FMDQ

THOUGHT LEADERSHIP SERIES

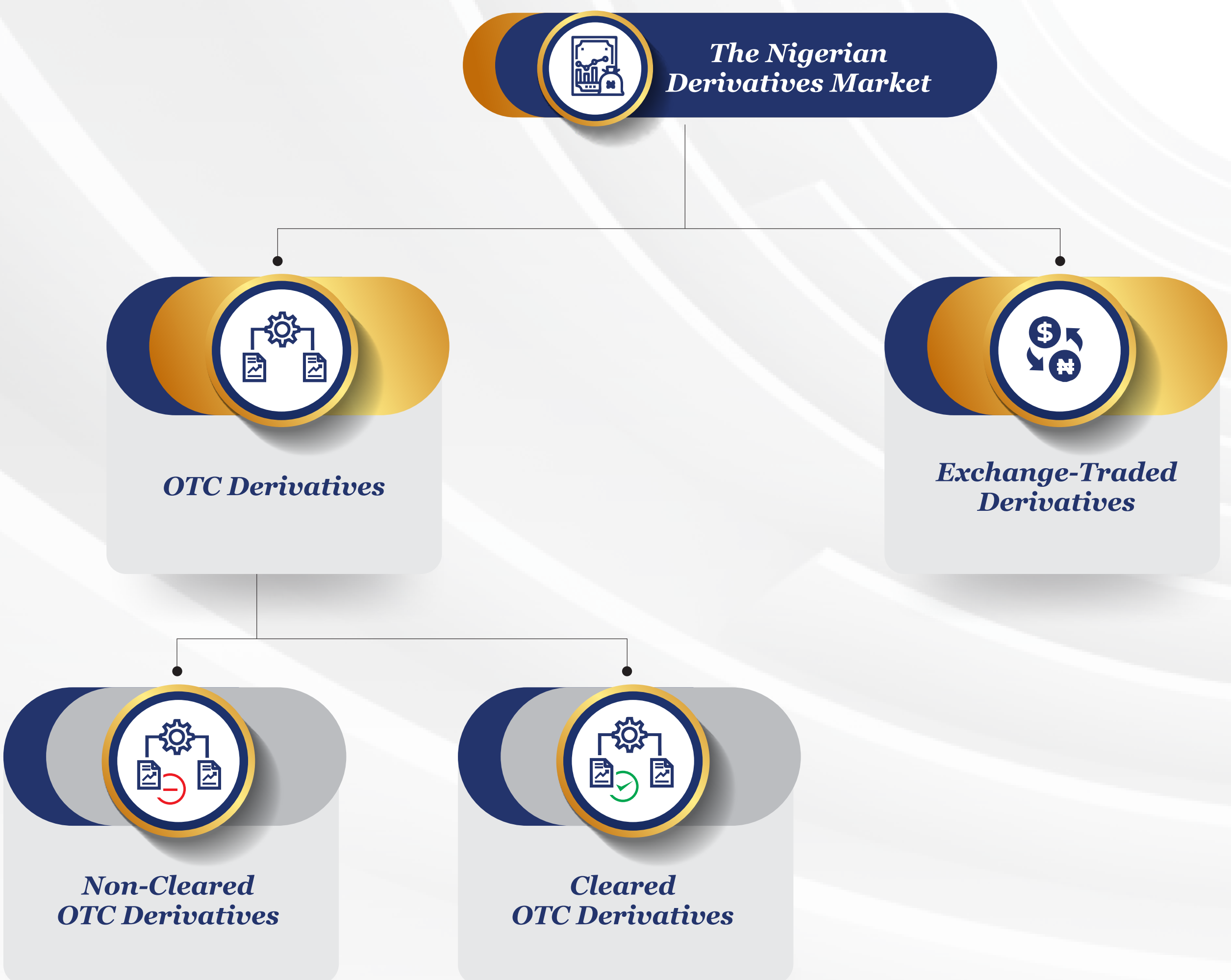
The Nigerian Derivatives Market PART 2

Structure of the Nigerian Derivatives Market

Globally, derivatives markets are divided into two major categories – *Over-the-Counter* ("OTC") *Derivatives* market and *Exchange-Traded Derivatives* ("ETD") market. While both market types are similar in some ways, including providing hedgers a means to manage their exposures and investors a means to express their views, they are different in several key areas (such as product customisation/standardisation and counterparty credit risk management).

