Financial Derivatives in Nigeria: Piloting a Safe Risk Management Tool on a Risky Regulatory Framework

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1. ABSTRACT

This article is focused on the regulation and use of financial derivatives which is a risk management tool in Nigeria. While the economic potential in Nigeria cannot be overemphasized and investors are now seeing Nigeria as the next frontier of growth, the Nigerian legal and financial systems must be positioned to take full advantage of the projected inherent potentials of the country. Investors would be better attracted to the Nigerian financial market where there is a reconcilable risk management tool available to manage investors' exposures and where there is also a constructive legal system that would take into consideration, the legal interest of all market participants in any derivatives transaction. This article emphasizes that the current regulatory structure does not extensively regulate derivatives transactions and there is a need to ensure a more robust regulatory environment in other to avoid issues of misselling and lack of transparency which contributed to the financial crisis of 2008. This work, therefore, analyses the Nigerian Financial Derivatives market vis a vis the current regulatory structure intended to regulate the Nigerian financial derivatives market. The paper begins by giving an insight into the state of the Nigerian financial market, the lack of academic research and by extension lack knowledge of the intricacies of derivatives by key stakeholders and concludes by proffering solutions which would ensure investor protection, market confidence and an overall deepened financial market that would enable investors manage their risk.

2.0 INTRODUCTION

The financial sector of every economy plays a pivotal role in the development and growth of the economy. This is particularly because the financial sector helps in facilitating business transactions as well as ensuring hedging and diversification of risks in order to achieve financial growth and stability. With every financial transaction entered into by market participants, market participants are constantly and inevitably faced with and or exposed to different forms of risks namely: Credit risks, Interest rate risks, Currency/foreign exchange risks, Commodity risks, Systemic risks, Operational risks to mention but a few. In 2016, Nigeria was faced with a currency/foreign exchange and commodity risk crisis particularly as there was a crash in the price of crude oil and the loss of markets such as the United States to which it heavily used to export its crude oil. This led to a strain on Nigeria's foreign reserves and by extension made it difficult and or more expensive to enter into international transactions. This meant that it was not just the government of the day that felt the loss that ensued as a result of the exposure but individual market participants and or investors in the crude oil industry equally made huge losses as a result. As a result, these risks have the tendency to threaten the investments and earnings of every investor. Thus market participants

especially banks in efficient markets, in their bid to eliminate and or minimize their exposure to the above risks, have taken advantage of developments in capital markets, in particular, the growth in derivatives markets and are now using derivatives to manage such risks.

On the other hand, it is the reality that the law transcends into every sphere of a financial transaction. The place of the law is in fact an indispensable element in every financial transaction. While financial transactions are to the market participant, an investment for the purpose of making earnings, all financial transactions are to the financial lawyer legal contracts and financial derivatives transactions/contracts are no exception. In this vein, should there be any dispute arising as a result of entering into derivatives contracts, the law/courts would come into play to enforce the contract and this by extension means that the courts play an important role in ensuring the smooth running of contracts entered into by derivatives counterparties. This also means that the courts would also be ensuring stability and efficiency in the overall financial derivatives markets with their judgments. Thus it is paramount that to ensure an effective and or efficient financial derivatives market, there is need for the Nigerian courts to fully appreciate the complexities that come with financial derivatives litigations. Furthermore, it is important to recognize the undisputable fact that financial markets function on market information as well as sentiments. Also, the courts / judges on the other hand, who are the interpreters of the law, place information on the financial markets by way of judicial decisions. The consequence of this is that market participants would then begin to make their financial decisions based on what the courts have interpreted the law to be. Thus, there is need to recognize the fact that there lies the risk of a wrong decision being made by the court which does not have an appreciation of the distinct nature of derivatives contracts and its complex documentation structure and as such, such wrong decision could contribute to systemic risk.

