How the Cleared Naira-Settled Non-Deliverable Forwards Market works on FMDQ Securities Exchange Limited

FMDQ Securities Exchange Limited

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Cleared Naira-Settled Non-Deliverable Forwards ("Cleared USD/NGN NDFs")

The Cleared USD/NGN NDFs are non-deliverable forwards (i.e. a contract 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[1] 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 Cleared USD/NGN NDFs.

Settlement Amount = (Difference between the Agreed Rate and NAFEX Spot on the Expiry Date) x Notional Contract Sum

The Spot FX Rate is the FMDQ Spot FX Rate Benchmark - Nigerian Autonomous Foreign Exchange Rate Fixing ("**NAFEX**[2]") which is an independent fixing of the inter-bank FX market. The Cleared USD/NGN NDFs contract is an effective exchange rate management tool supported by a transparent price driven two-way quote (2WQ) market.

All Cleared USD/NGN NDFs are trade-backed. Visible, invisible and evidenced investments qualify for Cleared USD/NGN NDFs.

Cleared USD/NGN NDFs Contracts Trade Flow

FMDQ Securities Exchange Limited ("**FMDQ Exchange**" or the "**Exchange**") acts as the market organizer and FMDQ Clear Limited ("**FMDQ Clear**") clears the Cleared USD/NGN NDFs i.e. collects initial and variation margins and settles the party to compensate on the expiry date.

All trading of Cleared USD/NGN NDFs contracts are executed on the FMDQ (Cleared Naira-Settled Non-Deliverable) Forwards Trading & Reporting System ("**FFTRS**").

[1] Foreign Exchange

[2] NAFEX represents the daily average of the prevailing spot market rate at mid-day at which the US Dollar (USD) is traded against the Nigerian Naira (NGN) in the Nigerian Autonomous Foreign Exchange Market ("**NAFEM**").

Trading (FMDQ Securities Exchange Ltd)

- NDFs Contracts executed on FMDQ Forwards Trading & Reporting System (Order Book)
- CBN publishes Cleared Naira-Settled Non-Deliverable Forwards rates on the FMDQ System
- FMDQ determines the Initial[1] and Maintenance[2] Margins and update on the System
- Dealing Member (Banks) input orders on the FMDQ System
- FMDQ System matches orders

Margin Management (FMDQ Clear Ltd)

- Variation[3] Margins determined from daily Mark-to-Market (MTM) by FMDQ Clear
- NAFEX used for Daily MTM
- FMDQ Clear determines margin call amounts
- FMDQ advises margin calls to Dealing Member (Banks)

Settlement (FMDQ Clear Ltd)

- Contracts matures
- FMDQ Clear based on NAFEX determines the final settlement amount
- Gain/(Loss) credited/debited into buyer/seller Cleared Naira-Settled Non-Deliverable Forwards Operation Accounts with NIBSS
- FMDQ Clear generates and circulates settlement advices

Note:
Tenor *– 1M, 2M, 3M, 6M, 9M, 12M, 13M, 24M, 36M, 48M and 60M (M – Month)*

1. *Initial Margin - Amount paid by the parties to cover the counterparty risk, based on the estimated volatility*
2. *Maintenance Margin – Minimum amount that must be maintained in a margin account*
3. *Variation Margin - Additional funds that must be deposited to balance up to the initial margin requirement*

