NIGERIA'S LIBERALIZED FOREIGN EXCHANGE REGIME: CURRENT IMPACTS AND THE NEAR FUTURE

When, on June 15, 2016, the Central Bank of Nigeria (**"CBN"** or **"apex bank"**) first announced its decision to launch a floating foreign exchange (**"FX"**) regime with effect from Monday, June 20, 2016; end-users of FX waited in apprehension to see the new regime take off whilst a few businesses, investors (local and foreign), corporates and other stakeholders in the money market expressed their shock.

In order to establish a workable framework for the new FX regime, the CBN released a three-in-one set of guidelines, namely: (1) Guidelines for the Operation of the Nigerian Inter-bank Foreign Exchange Market (2) Guidelines for Primary Dealership in Foreign Exchange Products; and (3) How the CBN Naira-settled OTC FX Futures Market will work. For the purpose of this article, we will refer to these three Guidelines as the "new FX Guidelines".

Beyond the popular expectation of the familiar devaluation exercise carried out in the past, the CBN, through the new FX Guidelines introduced a "fully liberalized" FX market. This move by the CBN, is considered by many stakeholders as the most adventurous by the CBN; since the Exchange Control (Anti-Sabotage) Act of 1962 was repealed in 1995 by the extant Foreign Exchange (Monitoring and Miscellaneous Provisions) Act, (Cap. F34, Laws of the Federation of Nigeria (**"LFN"**), 2004), (the **"Forex Act"**).

True to form, the FX market has been hit by constant illiquidity and volatility, primarily worsened by the crash in global commodity prices (especially the hitherto plummeting international oil prices) and the resultant diminishing FX earnings and shrinking foreign reserves for the country.

In other to achieve the intended objectives of transparency, liquidity and stability in the FX market, the CBN has been issuing specific regulations (published in a number of Circulars) to facilitate implementation of the new FX Guidelines, pursuant to its various powers under the CBN Act No. 7 of 2007), Forex Act and, the Banks and other Financial Institutions Act (**"BOFIA"**), (Cap. B3, LFN, 2004).

Simply, the aim of this article is to analyse the far-reaching changes, which the new FX Guidelines have introduced into the FX market and the specific implications they hold for domestic and foreign investors, businesses, the organised private sector and the overall economy; now and in the near future.

A FLEXIBLE SINGLE MARKET STRUCTURE

The new FX Guidelines have ended the old dual FX market system where both the pegged 'CBN/Official Rate' and the 'Inter-Bank Rate' coexisted; and created in its stead, an inter-bank autonomous market window for all FX transactions (**"Single Market"**).

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The FX rates in the Single Market are now market-driven i.e. determined through the interplay of demand and supply but kept within a daily maximum spread (i.e. the difference between the FX Bid rates and the Offer rates) which is determined by the FMDQ Over-The-Counter (**"OTC"**) Securities Exchange (**"the FMDQ"**). All Authorized Dealers are to buy and sell FX among themselves on a two-way quote basis via approved trading systems (which at this time, is only through the FMDQ Thomson Reuters FX Trading Systems – TRFXT Conversational Dealing). However, Authorized Dealers are also permitted, to offer one-way quotes (through the TRFXT Anonymous Firm Orders – Order Book) on all products to other Authorized Participants on request, via any approved trading system.

PARTICIPANTS IN THE NEW SINGLE MARKET

Under the new FX Guidelines, participants in the Single Market include Authorized Dealers (all deposit money banks); Authorized Buyers (corporates that are appointed by the CBN as such); oil companies; oil servicing companies; exporters; end users (businesses with legitimate FX demands i.e. demands for transactions that are valid for FX") and; others who may from time to time be designated by the CBN as participants.

PERIODIC CBN INTERVENTIONS IN THE SINGLE MARKET

The CBN reserves the right under the new FX Guidelines to intervene in the Single Market (for the primary purposes of ensuring liquidity and checking volatility), by either buying or selling FX at no predetermined or maximum spread through the two-way quote system. These interventions are either made via the inter-bank market or the Secondary Market Intervention Sales (**"SMIS"**).

