

## OTC DERIVATIVE PRODUCTS

An over-the-counter (OTC) is a bilateral contract in which two parties (or their brokers or bankers as intermediaries) agree on how a particular trade or agreement is to be settled in the future. It is usually from an investment bank to its clients directly. A key feature of the over-the-counter (OTC) derivative market is its flexibility, and the wider latitude it offers which tasks the creativity of the operators in term of product development. Forwards and Swaps and their variants are prime examples of OTC derivatives. The OTC market is an informal network of bilateral counterparty relationships. The market is characterised by a dynamic, time-varying credit exposures whose size and distribution are tied to important asset markets. International financial institutions have increasingly nurtured the ability to profit from OTC derivatives activities, and financial markets participants benefit from them. As a result, OTC derivatives activities play a central and predominantly beneficial role in modern finance

OTC derivatives are significant part of the world of global finance today. The OTC derivatives markets are large and have grown exponentially over the last two decades. The expansion has been driven by interest rate products, foreign exchange instruments and credit default swaps. The notional outstanding of OTC derivatives markets rose throughout the period and totaled approximately US\$601 trillion at December 31, 2010. In the past two decades, the major internationally active financial institutions have significantly increased the share of their earnings from derivatives activities. These institutions manage portfolios of derivatives involving tens of thousands of positions and aggregate global turnover of over \$1trillion.

### OTC DERIVATIVES VERSUS FUTURES

The OTC derivatives have some clear distinguishing features compared to the exchange traded derivatives such as futures.

1. Futures contracts are standardised including delivery places and dates, volume, technical specifications, and trading and credit procedures. This is not the case for the OTC, in which each type of contract has its specific particulars determined by the preferences of the counterparties.
2. Futures contracts are always traded on an exchange, while swaps are traded on a bilateral basis.
3. Those who engage in futures transactions assume exposure to default by the exchange's clearinghouse; for OTC derivatives, the exposure is to default by the counterparty.
4. Credit risk mitigation measures are automatically required for futures, but optional for swaps.
5. Futures are generally subject to a single regulatory regime in one jurisdiction, while swaps although usually transacted by regulated firms are transacted across jurisdictional boundaries and are primarily governed by the contractual relations between the parties.

The advantages of OTC derivatives over exchange-traded ones are mainly the lower fees and taxes, and greater freedom of negotiation and customization of a transaction, as it involves only a seller and a buyer and no standardization authority.

### OTC DERIVATIVE PRODUCTS

Some of the OTC derive products include forward contracts, forward rate agreements, interest rate agreements, options, interest rate options, cross currency swaps, credit default swaps, and total return swaps. The list is inexhaustible and is a function of the creativity of the market operators. The products are discussed in some details below.

#### 1. Forward Contracts

A forward is a customized, privately negotiated agreement between two parties to exchange an asset or cash flows at a specified future date at a price agreed on the trade date. Entering into a forward contract typically does not require the payment of a fee. The trade date is the date on which the parties agree to the terms of a contract. The effective date is the date on which the parties begin calculating accrued obligations, such as fixed and floating interest payment obligations on an interest rate swap. Notional principle, or notional amount, of a derivative contract is the underlying quantity upon which interest rate or other payment obligations are computed.

## MARKET UPDATE

	15/01/13	15/12/13	21/03/14
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	8.0
MORTGAGE RATE %	22.0	23.0	23.0

## STOCKS CONSTITUTING GMA INDEX

STOCKS	31/12/13 Price (N)	21/03/14 Price (N)	%Change in Price
OANDO	24.25	16.04	-33.86
GTBANK	27.02	25.86	-4.29
OKOMU	44.00	42.00	-4.55
STANBIC	21.35	21.00	-1.64
DANGSUGAR	11.70	8.85	-24.36
FIDSON	2.79	3.36	0.72
TRANSCORP	4.35	3.86	-22.76
CCNN	11.75	9.15	-15.32

	PRICE(N)	NAV (N)
	31/01/14	21/03/14
UHOREIT	50.00	55.58
UPDCREIT	10.00	10.17

Index	31/12/13	21/03/14	% Change
NSE ASI	41,329.19	37,803.86	-7.34
GMA Index	1.50	1.34	-11.03

Source: CBN, SEC and NSE

#### 2. Forward rate agreements (FRA)

This is a forward contract on a short-term interest rate, usually Libor, in which cash flow obligations at maturity are calculated on a notional amount and based on the difference between a predetermined *forward rate* and the market rate prevailing on that date. The settlement rate of an FRA is the date on which cash flow obligations are determined. The *Short-term interest rate* is the interest rate paid on interbank deposits in the international money markets; this is also called the *Eurocurrency markets*. Because Eurocurrency deposits priced at Libor are almost continually traded in highly liquid markets, Libor is commonly used as a benchmark for short-term interest rates in setting loan and deposit rates and as the floating rate on an interest rate swap.