Thus, the rest of this article will discuss the structure and operations of the different segments of the Nigerian Derivatives Market as depicted in *Figure 1* below.

Figure 1: *Structure of the Nigerian Derivatives Market*



OTC Derivatives Market in Nigeria

OTC derivatives are customised financial contracts which are traded directly between two (2) parties rather than through a securities exchange. Globally, OTC derivatives are offered in the form of forwards, swaps, options, or some combination of the aforementioned contract types.

As stated in the previous article, the Nigerian derivatives market is primarily an OTC market dominated by foreign exchange ("FX") derivatives. These transactions are typically executed bilaterally between market participants on the back of relevant agreements (such as the ISDA[1] Master Agreement). Banks, non-bank financial institutions ("NBFIs"), and large corporates are the main participants in this market segment.

The dominance of FX derivatives is understandable due to the heavy dependence on imports for the supply of goods[2] and services, as well as the fluctuation of the exchange rate of the Nigerian Naira against major foreign currencies in the FX market, as a result of volatility in FX supply. Hence, market participants rely on FX derivatives to mitigate FX risk.

I. Evolution of OTC Derivatives Regulations

Prior to the 2008/2009 global financial crisis ("GFC" or the "Crisis"), OTC derivatives markets were largely unregulated. Following the Crisis, however, the global financial market experienced the development of many new regulations impacting the operations of OTC markets generally. In Nigeria, the OTC derivatives market was not directly regulated before 2011, with its regulation in the banking industry being effected indirectly through prudential requirements such as the Foreign Exchange Net Open Position (long or short) Limit and Foreign Currency Trading Position Limit prescribed by the Central Bank of Nigeria ("CBN").

Though the Nigerian financial market was not directly impacted, the Crisis took on the peculiar characteristic of a banking crisis in the years that followed, as Nigerian banks had c. ₦1.60 trillion[3] exposure to both the oil and gas sector and the equity market (via margin lending).

The asset quality of Nigerian banks declined significantly as non-performing loans ("NPL") ratio of banks skyrocketed from c.3.70% at the end of 2008 to c.20.20%[4] by September 30, 2010, with attendant economic consequences.

This led to the introduction of long-term reform measures (the "Reforms") by the CBN with four (4) focus areas or pillars, namely: enhancing the resilience of banks, establishment of financial system stability, enabling healthy financial sector evolution, and ensuring that the financial sector contributes to the real economy. These Reforms were broad-based covering things such as products, practices, regulation, and supervision. One of the Reforms led to the release of the Guidelines for FX Derivatives and Modalities for CBN FX Forwards – January 2011 (superseded by the Guidelines for FX Derivatives in the Nigerian Financial Markets – March 2011[5]) (the "Guidelines"), in a move by the CBN to boost liquidity in the FX market and regulate the risk management products banks were allowed to trade and offer their clients.

[1]International Swaps and Derivatives Association
[2]Either finished goods for local consumption or intermediate goods as inputs for manufacturing
[3]https://www.cbn.gov.ng/out/speeches/2010/Gov_ATBU%20Convocation%20Lecture.pdf
[4]https://www.cbn.gov.ng/Out/2018/RSD/CBN%20EFR%20Volume%2055%20No%203%20September%202017%20-%20Draft%20for%20Upload.pdf
[5]https://www.cbn.gov.ng/OUT/2011/CIRCULARS/FMD/GUIDELINES%20FOR%20FOREIGN%20EXCHANGE%20DERIVATIVES%20IN%20THE%20NIGERIAN%20FINANCIAL%20MARKETS.PDF

These Guidelines represent the first comprehensive piece of regulation in the Nigerian derivatives market. Approved products per the Guidelines are as follows:

- FX Forwards (Outright and Non-Deliverable)
- FX Swaps
- Cross-Currency Interest Rate Swaps
- FX Options (European-styled) – *subject to the CBN's approval*

Subsequently, between 2015 - 2017, Nigeria experienced a severe FX crisis caused by a combination of a slump in crude oil prices and sharp reduction in the volume of crude oil produced, leading to five (5) consecutive quarters of economic contraction beginning in the first quarter of 2016. The impact of this FX crisis on the Nigerian financial markets and the economy in general led to revision of the structure of the inter-bank FX market in June 2016 on the back of the release of the Revised Guidelines for the Operations of the Nigerian Inter-Bank FX Market (the "Revised Guidelines"). The Revised Guidelines approved an additional hedging product – the Naira-settled OTC FX Futures ("OTC FX Futures").

