NON-DELIVERABLE FORWARDS AS A HEDGING TOOL FOR CURRENCY VOLATILITY IN NIGERIA

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Introduction

The Nigeria currency has been under a lot of pressure in recent times, owing to decrease in export earnings due to the instability in price of crude, increase in demand for the dollar, incursion of the corona virus which has considerably reduced business activities, high rate of import of raw material and luxury goods etc. Not surprisingly, in a Medium-Term Expenditure Framework and Fiscal Strategy (MTEF/FSP) report[1] recently released by the Federal Ministry of Finance, Budget and National Planning (**Ministry**), the Ministry indicated that the exchange rate between the dollar and the naira may be further devalued.

The Central Bank of Nigeria (**CBN**) in response to this pressure and in a bid to stabilise the currency has severally adjusted the currency rates. The official exchange rate was adjusted upwards to N360/US$1 by the CBN in March 2020 and at an auction for importers on 3 July 2020, the CBN directed that bids for foreign exchange be made at N380/US$1 against the previous rate of N360. At the Importers & Exporters Foreign Exchange (IEFX) window, where the bulk of foreign exchange transactions are consummated, the exchange rate recently depreciated from about N362/US$1 in January 2020 to over N385/US$1. Despite the CBN's strenuous efforts to stabilize the exchange rate, it is generally expected that the Naira will suffer further devaluation as Nigeria is projected to lose about US$26 billion in oil revenues, its principal source of foreign currency.[2]

The uncertainty surrounding the value of the naira and sheer scarcity of the dollar has made it difficult for foreign investors to access the foreign exchange required to repatriate their investment despite possession of a Certificate of Capital Importation (**CCI**). It is thus imperative for investors to have solutions that guarantees the return on their investments, easy repatriation of capital and avoidance of capital erosion on repatriation.

In 2016, the CBN, through the Revised Guidelines for the Operation of the Nigerian Inter-Bank Foreign Exchange Market (**2016 Guidelines**) introduced the Naira-settled OTC FX Futures to the Nigerian derivatives market in its attempt to the address similar foreign exchange risks plaguing the country. The Naira-settled OTC FX Futures are non-deliverable Forwards (i.e. contracts where parties agree to an exchange rate for a predetermined date in the future, without the obligation to deliver the underlying US Dollar (notional amount) on the maturity/settlement date).[3]

This article revisits the Naira-settle OTC FX Futures and its use as a tool for investors to hedge the currency instability risk in the Nigerian market.

The Naira-Settled OTC FX Futures

1 Budget Office of the Federation. July 2020. 2021-2023 Medium Term Expenditure Framework and Fiscal Strategy Paper. Pg 47

2 Ibid. Pg 15

3 https://www.fmdqgroup.com/markets/products/derivatives/ Last assessed on 28 July 2020.

The Naira Settled OTC FX Futures merges characteristics of a derivative forward and a futures contract to innovate a hedging product adapted for the Nigerian market.

A forward contract is a bilateral agreement where one party (the seller) agrees to sell an asset to another party (the buyer) at a predetermined settlement date in the future and at a strike price which is fixed at the time of entering into the contract. The contract value is the difference between the strike price and the market value at the settlement date. As a result of its bilateral nature, forward markets are done Over-the-Counter (**OTC**) and the market platform fixes the price of the financial asset for future delivery.

A futures contract on the other hand is a legal agreement to buy or sell a particular commodity asset (such as currencies, commodities, stock market indices, etc.) at a predetermined price at a specified time in the future. Futures contracts are standardized for quality and quantity to facilitate trading on a futures exchange. The buyer of a futures contract is taking on the obligation to buy and receive the underlying asset when the futures contract expires. The seller of the futures contract is taking on the obligation to provide and deliver the underlying asset at the expiration date. [4] However, the finite nature of a standardised exchange may not be appealing to investors who may want to contract on substantially different terms and product volumes from what the exchange market offers.