At the inter-bank market, the CBN trades directly with the Primary Dealers (appointed from among the Authorized Dealers based on CBN-specified criteria) either in FX Spot or in FX Derivatives (i.e. alternative products such as FX Forwards and FX Futures). The intervention-trading shall be for the standard amount (as defined in the Guidelines for FX Primary Dealers) or by placing orders for non-standard amounts in the FMDQ Order Book System.

However, at the SMIS, CBN intervention shall be by selling FX directly on wholesale basis to the Primary Dealers or indirectly on retail basis to end users (through the Primary Dealers) for eligible, documentation-backed transactions.

To kick-start the implementation of the new FX Guidelines in June, the first set of interventions by the CBN were made to clear parts of the $4.02 billion unmet FX demands in the market with the sales of FX Forwards contracts (with tenors ranging from one month to twelve months and amounting to $3.5 billion).

THE 41 BLACKLISTED ITEMS

In a Circular No: TED/FEM/FPC/GEN/01/010, the CBN on June 23, 2015 under the old, pegged FX rates policy, issued a regulation classifying some 41 items as "Not Valid for Foreign Exchange" in the

Nigerian FX markets (inter-bank, export proceeds and BDC segments). It is important to note that this regulation (which was updated on June 26, 2015) is retained under the new FX Guidelines. Thus, importers of these 41 items are to continue to source their needed FX from outside the Single Market, although proper documentation of the alternative sources used is to be made and filed with the CBN through their Authorized Dealers. The affected 41 items as listed in the Circular are: Rice; Cement; Margarine; Palm Kernel/Palm Oil Products/Vegetable Oils; Meat and Processed Meat Products; Vegetables and Processed Vegetable Products; Poultry - chicken, eggs, turkey; Private Airplanes/Jets; Indian Incense; Tinned Fish in Sauce (Geisha/Sardine); Cold Rolled Steel Sheets; Galvanized Steel Sheets; Roofing Sheets; Wheelbarrows; Head Pans; Metal Boxes and Containers; Enamelware; Steel Drums; Steel Pipes; Wire Rods (deformed and not deformed); Iron Rods and Reinforcing Bars; Wire Mesh; Steel Nails; Security and Razor Wire; Wood Particle Boards and Panels; Wood Fiber Boards and Panels; Plywood Boards and Panels; Wooden Doors; Furniture; Toothpicks; Glass and Glassware; Kitchen Utensils; Tableware; Tiles - vitrified and ceramic; Textiles; Woven Fabrics; Clothes; Plastic and Rubber Products, Cellophane Wrappers; Soap and Cosmetics; Tomatoes/Tomato Paste; Eurobond/Foreign Currency Bond/Share Purchases.

A NEW HEDGING PRODUCT

In addition to the hedging products earlier approved in the 2011 CBN's "Guidelines for FX Derivatives and Modalities for CBN FX Forwards", the new FX Guidelines introduced a new hedging product, through which the risks and volatility associated with the FX market can be further avoided. This newly introduced FX Derivative is tagged the "Naira-settled Non-deliverable OTC FX Futures (**"OTC FX Futures"**) and it is to be traded on the FMDQ.

Essentially, the OTC FX Futures are special purpose vehicles for guaranteeing future market liquidity at stable and bespoke exchange rates. They are contracts that obligate the counterparties to buy or sell foreign currency on a predetermined future date (the settlement date), for a fixed rate agreed on the date the contracts were entered into (trade date) , without the obligation to deliver the underlying foreign currency (i.e. the US$ notional amount) at maturity.

Simply, all that happens on the settlement date is that, whatever is the difference between the Spot FX rate (the market rate at the Nigerian Inter-Bank Foreign Exchange Market – **"NIFEM"**) and the OTC FX Futures rate (the agreed rate), will be settled through the Nigeria Inter-Bank Settlement System Plc (**"NIBSS"**) – the interim Clearing House appointed for the OTC FX Futures Contracts. With this, both parties end up trading at the predetermined or agreed FX rate.