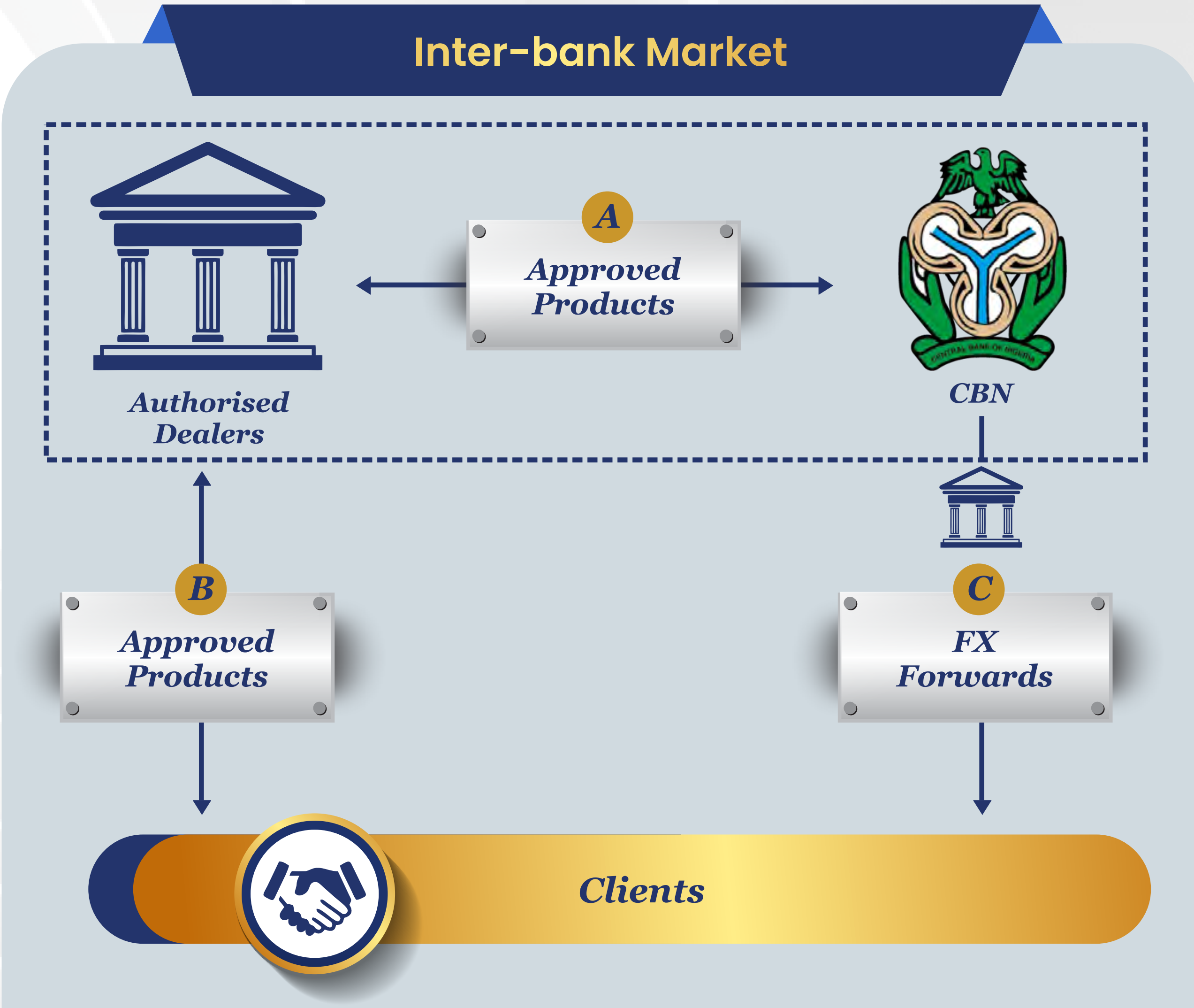
II. Non-Cleared OTC Derivatives

While the Guidelines approved products in the non-cleared segment of the OTC derivatives market in 2011, in 2016 the Revised Guidelines saw the introduction of the only cleared OTC derivatives in the Nigerian derivatives market today. This is in line with the continued evolution of the global derivatives market towards clearing of OTC derivatives transactions. While derivatives transactions in both segments are bilaterally executed, some features of cleared OTC derivatives are standardised and they are risk managed by a Clearing House or a Central Counterparty.

