

Guarantee Mechanisms for the Financial Markets of Cameroon

1 – THE PRINCIPLES OF FINANCIAL MARKET GUARANTEES

1.1 DIFFERENT TYPES OF RISK AND MANAGEMENT TOOLS

1.1.1 CREDIT RISK

Principle: Delivery systems against payment administered by the Central Depository eliminate credit risk.

Credit risk appears when there is a time lag between the delivery of shares and securities and the settling of the account. In the case where a PSI (investment service provider), during a negotiation at the Stock Exchange, makes delivery of shares or securities to the purchaser without receiving full settlement in exchange, then a cash flow deficit occurs. Equally, if the PSI who wishes to buy pays for the shares or securities, but does not immediately take possession of the shares, then the seller is in possession of a cash advance.

Each PSI, therefore, cannot be sure that the settlement or the delivery will be made, and until it is made, the transaction cannot be said to have been successfully concluded. The PSI is therefore running a credit risk.

If, however, the system assures that payment and delivery take place simultaneously, the credit risk disappears.

Credit Risk and Systemic Risk

Principle: The putting in place of market guarantee mechanisms allows the elimination of all credit risk and a large part of systemic risk.

Credit risk occurs when the other party to a transaction goes bankrupt or becomes insolvent and is no longer in a position to honour his commitments regarding payment for delivery. In the absence of a guarantee mechanism, the payment in cash or the delivery of shares to which the insolvent party has committed himself or herself, may not necessarily take place. It is easy to imagine the losses that can be incurred in such a situation. The 'domino effect' of such a situation could lead the other parties to themselves become insolvent, and so on down the line. This is known as systemic risk.

These risks can be alleviated to a great extent if we allow each PSI to freely choose the other party with whom he or she does business. This allows the PSI, to a great extent, to evaluate and manage the risks that he or she runs. This is one of the principal characteristics of markets which are controlled by the price or where market transactions are subject to strong constraints in terms of equity.

The system in place at the Douala Stock Exchange differs from that of a market controlled by price. Here, the market is controlled by orders, where:

The choice of the other party is not possible

The system of negotiation determines the equilibrium price according to supply and demand, and thus automatically attributes a counterpart to each order to buy or sell.

Another constraint imposed is that all participants in the market must be banking establishments

The absence of a series of constraints, other than that the participants must be banking establishments, justifies itself by the nature of the activity of each participant. The principal function of a PSI is not to buy or to sell shares on behalf of their clients. The role of the PSI is to transmit to the Stock Exchange orders to buy or sell which are issued by their clients, in order that the supply and demand for shares and securities may meet. Within the framework of this activity, the PSI never needs to use his own equity.

The existence of a system of guarantees for all transactions carried out in the financial market is therefore essential. These guarantees effectively ensure that each transaction is successfully completed and that the risk of insolvency or bankruptcy of one participant does not involve any risk to the other participant in the transaction, (credit risk), nor to the market as a whole (systemic risk).

The main objective of this mechanism is that, if a failure to pay in cash by one participant is observed, his or her commitment concerning settlement and delivery, both now and in the future, will be subrogated.

2 MARKET RISK

Principle: A successful conclusion to all transactions carried out in the financial market accompanies any market risk.

This mechanism covers all transactions carried out on the financial market, whether they have been completed or are in progress. In the event that the PSI does not respect his commitments, this mechanism will ensure a successful conclusion to the transaction.

Principle: the PSI must cover his or her market risk by means of an allocated deposit.

Market risk cover is assured by means of a call for contributions from the PSIs. Each PSI, therefore, makes a contribution to this guarantee mechanism. The amount of the contribution is proportional to the market risk presented by the totality of market transactions in progress. In the event of insolvency on the part of a PSI, this guarantee will allow him or her to liquidate his provision.

For each PSI, market risk can be calculated daily in proportion to negotiations carried out.

Each PSI contributes to the guarantee mechanism in proportion to the risk he or she bears.

3) MEMBERS

Principle: each PSI authorised to negotiate on the market must be a member of the market guarantee mechanism

Each PSI must settle calls for contributions within the time periods set down by the mechanism. A PSI who does not respect these rules will no longer have access to the market.

TRANSACTIONS COVERED

Principle: Only transactions concerning shares and securities listed and traded on the Douala Stock Exchange shall be covered by the guarantee mechanism.

GUARANTEE MECHANISM PROCEDURES

Principle: The guarantee mechanism only comes into play following insolvency. At the moment when any insolvency is observed, the mechanism will intervene in order to close out a position or positions.