3.0 UNDERSTANDING THE CONCEPT OF FINANCIAL DERIVATIVES

McDonald defines financial derivatives as a financial instrument that has its value derived and determined from or by the price and performance of something else. The term financial derivatives was similarly defined by the International Monetary Fund (IMF) as a ‘financial instrument that is linked to a specific financial instrument, indicator or commodity and through which specific financial risks can be traded in financial markets. The above definitions may appear too simplistic and not encompassing enough. Hudson also defined derivatives as including diverse categories of ‘financial products: exchange traded futures and options: debt securities with an ‘unusual’ rate of return as well as over the counter (OTC), individually negotiated, bilateral agreements including swaps....’ Simply put, financial derivatives is a contract and the value of that contract is often derived from the performance of anything the parties to the contract choose and call the ‘underlying’ asset. The assets from which a derivative contract derives its value in other words; the ‘underlying’ could be equity (i.e. stock or stock index), fixed-income instrument (which includes US Treasury bonds or notes), commodities (such as gold, silver, crude oil, wheat, rice, to mention but a few), interest rates (for example, London Inter-bank Offered Exchange Rate, EURIBOR- Euro Inter-Bank Offered Rate, NIBOR- Nigerian Inter-Bank Offered

Rate), foreign currency, weather, etc. It is this underlying asset that derivatives draws its value from. Derivatives can be traded either on the exchanges such as the NYSE, LSE, Nigerian Stock Exchange (NSE) or OTC, in other words, on a bilateral basis. However, the major derivatives products which trade on exchanges are the options and futures types of derivatives. All other forms of derivatives, such as swaps, including futures/forwards and options, can also be traded on the OTC derivatives market.

3.1 **Major Types Of Derivatives Contracts**

Derivatives contracts are broadly classified under two types which are: (1) the forward and or the futures contracts and (2) options contracts. However, one must note that these two major types of derivatives serve as building blocks for the new hybrid forms and somewhat more complicated forms of derivatives such as exotic options, credit derivatives, interest rate options, futures options, swaptions to mention but a few.

A futures/ forward contract is an agreement to buy or sell an asset at a certain time in the future for a certain price. It is important to note that while futures are traded on exchanges, forward is traded over the counter market, however, both terms have the same meaning and the only difference being that futures is the word used when trading on exchanges while forwards is the word used when trading on the over the counter derivatives market.

Options contract on the other hand is a derivatives contract that gives the buyer in the contract the right and option to buy or sell a specified underlying asset at a specified time in the future. What is important to note under options contracts is that the contract simply gives the buyer the right to exercise his “option” to buy the underlying asset but it does not “obligate” the buyer to buy the underlying asset. Thus, it beholds on the options buyer to decide whether he wants to exercise his right in the option contract at the future set date or not. However, the futures or forwards derivatives contracts give the buyer the right to buy and also saddles the buyer with the obligation to buy or sell the underlying asset or security at a future date and for a predetermined price.

In essence, while the holder of a futures contract is committed to buying an asset at a certain in the future, the holder of an option contract has a choice to decide as to whether or not to buy the underlying asset for a certain price and at a certain time in the future. Thus, for a financial derivatives lawyer and anyone interested in financial derivatives, understanding first and foremost, that the futures/forwards and options derivatives are basically contracts or agreements to protect against a future uncertainty is key. In essence, understanding the workings of the options derivative contract and the futures/ forwards derivative contract is key to understanding how financial derivatives work in general and this is because the futures and options serve as bedrock of all the other newer forms of financial derivatives.

4.0 REGULATORY FRAMEWORKS GOVERNING FINANCIAL DERIVATIVES IN NIGERIA

While there is minimal documentary evidence of financial institutions in Nigeria particularly banks and significantly important financial institutions, currently using

financial derivatives to manage their risk exposures, the very minimal degree of evidence of its use is evident only on the over the counter (OTC) market. The OTC market which is usually less standardized often has the larger volume of derivatives transactions. In Nigeria, the only specifically guideline governing derivatives is the Revised Guidelines for the Operation of the Nigerian Inter-Bank Foreign Exchange Market.

4.1 Revised Guidelines for the Operation of the Nigerian Inter-Bank Foreign Exchange Market

In June of 2016, the Central Bank of Nigeria released the "Revised Guidelines for the Operation of the Nigerian Inter-Bank Foreign Exchange Market" which is intended to guide the planned introduction of the Naira-settled OTC FX Futures market. This guideline was designed to guide and or give structure to market participants who planed to engage in foreign exchange futures derivatives transactions on the Nigerian over the counter derivatives Markets.

