FMDQ SPOTLIGHT

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Contents

New Stories

The Naira-settled OTC FX Futures Market: The Story so far

In the wake of the volatile state of the Nigerian foreign exchange (FX) market, the Naira-settled Over-the-Counter (OTC) FX Futures product was introduced by the Central Bank of Nigeria (CBN) to provide the much needed stability to the FX market by offering end-users (governments, corporates, investors, importers/exporters etc.) a means to guarantee a fixed rate for their FX needs, when required, thus ensuring the demand for the greenback is staggered appropriately to avoid front-loading of requirements as well as panic-buying in the Spot FX market. An immensely important tool, this OTC FX Futures product is rightly positioned to provide succor to Nigerian corporates, the CBN, the Nigerian FX market, and the nation's economy as a whole.

The Naira-settled OTC FX Futures market was launched by CBN and FMDQ OTC Securities Exchange (FMDQ or "the Exchange") on June 27, 2016, and kicked off with CBN as the pioneer seller of the first set of OTC FX Futures contracts; offering non-standardised amounts for different tenors, from one (1) month through to twelve (12) months to Authorised Dealers, who in turn offer same to customers with trade-backed transactions or who may trade same with other Authorised Dealers.

Immediately following the Launch, market participants recognised the value in hedging their FX exposures as well as improving their business planning, as FMDQ, the OTC FX Futures Exchange, through its bespoke OTC FX Futures Trading & Reporting System, began to record trades executed between the apex bank and Authorised Dealers. Citibank Nigeria Limited and Stanbic IBTC Bank PLC paved the way for Foreign Portfolio Investors (FPIs) by executing trades worth about $20.00mm (Twenty Million Dollars) and $68.00mm (Sixty-eight Million Dollars) respectively, with the CBN, on behalf of FPIs via the FMDQ Futures Trading & Reporting System (FFTRS). Ten (10) other banks executed OTC FX Futures trades with the CBN, on behalf of clients for varied needs and for themselves, in the course of the months.

As at July 28, 2016, a month after the Launch of OTC FX Futures market, a total value of circa $1.33bn had been traded on the CBN's OTC FX Futures contracts, across all tenors, with the profile of the buyers of the contracts including FPIs, Foreign Direct Investors, importers, among others. Trades executed by Access Bank PLC, Zenith Bank PLC and United Bank for Africa PLC made up the bulk of total value of open contracts, amounting to $463.15mm, $419.25mm and $109.46mm respectively. The tenors with the highest demand lie in the NGUS APR 26 2017, DEC 21 2016 and JUN 21 2017 contracts, with values recorded at $588.10mm, $186.08mm and $138.26mm respectively.

The first contract to mature, on July 27, 2016, was the NGUS JUL 27 2016 contract at $/₦279.00, totaling about $26.73mm, and was settled on FMDQ by the Clearing Agent, Nigeria Inter-Bank Settlement Systems PLC (NIBSS) on this date. Trading on this contract ceased on the Wednesday (July 20, 2016) immediately preceding the maturity date of the contract. The matured OTC FX Futures contract was valued at 12:00 noon against the Nigerian Inter-Bank Foreign Exchange Fixing (NIFEX) rate, to determine the final Settlement Amount, ₦962.23mm, paid to the 'Futures Banks' - the counterparties to the CBN.

The CBN has replaced the matured July 2016 contract and has now offered the new 12M NGUS JUL 19 2017 contract, with a total notional amount on offer of $1.00bn @ ₦250 to $1.

FMDQ, in its capacity as the market organiser, released the OTC FX Futures Market Framework and the OTC FX Futures Market Operational Standards during the month. These will help provide the market with clarity on the OTC FX Futures product and instill the requisite standards that market participants must adhere to in order to maintain the integrity of and ensure the success of the OTC FX Futures market.