FUNCTIONING OF THE MECHANISM

Principle: The mechanism is managed by the PSI Association

ESTABLISHMENT OF CONTRIBUTIONS

There are 2 levels of contributions:

- a) An initial contribution, in the form of a fixed inclusive application fee of 10 million fcfa
- b) A regular contribution, the amount of which varies according to the volume of transactions

MONITORING OF CONTRIBUTIONS

Principle: The PSI Association will carry out controls at regular intervals of the level of contributions of each member.

**INTERNAL RULES AND REGULATIONS GOVERNING THE GUARANTEE
MECHANISM**

PART 1: GENERAL ARRANGEMENTS

- 1) This handbook of internal rules and regulations, which conforms to law no. 99/015 of the 22nd December, 1999 concerning the organisation and the creation of the Cameroon Financial Market, and to clause 2 of the Articles of Association of the PSI Association, is intended to define:
 - Rules and regulations concerning the organisation of the guarantee mechanism
 - The amount of the initial contribution to be made by each PSI
 - The method used to calculate the periodic contributions made by each PSI
 - The periods at which these contributions shall be adjusted
 - The circumstances under which the Guarantee mechanism will come into force.
- 2) The present list of internal rules and regulations applies to each PSI who is entitled to negotiate on the Douala Stock Exchange and who, by this fact, participates in the post-market operations of delivery and settlement.
- 3)
 - 1) The Guarantee Mechanism, the subject of these rules and regulations, is aimed exclusively at covering net long or bull positions (PONA) shown by the PSIs at the close of the negotiating session.
 - 2) The Guarantee Mechanism has been put in place uniquely to deal with cash insolvency on the part of the PSI participating in negotiations at the Douala Stock Exchange.

PART 2: RULES FOR THE ORGANISATION OF THE GUARANTEE MECHANISM

- 4)
 - 1) The Guarantee mechanism is managed by the PSI Association (APPSI)
 - 2) The Guarantee Mechanism takes the form of a deposit in a bank account.
 - 3) The bank account in which the funds will be deposited will record as credit:
 - Contributions from the PSIs, both initial and regular
 - Repayments by insolvent PSIs and advances to them granted by the Guarantee Mechanism
 - Any interest payments to be paid by the bank where the account is held

And as debit:

- Releasing of funds destined for the settlement bank intended to substitute for the Guarantee Mechanism to insolvent PSIs
- Balance transfers to the PSIs in relation to any adjustment in their level of contribution
- Account handling charges imposed by the bank where the account is held
- Charges incurred by the management and operation of the Guarantee Mechanism.

PART 3: INITIAL CONTRIBUTIONS, MARKET RISK AND REGULAR CONTRIBUTIONS

5) Amount of the initial contribution

All PSIs who are members of the guarantee mechanism will make an initial non-recurrent contribution which shall be considered as an application fee. The amount of this inclusive initial contribution is fixed at 10,000,000 fcfa (ten million francs cfa)'

6) Market Risk

- 1) Each PSI negotiator at the Douala Stock Exchange is, in turn, either a vendor or a purchaser of shares and securities to other PSIs operating in the same Stock Exchange. When a PSI buys shares or securities, he or she must be able to pay all the sums due to the seller. When he or she sells, he is obliged to wait for the sums due to him.
- 2) Individual market risk appears at the moment when a PSI shows a net long or bull position (PONA) at the end of a negotiating session. This risk reflects the uncertainty as to whether the PSI has the ability to settle his account within the agreed period (4 days after the transaction.)
- 3) Market risk is reinforced by PSIs who show short or bear positions and, flowing from this, are waiting to be paid for the sales they have made.
- 4) Market risk can therefore be understood to be the maximum market capitalisation (Cmx) of a PSI of a share x that any given PSI can buy on the market. This capitalisation is inversely proportional to the market share (Pmx) of this share, that is to say:

$$RM = Cmx \frac{1}{Pmx}$$

This means that an increase in market share of a PSI on one share x converts into a lowering of market risk or settlement risk for the same share.

By way of illustration, consider the following hypothesis:

H1: The Stock Exchange begins its activities with 5 PSIs numbered PSI1, PSI2, PSI3, PSI4, PSI5.

H2: A single company is quoted on the market

H3: The total number of shares offered on the market is 1000

H4: The market price of the shares is 10,000 fcfa

H5: The market share of the PSIs is as follows:

MARKET SHARE

MARKET RISK

	QUANTITY OF SHARES	CAPITALISATION	PERCENTAGE	
PSI1	700	7,000,000	70%	3,000,000
PSI2	90	900,000	9%	9,100,000
PSI3	50	500,000	5%	9,500,000
PSI4	50	500,000	5%	9,500,000
PSI5	110	1,100,000	11%	8,900,000
TOTAL	1000	10,000,000	100%	

