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An Introduction to Derivatives in Nigeria - Dolapo Bolu and Oluwasolape Owoyemi[1]

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1. INTRODUCTION

The Nigerian market has witnessed a recent rise in the use of derivatives especially in transactions involving foreign counterparties. Derivatives are routinely utilised in many countries such as the United Kingdom and the United States of America. Other countries such as Germany, France and South Africa also operate thriving derivatives markets. In the UK for example, pension funds have in the past years increased their use of derivatives,[2] something that could be emulated in Nigeria. The global derivatives market is vast and estimated at more than $1.2 quadrillion.[3] Some market analysts estimate the derivatives market at more than 10 times the size of the total world gross domestic product (GDP).[4] Notwithstanding the frailties of the Nigerian capital market, the advent of derivatives has sparked a significant positive response from both local and foreign investors seeking to conduct businesses within Nigeria or with Nigerians. This signals a new opportunity for Nigeria, as derivatives are extremely flexible due to their contractual nature and they can be used to accomplish a broad array of risk management objectives, if properly utilised.[5]

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2 NAPF, Securing the Future of Pensions: Derivatives and Risk Management made Simple, *available at* https://www.jpmorgan.com/jpmpdf/1320663533358.pdf, *accessed on* 12th June 2017.

3 J. B. Maverick, Investopedia, *How Big is the Derivatives Market*? Investopedia, May 27th 2015, *available at* http://www.investopedia.com/ask/answers/052715/how-big-derivatives-market.asp?lgl=rira-baseline-vertical, *accessed on* 19th June 2017.

4 Ibid.

5 Alan N. Rechtschaffen (2014) ***Capital Markets, Derivatives and the Law*** Oxford University Press. p. 148.

2. DERIVATIVES AS A FINANCIAL INSTRUMENT

Derivatives are financial instruments that derive their value over a period from the value/performance of an underlying asset.[6] A derivative or derivatives transaction is often equated to a bilateral contract or a payment exchange agreement whose value is dependent on the value of an underlying asset.[7] The value of a derivative may be based on the value of a particular currency, treasury bonds, stock indexes or interest rates which are further determined by core market forces and applicable interest rates. Due to their nature, derivatives are highly leveraged and require little to no upfront monetary commitment, making them a veritable and attractive tool for hedging against market risk; lowering fund costs and managing assets.[8] A derivative is usually traded between two parties – who are generally referred to as the counterparties. These counterparties are subject to a pre-agreed set of terms and conditions that determine their rights and obligations.[9]

2.1 Types of Derivatives

There are generally four (4) types of derivatives

a. **Forwards**: These are non-standardised contracts between two parties to buy and sell an asset at a specified future time at a price agreed in the present.

b. **Futures**: A futures contract is an agreement made on the trading floor of a futures exchange between two parties to buy or sell an asset (commodity or financial instrument) at a certain time in the future at a certain price.[10]

c. **Swaps**: These are agreements to exchange one series of future cash flows for another. Although the underlying reference assets can be different, e.g. equity or interest rate, the value of the underlying asset will characteristically be taken from a publicly available price source. For example, under an equity swap the amount that is paid or received will be the difference between the equity price at the start and end date of the contract.[11]

d. **Options**: Exchange-traded options are standardised contracts whereby one party has a right to purchase something at a pre-agreed strike price at some point in the future. The right, however, is not an obligation as the buyer can

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6 John Osuoha, *Transforming Nigeria Economy through the Use of Derivatives*, 2013, *available at* (file:///C:/Users/Dolapo/Downloads/1396-3682-1-PB%20(1).pdf), *accessed on* 1st June 2017.

7 Ibid, NAPF (n.2).

8 Ibid.

9 NAPF, Securing the Future of Pensions: Derivatives and Risk Management made Simple, *available at* https://www.jpmorgan.com/jpmpdf/1320663533358.pdf, *accessed on* 12th June 2017.