Currently, non-cleared OTC derivatives are legally executed using the standard or a variation of the 2002 ISDA Master Agreement and in strict compliance with the Guidelines. Transactions executed as FX Forwards and Swaps amongst banks, clients and the CBN are done using executed mandate letters confirming the relevant transactions on the back of executed Master Agreements. *Figure 2* shows a more detailed market structure of the non-cleared segment of the Nigerian OTC derivatives market.

Based on reported transactions for 2021, the value of contracts executed in the non-cleared segment of the OTC FX derivatives market was c.$60.56billion.

Figure 2: *Market Structure of the Non-Cleared OTC Derivatives Market*



A. *Bilateral negotiation and execution of derivatives transactions in some or all the Approved Products (listed below) between Authorised Dealers and the CBN*
   - *FX Forwards*
   - *FX Swaps*
   - *Cross-Currency Interest Rate Swaps*
   - *FX Options (European-styled)*

B. *Bilateral negotiation and execution of derivatives transactions in some or all the Approved Products between Authorised Dealers and their clients*

C. *One-way transactions with the CBN selling deliverable forwards with maturities ranging between 30 days to 12 months to clients through Authorised Dealers during intervention sales*

III. Cleared OTC Derivatives (The Naira-Settled OTC FX Futures Product)

The only cleared OTC derivatives product in Nigeria remains the OTC FX Futures product. The product was introduced in 2016 through a collaborative effort between the CBN and the then FMDQ OTC Securities Exchange, now FMDQ Securities Exchange Limited ("FMDQ Exchange" or the "Exchange"), to facilitate hedging of FX risk by market participants.

Given that the OTC FX Futures product is essentially a non-deliverable forward with some of the risk management features of a futures contract, it could perhaps also be termed an “Exchange-listed” OTC derivative. Some of the features of the OTC FX Futures market which bears semblance with standard exchange-traded derivatives include:

- ***Centralised listing:*** OTC FX Futures contracts are listed on FMDQ Exchange
- ***On-system trade execution:*** Trades in OTC FX Futures contracts are executed on the FFTRS[6]
- ***Risk management:*** Daily mark-to-market, margining, and settlement is carried out by FMDQ Clear Limited (“FMDQ Clear”)

Figure 3: *The OTC FX Futures Product – A Mixed Breed*

	Naira-Settled OTC FX Futures	Standard FX Futures	Standard FX Forwards
Listed and traded on an exchange	✓	✓	✗
Bilaterally negotiated and executed	✓	✗	✓
Standardised Quantity	✗	✓	✗
Standardised Tenor	✓	✓	✗
Margining and daily mark-to-market	✓	✓	✗
Novated by a Central Counterparty	✗	✓	✗
Bilateral counterparty risk	✓	✗	✓

[6] FMDQ Futures Trading and Reporting System

Currently, these OTC FX Futures contracts are legally executed on the back of relevant OTC FX Futures master agreements between the CBN, participating banks (known as Futures Banks) and FMDQ Exchange. Each Futures Bank then executes relevant master agreement with their clients.

Besides the differences highlighted in *Figure 3*, a key feature differentiating OTC FX Futures from standard exchange-traded Futures is a regulatory requirement for OTC FX Futures transactions purchased by clients of banks to be used strictly for hedging purposes i.e., the transaction must be backed by an eligible underlying transaction ("EUTs") (please see *Figure 4* for details of EUTs).