Regular contributions by the PSIs to the Guarantee mechanism take the form of deposits allocated to the cover of settlement risk. It then becomes apparent that deposits made by any given PSI must be sufficient to allow for the possibility of an increase in market share by that PSI. In our example, these possibilities are:

PSI1: 30%, PSI2: 91% PSI3: 95% PSI4: 95% PSI5: 89%

7) Calculation of regular contributions

Regular contributions (PRs) to be made by the PSIs to the Guarantee Mechanism are calculated as follows:

The average monthly growth rate of the share in the portfolio (Tcmx) is multiplied by the market risk (RM) for the PSI as follows:

PR = Tcmx RM

- 1) The monthly growth rate is calculated by the PSI Association taking into account the positions of shares at the beginning and at the end of each month. These figures are held in the Central Depository and are made available to the PSIs. The PSI Association will ask for this information on a regular basis.
- 2) We will illustrate this by use of the previous example, taking the case of PSI2. This PSI has a market share of 9% and a market risk of 9,100,000. If we further suppose that the monthly growth rate at the end of the month is 30%. It follows that, for the following month (M + 1), the PSI must make a contribution of 2,730,000 i.e. 30% of 9,100,000.
- 3) At the end of the month M + 1, it is necessary to recalculate the contributions needed for the following month (M + 2), again taking into account the growth rate during this period. Let us suppose that during M1 the growth rate was 20%. We can see that, between M and M + 1, the market share of the PSI increased from 9% to 11.7%. The market risk, which is inversely proportional to the market share, dropped from 9,100,000 fcfa to 8,830,000 fcfa. Using these figures as a basis, the contribution to be made by the PSI for M + 2 will be 1,766,000 fcfa. The PSI will be entitled to a reduction of 964,000 fcfa.
- 4) If, on the other hand, at the end of M + 1 the PSI2 only sold shares and the monthly growth rate (Tcmx) was negative (for example minus 5%), the market share of the PSI will move from 11.7% to 11.15% and his market risk from 8,830,000 to 8,888,500. His monthly contribution will therefore change from 1,766,000 fcfa to 2,210,425 fcfa.

8) Payment of contributions

- 1) Members of the Guarantee mechanism will receive from the PSI Association at the end of every month a statement showing the amount of contributions to be paid, or, in the event of a decrease in market risk for the PSI, the amount due to them.
- 2) Contributions can be paid by direct transfer to the Guarantee mechanism account, or by bank cheque to the Association of PSIs with a copy of the transfer order from the PSIs own bank.

PART 4: GUARANTEE MECHANISM: PROCEDURES FOR USE

- 9) In the event of a failure to pay by one of the PSIs at J + 4 (four days after the date of the transaction), the Douala Stock Exchange, acting in the name of the settlement bank and the Central Depository (divisions of the DSX responsible for settlement and delivery) will officially contact the Association of PSIs no later than 13.30 on J + 4 in order to make them aware of the non-payment and

to instruct them to put the Guarantee mechanism into action. A copy of this notification will be sent to the settlement bank.

- 10) This notification by the DSX shall be made by any traceable means and if necessary in writing. The notification will include the amount owed as well as any interests paid, and shall be invoiced by the settlement bank.
- 11) Notification having been sent, the PSI Association will put the guarantee mechanism into action no later than 15.30 on J + 5.
- 12) The putting into action of the guarantee mechanism will take the following forms, either:
 - A transfer of funds by the PSI Association in favour of the settlement bank
 - A bank cheque issued by the PSI Association in favour of the settlement bank

The amount transferred or the value of the cheque must be equivalent to the amount owed by the PSI plus any interest due, calculated at penalty rates by the settlement bank.

- 13) The penalty rate imposed by the settlement bank shall be equal to the penalty rate set by BEAC.
- 14)
 - 1) By virtue of the fact that the Guarantee mechanism has thus been put into action at J +5, the settlement bank will release, from its own resources, on J + 4, the sum owed by the PSI.
 - 2) The release of this sum by the settlement bank on J + 4 makes it unnecessary for the Stock Exchange to suffer further delays in the settlement or delivery of shares or sums due. It also justifies the invoicing of interest payments by the settlement bank.
 - 3) The release of any of the settlement banks own funds shall serve exclusively to settle the short or bear positions of the other PSIs.

PART 5: FINAL ARRANGEMENTS

- 15:**
 - 1) Any PSI who fails to make delivery or payment under the terms of the Guarantee mechanism shall be legally liable for those sums.
 - 2) The repayment of all sums due under the Guarantee Mechanism shall be a prior condition of any new admission of the PSI to the trading floor of the DSX.

- 16:** By way of special dispensation, a PSI who owes money via the Guarantee mechanism may be permitted to negotiate on the trading floor of the DSX if he or she is only selling shares. The person responsible for the trading floor shall check his order book before any trading is allowed.