4.1.1 Documentation Structure

The 2016 Central Bank of Nigeria's revised guideline was designed to give the over the counter derivatives market in Nigeria some form structure in the absence of standardization and regulation. It is expected that the structure which is provided, is holistic in form and incorporating salient issues regarding documentation structure, misuse and or abuse of derivatives and consequences thereof, however, the guideline fails in this regard. It suffices to posit therefore that this 2016 guideline fails to take into cognizance the necessity to have a documentation structure which brings into effect the legal aspect of entering into financial derivatives contracts. In fact, the UK and US ISDA Master Agreements are the forms of documentation structure currently being used by Nigerian financial institutions and these documentation structures in several forms do not take into consideration the Nigerian legal and economic peculiarities.

The documentary structure triggers the legal nature of all derivatives contracts and there is need to address this omission. For most market participants, financial derivatives are employed as a tool to manage the risks they may be exposed to due to market fluctuations and or incomplete markets. Thus, market participants value any form of certainty that a market avails them. The derivatives industry is no different. The need for a considerable level of certainty and standardization of contract terms as well as a common understanding of trading strategies, risk measuring strategies and issues of law in the derivatives market amongst market participants, especially in the over the counter derivatives market cannot be overstated.

The lack of a standard documentation structure in a growing financial derivatives market like Nigeria's would give room for a financial derivatives market that is devoid of transparency, however a standard documentation structure allows not just for certainty of terms but also an efficient financial derivatives market. The development of the ISDA was done in recognition of the fact that the financial derivatives industry has a language and or group of terminology peculiar only to financial derivatives transactions and a lack of a documentation structure had the effect of giving conflicting meaning to these terminologies. Now where counterparties in financial derivatives

transactions for instance have conflicting opinion and or interpretations as to the meaning of terms between them, then of course there is no saying that many financial derivatives contracts stand the risk of failing and the result of this poses systemic risks to the entire financial market.

In this vein, it is very important that the Nigerian financial market regulators and market participants recognize the potential problem of lack of certainty, standardization, uniformity, legal and systemic risks that face market participants as a result of a lack of a standard documentation structure for the Nigerian financial derivatives market. It is also important to note that the development of a standard documentation structure for the Nigerian over the counter FX futures derivatives market does not in any form erode the distinct nature of over the counter markets which is flexibility and the fact that it allows the derivatives to be designed specifically to suit the needs of the buyer. With the inclusion of a schedule attached to the master agreement, market participants can still enjoy flexibility and suitability of any financial derivatives transactions they enter into.

4.1.2 Investor protection

Investor protection is simply put, ensuring that financial market frameworks and or structures are in place to protect investors against manipulation by other market participants especially sellers, advisers and or structurers of financial products. The 2016 revised Central Bank of Nigeria guideline did not make any provision requiring that derivatives products be suitable, that market participants especially financial derivatives advisers, they were no provisions regarding market abuse or mis-selling of derivatives products, neither did the guideline make any prudential provision to regulate the derivatives market participants. This is a huge regulatory gap and as such, such loophole and or gap must be closed to ensure that both the bank and its counterparty are transacting on the same pedestal. Furthermore, the failure to properly guide market participants especially market participants on the over the counter derivatives market would create a free for all kind of market which could result in financial misconducts with the ripple effect of triggering a financial crisis.

4.1.3 Sanctions

The over the counter derivatives market must be constantly monitored and supervised. This monitoring and supervision does not mean that regulators would interfere in the kind of terms that are to be included by market participants in their financial derivatives transactions but supervision must come in handy as there is need to know how much risk is being taken on by each and every counterparty especially Systematically Important Financial Institutions (SIFIs). The only provision for sanction is to the effect that failure to abide by the CBN's guidelines could result in the suspension and or license withdrawal of the market participant that engaged in the misconduct. This is certainly not enough in a market where as evidenced in the financial crisis, abuse of derivatives products by market participants resulted in the 2007/2008 financial crisis.

The emphasis is on abuse and not use of derivatives products. Furthermore, although the 2011 guidelines projected a development of a set of prudential guidelines which was to be developed by the Policy & Regulation and Banking Supervision Departments

of the Central Bank of Nigeria, it is pertinent to note that regardless of this projection, five years after, the Central Bank of Nigeria is still yet to develop the above mentioned prudential regulation and financial derivatives transactions are now being actively carried on by banks in the over the counter derivatives market. Although an over regulated market deters investors, it is also important to note also that an under-regulated financial market would breed massive market misconduct by market participants and by extension could have the effect of crippling the financial stability of any economy. Under regulation or as Gordon Brown called it "light touch regulation" is no doubt what contributed to the financial crisis of 2007/2008.