In order to mitigate counterparty exposure, the futures contract incorporates a margin requirement allowing a clearing house to collect an initial margin and from time to time a variation margin amount to cover the day to day gain/ loss from the fluctuations in prices of the futures asset and settles each day by marking the daily value of the asset to its market price. At closing, the intermediary and the clearing house nets out each counterparty's final day position and pays out the difference to the party in the money. Settlement is more often done in cash than actual physical delivery.

The OTC Futures contracts are cash-settled in Naira and the differential between the contract rate and the Nigerian Autonomous Foreign Exchange Fixing (NAFEX) rate on the maturity day determines the settlement amount.

Legal Framework for the Naira Settled OTC FX Futures

The use of the NDFs in Nigeria dates back to 2011, when the CBN introduced NDFs into the Nigerian market through the Guideline for FX Derivatives and Modalities for CBN FX Forwards 2011 (**2011 Guideline**), "*in order to provide hedging opportunities for customers (investors) with long-term perspectives and providing customers with a choice as to where to bank and where to hedge.*"[5]

The 2011 Guideline provided that all hedge transactions with customers must be backed by trade (visible and invisible) transactions and gave the Financial Markets Dealers Association (**FMDA**) the responsibility of ensuring appropriate governance over the inter-bank spot market

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[4]https://www.investopedia.com/terms/f/futurescontract.asp#:~:text=A%20futures%20contract%20is%20a,specified%20time%20in%20the%20future.&text=The%20seller%20of%20the%20futures,asset%20at%20the%20expiration%20date. Assessed on 28 July 2020.

[5] Regulation 4.0 Guideline for FX Derivatives and Modalities for CBN FX Forwards 2011

including providing benchmarks for settlement.

The 2016 Revised Guidelines expanded on the provisions of the 2011 Guidelines, by introducing the Naira settled non-deliverable OTC FX futures (OTC FX Futures). The Naira settled OTC FX Futures are traded on the FMDQ platform and are sold by Deposit Money Banks (DMBs) who are authorized to deal in foreign exchange. The FMDQ is responsible for providing the appropriate benchmarks for the valuation and settlement of the OTC FX Futures and other FX derivatives. FMDQ is also responsible for developing detailed registration and operational guidelines and driving the development of other risk management products and attendant guidelines.[6]

In line with its functions, the FMDQ introduced the Foreign Exchange Futures Market Standards, 2018 (**Operational Standards**) and the Foreign Exchange Futures Market Framework, amended in 2020 (**FX Framework**) (the Operational Standards and the FX Framework together the "**FMDQ Regulations"**) which regulate OTC FX Futures contract and trading in Nigeria.

The Naira-settled non-deliverable OTC FX Futures

Under Paragraph 2.2 of the 2016 Revised Guidelines, the OTC FX Futures are non-standardised with fixed tenors and bespoke maturity dates and must be backed by trade transactions (visible and invisible) or evidenced investments.

The CBN currently offers non-standardised amounts for different tenors, from one (1) month through to sixty (60) months to DMBs, who in turn offer same to customers with trade-backed transactions or trade same with other DMBs; settling on bespoke maturity dates. Trades will be done via the FMDQ Futures Trading and Reporting Systems (FFTRS).

While the OTC Futures are to be Naira settled, settlement amounts evidenced by an FMDQ OTC FX Futures Settlement Advice may be externalized (converted into foreign exchange and repatriated offshore) for Foreign Portfolio Investors (FPIs) and Foreign Direct Investors (FDIs) with certificates of capital importation[7].

The Naira-settled OTC FX Futures is a variant of NDFs where parties agree to an exchange rate for a predetermined date in the future, without the obligation to deliver the underlying US Dollar (notional amount) on the expiry date. On the expiry date, it will be assumed that both parties would have transacted at the Spot FX market rate. The party that would have suffered a loss with the Spot FX rate will be paid a settlement amount in Naira. This ensures that both parties enjoy the rate that had been guaranteed to each other through the OTC FX Futures.

It is useful to note that customers are allowed to execute their OTC FX Futures transactions with their preferred DMB (**Futures DMB**) while the eligible underlying transaction documents are held by another DMB (**Trade DMB**). Thus, an investor's supporting documents e.g. the CCI, Form A, may be obtained through Bank A, while the OTC FX Futures trade is done with Bank B.

