the IFI as collateral.
- h. NCCPL will deliver purchased shares to an IFS Blocked account maintained in the name of IFI. The shares will be held in this account in block status on behalf of the securities broker to secure IFS transaction. However, IFI will have recourse to these shares in case of default by the securities broker.
- i. Any right including right to dividend, right to vote etc. in respect of shares held in IFS blocked account will vest with the securities broker. NCCPL and CDC will make suitable arrangement to ensure the same.
- j. **Risk Management:** Till settlement date, the securities broker will be responsible for margin requirement. After settlement of trade on settlement date, IFI as IFS financier will be

responsible to collect margins from the securities broker as per terms and conditions of Murabaha transactions.

- k. **Default Management:** Since the securities broker will be responsible for settlement of the ready market trade, hence in case of default to meet settlement obligations on the settlement date, NCCPL will carry out default management procedures as per the existing default mechanism.

In case of a post settlement default by a securities broker to meet its obligations, such default shall be managed by IFI and the securities broker privately without any obligation of NCCPL. However, based on specific request of IFI, NCCPL will assist IFI to retrieve shares held in IFS Blocked Account and other securities collaterals.

## II. Murabaha Recording on Future Date

- a. IFI will be admitted as IFS Financier (clearing member) of NCCPL.
- b. A securities broker and IFI have to sign and submit MMA. The securities broker also has to make an irrevocable promise to buy shares from IFI based on a contract of Murabaha.
- c. The securities broker as an agent of IFI will purchase the required shares from the ready market using its proprietary UIN through a specific key to be introduced by the stock exchange to identify the trade.
- d. Obligation to provide margins will rest with the securities broker however; the securities broker may collect required margins from IFI to meet its obligation as his agent.
- e. On the trade date, the securities broker will communicate to NCCPL regarding its intention to purchase securities, which the securities broker (on behalf of IFI) has purchased using its proprietary UIN, from the IFI based on Murabaha on a future date.
- f. On the settlement date, the purchased securities shall be delivered to the blocked account of the IFI based on the above communication whereas payment is to be made by the IFI to the extent of agreed FPR.
- g. On the agreed date, the IFI shall request NCCPL through IFS to record Murabaha transaction. NCCPL will record the Murabaha transaction and arrange for transfer of relevant securities from the blocked account of the IFI to the designated account of such securities broker. The shares will be held in this account in block status on behalf of the broker to secure IFS transaction. However, the IFI will have recourse to these shares in case of default by the broker to meet obligations of Murabaha transaction.
- h. Any right including right to dividend, right to vote etc. in respect of shares held in IFS blocked account will vest with the securities broker. NCCPL and CDC will make suitable arrangement to ensure the same.

- i. Upon meeting obligations of Murabaha transaction by the securities broker, the IFI shall intimate to NCCPL through IFS which shall make arrangement for transfer of securities from IFS blocked account to the securities broker designated account.
- j. IFI, as per the terms and conditions set out in the Murabaha Agreement, will record Murabaha Sell transaction to Finanee at cost + profit. Such sell transaction will be recorded after the settlement of ready market purchase where shares are made available in the IFI Block account.
- k. **Risk Management:** Stock Exchange will apply margin on ready market purchases as per existing risk management regime till settlement date. Upon settlement of the Ready Market purchase, Mark-to-market losses will be collected from the securities broker by the financier outside IFS.
- l. **Default Management:** Till settlement of ready market transaction, in case of default by either the IFI or the securities broker, normal default proceedings shall be initiated by the NCCPL against the securities broker.

In case of default by securities broker on obligations arising out of Murabaha transaction, such default shall be managed by the IFI outside IFS. However, upon request of the IFI through IFS, NCCPL shall make arrangement for transfer of relevant securities from IFS blocked account to the house account of IFI.

### **3. Financing by IFI to a customer of a securities broker**

#### **I. Murabaha Recording on Settlement Date**

- a. IFI will be admitted as IFS Financier (clearing member) of NCCPL
- b. The securities broker will only act as agent of the customer and the IFI.
- c. A securities broker, customer of such securities broker and IFI has to sign and submit MMA. The securities broker on behalf of IFI will obtain from customer an irrevocable promise to buy shares from IFI based on a contract of Murabaha.
- d. The securities broker as an agent of IFI will purchase the required shares from the ready market using customer UIN through a specific key to be introduced by the stock exchange to identify the trade.
- e. Obligation to provide margins will rest with the securities broker however the securities broker may collect required margins from IFI and the customer to meet its obligations as an agent
- f. Before the end of trade date, the securities broker on behalf of IFI will intimate NCCPL through IFS its intention to sell the purchased shares to customer based on contract of Murabaha on the respective settlement date after assuming ownership of the purchased securities on behalf of IFI. Once affirmed by IFI, the transaction will be recorded in IFS.

In case the customer agrees to pay complete settlement amount before the settlement date, no mark-up will be charged in Murabaha transaction. In other cases, agreed mark-up rate will be applied.

