

DERIVATIVES: THE NEW BRIDE OF THE CAPITAL MARKET

Every season and almost every sector in Nigeria; a new bride emerges from time to time. In recent times, with the capital market it has been the slow arrival of derivative products on the scene, an extremely long courtship if the pace of consummation this evolving relationship is anything to go by. However, 2014 seems to be the year when we will finally see a meeting of minds of all moving parts resulting in a marriage which, if well-orchestrated, will bring the much needed diversification to the market as well as a veritable source of application of our ever increasing pension funds.

This feature purposes to guide market participants and interested bystanders on this evolution by providing information which will provide clarity to what appears as a vague issue for most people and hopefully attract full participation from all parties at the appointed time. This will thus be the demystification of the bride BUT not with the intention of demeaning her but to ensure a marriage that is blissful and meets the fundamental purposes for which it is being consummated.

Bearing this in mind, this maiden piece will attempt to paint a picture by providing a background to the subject, walking us through its history and subsequently attempting to chart a course for its near future.

BACKGROUND

Derivatives are one of the three main categories of financial instruments, the other two being equities and debt. A derivative is a financial contract which derives its value from the performance of another entity such as an asset, index, or interest rate, called the "underlying". Derivatives include a variety of financial contracts, including futures, forwards, swaps, options, and variations of these.

There are two groups of derivative contracts: the privately traded over-the-counter (OTC) derivatives such as swaps that do not go through an exchange or other intermediary, and exchange-traded derivatives (ETD) that are traded through specialized derivatives exchanges or other exchanges.

HISTORY

Although generally thought of as a high tech trading tool, derivatives have been around for quite a while. The use of derivatives dates back to the Ancient times, about 100,000 years from today. Bartering came with the problem of differentiated harvest times for produce requiring a solution that involved using less or non-perishable commodities like wine, grains, or other objects as intermediaries. These types of trades eventually led to the development of commodity money, an intermediate store of value that expanded the number of trading opportunities.

To start we need to go back to the Bible. In Genesis Chapter 29, Jacob purchased an option costing him seven years of labor that granted him the right to marry Laban's daughter Rachel. His prospective father-in-law, however, reneged, perhaps making this not only the first derivative but the first default on a derivative. Laban required Jacob to marry his older daughter Leah. Jacob married Leah, but because he preferred Rachel, he purchased another option, requiring seven more years of labor, and finally married Rachel. Some argue that Jacob really had forward contracts, which obligated him to the marriages but that does not matter. A forward contract is an agreement where a seller agrees to deliver an item by a certain date to a buyer at an agreed price. Typically, forward contracts are settled upon the delivery of the item at the expiration date. Regardless of type, Jacob did derivatives, one way or the other.

In ancient Greece, the Athenians used shipping contracts for trading which resemble forward contracts, with a twist. Prior to a trading voyage, an entrepreneur (buyer) looking to profit on a trade of commodities would make an agreement with a merchant who would finance the voyage. They would draw up a contract which would state the amount of money loaned and required interest the entrepreneur would pay the merchant upon return and the latter now had an effective ownership of the

Market Update			
	15/01/13	15/12/13	15/01/14
Naira/US\$	154.1	155.2	155.2
Brent, US\$/bbl	109.78	107.84	113.59
Cocoa, US\$	1487.82	2685.47	2760.56
MPR%	12.00	12.00	12.00
Inflation rate%	10.3	7.9	7.9
Mortgage rate%	22.0	23.0	23.0

STOCKS CONSTITUTING GMA INDEX			
STOCKS	31/12/13 Price (N)	15/01/14 Price (N)	% Change in Price
OANDO	24.25	25.60	5.57
GTBANK	27.02	28.50	5.48
OKOMU	44.00	44.25	0.57
STANBIC	21.35	22.00	3.04
DANGSUGAR	11.70	12.23	4.53
FIDSON	2.79	2.80	0.36
TRANSCORP	4.35	4.10	-5.75
CCNN	11.75	10.87	-7.49
UHOREIT	50.00	50.00	0
UPDC REIT	10.00	10.00	0

Index	31/12/13	17/01/14	% Change
NSE ASI	41,329.19	41,751.55	+ 0.68
GMA Index	1.50	1.56	+ 3.57

Source: CBN, DMO and NSE

commodities until payment. The similarity to a forward contract can be seen since the factors of price, commodity, and time are stipulated in the shipping contract. Because trade was so important, laws and regulations would develop to ensure each party would be justly treated in disputes.