The CBN, on June 27, 2016 announced the rates and tenors for the OTC FX Futures for different tenors and entered into the first sets of FX Futures contracts, on the same day, for tenors ranging from one month through to 12 months as follows: 12-Month Contract (maturing June 2017) at ₦225/US$; 9-Month Contract (maturing March 2017) at ₦222/US$; 6-Month Contract (maturing December 2016) at N250/US$; 3-Month Contract (maturing September 2016) at ₦275/US$ and; 1-Month Contract (maturing July 2016) at ₦279/US$.

The 1-Month component of the FX Futures Contracts matured on the 27th of July, 2016 and were settled that day at the bespoke rate of ₦279/US$ (about US$26.73 million Naira-settled at ₦962.23 million) in spite of the fact that the Spot FX rate at the inter-bank market closed on the date at circa ₦304/US$.

Since the settlement of the first sets of FX Forwards and Futures Contracts in the last days of July, renewed confidence in the new FX Guidelines has been recorded among corporate treasurers,: businesses, governments, pension managers, oil and other commodities importers, corporates, and individual investors. End users no longer have any need for making front-loaded FX demand or involving in speculation. Instead, they are now simply keying into the OTC FX Futures Contracts as a safe way of hedging their risks in the FX market.

Notably, the CBN immediately replaced the 1-Month FX Futures Contracts settled in July with a new 12-Month FX Futures Contracts (of US$1 billion notional amount on offer), which are to mature in July 2017 at the bespoke rate of ₦250/US$. The CBN has since continued to replace other tenors of FX Futures Contracts with new ones, at their maturity dates.

STATUS OF THE BUREAU-DE-CHANGE OPERATORS IN THE SINGLE MARKET

The new FX regime initially provided no official role for the Bureau-De-Change (**"BDC"**) Operators in the new Single Market, in line with the CBN regulation of January 2016 by which the CBN had stopped the sale of its FX to the BDCs as well as prohibited them from accessing the inter-bank market. However, in a new Circular (dated July 22, 2016 and discussed below), the CBN has recently designated a new role for the BDCs.

THE SUPPORTING CIRCULARS

As noted earlier, the CBN has since the commencement of the Single Market, issued some Circulars which, invariably, are instruments of enforcing compliance with, and achieving the specific objectives of, the new FX Guidelines. These Circulars are shaping significantly the way businesses are done and the directions which investments are headed presently, and in the near future. The impacts of some of the Circulars are discussed as follows:

1. Externalization of Differentials on OTC FX Futures Contracts

The OTC FX Futures contract, as earlier indicated, operates by settling (in Naira value) the difference in the Spot FX rate at the NIFEM and the bespoke FX Futures rate at maturity. Where a party to an FX Futures contract is a foreign portfolio investor (**"FPI"**), thereby necessitating the need to repatriate the settled differentials in the FX rates, the concerned FPI is expected to get a clearance to this effect (to be issued by the FMDQ) known as the "OTC FX Futures Settlement Advice".

This regulation is contained in the CBN Circular No: FMD/DIR/GEN/07/001 of June 24, 2016 titled ***"Externalisation of Differentials on OTC FX Futures Contracts for Foreign Portfolio Investors"*** and issued to all deposit money banks. Though repatriation from the country of any foreign currency purchased from the FX market by FPIs are guaranteed under Nigerian laws (see section 13 of the Forex Act and section 24 of the Nigerian Investment Promotion Commission Act (Cap. N117, LFN 2004)), the OTC FX Futures Settlement Advice is henceforth required, in addition to the requirement of Certificate of Capital Importation (**"CCI"**), before proceeds of the FX Futures Contracts can be repatriated by FPIs trading in the Nigerian FX market.

2. <u>All FX Trades by Corporates to be done on the FMDQ-Advised FX Trading System</u>

Another CBN Circular No: FMD/DIR/GEN/CIR/07/002 dated July 8, 2016 and titled "Onboarding Corporates on FMDQ-Advised FX Trading and Surveillance System" was also issued to all Authorized Dealers, directing that effective August 1, 2016; all FX-related trades by Authorized Dealers among themselves and with their Clients (i.e. Corporate Institutions), must be executed through the FMDQ-advised FX Trading, Auction & Surveillance Systems (**"FMDQ-advised FX Systems"**). Prior to the take-off date of the Circular, some transactions were being done outside of the FMDQ-advised FX Systems and were only voice-reported on it after, in line with the "Execution and Reporting" mandate contained in the new FX Guidelines.