FMDQ, as the market organiser and front-line regulator for the Nigerian fixed income, currency and derivatives markets, remains resolute in its drive to steer the Nigerian financial market through innovative and value-adding initiatives, towards being globally competitive, operationally excellent, liquid, and diverse.

Back to Top

FMDQ Holds Simulation and Sensitisation Sessions on new Trading System for the Nigerian Pension Industry

Following the execution of the Regulatory Supervision Collaboration Agreement between FMDQ and the National Pension Commission (PenCom or "the Commission"), towards a transparent and organised market for the pension industry, FMDQ and PenCom commenced in earnest, the operationalisation of some of the terms of the collaboration. Consequently, FMDQ proceeded to, in addressing the Commission's desire for more efficient and effective oversight of its supervisees, develop a Trading & Surveillance System to aid PenCom achieve this objective. Sensitisation and Simulation Sessions were held with PenCom, Pension Fund Administrators (PFAs), Closed Pension Fund Administrators (CPFAs), Pension Fund Custodians (PFCs) and FMDQ Dealing Member (Banks) with the aim of introducing the attendees to the System, PenDealer, the FMDQ-PenCom Automated Trading & Surveillance System. These Sessions also provided an opportunity to test the System in order to identify any issues encountered and proffer solutions to be incorporated.

The first Session, which held with the PFAs, CPFAs, PFCs and PenCom, took place on July 19, 2016 in Ikeja, Lagos and had in attendance a total of thirty (30) institutions, commenced with a Welcome Address by Mr. Ehimeme Ohioma, Head of Investment Supervision (PenCom). This was then followed by a presentation by FMDQ, which focused on the following areas:

- The Role of PenCom & FMDQ in creating an efficient and more transparent Market
- The proposed FMDQ-PenCom Automated Trading System (PenDealer) Market Structure
- The PenDealer Market Framework & Trading Standards

There was a Questions & Answers segment after the presentation, which helped participants further understand, among others, the market structure, trading standards and the expected rules that will guide market participation. This was followed by a Simulation Session where participants were given the opportunity to test the workings of the System and get a sense of what live trading would be like.

The following day, July 20, 2016, a similar Session was hosted by FMDQ for the Dealing Member (Banks), introducing them to the Market Framework, Trading Standards and Trading & Surveillance System.

FMDQ, as well as PenCom, are confident that this development will serve to change the face of the Nigerian financial markets from the buy-side perspective towards improved investor protection, increased market transparency and integrity of service, and fairer return on investments, ultimately developing the nation's economy.

Back to Top

FMDQ Hosts the International Monetary Fund

FMDQ welcomed representatives of the International Monetary Fund, accompanied by officials from the Federal Ministry of Finance, on a courtesy visit to the Exchange on Friday, July 22. The representatives of the IMF, led by Mr. Gene Leon, the Senior Resident Representative/Mission Chief, were received by the FMDQ team, led by Mr. Bola Onadele. Koko, the Managing Director/CEO.

The visit presented an opportunity for the IMF to understand FMDQ's role in the Nigerian financial market as well as its strategies for the development of the market. There were also discussions on FMDQ's ongoing market development initiatives, particularly in the FX market. FMDQ assured the IMF of its continuous commitment to the empowerment of the nation's financial market and the IMF, in return, committed to supporting FMDQ towards the achievement of this mandate.

Back to Top

FMDQ Turnover & Dealing Member (Banks)' League Table

The FMDQ OTC Market Turnover Report shows the turnover on all products traded on the FMDQ secondary market – Foreign Exchange (FX), Treasury Bills (T.bills), Bonds (FGN Bonds, other Bonds (Agency, Sub-national, Corporate & Supranational) & Eurobonds)) and Money Market (Repos/Buy-

Backs and Unsecured Placements/Takings). These figures exclude primary market auctions in T.bills and Bonds.

The data, collated from the weekly trade data submissions by FMDQ Dealing Member (Banks), represents trades executed amongst the Dealing Member (Banks), Dealing Member (Banks) & Clients, and Dealing Member (Banks) & the CBN.

