DERIVATIVES – IS KENYA READY?

It is our view that Kenya is ready for a derivatives market. In finance, a derivative is a contract that derives its value from the performance of an underlying entity. This underlying entity can be an asset, index, or interest rate. The main types of derivatives are:-

- **Forwards** - These are contracts between two parties to sell or buy an asset in future at an agreed future time and given price. Participants thereafter exchange the product at the price agreed during the contract irrespective of the prevailing market price. Forwards have a very high risk since they are not regulated and are to meet the needs of the buyer and the seller.
- **Futures** – These are standardized contracts between two parties to buy or sell an asset at an agreed future date at a given price. The risk is minimal since they are regulated and one person himself or herself paying the premium. The parties involved are locked in and have to execute the transaction regardless of prevailing market conditions. It is worth noting that participants can lose a significant amount of money with a trade.

As from the early 2000s, the Nairobi Securities Exchange (NSE) and the market regulator, the Capital Markets Authority (CMA), had plans to reform the investment market in Kenya. The reforms led to the reorganization of the NSE into four divisions:-

- Alternative Investments Market Segment (AIMS),
- Main Investments Market Segment (MIMS),
- Fixed Income Securities Market Segment (FISMS), and
- Futures and Options Market Segment (FOMS).

The market segments highlighted above are active with the exception of the fourth (FOMS) i.e. the derivatives market which remains underdeveloped. There are many reasons why the derivative market is not active. These include: lack of proper legislative regulations, low-level awareness among potential investors, high frictional costs involved, inadequate risk management and segmented regulation.

With the reintroduction of derivatives through the Capital Markets Act vide Legal Notice 37 dated 4th March 2016, there will be three main players in the market namely:-

- A derivative exchange,
- Clearing house (six clearing banks have already signed with the NSE), and
- Derivative brokers.

The legal notice also outlines the requirements and duties of the three market players, the conduct of derivative business, market offences and penalties. Market offences include false trading, price manipulation, and use of fraudulent devices for which strict penalties have been imposed in order to avert future market risk on participants.

The implementation of derivatives in Kenya presents a challenge due to low investor knowledge on derivatives. Stakeholders are thus seeking to deepen knowledge among market participants and create public awareness. This will involve the rolling out of an intensive public awareness program that will cover basics on the types of contracts expected, how the derivative market will operate, the risks and benefits of trading in the derivative market. Initial plans were to start derivative trading by June 2016. Based on recent media reports, this timeline has since been extended to facilitate public education. It has also been reported that the NSE has already drafted proposed derivative contracts which have been submitted to the CMA for further review.

The derivatives market will enable participants to enter into contracts for buying and selling underlying assets at a future time at a pre-agreed price determined at the time of contract initiation and execution. Participants will be able to transfer risks, lower their transaction costs, stabilize market prices and speculate the value of their assets in future. The NSE will mirror the

Johannesburg Stock Exchange Derivative Market with futures and options traded on bonds, indices, interest rates, currencies, warrants, commodities, agriculture, energy, metals, debt, equities etc.

Derivatives are aligned with Kenya's economic growth objectives as set out under vision 2030. This is because they offer an alternative investment market segment for both local and foreign investors. Many large economies globally have strong developed derivatives markets and Kenya has invested in learning and benchmarking against such solid financial markets.

It remains to be seen how the legal and regulatory frameworks in place to govern derivatives in Kenya will evolve and be implemented. One important area that so far seems to have been overlooked is the development of legislation for the taxation of derivatives. We trust that this legislation is in the pipeline in order to avert future points of conflict between the Revenue Authority and derivative market participants.

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