4.1.4 Reporting Standards and Transparency

Regulators in the United Kingdom and the United States had failed to clearly quantify the volume of financial derivatives transactions that was being transacted on the over the counter derivatives market and this crippled how well the regulators could properly supervise over the counter derivatives transactions. The Central Bank of Nigeria's 2016 guidelines commendably included a reporting structure requiring the FMDQ to keep reports of every financial derivatives transaction between the seller (The Central Bank of Nigeria) and all authorized dealers and the Central Bank of Nigeria is to have access to the report. The 2016 revised guidelines however fails to provide for reporting standards especially where the derivatives transaction is a bilateral transaction between any parties who are neither authorized dealers nor end users but who still choose to enter into FX futures derivatives transactions to hedge their exposures to FX fluctuations. Failure to take into cognizance financial derivatives transactions that are likely to occur between independent and or individual market participants who are neither authorized FMDQ traders nor required to report their transaction already puts a gap in the guidelines requiring reporting to the FMDQ. This is because, the over the counter FX futures users may on one hand choose not to be authorized dealers in other not to have to report to FMDQ and by extension the Central Bank of Nigeria, consequently giving room for regulatory arbitrage. This also would defeat the aim of including transaction reporting in the guideline as not reporting would erode transparency.

It becomes obvious therefore, that the simple requirement that FMDQ takes record of derivatives transactions operating on its systems (that is on the FMDQ OTC market) is not enough to ensure proper reporting of OTC derivatives transactions. This reporting standard could give rise to a similar situation faced by regulators of both the United Kingdom and the United States of not knowing the actual volume of derivatives being traded on the over the counter market. The Nigerian chief regulator of the derivatives market, the Central bank of Nigeria cannot therefore afford to make the same mistakes that had been made by the regulators of the United Kingdom and the United States.

Furthermore, there is no emphasizing the consequences of the failure to properly regulate financial derivatives activities especially bilateral derivatives transactions on the over the counter taking into consideration the obvious consequences (the financial crisis of 2007/2008) of such failure by regulators in the United States and in the United Kingdom in the form of "light touch" regulation. During the financial crisis of 2007/2008, most high-level committee reports posited that the regulators couldn't

quantify the value of financial derivatives transactions that had been conducted on the over the counter derivatives market, majorly because the reporting standards were lax. Thus the introduction by the United Kingdom for example of the derivatives swap clearing houses to ensure an efficient reporting standard and to keep the regulator's eyes on the actual state of the over the counter derivatives market.

5.0 The Investment and Securities Act

The Investment and Securities Act is the primary legislation governing the capital market in Nigeria. The Act provides the regulatory framework for the regulation of the Nigerian capital market by the Securities and Exchange Commission. The Investment and Securities Act also empowers the Securities and Exchange Commission of Nigeria to make its own rules for the practical governing of Nigerian financial market participants. Although the Investment and Securities Act, 2007 makes no specific mention of financial derivatives, it is implied that since the Act regulates every form of security being traded or projected to be traded on the Nigerian Capital market, then by extension, the Investment and Securities Act may have been designed to also cover the regulation of financial derivatives. However the Act fails to take into cognizance, certain salient issues pertaining to financial derivatives. This is in particular, the issue of disclosure and transparency.

5.1 Disclosure of Material Information and Refusal to Disclose Material Information

The Act fails to make it mandatory to provide necessary information to the client apart from disclosure of financial profits. This means that there is no emphasis on any other disclosure apart from probable financial benefits. There are no specified provisions as to whether or not the investment adviser, dealer, seller in the derivatives transaction should disclose other material information to the client such as suitability of the derivatives product for the purpose required by the investor and or buyer. Furthermore, the act does not provide that the investment adviser, dealer, seller or underwriter is in its "communications" to the derivatives buyer or investor required to provide communications and or advise and or information that is material to ensuring that the investor makes an informed financial decision.

The implication of this is that the dealer and or adviser could disclose any information it deems fit to the investor, he could disclose all the advantages of the transaction and withhold disclosure of the downside to entering into the derivatives transaction and would still not be held liable because there is a loophole in the regulation which does not require necessary and complete disclosure on the part of the derivatives seller, dealer and or adviser. The investment adviser or seller in the derivatives transactions may not be held liable for not providing information that is would be regarded "material" for the investor especially if the adviser and or dealer ensures that it communicates all probable financial benefits that would accrue from the transaction as required by the Investment and Securities Act. Furthermore, the Investment and Securities Act makes no provision regarding the refusal to disclose material information on the part of the seller.

