

DERIVATIVES IN NIGERIA FINANCIAL MARKET: THE COMPELLING NEED

The absence of a robust financial and derivatives market works against efforts to transform Nigeria's abundant resources to real economic gains. A key element of this transformation is the development of a deep financial market, coupled with a dynamic derivatives market where most of her natural resources can be traded globally in a competitive and transparent manner. Derivatives play vital role in the development and growth of an economy through its crucial role of price discovery, market completeness, risk management and market efficiency. It attracts foreign capital flow, reduce cost of capital and help deepen the market.

Derivatives are financial instruments that derive their values from the value of other instruments. The instruments from which derivatives get their values are known as traditional instruments, primitive instrument, underlying instrument, original instrument or basic instruments. These underlying instruments include stock, shares, bonds, interest rate, exchange rate, commodities, precious metals, base metals, weather, electricity emission to mention but a few. Major types of derivatives include options, futures and swap. Others include forward, caps, floors, collars, swaption and rights.

Derivatives markets have grown at an incredible pace, many times faster than basic indicators of international economic development. The most common problems that constrain the development of local derivatives markets are relatively underdeveloped underlying markets, weak or inadequate legal and market infrastructure and restrictions in the use of derivatives. Financial derivative markets have helped to support capital inflows into emerging market economies. On the other hand, the use of financial derivatives has led to exacerbated volatility and accelerated capital outflow.

Financial markets serve to reduce risk thus allowing for greater fiscal autonomy and political sovereignty. Firms also use derivatives to reduce their financial distress risk and this distress risk has a systematic component that is priced in the market. The risk management function must integrate assessment of each product to achieve a comprehensive picture of the risk profile of the firm, taking into account any interdependence among the activities in different lines of business.

Derivatives exchanges perform more complex functions than real-market exchanges, and are being transformed and modernized. Derivatives meet the challenges of financial globalization and the money revolution. They are compatible with qualitative changes in the shareholders (corporate) economy, offering along with these changes, strategies and paths of socioeconomic change. Financial derivatives remain one of the world's most important markets. It is reported that 50% of US firms use derivatives, just as 48% of the firms in New Zealand also use derivatives.

WHY DERIVATIVES MARKET FOR NIGERIA?

The global market is moving at a very fast pace. It is therefore imperative that Nigerian financial market is strategically positioned to leverage on this trend for its economic growth and stability. Presently, the Nigerian capital and money markets are lacking in hedging mechanism to protect investors. Derivatives are needed to play this role. More so foreign investment fund managers prefer more sophisticated investment products like derivatives. There is therefore need to introduce a derivatives exchange where more sophisticated instruments are traded so as to attract foreign investors. The derivative product will provide a mechanism for hedging the price fluctuations of oil and Gas and other natural resources abundantly available in Nigeria. The emergence and growth of this specialized market will standardize other market segments such as real estate. While offering a platform for price discovery, market completeness and market efficiency; it will also increase capital market participants such as banks, insurance companies, oil companies, pension funds, as well as avail the Nigerian investors the many benefits of derivatives.

Markets with derivatives respond more quickly to new information. Information is more rapidly incorporated into the prices of underlying securities in the presence of derivatives because of the link between the derivative market and underlying markets. Development of derivative markets is an offspring of the modern globalization and liberalization process of the world economy. A closed economy can be predictable but poor. On the other hand, open economies are wealthier as gains from trade are realized but also riskier. Derivative market allows this risk to be hedged by individual firms. The growth of financial markets and in particular the derivatives market will enhance the effectiveness of monetary policy by speeding up the transmission process, influencing expectations and thus add power and credibility.

The greater use of derivative have two clear impacts for the financial markets one, it can speed up the transmission of monetary policy from short term interest rates, which are more sensitive to developments, and two, it can moderate the financial market reactions to monetary policy and make it less abrupt. Derivative market and underlying markets are closely linked, hence making the market complete and thereby reduce friction in prices across the two markets. The effect is that trading volume is increased and by extension, the market size is boosted.