Figure 4: *Eligible Underlying Transactions in the OTC FX Futures Market*

Eligible Underlying Transactions

Visible Trade Transactions

- Trade obligations' arising from Letters of Credit and Bills for Collection

Invisible Trade Transactions

- Dividend payments
- Airline remittance
- "Miscellaneous Payments" as detailed in the CBN Foreign Exchange Manual

Foreign Portfolio Investments

- Portfolio investments in Fixed Income and listed/quoted equity securities
- Returns earned on such investments

Foreign Direct Investments

- Long-term investments (such as equity capital)
- Returns earned on such investments

Foreign Currency Loans

- Principal and interest obligations on FCY** loans (evidenced by a CCI***) and Write-offs or provisions on non-perfoming FCY loans

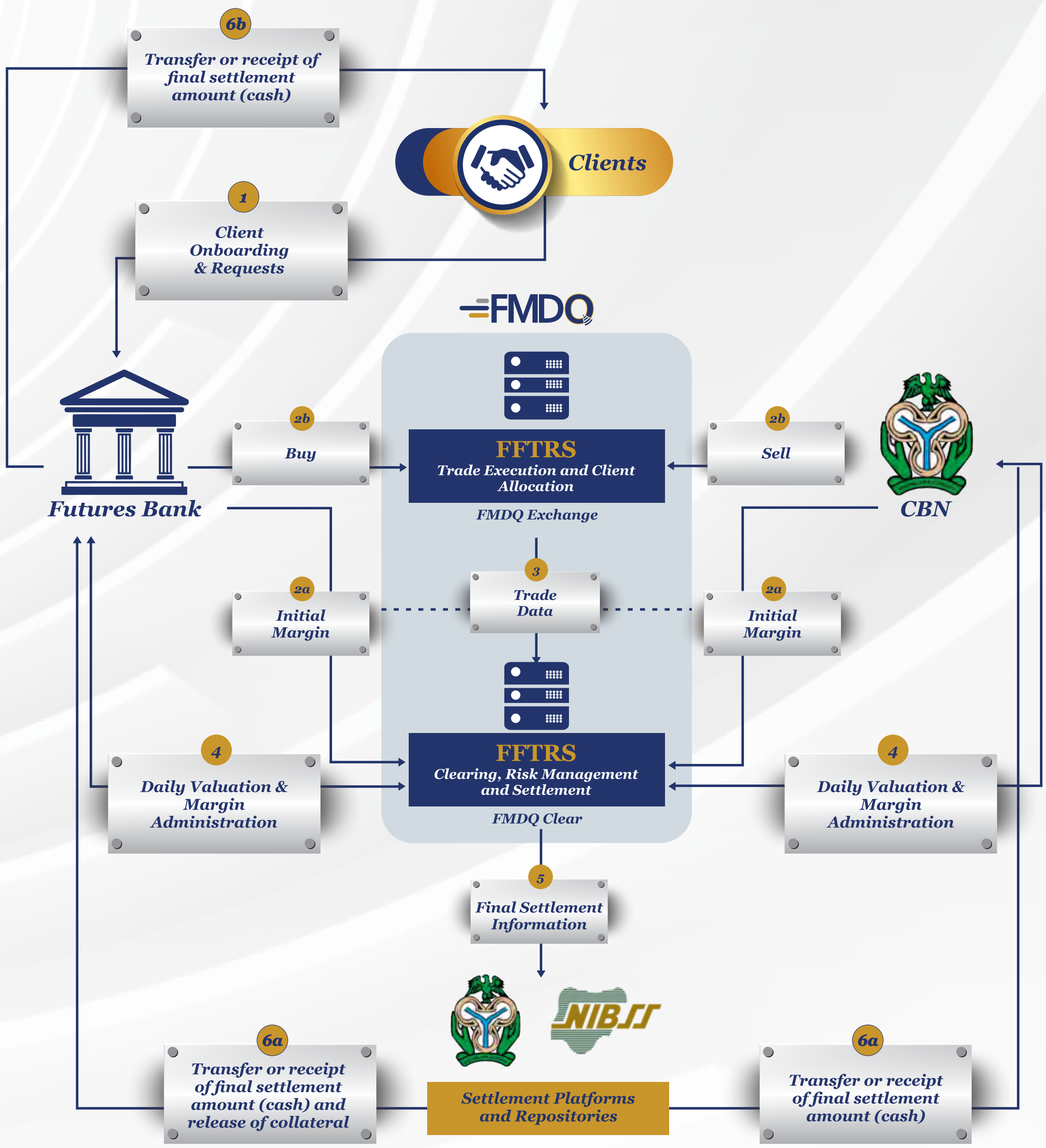
Others

- FX Forward agreements for importation of FCY into Nigeria at a later date
- Such other eligible transaction as may be permitted by the CBN

