



Central Bank of Nigeria

GUIDELINES FOR FX DERIVATIVES AND MODALITIES FOR CBN FX FORWARDS

1.0 Introduction

Development of the Nigerian financial markets and assurance of financial system stability are two of the four reform pillars of the Central Bank of Nigeria (CBN). The CBN has therefore articulated various financial markets reforms after a series of sensitisation workshops with the market operators. The reforms cover products, practices, regulation and supervision. The objective of the CBN is to make our financial markets global, organised, liquid and diversified. The development of the financial markets will enhance the transmission of the monetary policy and minimize the risk to financial system stability.

In support of the various initiatives led by the Authorised Dealers, over the years, in deepening the Nigerian inter-bank foreign exchange market, the CBN is releasing these guidelines on the risk management products Authorised Dealers are allowed to offer to their customers and the modalities under which the CBN intends to boost the trading liquidity in these products.

The Authorised Dealers are expected to be professional in their conduct in ensuring the efficient operations of the Foreign Exchange (FX) market. It is imperative to mention that the FX market is under the CBN jurisdiction and Authorised Dealers should avoid causing a shutdown of the market for any reason. Also, unprofessional conduct by the staff of the Authorised Dealers shall not be tolerated.

2.0 Approved Products

The approved hedging products are FX Options, Forwards (Outright and Non-Deliverable), FX Swaps and Cross-Currency Interest Rate Swaps. Authorised Dealers are now allowed to offer European-styled FX call and put option contracts to their customers and in the inter-bank market. All hedge transactions with the customers must be backed by trade (visible and invisible) transactions. The CBN shall grant approvals for Authorised Dealers that qualify to engage in Options. Details on the approval process shall be released in due course.

3.0 Prudential Guidelines on FX Options

The Financial Policy & Regulation and Banking Supervision Departments of the CBN will be developing detailed prudential guidelines on FX Options. These will cover qualifying criteria, limits, capital adequacy charge, spot-hedge position limits (in the

absence of a developed inter-bank options market), accounting, returns, staffing requirements, market risk management standards, internal controls standards etc. Authorised Dealers shall apply to the Banking Supervision Department for approvals to deal in FX Options after which they shall be required to make presentations to the CBN. This presentation shall cover: strategy, treasury competence, trading systems, market risk management, internal controls etc.

4.0 FX Forwards (Outright and Non-Deliverable)

Outright Forward FX transactions have always been approved by the CBN. 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, the CBN is now allowing Non-Deliverable Forwards (NDFs). All hedge transactions with the customers must be backed by trade (visible and invisible) transactions. As the NDFs will require benchmarks for settlement, the FMDA will ensure appropriate governance over the inter-bank spot market.

The maximum tenor allowed for FX Forwards and by implication FX Swaps and Cross-Currency Interest Rate Swaps is now extended to five (5) years. Authorised Dealers may seek specific approval for longer tenors.

5.0 Trading Liquidity in Cross-Currency Interest Rate Swap (CCIRS)

With the anticipated external interest in financing infrastructural gaps in Nigeria, the CBN is supporting the Authorised Dealers with CCIRS trading liquidity. The CBN will be willing to provide hedges for CCIRS to support projects with long-term foreign exchange exposure. All CCIRS requests to the Financial Markets Department (FMD) of the CBN shall therefore be project backed. The FMD will issue detailed guidelines on the CCIRS structures offered by the CBN. The CBN shall not deal in synthetic CCIRS for now, therefore, principal amounts of the currencies (Naira and US Dollar) will have to be exchanged.

6.0 Trading Liquidity in FX Forwards & Modalities for CBN FX Forwards Operations

The CBN intends to offer to Authorised Dealers short-tenored FX forwards to boost the trading liquidity in hedging products. With a deep forward market it is believed that the demand for foreign exchange will smoothen out and accelerated demand in reaction to anticipatory depreciation in Naira will reduce.

Consequently, the modalities for the CBN FX forwards operations are detailed as follows:

6.1. Documentation

A Nigerian Master FX Agreement (NMFA) shall be executed by any Authorised Dealer that intends to engage in CBN FX Forwards. Specific transactions shall be backed by confirmations duly executed by the signatories of the Authorised Dealers.

Similarly, Authorised Dealers shall execute Master FX Agreements with their customers.

6.2. Trade-Backed Requirement

The CBN objective for boosting the trading liquidity in the forwards market is to offer risk management support to the exchange rate risk exposures of the customers therefore all the FX forward purchases by the Authorised Dealers from the CBN must be trade-backed. Authorised Dealers are therefore expected to evidence the existence of the trade transactions before bidding for FX forward purchases from the CBN on behalf of their customers.

6.3. Auction Style

The Bank shall adopt multiple-price Dutch Auction System. The auctions shall be referred to as Wholesale Dutch Auction System – Forwards (WDAS–FWD) in USDollar/Nigerian Naira.

The auctions shall be conducted by the CBN on Monday and Wednesday on the same day with WDAS-SPT for 1, 2 and 3-month forwards. The CBN may choose to offer longer tenors.