Derivative can alter international transmission by making arbitrating less expensive through reduced transaction costs. This again explains the increase in market size. Overall evidence shows that development and spread of derivatives activities have resulted in better financial market in terms of efficiency, capital raising, hedging and lower transaction cost. The rationale is that derivatives by lowering transaction costs, increases liquidity. Compared with equivalent transactions in underlying assets, derivatives can reduce the occurrence of large funds transfers and thus lower the risk of systemic failure. The overall financial system will be enhanced thus promoting the economic development of the Nigeria as a country.

MARKET UPDATE

	15/01/13	15/12/13	04/04/14
Naira/US\$	154.1	155.2	155.75
Brent,US\$/BBL	109.78	107.84	109.9
COCOA, US\$	1487.82	2685.47	2760.56
MPR%	12.00	12.00	12.00
INFLATION RATE %	10.3	7.9	7.7
MORTGAGE RATE %	22.0	23.0	23.0

STOCKS CONSTITUTING GMA INDEX

STOCKS	31/12/13 Price (N)	04/04/14 Price (N)	%Change in Price
OANDO	12.00	17.02	-29.81
GTBANK	23.00	27.00	-0.07
OKOMU	41.00	42.00	-4.55
STANBIC	11.00	20.30	-4.92
DANGSUGAR	5.98	9.60	-17.95
FIDSON	1.08	3.00	7.53
TRANSCORP	1.03	3.63	-16.55
CCNN	5.30	9.50	-19.15

	PRICE(N)	NAV (N)
	31/01/14	04/04/14
UHOREIT	50.00	55.58
UPDCREIT	10.00	10.17

Index	31/12/13	04/04/14	% Change
NSE ASI	41,329.19	38,712.76	-6.33
GMA Index	1.50	1.39	-7.64

Source: CBN, SEC and NSE

USEFULNESS OF DERIVATIVES IN NIGERIAN FINANCIAL MARKET

A treasurer in a risk averse firm may use derivative to hedge while another in a profit-centered firm may use derivative to speculate. The development of financial derivatives, of all kinds, has given business the tools it needs to shed unwanted risks. The propensity to use derivatives is positively related to bank size, currency exposure, and issuance of preferred stock, while negatively related to leverage and diversification of long-term liabilities. Specifically, banks with greater international activities are more likely to face, and accordingly manage, currency exposure. Other applications of financial derivatives include management of risk, efficiency in trading, speculation, price discovery and price stabilization functions. Hedgers wishing to avoid risk can use it. Arbitrageurs seeking for riskless profit can employ it. Speculators can take calculated risk in search of profit with the use of derivatives. It is useful to producers, farmers, manufacturers, investors, corporations, international traders and nations in general. Users of derivatives include supranationals (World Bank, European Development Bank, African Development Bank etc), Governments and government agencies, banks (for their own or client positions), companies, asset managers, hedge funds, high net worth individuals, and private clients.

Derivatives market in an economy enhances risk management, price discovery, market completeness, speculations, market efficiency, operational efficiency as well as achieving leverage. As a risk management tool, derivatives enable risk averse investors to transfer their risks to those willing to take it. It is necessary for a business enterprise to take risks but these risks must be addressed within the context of that particular enterprise's business strategy. For price discovery, derivatives help investors to obtain information about future

prices. As a market completion mechanism, derivatives help investors identify all possible payoffs in the financial market and exploit them. The ease and low cost of transacting in the derivative market makes the market efficient. Greater liquidity in the derivative market accounts for its operational efficiency.