10 Ibid.

11 Ibid.

allow the contract to expire and walk away. The cost of buying an option is the seller's premium, which the buyer must pay to obtain the option right. Two types of option contracts that can be either bought or sold are Call option and Put Option. A buyer of a call option has the right but not the obligation to buy the asset at the strike price (price paid) at a future date while a seller has the obligation to sell the asset at the strike price if the buyer exercises the option. A buyer of a put option on the other hand has the right, but not the obligation, to sell the asset at the strike price at a future date. A seller has the obligation to repurchase the asset at the strike price if the buyer exercises the option.[12]

Derivatives can be traded on or off an Exchange and may take either of the following forms:

a. **Exchange-Traded Derivatives (ETDs)**: These are standardized derivatives contracts traded on a recognised exchange, with the counterparties being the holder and the exchange. The contract terms are non-negotiable and their prices are publicly available.[13] The Nigerian Stock Exchange (NSE) has stated that it will launch ETDs before the end of 2017, which would be useful to investors seeking to actively manage their risks and potentially develop the market and help boost the economy.[14]

b. **Exchange-Traded Fund (ETFs):** This is a type of fund that tracks the performance of an index or a commodity. They trade like shares on a stock exchange and derive their value from the index or commodity they track. ETFs provide investors the opportunity to diversify their portfolios without going through the rigours of selecting individual securities.[15]

c. **Over-the-Counter Derivatives (OTCs)**: These are private bespoke contracts that are traded off-exchange without an intermediary and with specific terms and conditions determined and agreed by the buyer and seller (counterparties). As a result, OTC derivatives are more illiquid, e.g. forward contracts and swaps.[16] The main parties in OTC derivatives transactions are banks, non-financial institutions and corporations.

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12 Ibid.

13 Ibid

14 The Nation Newspaper Nigeria, NSE to launch Exchange Traded Derivatives by Taofik Salako, June 14th 2017, *available at* http://thenationonlineng.net/nse-launch-exchange-traded-derivatives/ *accessed on* 3rd July 2017.

15 Ibid

16 NAPF, Securing the Future of Pensions: Derivatives and Risk Management made simple, *available at* https://www.jpmorgan.com/jpmpdf/1320663533358.pdf, *accessed on* 12th June 2017.

2.2 Derivatives Documentation

Derivatives require effective legal documentation to delineate the rights and obligations of each counterparty to the transaction. The standard documentation developed by the International Swap Dealers Association (ISDA) for derivatives transactions has no direct application in Nigeria. However, parties in the Nigeria derivatives market can use this template to document their transactions, adjusting the document to match the uniqueness of each respective transaction.[17] Under Nigerian law, parties are free to document their own contract or to adopt terms of a contract by reference, and nothing precludes parties from utilizing a standard contract such as that developed by the ISDA.[18]

2.3 Derivatives as a Risk Management Instrument

Due to the leveraged nature of derivatives, they may be used to effectively lock down transactions over the primary asset. For example, it may be used where a firm or corporation does not have an immediate need or capability to fully transact an underlying commodity but nevertheless foresees a future transaction in that asset. A firm or corporation has the option of locking-in the price of the commodity at the present rate, thereby hedging the risk in fluctuating market prices of that asset. This option allows the firm to make a planned future transaction that will not be more expensive than contemplated.[19] Thus derivatives may be used to hedge risk exposures such as commodity price fluctuations or seasonal risks.[20]

Hedging pension funds is an example of derivatives being used as a risk management instrument. Pension funds are dynamic and are easily heavily exposed to interest and inflation rate risks because these determine the present value of the scheme's liabilities; these risks are referred to as 'unrewarded' risks as they are fundamental to the investors liabilities.[21] While these market risks cannot be completely removed by diversification; hedging can reduce them. Making efficient use of interest and inflation rate swaps can produce offsetting positions whereby the risks are hedged. Through liability-driven investment funds (LDI) or derivatives, pension funds can access favourable interest rates and inflation hedges. Typically,

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17 Olayemi, Anyanechi, *Dealing with Derivatives in an Emerging Market*, 14th December 2014, *available at* http://www.internationallawoffice.com/Newsletters/Derivatives/Nigeria/Sefton-Fross/Dealing-with-derivatives-in-an-emerging-market, *accessed on* 14th July 2017.

18 Ibid.

19 Alan N. Rechtschaffen (2014) ***Capital Markets, Derivatives and the Law,*** Oxford University Press. p. 148.

20 Iwa Salami (2012) *Derivative Markets in Africa: Legal and regulatory issues* Journal of International Banking Law and Regulations p. 416.

21 *Supra, NAPF,* (n. 2).

derivatives contracts also carry collateral requirements to manage counterparty exposure.[22]

2.4 Current Developments in the Use of Derivatives in Nigeria

In 2011, the Central Bank of Nigeria introduced the use of Foreign Exchange Derivatives in the Nigerian market through guidelines.[23] The guidelines regulate the activities of authorised dealers of foreign exchange in Nigeria (i.e., banks, bureaux de change and discount houses) in regard to derivatives transactions.[24] Under the guidelines, the approved hedging products are; foreign exchange options; forwards (outright and non-deliverable); foreign exchange swaps; and cross-currency interest rate swaps (CCIRS).