Around 1100 European merchants developed the "fair letter" that acted like a letter of credit between the buyer and seller. These letters would then be settled at regional trade fairs such as the Fairs of Champagne; an annual cycle of trading fairs held in town located in the Champagne and Brice regions of France, which were the main markets for Northern Europe. The seller would have the merchandise ready for pickup at a fair, and the buyer would give a "fair letter" for payment. Over time, the fairs began to lose their dominance in trade as a result of wars and political issues which turned traders to sea routes.

In 1515, the city of Antwerp opens the Bourse, a dedicated building where local and international traders could gather to conduct business. Before the Bourse, traders generally met at a specified place and time to conduct their affairs. Due to its success, by 1531 a new and larger Bourse was built outside the city in a planned development specifically with trade in mind. Traders were not purchasing commodities directly; they were buying and selling rights to commodities - intangibles. A true financial market had been established.

The Chicago Board of Trade was created in 1848. Due to its prime location on Lake Michigan, Chicago was developing as a

major center for the storage, sale, and distribution of Midwestern grain. Due to the seasonality of grain, a group of grain traders created the "to-arrive" contract, which permitted farmers to lock in the price and deliver the grain later. These contracts proved useful as a device for hedging and speculating on price changes and were eventually standardized around 1865, and in 1925 the first futures clearinghouse was formed.

In the mid 1800s, famed New York financier Russell Sage began creating synthetic loans using the principle of put-call parity. Sage would buy the stock and a put from his customer and sell the customer a call. By fixing the put, call, and strike prices, Sage was creating a synthetic loan with an interest rate significantly higher than usury laws allowed.

Interestingly, derivatives trading was banned numerous times in Europe and Japan and even in the United States in the state of Illinois in 1 though the law was quickly repealed. The early twentieth century was a dark period for derivatives trading as small fraudulent operators in options and securities emerged. In 1922 the US Government made its first effort to regulate the futures market with the Grain Futures Act. In 1936 options on futures were banned in the United States. All the while options, futures and various derivatives continued to be banned from time to time in other countries. In the 1950s onion futures were banned.

In 1972 the Chicago Mercantile Exchange created the International Monetary Market, which allowed trading in currency futures. These were the first futures contracts that were not on physical commodities. In 1975 the Merc created the Treasury bill futures contract after the first interest rate futures contract tanked.

In 1983, the Chicago Board Options Exchange decided to create an option on an index of stocks. Though originally known as the CBOE 100 Index, it was soon turned over to Standard and Poor's and became known as the S&P 100, which remains the most actively traded exchange-listed option. The 1980s marked the beginning of the era of swaps and other over-the-counter derivatives. Although over-the-counter options and forwards had previously existed, the generation of corporate financial managers of that decade was the first to come out of business schools with exposure to derivatives. Soon virtually every large corporation, and even some that were not so large, were using derivatives to hedge, and in some cases, speculate on interest rate, exchange rate and commodity risk. New products were rapidly created to hedge the now-recognized wide varieties of risks. As the problems became more complex, Wall Street turned increasingly to the talents of mathematicians and physicists, offering them new and quite different career paths and unheard-of money. The instruments became more complex and were sometimes even referred to as "exotic."

In 1994 the derivatives world was hit with a series of large losses on derivatives trading leading to a huge public outcry in the US, sometimes against the instruments and sometimes against the firms that sold them. While some minor changes occurred in the way in which derivatives were sold, most firms simply instituted tighter controls and continued to use derivatives until the global crisis in 2008.

FUTURE OF DERIVATIVES

The recent past has evidenced key movements in the financial sector relating directly or indirectly to the deepening of the derivatives market including the privatization of the power sector and the re-emergence of agriculture as major source of revenue; the NSE's investment in Nigerian Association of Securities Dealers Ltd (NASD) in 2012 and in FMDQ OTC Plc., a newly established firm registered to carry out the business of securities dealings; passage by the National Assembly of the Securitization Bill; the emergence of the Nigerian Mortgage Refinance Company; restructuring of most segments of the financial sector and so on.

These developments should naturally require that various forms of derivatives are structured to enhance and finance these structures especially with the strengthening of institutions to promote their active trading. The increase in pension funds coupled with a forward thinking PENCORP which has always been ahead of the curve by including regulated derivatives as an approved investment window should also encourage the development of these products to match demands on both the buy and sell sides.

We can say in conclusion, all things being equal, that the new bride has come to stay. As she does emerge, regulators are also advised to build the capacity required to manage this marriage, to avoid the situation that the poor management of synthetic derivatives and sub-prime mortgages led up to in the year 2008. This is however, a subject for discussion in subsequent articles.

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