Eligible transactions

6 Paragraph 2.2.3 and 2.2.8 of the Guidelines for Flexible Exchange Rate Market, 2016

7 This is made pursuant to CBN Circular FMD/DIR/GEN/07/001 on the Externalisation of Differentials on the OTC FX Futures Contracts for Foreign Portfolio Investors released June 24, 2016

The Operational Standards regulates the trading of OTC FX Futures and provides that "*OTC FX Futures shall be utilised by Clients solely for foreign exchange risk management purposes and shall not be used as a mechanism for speculation, trading or such other purposes as may be prohibited by the CBN and FMDQ.*"

As mentioned above**,** OTC FX Futures transactions between Deposit Money Banks (DMBs) and their customers must be trade-backed.[8] Eligible underlying transactions include:

a) Fixed income and listed/quoted equity investments;

b) Long-term investments e.g. foreign direct investments (FDI)[9];

c) Dividend payments duly reported in the latest audited annual report and accounts of the entity, evidenced by a Board Resolution of the entity;

d) Foreign currency (FCY) loans (evidenced by a currency conversion and the attendant Certificate of Capital Importation) and attendant interest amounts;[10]

e) Airline remittances;

f) Import transactions, letters of credit (confirmed and unconfirmed) and bills for collection;

g) Write-offs on FCY loans or provisions on non-performing FCY loans; or

h) Such other eligible underlying transactions as may be permitted by the CBN including 'Miscellaneous Payments' as detailed under Memorandum 15 of the CBN Foreign Exchange Manual.

All transactions expressly prohibited by the CBN from accessing the Nigerian FX market remain ineligible underlying transactions for OTC FX Futures.

Thus foreign investors who have invested in companies or projects either by way or equity, loan or hybrid instruments may trade in OTC FX Futures, if they obtained a Certificate of Capital Importation (CCI) on importation of capital, in line with extant foreign exchange laws and regulations.

Documentation and other transactional requirements

All OTC FX Futures are to be documented in the manner required by the FMDQ depending on the nature of the transaction and the stage of the transaction cycle i.e. point of execution of the OTC FX Futures contract, between execution and settlement, and point of maturity/settlement of the OTC FX Futures contract.[11]

The DMB would typically execute a Nigerian Master FX Agreement (NMFA) with the CBN. The Operational Standards expects DMBs to enter into appropriate Master FX Agreements with its customers.[12] Confirmations are then issued to document particular transactions.

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8 Section 2.2, Revised OTC FX Futures Market Operational Standards 2018

9 Capital hedges must be restricted to the longest-tenored OTC FX Futures contract

10 Hedges for FCY loan amounts shall also be restricted to the longest-tenored OTC FX Futures contract while their attendant interest amounts must be matched with the contract's maturity date.

11 Paragraph 3 of the Operational Standards

12 Ibid. Section 9.4(i)

The minimum documents required by the FMDQ at the point of trade differs depending on the nature of the transaction, whether visible, invisible, export or evidenced foreign portfolio investments in fixed income and listed/quoted equity investments and other assets and would typically include

For transactions on **evidenced foreign portfolio investments in fixed income and listed/quoted equity investments and other assets**,[13] the Futures DMB is expected at the point of trade to update the details of the supporting documents unto the FFTRS or such other FMDQ-advised medium, for confirmation by the Trade DMB. The Trade DMB and the Futures DMB may however be the same entity. However, where the investment capital is a new foreign currency inflow, the Futures DMB may execute the OTC FX Futures contract with minimum documentation such as the SWIFT confirmation of the inflow and update same to FFTRS or such other FMDQ-advised medium. Subsequently, the Trade DMB shall, within three (3) business days of the eligible underlying transaction, update the FFTRS or such other FMDQ-advised medium with details of the CCI confirming the exchange of foreign currency to Nigerian Naira,[14] other valid capital importation documentation and such other documentation as may be prescribed by CBN and FMDQ from time to time (if applicable).