In compliance with the directives contained in the Circular, all trades outside of the FMDQ-advised FX Systems have since become prohibited. Thus, by limiting all transactions in the market to just one, uniform and predictable platform for all participants, the activities in the FX market have become more streamlined, transparent and seamless.

3. <u>Sales of Foreign Currency to Bureau-De-Change Operators</u>

As indicated above, a new role has recently been designated for the BDC operators. By a Circular No: TED/FEM/FPC/GEN/01/004 issued to all Authorized Dealers and BDC Operators and titled "Sales of Foreign Currency Proceeds of International Money Transfers to Bureaux De Change Operators", the ban from participation in the NIFEM earlier placed on the BDC operators has been lifted.

In effect, International Money Transfer Operators are now mandated to remit foreign currency to their agent banks for disbursement in Naira to the beneficiaries while the foreign currency proceeds are to be sold to the BDC operators. In doing this, full compliance with the extant Anti-Money Laundering Laws and the CBN's regulatory frameworks such as the Know-Your-Customer principles, including BVNs, is to be observed. Furthermore, Authorized Dealers and BDC operators are required to give daily and weekly returns on their operations to the CBN's Director of Trade & Exchange.

Further to this, the CBN on August 9 issued a supplementary Circular to all Authorized Dealers and BDC operators (Ref: TED/FEM/FPC/GEN/01/006), setting some limits to the BDCs' trading in FX.

In line with the provisions of the supplementary Circular, Authorized Dealers are now to buy FX from approved IMTOs at a maximum of 10% above the inter-bank rates and sell to the BDC operators at a margin not exceeding 1.5%. The BDCs, in turn, shall sell the FX cash bought from the Authorized Dealers to end-users at rates not exceeding 2% of the rates for which the FX were bought. Additionally, all funds being retailed by BDC operators (regardless of source) shall henceforth be at a maximum margin of 2%.

4. Provisioning for Loss on Foreign Currency Loans

In enforcing compliance with the Prudential Guidelines for Deposit Money Banks in Nigeria, issued by the CBN on 1st of July, 2010 (**"Prudential Guidelines"**), the apex bank released a Circular dated July 27, 2016 (Ref: BSD/DIR/GEN/LAB/09/037), titled "Provisioning for Foreign Currency Loans", which mandated all deposit money banks in Nigeria to review their loan portfolios latest by August 3, 2016.

By the date mentioned, all banks were to; 1) make additional provisions in their income statements in respect of the 'unprovisioned portion' of all Non-Performing-Loans (**"NPL"**) in their loan portfolios; 2) forward evidence of the additional provisions to the CBN's Director of Banking Supervision; and 3) review all foreign currency-denominated loans and make adequate provisioning on all the delinquent ones, in line with the Prudential Guidelines.

Essentially, as a result of the "devaluation" of the Naira, which came with the introduction of the new FX regime, it has become more expensive for most borrowers to source FX to repay their foreign currency-denominated loans (which were executed and provisioned for, at the old CBN-pegged rates). Indeed, for those who may even be able to afford to buy FX at the liberalized inter-bank rates, the illiquidity in the market has led to an increase in defaults, hence the need for lenders to make new loss provisioning in their income statements in respect of their NPLs.

Since this directive was made, the banks have been calling on the CBN to amend the provisions of section 3.21 (a) of the Prudential Guidelines, which mandates that the banks retain in their records, fully provided NPL for a period of one year before write-off. Whilst the CBN has turned down this request by the banks, it has however granted a one-off permission to the banks to write off the said NPL only for the year 2016. It is generally believed that this would reduce the pressure that has been brought on the banks by the implementation of the new floating FX rates policy.

RECENT DEVELOPMENTS

Unfortunately, the new FX Guidelines has come at a time when the country is “technically in recession”.