- g. NCCPL, on the settlement date and upon receipt of money from the IFI, record Murabaha transaction in IFS.
- h. The customer through its securities broker communicate its standing instruction to NCCPL to make arrangement for transfer its securities purchased through Murabaha transaction to the designated blocked account of the IFI as collateral.
- i. NCCPL will deliver purchased shares to an IFS Blocked account maintained in the name of IFI. The shares will be held in this account in block status on behalf of the customer to secure IFS transaction. However, IFI will have recourse to these shares in case of default by the customer.

- j. Any right including right to dividend, right to vote etc. in respect of shares held in IFS blocked account will vest with the customer. NCCPL and CDC will make suitable arrangement to ensure the same.
- k. **Risk Management:** Till settlement date, the securities broker will be responsible for margin requirement. After settlement of trade on settlement date, IFI as IFS financier will be responsible to collect margins from the customer, directly or through securities broker as per terms and conditions of Murabaha transactions.
- l. **Default Management:** Since the securities broker will be responsible for settlement of the ready market trade, hence in case of default to meet settlement obligations on the settlement date, NCCPL will carry out default management procedures as per the existing default mechanism.

In case of a post settlement default by a customer to meet its obligations, such default shall be managed by IFI and the customer privately without any obligation of NCCPL. However, based on specific request of IFI, the securities broker and NCCPL will assist IFI to retrieve shares held in IFS Blocked Account and other securities collaterals.

## II. Murabaha Recording on Future Date

- a. IFI will be admitted as IFS Financier (clearing member) of NCCPL.
- b. The securities broker will only act as agent of the customer and the IFI.
- c. A securities broker, customer of such securities broker and IFI has to sign and submit MMA. The securities broker on behalf of IFI will obtain from customer an irrevocable promise to buy shares from IFI based on a contract of Murabaha.
- d. The securities broker as an agent of IFI will purchase the required shares from the ready market using customers UIN through a specific key to be introduced by the stock exchange to identify the trade.
- e. Obligation to provide margins will rest with the securities broker however the securities broker may collect required margins from IFI and the customer to meet its obligations as an agent
- f. On the trade date, the customer through its securities broker will communicate to NCCPL regarding its intention to purchase securities, which the securities broker (on behalf of IFI) has purchased using customer's UIN, from the IFI based on Murabaha on a future date.

- g. On the settlement date, the purchased securities shall be delivered to the blocked account of the IFI based on the above communication whereas payment is to be made by the IFI to the extent of agreed FPR.
- h. On the agreed date, the IFI shall request NCCPL through IFS to record Murabaha transaction. NCCPL will record the Murabaha transaction and arrange for transfer of relevant securities from the blocked account of the IFI to the designated account of such customer of a securities broker. The shares will be held in this account in block status on behalf of the customer to secure IFS transaction. However, the IFI will have recourse to these shares in case of default by the broker to meet obligations of Murabaha transaction on behalf of customer.
- i. Any right including right to dividend, right to vote etc. in respect of shares held in IFS blocked account will vest with the customer. NCCPL and CDC will make suitable arrangement to ensure the same.
- j. Upon meeting obligations of Murabaha transaction by the broker on behalf of the customer, the IFI shall intimate to NCCPL through IFS which shall make arrangement for transfer of securities from IFS blocked account to the customers designated account.
- k. IFI, as per the terms and conditions set out in the Murabaha Agreement, will record Murabaha Sell transaction to Finanee at cost + profit. Such sell transaction will be recorded after the settlement of ready market purchase where shares are made available in the IFI Block account.
- l. **Risk Management:** Stock Exchange will apply margin on ready market purchases as per existing risk management regime till settlement date. Upon settlement of the Ready Market purchase, Mark-to-market losses will be collected from the customer by the financier outside IFS.
- m. **Default Management:** Till settlement of ready market transaction, in case of default by either the IFI or the customer, normal default proceedings shall be initiated by the NCCPL against the securities broker.

In case of default by customer on obligations arising out of Murabaha transaction, such default shall be managed by the IFI outside IFS. However, upon request of the IFI through IFS, NCCPL shall make arrangement for transfer of relevant securities from IFS blocked account to the house account of IFI.

## **G. Other Risk Management Features**

1. Free float based position limits shall be applicable on Financees as follows:
  - Market level: 40% of free float
  - Broker level: 5% of free float
  - Customer level: 3% of free float
2. Exposure to IFS shall not exceed 10 times NCB of the BCM.

## **H. Identification of the following Sell Transactions through Reports to be Provided by NCCPL**

1. **If financing is provided by the securities broker to its customer**
  - a. Purchase of a particular shares by the securities broker (in ready market)
  - b. Sale of the shares by securities broker to customer (Finanee)
2. **If financing is provided by IFI**
  - a. Purchase of a particular shares by the securities broker on behalf of IFI (in ready market)
  - b. Sale of shares by IFI to the securities broker or the customer, as the case may be (Finanee).

## **I. Disclosure**

A comprehensive disclosure framework should be developed in line with the present disclosure framework of other leveraged products to provide information in a fair and transparent manner.