FMDQ OTC Market Turnover (January - June 2016)

Product Category	Turnover (₦'mm)
Foreign Exchange	7,203,687
Foreign Exchange Derivatives	3,041,028
Treasury Bills	18,595,331
FGN Bonds	4,974,388
Other Bonds*	28,530
Eurobonds	25,834
Repurchase Agreements/Buy-Backs	13,771,231
Unsecured Placements/Takings	1,300,643
Money Market Derivatives	495
Total	**48,941,167**
USD equivalent (mm)	*232,400*
No. of Business Days	**125**
Average Daily Turnover	**391,529**
USD equivalent (mm)	*1,859*

mm - million
Note: USD/₦ @ 210.59
*Other Bonds include Agency, Sub-national, Corporate & Supranational Bonds
Note: Figures may be subject to change due to potential adjustments from Dealing Member (Banks)
Source: FMDQ Data Portal as @ July 7, 2016; Figures reported by Dealing Member (Banks) on a week-ending basis

The total turnover for the period January to June 2016 amounted to ₦48.94trn. Trading activities in T.bills contributed the largest to overall turnover, accounting for 38%, secured market transactions (Repos/Buy-backs) accounted for 27%, while FX market transactions accounted for 26%, FGN Bonds, 5% and Unsecured Placement & Takings, 4% of overall market turnover.

Back to Top

Top Ten (10) Dealing Member (Banks) in FMDQ Market (January - June 2016)

The FMDQ League Table shows the rankings of its top ten (10) Dealing Member (Banks).

RANK	DEALING MEMBER (BANKS)
1	ACCESS BANK PLC
2	DIAMOND BANK PLC
3	STANBIC IBTC BANK PLC
4	UNITED BANK FOR AFRICA PLC
5	FIRST BANK OF NIGERIA LIMITED
6	ECOBANK NIGERIA LIMITED
7	STANDARD CHARTERED BANK NIGERIA LIMITED
8	UNION BANK OF NIGERIA PLC
9	SKYE BANK PLC
10	GUARANTY TRUST BANK PLC

The top ten (10) Dealing Member (Banks) accounted for 70% (₦58.53trn) of the overall turnover in the market, with the top three (3) accounting for 40% (₦23.67trn) of this sub-section of the market. Access Bank PLC, Diamond Bank PLC and Stanbic IBTC Bank PLC maintained their positions as leaders for the 4th month running, ranking 1st, 2nd and 3rd respectively, in the value traded for the overall OTC market. However, Access Bank PLC moved a step up from 2nd to 1st place, pushing Diamond Bank PLC to 2nd place. Other institutions maintained their positions on the League Table with the exceptions of Standard Chartered Bank Nigeria Limited, moving a step up the League table from the 8th to the 7th position, Union Bank of Nigeria PLC, also moving a step up from the 9th to the 8th position and Skye Bank PLC, moving down two (2) steps from 7th to 9th place.

Back to Top

FMDQ Learning

Non-Deliverable Forwards: An Introduction

A company requiring a certain amount of foreign currency at a predetermined future date, faces the risk that the exchange rate may move in an adverse direction by the time the requirement falls due. In order to mitigate this risk, it can enter into an agreement called a Forward Contract (often referred to as a forward). A Forward Contract is an agreement to buy or sell an asset at a certain future time for a certain price[1]. In essence, the forward contract allows a company to buy the foreign currency at a specified point in the future, at a price fixed today. The company may, also enter into a Non-Deliverable Forward (NDF) contract.

An NDF, although broadly similar to a forward, is a cash-settled, short-term forward or futures contract where parties agree to a rate/price for a predetermined date in the future, without the obligation to deliver the notional amount on maturity. The NDF is settled at maturity for the difference in the Spot FX rate and the NDF rate. As settlement was done in cash, one party compensates the other with an amount reflecting the difference between the contracted forward rate and the value of the designated 'fixing' rate (the representative spot market rate), as is the case with the "Naira-settled OTC FX Futures" traded on FMDQ OTC Securities Exchange.