Margin requirements

In order to mitigate counterparty risk, all OTC FX Futures contracts must be subject to margin requirements as the FMDQ Exchange and the Clearing House shall prescribe from the dates of execution up until the settlement dates of the contracts.[15] DMBs are thus required to operate Margin accounts with the Clearing House and to pledge/deposit Eligible Collateral[16] as may be required by FMDQ Exchange and the Clearing House.

Margin, in this context means **"***Eligible Collateral in the form of either Initial Margin[17], Variation Margin[18], Maintenance Margin[19], or such other margin as may be determined by FMDQ and/or the Clearing House".[20]*

Margin requirements are generally set by the FMDQ and Clearing House. However, DMBs, may, in conducting their credit risk assessments of Clients, stipulate margin requirements which their respective Clients. Each transaction will be governed by whichever margin is

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13 ibid paragraph 3.4

14 Please note that under the Foreign Exchange Monitoring & Miscellaneous Provisions Act, CCI's are only issued in respect of foreign capital inflow which have been converted into Naira.

15 Paragraph 5.1 of the Operational Standards

16 Eligible Collateral includes cash, Federal Government of Nigeria ("FGN") securities such as FGN bonds and Nigerian treasury bills, CBN bills and any such other asset/instrument as may be determined by FMDQ.

17 The value of Eligible Collateral determined by the Clearing House on the basis specified by FMDQ Exchange and held in respect of the aggregate positions of Transaction Counterparties to mitigate counterparty risk which may be associated with OTC FX Futures contracts

18 The amount of Margin payable by a counterparty as a result of the marking-to-market of positions in its OTC FX Futures contracts in order that the balance in the counterparty's Margin account returns to the Initial Margin requirement.

19 The minimum amount of Eligible Collateral that must remain in the Margin account of Transaction Counterparties at any point during the life of an OTC FX Futures contract

20 The Operational Standards,

higher and the DMB is required to report the value of margin determined by the Clearing House and the margin payable by a counterparty as a result of market-to-market positions received for each client trade on the day the margin is obtained on the FFTRS. DMBs are also required to, update on the FFTRS, details of the return of Clients' attendant Margins on matured OTC FX Futures contracts.

The Collateral Margin remains the assets of the DMBs, the Clients margined for their OTC FX Futures trades executed with DMBs and CBN, and the Clearing House shall hold the Collateral Margin in trust for the DMBs, the relevant margined Clients, and CBN respectively. Such CBN's Collateral Margin is to be invested in short-tenored sovereign fixed income securities held with designated Custodians in favour of "*NIBSS/FMDQ: OTC FX Futures Margins "*[21]

Settlement of OTC FX Futures contracts

Settlement amounts are to be credited into the DMBs' CBN operating account no later than 4:00 p.m. on the settlement date. Within one day of its receipt of the settlement amount, the DMB is required to transfer the settlement amount to the client after ensuring that the client has provided relevant and complete documentation and the FFTRS or other FMDQ advised platform has been so updated. All amounts that cannot be settled as a result of incomplete documentation or is being investigated will be debited to the DMB's Futures account and transferred to the OTC FX Futures Resolution Account with the Clearing House.

Event of Default

An event of default (**EoD**) event is defined by the FMDQ Standards to include issues ranging from regulatory action against a DMB, voluntary or involuntary liquidation, insolvency, bankruptcy or any other such arrangement by the DMB, inability of DMB to pay debts, dissolution of DMB, consolidation, amalgamation, mergers or acquisition of a DMB which negatively impacts on the ability of the DMB to meet its obligations under its OTC FX Futures contract(s) to a secured party taking possession of all or substantial assets of the DMB.

Where an Event of Default occurs, the cash-equivalent of the Initial Margin requirement on all the defaulting DMB's open contracts with the CBN and other DMBs (Transaction Counterparties), and estimated potential loss amounts, shall be immediately debited to the DMB's CBN operating account by the Clearing Agent. FMDQ shall issue a market notice designating an Early Termination Date[22] for the relevant open contracts of the defaulting DMB with Transaction Counterparties, upon which the Early Termination Amounts shall be determined.