Benefits of the Cleared Naira-Settled Non-Deliverable Forwards

- The introduction of the Cleared Naira-Settled Non-Deliverable Forwards market encourages end-users to spread out their demand for Spot FX deals as they are now able to lock down the exchange rates for future FX requirements. This has the potential to eradicate the constant front-loading of FX requirements and minimise the disequilibrium in the Spot FX market. End-users will make better judgement as to the timing of accessing the Spot FX market
- The availability of the Cleared Naira-Settled Non-Deliverable Forwards improves the business planning practice of end-users and FX sellers, as the future exchange rate is guaranteed through the Cleared Naira-Settled Non-Deliverable Forwards
- An end-user (buyer of USD) may consider it wiser to delay the purchase of its USD requirement in the Spot FX market if the Spot FX rate is higher than the Cleared Naira-Settled Non-Deliverable Forwards rate of a particular tenor. The end-user will borrow USD or obtain trade finance and simultaneously hedge its exchange rate exposure with an attractive Cleared Naira-Settled Non-Deliverable Forwards contract sold by the CBN. Upon maturity of the Cleared Naira-Settled Non-Deliverable Forwards contract, the end-user will access the Spot FX market
- The Cleared Naira-Settled Non-Deliverable Forwards are used to attract significant capital flows to the Nigerian fixed income and equity markets as returns are enhanced as FX exposures are hedged. Foreign Portfolio Investors (FPIs) are able to use the Cleared Naira-Settled Non-Deliverable Forwards for capital protection
- The envisaged increase of supply of US Dollars due to the Cleared Naira-Settled Non-Deliverable Forwards offered by the CBN in the Spot FX market causes the Spot FX rate to moderate

- Cleared Naira-Settled Non-Deliverable Forwards which are non-deliverable are ideal for FPIs and even Foreign Direct Investors (FDIs). Cleared Naira-Settled Non-Deliverable Forwards are used when the investor wants to hedge the exchange rate risk without interest in buying outright Forwards which necessitates liquidation of its investment to pay for outright Forwards
- Banks increase the liquidity in the Cleared Naira-Settled Non-Deliverable Forwards market (by selling Cleared Naira-Settled Non-Deliverable Forwards) when the $/₦ Spot FX rate starts dropping. This causes the Spot FX rate to drop further

Settlement Analysis for Cleared Naira-Settled Non-Deliverable Forwards Contracts

****For Illustration Purposes Only****

Day 1: September 1, 2018 - Bank A buys a 3-month Cleared Naira-Settled Non-Deliverable Forwards contract from the CBN on the FFTRS with the following details:

- Buyer: Bank A
- Seller: CBN
- Notional amount: $1,000,000.00
- Cleared Naira-Settled Non-Deliverable Forwards Rate: $/₦360.00
- Benchmark: NAFEX
- Expiry Date: November 28, 2018
- Initial Margin: 5% (payable by both parties)
- Maintenance Margin: 3.75% of Initial Margin
- Settlement Currency: Naira

The Cleared Naira-Settled Non-Deliverable Forwards contract will be valued on a daily basis against the NAFEX to determine variation margin obligations.

Expiry Day: November 28, 2018 - NAFEX is $/₦362.00

It is assumed that Bank A would have transacted (bought USD in the Spot FX market) at $/₦362.00 which is higher than the Cleared Naira-Settled Non-Deliverable Forwards contract rate of $/₦360.00.

The Clearing Agent, FMDQ Clear, will pay Bank A ₦2,000,000.00 (i.e. ₦2.00 [₦362.00-₦360.00] per USD) thereby bringing Bank A's effective rate to $/₦360.00 (₦362.00 assumed paid in buying USD less ₦2.00 received on the Cleared Naira-Settled Non-Deliverable Forwards) which is the Cleared Naira-Settled Non-Deliverable Forwards rate.

CBN is assumed to have transacted (sold USD in the Spot FX market) at $/₦362.00 which is higher than the Cleared Naira-Settled Non-Deliverable Forwards contract rate of $/₦360.00.

FMDQ Clear (the Clearing Agent), will take ₦2,000,000.00 (i.e. ₦2.00 per USD) from the margin account of the CBN thereby bringing CBN's effective rate to $/₦360.00 (₦362.00 assumed received in selling USD less ₦2.00 paid out on the Cleared Naira-Settled Non-Deliverable Forwards) which is the Cleared Naira-Settled Non-Deliverable Forwards rate.

Both parties end up with an effective rate of $/₦360.00 as this was the guaranteed rate for both parties. If NAFEX had been $/₦358.00 on maturity date, Bank A would pay CBN ₦2.00 per USD.