DERIVATIVES FAQs

What is a derivative?

✓ Derivatives are an investment tools whose value is derived from underlying assets like bonds, commodities, currencies, interest rates, market indexes and stocks based on the expected future price movements of the asset.

What types of derivatives are there?

✓ Derivatives can be broadly classified into four categories:
- Forwards
- Futures
- Options
- Swaps

What types of derivatives are available in the Kenyan Market?

✓ Futures contracts:
- These are Equity Index Futures and Single Stock Futures.
- The new Derivatives market will comprise of key NSE stocks among them: Safaricom, KCB, Equity, EABL and BAT in addition to a Futures option on the entire NSE25 portfolio.

1 . NSE 25 Index Futures	
i. Underlying asset	NSE 25 share index
ii. Contract Size	One index point equals one hundred Kenyan Shillings (KES 100.00)
iii. Minimum Price movement	One index point (KES 100.00)
iv. Contract months	Quarterly contracts (3 Months)
v. Settlement	Cash settled in Kenyan Shillings
vi. Settlement Price	VWAP* for liquid contracts or theoretical price i.e (spot + cost of carry*) for illiquid contracts
vii. Expiry dates	3 rd Thursday of every expiry month
2. Single Stock Futures	
i. Underlying asset	Stocks (shares)
ii. Contract Size	**For shares trading below KES 100;** One contract equals 1,000 underlying shares **For shares trading above KES 100;** One contract equals 100 underlying shares

iii. Minimum Price movement	**Price range** **Tick size** Below 100.00 0.01 ≥ 100.00 < 500.00 0.05 ≥ 500.00 0.25
iv. Contract months	Quarterly contracts (3 months)
v. Settlement	Cash settled in Kenyan Shillings
vi. Settlement price	VWAP* for liquid contracts or theoretical price i.e (spot + cost of carry*) for illiquid contracts
vii. Expiry dates	3rd Thursday of every expiry month

Source; NSE

*Cost of carry: There are costs/ benefits associated with holding Futures instead of the underlying asset.
*VWAP: Volume-Weighted Average Price

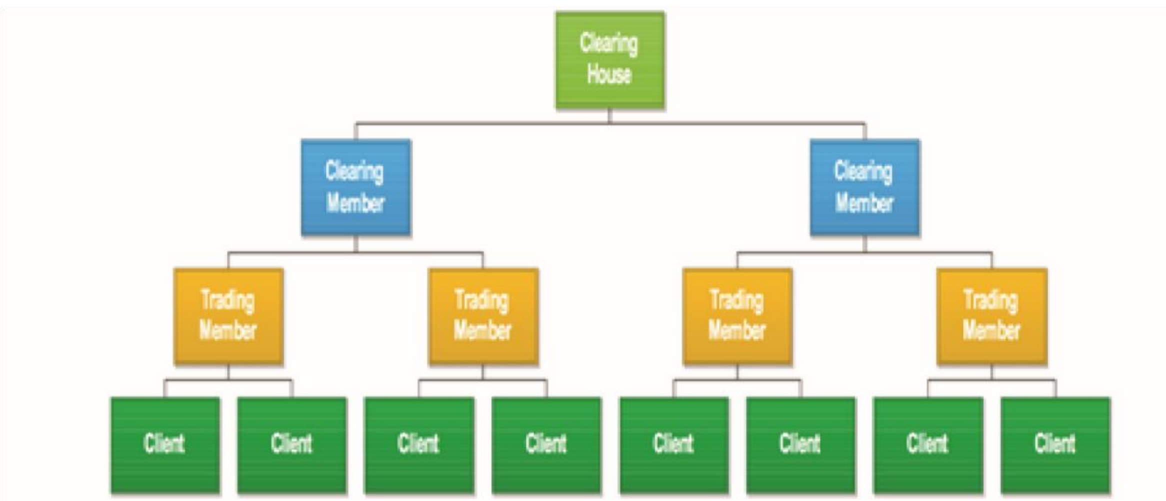
What is a Futures contract?

- ✓ A Futures contract is a **contractual agreement** made through an exchange, to buy or sell a particular asset at some time in the future, but at a price set today.
- ✓ Futures contracts **detail the quality and quantity** of the underlying assets.
- ✓ They are **standardized** to facilitate trading on an exchange.
- ✓ Futures contracts require either physical delivery of the asset or settlement in cash. For now, all futures contracts are settled in cash on a daily basis.

Source: NSE

What is the structure of a derivatives market?

- ✓ At the top of the hierarchy, is the Clearing House (NSE Clear), which is a wholly owned subsidiary of the NSE.
- ✓ The Clearing House notates all transactions and is therefore the legal counterparty to both parties.
- ✓ Clearing Members are under the Clearing House. They are either banks or financial institutions that are responsible for clearing, settlement and risk monitoring of Trading Members.
- ✓ Clients open accounts with Trading Members (brokers) who then execute orders on their behalf i.e. buy and sell derivative contracts for them.



What are the benefits of trading derivatives?

- ✓ Derivatives are cheaper to transact.
- ✓ Derivatives are more flexible than the underlying instruments while the value is still based on the price of the underlying assets. For example, derivatives can be traded multiple times in a day.
- ✓ Enhanced returns due to leverage; since only a small margin is required upfront for the trade, the investor stands to gain significantly more than they put in.
- ✓ Futures contracts provide investors with a risk management tools in the wake of unexpected volatility in asset prices.
- ✓ Derivatives are quicker to complete than a number of individual transactions. Derivative settlement is faster (T +1) in comparison to E.g. equities (T +3)
- ✓ Wider variety of trading strategies such as shorting securities, replication of index performance, arbitrage etc.

How do I open a derivatives account?