In addition to the above, a client with an open position(s) in an OTC FX Futures contract with a defaulting DMB may opt to close-out its open contract(s) with the defaulting DMB or transfer its open contracts to a substitute DMB(s). Where the client opts to close-out, or for a transfer but is unable to effect the transfer within ten (10) business days of the declaration of an or where, at the open contract is within thirty (30) calendar days or less to maturity at the time of

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[21] ibid, paragraph 8

[22] Means a date, being no more than two (2) business days or such other period as may be commercially reasonable upon the declaration of an Event of Default so designated by FMDQ Exchange as the date in which all transactions of a defaulting DMB would be closed out and Early Termination Amounts determined.

declaration of an EOD, such contract with the client shall be closed out by the Exchange and the Early Termination Amount calculated.[23]

The Early Termination Amounts is the amount equal to the sum of the Unpaid Amounts (inclusive of interest) and the Close-Out Amount with respect to OTC FX Futures contracts upon the occurrence of an Event of Default. The Close-Out Amount is the amount of loss or gain to the non-defaulting party in the Event of Default which would be determined at the Early Termination Date in accordance with the OTC FX Futures Close-Out Methodology. [24]

For the avoidance of doubt, FMDQ Exchange is the determining party for all/any amounts due to/from non-defaulting party or defaulting party upon the declaration of an EOD.

Externalisation of proceeds

As previously mentioned, although OTC Futures are to be Naira settled, settlement amounts evidenced by an FMDQ OTC FX Futures Settlement Advice may be externalized for foreign portfolio investments and foreign direct investments with certificates of capital importation[25]. Foreign portfolio investments (**FPI**) are not allowed to externalise imported capital until after the maturity date of the OTC FX Futures contract. However, they may externalise settlement amount(s) without liquidating capital.

Obligors of foreign currency loans (**FCY**) are permitted to externalise the maximum amount which shall not exceed the value of the principal and interest payments on the loans. Thus, any settlement amount received for hedging foreign currency loans cannot be externalised.

Aside from FPIs and FCY loans exempted which are exempted, settlement amount(s) of OTC FX Futures for all eligible invisible transactions qualify for externalisation only after the completion of the transaction cycle.

Transfer of OTC FX Futures Contract

Generally, the transfer of contracts are prohibited. However, the FMDQ may permit transfer of contract to other clients prior to maturity in the following circumstances:

a) Where an eligible underlying transaction (visible or invisible) is cancelled;

b) Where an eligible underlying transaction (visible or invisible) is extended;

c) Where a circumstance occurs which would otherwise lead to the early termination of an OTC FX Futures contract but which does not qualify as an Event of Default within the definition provided in these Standards;

d) Where an Event of Default occurs; or

e) Such other circumstances as may be prescribed by the FMDQ from time to time

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23 ibid, paragraph 6.3 and paragraph 3 of the OTC FX Futures Market Close-Out Methodology

24 Detailed information on FMDQ's close-out methodology can be found at https://www.fmdqgroup.com/wp-content/uploads/2020/02/OTC-FX-Futures-Market-Close-Out-Methodology-February-13-2020.pdf.

25 This is made pursuant to CBN Circular FMD/DIR/GEN/07/001 on the Externalisation of Differentials on the OTC FX Futures Contracts for Foreign Portfolio Investors released June 24, 2016

Duties and obligations of dealing members, Clearing House and the CBN

Dealing Members

The dealing members are deposit money banks **(DMB)** which act as Settlement Banks with respect to all executed OTC FX Futures contracts. Section 9 of the Operational Standards enumerate their general obligations, reporting obligations, responsibility to clients and expected business practice.