Decaying infrastructures and weak economic fundamentals have resulted in low productivity and competitiveness, high import bill and poor FX earnings. Under a floating FX policy, these factors combine to trigger the devaluation of the Naira with larger economic consequences. Challenges of volatility and illiquidity that trail the liberalized FX market with the attendant negative impacts on businesses (particularly imports, banking & loan markets and manufacturing) have a multiplier effect on the overall economy.

The manufacturing sector (being one of the worst hit by the impacts of the new flexible FX policy), has experienced incessant closure of factories and massive lay-off of workers in recent times. The Manufacturers Association of Nigeria (**“MAN”**) has consistently issued statements on how scarcity of FX for the import of inputs of production, in addition to the continued ban from sourcing FX from the inter-bank market for importation of the ‘41 blacklisted items; has continually dealt a death blow on the real sector of the economy.

Although the ban on the ‘41 blacklisted items’ remains, the CBN, in addressing the concerns of MAN, directed, in a Circular (Ref: TED/FEM/FPC/GEN/01/007) dated August 22, 2016 that, until otherwise directed; ***all Authorized Dealers shall dedicate at least 60 percent of their total FX purchases from all sources, including inter-bank, to end users from the manufacturing sector for the purpose of importation of raw materials, plant and machinery while the balance of 40 percent should be used to meet other visible and invisible trade obligations.*** This regulatory intervention is expected to revamp the production capacity of the manufacturing sector, in the short to medium term.

Recently, on August 23, 2016 the apex bank barred 9 deposit money banks (**“DMBs”**) from participating in the FX market, for failure to promptly remit to the CBN (in non-compliance with the Treasury Single Account (**“TSA”**) policy of the federal government), the dollar proceeds of oil sales deposited with the banks by the Nigerian National Petroleum Corporation (**“NNPC”**). Notably, the affected 9 DMBs are Authorized Dealers and some of them are also Primary Market Dealers in the FX market. This, expectedly, worsened the challenges confronting the FX market as the Naira immediately fell further against the dollar at the inter-bank market and against the greenback at the BDC segment; with FX end-users finding it difficult establishing letters of credit through the affected Authorized Dealers. The ban placed on the affected banks was however lifted few days after, following series of meetings between the CBN and other market stakeholders, to resolve the crisis.

Nonetheless, the FX market has begun to record positive results lately, as foreign investors (confident of the transparency and credibility of price formation that are brought into the market by the new FX Guidelines) start to return into the country with millions of dollars’ worth of FPIs. As this development continues and increases in volume in the coming months, the liquidity challenge and the associated volatility of FX rates at the inter-bank market are expected to reduce.

CONCLUSIONS

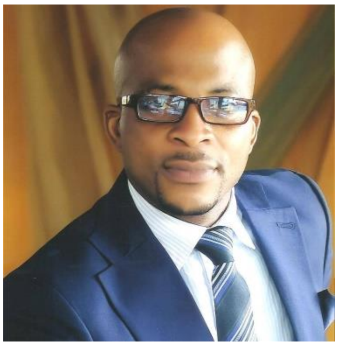
The new regime in the Nigerian FX market, which became operational in June 2016, is still within its first six months of implementation. We believe that whilst the flexible exchange rate policy, operated within a Single Market structure, is appropriate for rebuilding confidence of investors and attracting inflow of growth capital into the economy; the government and the apex bank must endeavor to keep the policy stable and without undue interference.

It is recommended that the current overall economic objectives of the CBN, articulated in the ***"Monetary, Credit, Foreign Trade and Exchange Policy Guidelines for Fiscal Years 2016/2017"***, should be implemented with great care; so as not to trigger an unintended consequence of a further fall into economic recession.

We advocate an economic growth plan that will support local content development through massive incentives and adequate credit facilities made available to domestic industries. Naturally, as the national industrial capacity grows and local production rises, economic competitiveness will be enhanced and importation of items will ordinarily become unattractive.

In the near future, the economy is expected to rebound as the apex bank maintains policy consistency and a transparent exchange system. Hopefully, the Naira will soon find its equilibrium at the FX market and firm against the major foreign currencies.

The Grey Matter Concept is an initiative of the law firm, Banwo & Ighodalo



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