These contracts [Naira-settled OTC FX Futures] are NDFs where parties agree to an exchange rate for a predetermined date in the future, without the obligation to deliver the underlying US Dollars (the notional amount) on the maturity/settlement date. On the maturity date, it will be assumed that both parties would have transacted at the Spot FX market rate, which will be the FMDQ Spot FX Rate Benchmark -Nigerian Inter-Bank Foreign Exchange Fixing (NIFEX), an independent fixing of the inter-bank FX market, used for settlement.

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.

Uses of NDFs

- The demand for NDFs arises principally out of regulatory and liquidity issues in the underlying currency, where overseas players are essentially barred from access to the domestic market
- They are typically utilised by banks, multinational corporations, investment managers, and proprietary traders to hedge currency risk
- They are used in managing the currency risks associated with exporting or importing products purchased in foreign currency, investing or borrowing overseas, repatriating profits, or settling other FX contractual arrangements
- They are also used as a tool to facilitate locking in the enhance yields of currencies

Components to an NDF

- **Notional** – This is the face value of the NDF to be transacted
- **Fixing Date** – This is the date at which the difference between the prevailing Spot market exchange rate and the agreed upon NDF rate is calculated
- **Settlement Date** – This is the date on which the payment of the difference between the NDF and spot rate is paid
- **Effective Date** – This is the date when the NDF contract takes effect, usually the trade date
- **Maturity Date** – This is the date the contract expires

[1] John C. Hull ((2003) Options, Futures and Other derivatives (Fifth Edition)

Key differences between Non-Deliverable Forwards and Forwards

NDF contracts are similar to forward contracts, however, they do differ in some respects to forwards.

Table 1: Key differences between Non-Deliverable Forwards and Forward Contracts

S/N	Non-Deliverable Forwards	Forwards
1.	Margin required to be posted at contract initiation. The margin will require marking to market, with the winner's account being credited with the difference while the loser's account is reduced by same	No margin requirement posted. Contracts are settled at maturity and do not require marking to market or parties to the contract settling up until the expiration of the contracts
2.	There is no physical settlement of the asset at maturity	At maturity, the asset is physically settled
3.	The NDF market is regulated (usually by the government) and highly controlled	The forward market is typically not regulated

Key Benefits of NDFs

- There are no up-front costs
- They provide protection against unfavourable foreign exchange rate movements between the time an NDF contract is executed and the maturity date
- They are flexible and the maturity date and contract amount can be tailored to meet specific requirements
- They help improve planning and capital budgeting as companies can make forecasts on budgets and investments with a greater degree of certainty
- They improve management of foreign exchange risk as companies can hedge against cash flow shortfalls
- They increase predictability of financial results as hedging enables companies deliver more predictable earnings by aligning their corporate hedging strategy to future FX cash flows in order to reduce the impact of currency volatility
- They serve as hedging tools for foreign investors with local currency exposure, allowing corporates and other investors hedge or take investment positions offshore on local currency movements without actually dealing in the underlying

Risks associated with NDFs

- They are not perfect hedges against exposures, as any benefit of a favourable exchange rate movement, between the time the NDF is executed and the maturity date, may be foregone
- There is some exposure to counterparty and credit risks. In the event that a party to the contract is unable to perform their obligations under the NDF contract, the other party may be exposed to market exchange rate fluctuations as if the NDF contract was not executed
- There are charges for any cancellations or adjustments to the contract
- There is potential for limited liquidity in this specialised product

An NDF is indeed a useful risk management tool used to hedge currency fluctuations and should ideally be used where you have a genuine commercial need to manage currency risk associated with a particular currency pair and not for speculative purposes.

Back to Top