BENEFITS OF USING DERIVATIVES IN NIGERIAN FINANCIAL MARKET

The derivatives market can bring into an economy such benefits as lower transaction cost, better liquidity, faster and easier transaction, possibility of short selling, achieving greater leverage, deepening of the market, and possibility of investing in a whole basket of stock through stock index which will be much more costly to buy directly. Through exchange traded derivatives standardization can be achieved. Market participants can hedge their risk exposure with the use of derivatives. Appropriately regulated OTC market should be encouraged and developed based on the benefits they provide and on their inherent complementarities to exchange traded derivatives. The development of all kinds of financial derivatives has given business the tools it needs to shed unwanted risks. These instruments enable management to focus on risks that they understand and choose to manage while they leave the market to manage those risks that is outside the overall strategy of the firm. With derivatives mutual funds manage risk in their portfolio. Banks use them to guard against losses. Oil companies use them to hedge against or counteract the prospect of future price changes. Airlines use them to try to lock in more favorable fuel prices. Cross border transactions depend on derivatives to ameliorate the risk of currency exchange rate fluctuations. Derivatives such as forwards, futures and options provide an effective method for managing cash flow exposure arising from regular and uncertain transactions such as imports and exports. In the US non-financial firms, it is found that the cost of equity of derivatives users is lower than non-users, suggesting that firms use derivatives to reduce their financial distress risk. The effect of derivative use on a firm's value is positive. Using derivatives is associated with significantly high value, abnormal returns and larger profit during economic downturn. Exchange traded derivatives enjoy the guarantee of the exchange thus lowering the risk of default.

CHALLENGES OF USING DERIVATIVES

The misuse of derivatives and misapplication of financial engineering can lead to devastating consequence on the investor and the nation. One of the major reasons for low usage of derivatives instruments is lack of information about the procedure of derivative usage and lack of knowledge about the potential benefits of derivatives use. This lack of knowledge is attributed to the complexity, the size of the market and the high degree of risk concentration, increasing reliance on financial mathematics, lack of transparency about the risks associated with the products and the exclusion of derivatives from consumer protection and disclosure laws on the assumption that they are only traded between sophisticated investors.

MAJOR CHALLENGES FOR NIGERIA'S DERIVATIVE MARKET

In Nigeria, the derivatives market faces fundamental challenges.

- Absence of an organized derivatives exchange:** No single derivatives exchange in Nigeria. The Abuja Commodity and Securities Exchange do not trade in derivatives but operate as a spot market for some agricultural produce. However, there are low level OTC derivatives transactions by some banks and multinationals. The Nigeria Stock Exchange has plans to introduce futures and options. It has also listed exchange traded Funds (ETFs) and a gold-linked security which though are a form of derivatives but they are traded spot on the exchange. Government should corroborate with the organized private sector to ensure the establishment of a derivatives exchange in Nigeria.

- Absence of robust regulatory framework:** The CBN recently issued some guidelines for Banks that trade on OTC derivatives - These guidelines are not robust and do not cover all aspects of derivatives transactions. There should be a separate regulatory body for derivatives transactions. The regulatory framework should be well thought out to ensure it does not inhibit the development and growth of the derivatives market in Nigeria.
- Scarcity of local talents in derivatives trading:** There will be need to build capacity and train adequate manpower on the operations of derivatives.
- Under-developed underlying markets:** The basic markets on which derivatives are structured are not fully developed and this can inhibit the development of the derivatives market. According to IMF (2003), the main reasons for the underdevelopment of local derivatives markets are the underdevelopment of the underlying markets themselves and also tight regulations that restrict their use by banks and investors. Efforts should be made in developing a more robust and deep capital market, money market, commodities markets and market for other underlying instruments.

CONCLUSION

The degree of financial market development is an important determinant of the distribution of capital flow across countries. There is strong positive correlation between private capital inflows and real GDP growth in the recipient countries. The more developed the capital market, the higher the capital inflow. As a result of the global financial crises and recession, private capital flows to all regions of the world have declined. Investors are likely to remain risk averse than they were previously even as the financial market return to health. The implication is that policy makers in Sub-Sahara Africa will need to pay increasing attention to efforts aimed to attract private capital to their countries. One of the most important things policy makers can do is to strengthen the domestic capital markets.

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