6.4. Auction Notice and Timing

The CBN will announce the amount on offer and the specific maturity dates for each tenor being auctioned alongside the WDAS-SPT notice released at 8.30am on auction days. The auction for forwards shall be conducted between 2PM and 3PM.

6.5. Bid Format

Authorised Dealers shall have no more than one bid (volume and forward points) on a single tenor. The Authorised Dealers shall bid forward points and not forward rates i.e. forward rates plus/minus the spot rate. However, the Authorised Dealers will explicitly state the points as (+) points for premium or (-) points for discount. The relevant spot rate shall be the weighted average rate of successful bids of the just concluded WDAS-SPT of that day. The weighted average rate shall be announced with the WDAS-SPT result. (For example, from a calculated forward rate by the Authorised Dealer of N152.1704 for a 1M forward the Authorised Dealer shall bid +1.8696 which is the

N152.1704 less the communicated weighted average rate of N150.3008. If the forward rate had been N150.3008 and the spot rate N152.1704, the Authorised Dealer shall bid -1.8696. The signs are important as in some cases they may be negative). The points bid shall be expressed to four decimal places.

6.6. Bidding Platform

The bids shall be submitted via electronic means which for now is the Reuters Dealing 3000 Xtra System. In the event that the Reuters Dealing system is unavailable at 2.45pm, Authorised Dealers can place bids by calling the CBN Dealing Room, Abuja directly. All bids received must be delivered in hard copy to either the CBN FMD Lagos or Abuja office no later than 5pm on the day of the auction. The hard copies shall be signed by the persons whose signatures are given on the Authorised Dealers' valid specimen form at the CBN's disposal.

6.7. Bid Result

The results – marginal points and weighted average points shall be announced by 4PM via an electronic platform – CBN website and/or other news wire service e.g. Reuters. A copy of the results shall be communicated by Financial Markets Department (FMD) to the Financial Markets Dealers Association. The detailed results shall later be made available to the market.

6.8. Minimum Allowable Bid Amount

The minimum allowable bid amount by an Authorised Dealer for each tenor offered shall be \$500,000.00

6.9. Individual Allocation Limit

The CBN reserves the right to adjust the amount sold on each tenor and shall exercise its discretion over the amount sold on each tenor to a single Authorised Dealer.

6.10. Maximum Spreads

The maximum spread of 50 kobo is allowed on the sale of forwards with less than three (3) months tenor whilst 75 kobo is allowed for tenors above 3 months. The spreads are graduated due to the attendant counterparty risk in forwards. Authorised Dealers are advised to implement adequate risk management practices, to mitigate the counterparty risk, and generally upgrade their market risk management practices.

6.11. Squaring the Forward Positions

Authorised Dealers are allowed to sell the forwards bought from the CBN only as forwards to their customers. In circumstances where for any reason a customer has

indicated that it will not meet its obligations under agreed forward interest or transaction, an Authorised Dealer can manage its exposures as it seems fit, whether through customer spot or forwards markets. FX purchased from the WDAS-SPT cannot be sold forwards to customers as it must be utilised within five (5) business days after settlement as per the WDAS-SPT guidelines (revised December, 2010).

6.12. Transferability

All FX forwards bought from the CBN are not transferable in the inter-bank market. Authorised Dealers are expected to bid on behalf of their customers.

6.13. Settlement

Authorised Dealers shall ensure their operating accounts are adequately funded on the maturity dates of the forward purchase. ***The 1% commission shall be calculated on the forward rate and debited on the settlement date.*** Maturity dates shall be set at spot date (T+2) plus the one month, two months or three months depending on the tenor. The maturity dates shall be set in line with internationally accepted practice.

All forwards sold to the CBN must also be adequately settled to the CBN SPECIAL FEM ACCOUNT with JP Morgan Chase, New York.

6.14. FX Position Impact

The CBN expects the Authorised Dealers not to have any position impact on the FX forwards bought from the CBN as they are bought on behalf of customers. The blotters should be immediately updated once the Authorised Dealer's success at the auction is known through the announced result and the Authorised Dealers' purchases are simultaneously sold down to customers.

Authorised Dealers are to maintain separate blotters for their CBN FX Trading (spot and forwards) transactions and their Inter-bank/Autonomous trading transactions.

6.15. Defaults by Customers

Authorised Dealers are to file reports with the CBN on any customer that defaults on its obligations under forward contracts. In that circumstance the provision of 6.11 on selling spot or forward shall apply.

7.0 FX Forward Purchases by the CBN

The CBN shall also be prepared to purchase forwards from Authorised Dealers. CBN forward rates shall be advised from time to time.

8.0 Financial Statements and Returns

Forward contracts will be recognised as off-balance sheet exposures in the books of Authorised Dealers. Banking Supervision Department will be reviewing the set of returns submitted by the Authorised Dealers to ensure the hedged and un-hedged foreign exchange exposures in the system are appropriately captured.

Financial Markets Department
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