6.0 Dearth of Literature and Academic Research on Financial Derivatives

Although the foreign exchange financial derivatives is currently being used by market participants in Nigeria, there is a dearth of research and or literature in this area. This by extension means that there is very limited and or little understanding of the workings of derivatives and this no doubt could lead to the problem of information asymmetry and by extension, a lack of transparency. Characteristics found to have contributed to the financial crisis of 2007/2008. Also the scanty literature available fails to recognize the legal consequences of using financial derivative for example, the impact of the Nigerian court's judgments on the financial stability of Nigeria vis a vis adjudicating financial derivatives cases especially with regards to the sophisticated investor doctrine. Little or no research emphasizes a lack of understanding of the growing derivatives market.

7.0 Recommendation and Conclusion

It is apparent that the current regulatory framework in Nigeria is not just inadequate in terms of governing financial derivatives transactions and market participants in Nigeria but is also not intandem with regulatory best practices in sophisticated financial economies such as the United Kingdom and the United States of America. For example, Section 100 (1) of the Nigerian Investment and Securities Act provides that: where a securities dealer, investment adviser, underwriter or an associated person of a securities dealer, investment adviser or underwriter, issues circulars or other similar written communications with respect to securities or a class of securities in which he has interest, he shall disclose in legible form, the nature of that interest. The Act fails to make it mandatory to provide necessary information to the client apart from disclosure of financial profits. This means that there is no emphasis on any other disclosure apart from probable financial benefits. There are no specifics as to whether or not the investment adviser, dealer, seller in the derivatives transaction should disclose other material information to the client such as suitability of the derivatives product for the purpose required by the investor and or buyer. Where the regulations do not hold the sellers to a reasonable standard of disclosure, then the sellers would have found an explorable loophole in the law to use to their advantage and to the detriment of the investor buyer. It is in this vein that the following disclosure requirements are recommended as amendments to the Nigerian Investment and Securities Act 2007.

There is also need to consistently supervise financial derivatives market participants' to ensure internal risk management and control as well as capital adequacy of the banks, Oil Companies, Oil Service Companies, Exporters, End-users etc who would be using the foreign exchange derivatives on the Nigerian over the counter market. Furthermore, to curb risky and reckless behavior such as mis-selling of financial derivatives products by market participants, it is important that market participants are aware of the consequences of market abuse.

The principal approach to protecting an investor is to ensure that the investor is armed with the requisite information needed by the investor to make an informed decision about the financial product being sold to it. These include requiring all market participants to make full disclosures not just to the regulators but to the derivatives

buyers and attaching liability to the banks for the failure to disclose or liability for the inclusion of misleading Statements. The inclusion of these provisions must be unequivocal in order to ensure transparency and accountability in the Nigerian derivatives market.

Finally, one of the many reasons why the financial crisis of 2007/2008 occurred was that market participants and regulators did not have adequate knowledge and or information about the product they were investing in and or regulating. Knowledge and education is a key element in trading financial derivatives. The place of educating all market participants including lawyers, banks and bankers and other financial institutions such as insurance companies, hedge funds, the Nigerian courts or judiciary cannot be over emphasized. Drawing from sophisticated derivatives markets like that of the US, the United States of America's Dodd Frank Investor Protection and Securities Act recognized the need to educate market participants as a form of investor protection and adequately made provision for that in Section 917 of the Act. The International Swaps and Derivatives Association (ISDA) is an organization of over the counter international financial derivatives market participants which has over 850 member institutions from 67 countries. In the a bid to ensure financial derivatives literacy, the International Swaps and Derivatives Association engages constructively with policymakers as well as legislators around the world to advance the understanding and treatment of derivatives as a risk management tool. The association also schedules and or frequently organizes conferences, for banks, lawyers, policy makers, regulators and by extension all interested financial derivatives market participants in order educate and keep market participants up to date with the constant innovations, hybrid derivatives products and changed modes of working financial derivatives on the over the counter derivatives market. With regards to Nigeria's over the counter derivatives market, there is no doubt that the 10 paged guidelines released by the Central bank of Nigeria in July of 2016 would not suffice in adequately regulating the derivatives market in Nigeria, neither will it achieve the goal of keeping market participants in the know of fast changing financial derivatives practices in its current state.

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