#### 3. Interest rate swaps

Interest rate swap is an agreement to exchange interest rate cash flows. It is determined or calculated on a notional principal amount, at specified intervals or payment dates during the life of the agreement. Each party's payment obligation is computed using a different interest rate. In an interest rate swap, the notional principle is never exchanged. Although, there are no standardized swaps, a plain vanilla swap typically refers to a generic interest rate swap in which

one party pays a fixed rate while the other party pays a floating rate.

#### The value of an interest rate swap

The value of an interest rate swap to counterparty is the net difference between the present value of the payments the counterparty expects to receive and the *present value* of the payments the counterparty expects to make. At the inception of the swap, the value is generally zero to both parties, and becomes positive to one and negative to the other depending on the movement of interest rates. *Present value* is the value of a quantity to be received in the future, adjusted for the time value of money i.e. interest foregone while waiting for the quantity.

#### 4 Options

An option is an agreement that gives the buyer, who pays a fee (*premium*), the right but not the obligation to buy or sell a specified amount of an underlying asset at an agreed upon price on or until the expiration of the contract. A call option is an option to buy, and a put option is an option to sell.

#### How do options differ from swaps and forwards?

In a forward or swap, the parties lock in a price (e.g., a forward price or a fixed swap rate) and are subject to symmetric and offsetting payment obligations. In an option, the buyer purchases protection from changes in a price or rate in one direction while retaining the ability to benefit from movement of the price or rate in the other direction. In other words, the option involves asymmetric cash flow obligations.

#### 5. Interest rate options

In an interest rate option, the underlying asset is related to the change in an interest rate. In an interest rate cap, for example, the seller agrees to compensate the buyer for the amount by which an underlying short-term rate exceeds a specified rate on a series of dates during the life of the contract. In an interest rate floor, the seller agrees to compensate the buyer for a rate falling below the specified rate during the contract period. Finally, a swap option gives the holder the right but not the obligation to enter an interest rate swap at an agreed upon fixed rate until or at some future date.

#### Currency derivatives

The parties in this contract agree to exchange cash flows in two different currencies at an agreed upon date in the future. A cross-currency swap is essentially an interest rate swap in which each side is denominated in a different currency. And a currency option is a contract that gives the buyer the right, but not the obligation, to exchange one currency for another at a predetermined exchange rate on or until the maturity date.

#### 6. Cross-currency swaps

A cross-currency swap is an interest rate swap in which the cash flows are in different currencies. Upon initiation of cross-currency swap, the counterparties make an initial exchange of notional principles in the two currencies. During the life of a swap, each party pays interest in the currency of principle received to the other. And at the maturity of the swap, the parties make the final exchange of the initial principle amounts, reversing the initial exchange at the same spot rate. A cross-currency swap is sometimes confused with a traditional FX swap, which is simply a swap currency transaction that will be reversed at a predetermined date with an offsetting forward transaction; the two are arranged as a single transaction.

#### 7. Credit default swap

A credit default swap is a credit derivative contract in which one party referred to as protection buyer pays a periodic fee to another party typically known as protection seller in return for compensation for default or similar credit event by a reference entity. The reference entity is not a party to the credit default swap. It is not necessary for the protection buyer to suffer an actual loss to be eligible for compensation if a credit event occurs. The protection buyer gives up the risk of default by the reference entity, and takes on the risk of simultaneous default by both the protection seller and the reference credit. The protection seller takes on the default risk of the reference entity, similar to the risk of a direct loan to the reference entity.

#### 8. Total return swaps

A total return swap is an agreement in which one party, the total return buyer, transfers the total economic performance of a reference obligation to the other party, the total return receiver. Total economic performance includes income from interest and fees, gains or losses from market movements, and credit losses.

#### CONCLUSION

The advantages of OTC derivatives over exchange-traded ones are mainly the lower fees and taxes. It also offers flexibility and greater freedom of negotiation and customization of a transaction, as it involves only a seller and a buyer and no standardization authority.

#### Disclaimer

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