Derivatives in Nigeria are also regulated by the Securities and Exchange Commission of Nigeria (SEC). The definition of the term 'securities' under the Investment and Securities Act (ISA or the Act) 2007 includes futures, options and *"other derivatives"*.[25] Section 54 of the Act states that where a public company enters into a derivatives transaction, such a transaction must be registered with the SEC. Also from the definition of 'securities exchange' under Section 315(3) of the Act, every derivatives market in Nigeria must be registered with and regulated by the SEC. This includes the various derivatives markets through which derivatives may be offered, such as exchanges, over-the-counter (OTC) markets and primary markets.

Recently, the Nigerian Stock Exchange (NSE) and Nasdaq officially announced that, they have launched a new market surveillance platform powered by SMARTS, Nasdaq's surveillance technology. SMARTS will *"enable the NSE to proactively monitor market manipulation (including spoofing and layering), detect and deter manipulative tendencies, gather intelligence, carry out traders' monitoring and analysis, conduct multi-asset and cross-market surveillance, and execute risk-based supervision of flagged participants".*[26]

The Central Counterparty (CCP) through the process of novation clears derivatives traded on the Nigerian Stock Exchange. The process of novation involves a

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22 Ibid.

23 Central Bank of Nigeria, *Guidelines for FX Derivatives in the Nigerian Financial Markets*, March 2011.

24 Olayemi Anyanechi, *Dealing with derivatives in an emerging market*, available at http://www.internationallawoffice.com/Newsletters/Derivatives/Nigeria/Sefton-Fross/Dealing-with-derivatives-in-an-emerging-market# *accessed on* 15th June 2017.

25 Section 13(b) of the Investment and Securities Act 2007.

26 NASDAQ via GlobesNewswire, NASDAQ: *The Nigerian Stock Exchange goes Live with NASDAQ SMARTS Market Surveillance Technology*, available at http://www.nasdaq.com/press-release/the-nigerian-stock-exchange-goes-live-with-nasdaq-smarts-market-surveillance-technology-20170717-00094 *accessed on* 18th July 2017.

replacement of an initial contract between counterparties matched in the trading engine with a new contract between the CCP and the investors; and as a result, the CCP becomes the buyer to the seller and the seller to the buyer.[27] On a daily basis, CCP cleared derivatives are settled and gains and losses from a day's trading are deducted or credited to an investor's account each day until the expiration of the contract.[28]

Derivatives contracts have the option of being cash settled or physically settled. Physical settlement involves the delivery of the underlying asset, while cash settled contract is settled by receiving (or making) the net cash payment of the difference between the value at the position's Exchange Delivery Settlement Price (EDSP) and the value based on the previous day's closing price.[29] This is due to the fact that all contracts are marked to market at the end of each trading day and the CCP either receives or pays that day's variation margin.[30]

3. CONCLUSION

The advent and increased utilisation of structured financial products in Nigeria has encouraged the need for well-tailored legislation/legislations to further bolster the Nigerian capital market. A well-developed derivatives market is crucial to the advancement of the Nigerian financial markets. It is however impossible to harness the benefit of derivatives where there is no concrete financial regulatory framework in place and a substantial number of lawyers who are well informed on structured products to give adequate advice. It is crucial that lawyers are well versed on the usage of Derivatives to adequately advise end users of the benefits and potential risks associated with derivatives markets, especially in the absence of a well-rounded and effective regulatory regime to guide its usage.

The benefits however outweigh the risks. Markets with derivatives respond quickly to information as the information is more rapidly incorporated into the prices of underlying securities in the presence of derivatives because of the link between the derivatives market and the underlying market. It is also fundamental to attracting foreign investment, as foreign investors and investment fund managers seem to

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27 The Nigerian Stock Exchange, *Manage your risk with derivatives: Derivatives*, available at http://www.nse.com.ng/products-site/derivatives/Pages/default.aspx *accessed on* 10th July 2017.
28 Ibid.
29 Ibid.
30 Ibid.

prefer more sophisticated and financially rewarding investment products like derivatives.[31]

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[31] *Supra*, Osuoha, p. 672.