- ✓ Firstly, the investor completes the client agreement form with AIB Capital Ltd.
- ✓ After completion of the documents, AIB Capital Ltd will open the account and give the investor a unique client identification number.
- ✓ To begin trading, the investor must deposit cash into their account.

How and where do I deposit money into my account?

COOPERATIVE BANK	
ACCOUNT NAME	AIB CAPITAL LIMITED
ACCOUNT NO.	01136709278000
BANK	C0-0PERATIVE BANK
BRANCH	CITY HALL
SWIFT ADDRESS	KCOOKENA
MPESA	
PAYBILL	400200
ACCOUNT NO.	01136709278000

How do I buy/sell my derivatives?

- ✓ The market is a pre-funded market; which means you must deposit funds before you may trade. Trade execution is through the trading members, who receive orders via email/ direct written instructions and execute. Execution is dependent on the availability of a counter-party and a price match. Upon execution clients will receive confirmation from the dealing desk.

How soon do I get paid after selling my derivative?

- ✓ A key distinguishing benefit of the derivatives market to the Equity market is that settlement is done on a T + 1 basis. This means that parties to a trade satisfy the obligations arising from the transaction one day after the trade is executed. All futures contracts are settled in cash on a daily basis.

How is Clearing and Settlement done?

- ✓ The Clearing House (NSE Clear), through its appointed Clearing Members, computes the obligations of investors who have traded through Trading Members.
- ✓ These obligations detail the amounts an investor needs to pay or receive in terms of margins.

  The computation of these obligations is the "clearing" process. The actual flow of cash to satisfy the obligations is the "settlement" process. The clearing and settlement process is performed daily for all trades executed.

What is NSE Clear and NEXT?

- ✓ NSE Clear is the institution that notates or guarantees the settlement of trades on NEXT. It is set up with its own equity capital and governance structure independent from the governance of the NSE.

- ✓ NSE Clear is the buyer to every seller and the seller to every buyer (the middle-man). Depending on the settlement terms of the contract, NSE Clear either delivers the asset to the buyer and pays the proceeds to the seller, or settles with both the buyer and seller in cash.

- ✓ NEXT is the Nairobi Securities Exchange (NSE) derivatives market that facilitates the trading of futures contracts in the Kenyan market. NEXT is regulated by the Capital Markets Authority (CMA)

Can I trade online?

- ✓ For now, investors cannot use the online platform to trade derivatives.

How do I know which derivatives to invest in?

- ✓ A Derivatives trader will assist a client in selecting a suitable investment portfolio depending on the investor's investment objective and risk appetite.
- ✓ Derivatives traders have a research department that does analysis on the Companies quoted on the Nairobi Securities Exchange to enable the traders to advise clients accordingly.

What is the recommended minimum capital I can invest?"

- ✓ Given that derivatives market trade on margin of 10%, the recommended minimum capital is KES 50,000. This gives a maximum exposure of around KES 500,000 depending on the futures traded. For further queries, kindly reach out to the derivatives team who are always available to serve.

Can I buy derivatives and sell them the same day?

- ✓ Yes, unlike shares there is intra-day trading with Derivatives which means you may sell / buy shares any number of times within a day.

Is there a particular time of the year or week when it's favorable to trade?

- ✓ Not necessarily. There are other factors in the market that determine the price of the underlying asset (index/stocks) including market sentiments and price sensitive information.
  A Derivatives trader will assist a client in selecting a suitable investment portfolio depending on the investor's investment objective and risk appetite.

What are the costs associated with buying and selling of derivatives?

Fees	Single Stocks Futures	
Exchange Fee (NSE)	0.025%	0.02 %
Clearing Member	0.025%	0.02 %
Brokerage Fee	0.100%	0.08 %
Investor Protection Fund	0.010%	0.01 %
Statutory Fee (CMA)	0.010%	0.01 %
TOTAL	**0.17**	**0.14**

Note: *Trading fees are accepted as a percentage of the value of the trade. E.g. A single stock future trade worth KES 1,000,000 would attract a total fee of KES 1,700.*

Is there payment to a third party?

- ✓ No. Payments are made to account owners. Third-party in this case would mean anyone whose name does not show ownership of said account.

What are the risks of trading in derivatives?

- ✓ Two of the primary risks involved in trading Derivatives include:

  a) Counterparty risk i.e. one party does not honor their side of the contract.
  b) Market risk i.e. the general risk in any investment. Investors make decisions and take positions based on assumptions, technical analysis or other factors leading them to certain conclusions about the performance of an investment.

How does AIB deal with these risks?

a) Investors require Initial Margin to enter into any futures position. This is a minimum (good faith) deposit required from an investor for the duration of an open contract. The investor is also required to deposit Variation Margin. These margin requirements apply to both the buyer and seller.

Daily profits or losses on an investor's position are either taken out of or added to the investor's Variation Margin deposits.

The regular administration of margins prevents participants from accumulating large unpaid losses which could impact the financial positions of other market users (systemic risk).
All contracts traded on NEXT are traded against NSE Clear. This drastically reduces the counterparty risk compared to traditional OTC transactions.

b) As previously stated; a Derivatives trader will assist a client in selecting a suitable investment portfolio depending on the investor's investment objective and risk appetite. Derivatives traders have a research department that conducts Investment Analysis.
An important part of investment analysis is determining the likelihood of an investment being profitable and assessing the risk/reward ratio of potential losses against potential gains.

Source; NSE, AIB

What is a Variation Margin?

- ✓ Unlike the cash market where profit or loss is only realized when the instrument is sold, trading on NEXT means that investors receive or pay profit or loss on a daily basis.
- ✓ This payment is known as the Variation Margin and is equal to the difference in the value of the investor's position from day to day.

Source; NSE