

# DERIVATIVES



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## WHAT ARE DERIVATIVES?

A derivative is a financial contract that derives its value from an underlying asset. The buyer agrees to purchase the asset on a specific date at a specific price, while the seller agrees to deliver a certain quantity of the asset on the agreed date.

The derivative itself is merely a contract between two or more parties.

2.

## DERIVATIVES EXAMPLE

For instance, a company (Ugali Industries) that processes maize into Ugali flour requires maize as a raw material. As we all know, maize prices and availability are constantly fluctuating. To ensure that Ugali Industries is not affected by these fluctuations, the company can enter a contract with farmers. In such a contract, the farmers will commit to delivering a given amount of maize at a certain date while Ugali Industries will commit to paying a fixed price on delivery of the maize by the farmers. What this means is that the unga producing company is assured of raw material on the agreed date while the farmer is assured of the exact price that they will sell their maize. A win-win situation.

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## HOW ARE DERIVATIVES CONTRACTS TRADED AND SETTLED?



**Exchange Traded Derivatives:** In this form of derivative market, trading is conducted via specialized derivatives exchanges or other exchanges. In Kenya, all regulated derivatives transactions are exchange traded at Nairobi Securities Exchange under the name NSE NEXT.



**Over the Counter (OTC) Derivatives:** Parties trade with each other without going through an exchange or intermediary. This form of derivatives trading is not regulated and entails private negotiations between two or more parties.

**Note:** Exchange Traded Derivatives are the most secure since there is more regulation, transparency in pricing and trade reporting.

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## TYPES OF DERIVATIVES CONTRACTS

**1. Futures:** Agreements between buyers and sellers to trade an asset at a future date. Futures contracts are exclusively traded on an Exchange, such as the NSE NEXT which is Kenya's only licensed derivatives exchange.

**2. Forwards:** Agreements between buyers and sellers to trade an asset at a future date. The price of the asset is set when the contract is drawn up. Forward contracts have one settlement date - they all settle at the end of the contract. The key feature about forward contracts is that they are traded Over the Counter (OTC).

**3. Options:** Agreement that gives the buyer the right but not the obligation to buy or sell the underlying asset at a pre-agreed price. Options trade on both OTC and Exchange markets.

**4. Swaps:** Agreement that allows parties to exchange cash flows. E.g. swapping fixed interest rate payments for floating interest rate payments. Swaps create obligations and trade in OTC markets.

**Note:** In Kenya today, the only form of derivatives product that you can trade in is FUTURES. The other forms of derivatives have not yet been rolled out in Kenya.

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## HOW TO TRADE DERIVATIVES IN KENYA:

Currently, the only derivatives products that are available for trading in Kenya are Futures. According to the definition of futures, they are usually exchange traded, therefore they are regulated and there is transparency in the whole process.

There are two futures products that are currently being traded in Kenya, that is:

1.

**Single Stock Futures:** These are derivative instruments that give investors exposure to price movements on an underlying stock. Parties agree to exchange a specified number of stocks in a company for a price agreed today (the futures price). NSE NEXT Single Stock Futures are currently cash settled. By cash settlement, upon expiration or exercise, the seller of the financial instrument does not deliver the actual (physical) underlying asset but instead transfers the associated cash position.

### Advantages of trading NSE NEXT Single Stock Futures

- Provide an effective and transparent hedge against unfavorable share price movements;
- They are liquid and easy to trade instruments;
- Positions in single stock futures allow investors to benefit from downwards or upwards movement of share prices; and
- Investors can have exposure on share price movements without owning the underlying share.

2.

**Equity Index Futures:** These are derivative instruments that give investors exposure to price movements on an underlying index. Market participants can profit from the price movements of a basket of equities without trading the individual constituents. In Kenya, we have the NSE 25 Index as the underlying asset for this class of derivative products.

### Advantages of trading NSE NEXT Equity Index Futures

- Price transparency and liquidity. These contracts can be sold as easily as they can be bought;
- Lower transaction fees than those incurred when buying or selling the basket of securities making up the index;
- Reduction of counterparty risk a result of trading via the exchange; and
- Centralized clearing.

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## WHY DO INVESTORS ENGAGE IN DERIVATIVES TRADING?

Currently, the only derivatives products that are available for trading in Kenya are Futures. According to the definition of futures, they are usually exchange traded, therefore they are regulated and there is transparency in the whole process.

There are two futures products that are currently being traded in Kenya, that is:



**Hedging:** is a mechanism by which an investor seeks to protect his asset from erosion in value due to adverse market price movements. A Hedger is usually interested in streamlining his future cash flows. He is most concerned when the market prices are very volatile. He is not concerned with future positive potential of the value of underlying asset. In the Kenyan context, it is possible to protect against fluctuation in prices of shares and the NSE-25 Index using single stock futures and equity index futures respectively.



**Speculation** Is a mechanism where traders look for enhancing their income by making a two-way price for other market participants. Speculators set their eyes on making quick money by taking advantage of the volatile price movements. In the Kenyan context, one can make a profit through consistent and accurate prediction of market conditions through derivatives.

In case of further queries regarding derivatives, please visit the links below:

Single Stock Futures: <https://www.nse.co.ke/next-derivativeproducts/single-stock-futures.html>

Equity Index Futures: <https://www.nse.co.ke/next-derivativeproducts/equity-index-futures.html>

Derivatives introduction: <https://www.nse.co.ke/next-derivatives-education-resources.html?download=8544%3Aderivatives-education-deck>

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**For further information, please contact:**



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