*All trade obligations from the purchase of items prohibited by the CBN from accessing the Nigerian FX market shall not be valid as EUTs for OTC FX Futures
**Foreign Currency
***Certificate of Capital Importation

Initiating a transaction in the OTC FX Futures market starts with an EUT. Clients with any of the EUTs in *Figure 4*, who seek to hedge their FX risk, will approach their Futures Bank with supporting documents, as applicable, to buy OTC FX Futures contracts with appropriate maturity. The Futures Bank then proceeds to buy OTC FX Futures contracts on the trading system (FFTRS) from the CBN to fulfil the client's request after collecting initial margin from the client and remitting same to FMDQ Clear. Following trade execution, FMDQ Clear values open positions daily to determine variation margins and prevent accumulation of losses. This continues till the expiry date of the contract. *Figure 5* below briefly summarises the transaction flow in the OTC FX Futures market today.

Figure 5: *Transaction Flow in the OTC FX Futures Market*



1. ***Client Onboarding and Requests:*** *Client approaches Futures Bank who carries out its Know-Your-Client ("**KYC**") procedures (including the onboarding of clients on FFTRS) and receives client's request to purchase OTC FX Futures contracts with EUTs*
2. ***Purchase of OTC FX Futures Contract***
   a. *Initial margin for client's order/request is determined and paid by the Futures Bank and CBN to FMDQ Clear*
   b. *Futures Bank buys an OTC FX Futures contract from the CBN for onward sale to client and/or for its own account on FFTRS, following which initial margin is immediately determined and paid by the Futures Bank and CBN to FMDQ Clear*
3. ***Trade Data Transfer:*** *Executed trade data flows to FMDQ Clear for administration till contract maturity*
4. ***Daily Valuation and Margining:*** *Daily valuation carried out by FMDQ Clear based on the Nigerian Autonomous Foreign Exchange Rate Fixing ("NAFEX") for the determination of variation margins*
5. ***Final Settlement Information:*** *Advice of final settlement amount by FMDQ Clear based on NAFEX and circulation of settlement advices*
6. ***Transfer/Receipt of Final Settlement Amount:***
   a. *Gain/(losses) are credited/debited into buyer/seller OTC FX Futures operating account with the Nigerian Interbank Settlement System ("NIBSS")*
   b. *Where trade is based on client's request, gain/(loss) is transferred to or received from client*

Exchange-Traded Derivatives Market in Nigeria

In concluding this article, the subject of the ETD market in Nigeria will be briefly introduced and thoroughly discussed in subsequent article(s) in the series.

ETDs are standardised financial contracts, mostly anonymously traded on established securities exchanges such as FMDQ Exchange. Globally, ETDs are offered in the form of futures, options, or some combination of both types of contracts with varying underlyings. Although, there is an increasing awareness and agreement amongst financial market participants on the need for an ETD market in Nigeria, efforts to develop ETD markets in Nigeria in the past has been ineffectual because of the absence of critical success factors such as laws, regulations, and market infrastructures.

Nigeria – the economically largest country in Africa – is still without a pure ETD product, while South Africa and Kenya remain the only countries on the continent with ETD markets. That said, it must be pointed out that the Nigerian financial markets received two (2) major stimuli that has supported the efforts of market operators championing the development of ETD market in Nigeria.

The first, a two-in-one regulatory stimulus, is the release by the Securities and Exchange Commission ("SEC") of two (2) sets of rules in December 2019 – Rules on the Regulation of Derivatives Trading and Rules on Central Counterparty ("CCP"); while the second, a legal stimulus, is the repeal and the re-enactment of the Companies and Allied Matters Act ("CAMA"), 1990 as CAMA 2020 in August 2020. While the rules released by the SEC provide the necessary regulatory framework for the broader application of derivatives beyond the FX market in Nigeria and the establishment of a CCP – a critical market infrastructure in the derivatives market, the inclusions of netting and bankruptcy remoteness provisions in CAMA 2020 addressed deficiencies in the legal framework of the Nigerian financial market, thus ensuring the enforceability of transaction arrangements and agreements in liquidation. These two stimuli are expected to make the Nigerian financial system more attractive and serve as springboards for continued and accelerated growth of the economy at large.

Ongoing efforts to introduce pure ETD products and launch an active and viable ETD market in Nigeria by FMDQ Exchange will be discussed later in this series.

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