General obligations include the obligation to maintain confidentiality, take reasonable steps to ensure that their Authorised Representatives do not participate in or assist any legal entity to participate in any form of insider trading, speculative activity, fraudulent acts, report all defaulting clients etc.[26]

The Standards further stipulates that dealing members shall comply with the Margin requirements as may be stipulated from time to time by FMDQ and the margining process as advised by the Clearing House. As regards their responsibility to client, they shall conduct due diligence and product suitability assessment and inform client in writing of the risk associated with the futures contract. Dealing members are required to provide Clients with daily reports on the status of their OTC FX Futures contracts (including but not limited to potential gains or losses, eligible underlying transaction documentation status and relevant margin requirements) and act honestly, fairly and professionally at all times in the best interests of their Clients.[27]

In performing its duties, dealing members must comply with all applicable laws and regulations and maintain a robust compliance program which includes procedures to identify and mitigate legal, regulatory, financial, and reputational risks. Reporting obligations are imposed on dealing members in order to ensure transparency in the market and late submission fine of N250,000.00 (two hundred and fifty thousand Naira), and then N10,000.00 (ten thousand Naira) for each business day that the report remains unfiled

Clearing House

The Clearing House acts as the trustee holding securities on behalf of the DMBs and clients in the OTC FX Futures trade and ensures that all the relevant pledge indicators are placed on the collateral accounts of all participants, including the CBN. The Clearing House is also responsible for ensuring the risk management structures put in place are implemented in a timely and orderly manner. [28]

CBN

While the CBN is recognized as the regulator in the financial market, the Operational Standards clarified its role when transacting in the OTC FX Futures market as being a participant and not a regulator, so, all transactions duly executed by the CBN's authorized representatives will be valid and enforceable against it. It is useful to note however that CBN transactions are done

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[26] ibid, paragraph 9.1

[27] ibid, paragraph 9.3

[28] ibid, paragraph 10.1

with DMBs and not directly with investors.

Dispute resolution and enforcement of standards

Disputes and complaints under the Operational Standards are managed in accordance with the FMDQ Complaints Management Framework, thus all disputes arising from the OTC FX Futures Market shall be referred to the FMDQ for investigation and adjudication.[29]

Any DMB found to have flouted the Operational Standards may be awarded a penalty according to the Operational Standards.[30]

Primacy of the standards

The Operational Standards was endorsed by the CBN, thus in the event of a conflict between it and any other related documents, the provisions of the standard supersedes such document to the extent of the inconsistency.[31]

Conclusion

Volatility in the FX Rate during a recessionary period is a major factor which can deter foreign investments inflows and the implementation of policies to alleviate the impact of this volatility remains necessary to grow the nation's economy. The volatility has occasioned widening gaps between the interbank window and the parallel market and the use of the OTC FX Futures has the capacity to eliminate this gap as it encourages more access to FX for trade backed investments.

An NDFs (including the OTC FX Future) is no doubt a veritable tool that can be used by companies and investors to hedge against currency fluctuation. By allowing parties to agree to an exchange rate for a predetermined date in the future, without the obligation to deliver the underlying US Dollar notional amount on the maturity date, but rather the settlement amount, the Naira-Settled OTC FX Future affords market participants the opportunity to manage the investment risks occasioned by the currency fluctuations which has in recent times increased as a result of the shortage of dollar supply, to meet the end-users demands for FX to finance eligible trade-backed transactions.

The introduction of the OTC FX Future to the Nigerian market in June 2016 provided great succour to Nigerian corporates, FPIs, FDIs and other investors, as the product served to minimise the disequilibrium in the Spot FX market and caused the exchange rate to moderate; attracting significant capital flows to the Nigerian fixed income and equity markets.

Under the joint supervision of the CBN and the FMDQ, the administration of the product via the bespoke FMDQ FX Futures Trading & Reporting System has been near seamless. There has been no settlement default, with FX Futures contracts over the last 43 maturities, totalling circa $25.53 billion, successfully cleared and settled by FMDQ's wholly owned clearing house, FMDQ Clear Limited.

The robust legal and regulatory framework which guides the OTC FX Market in conjunction with the record set so far by the regulators in the market improves the confidence reposed in

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29 ibid, paragraph 12

30 ibid, paragraph 13

31 ibid paragraph 14

the NDF by investors as a tool to hedge against currency risk.