How the Naira-Settled OTC FX Futures Market works on FMDQ Securities Exchange Limited

FMDQ Securities Exchange Limited

February 13, 2020

Naira-settled OTC FX Futures

The Naira-settled OTC FX Futures ("**OTC FX Futures**") 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 OTC FX Futures.

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 OTC FX Futures contract is an effective exchange rate management tool supported by a transparent price driven two-way quote (2WQ) market.

All OTC FX Futures contracts are trade-backed. Visible, invisible and evidenced investments qualify for OTC FX Futures.

Naira-settled OTC FX Futures Contracts Trade Flow

FMDQ Securities Exchange Limited ("**FMDQ Exchange**" or the "**Exchange**") acts as the 'Futures Exchange' and FMDQ Clear Limited ("**FMDQ Clear**") clears the inter-bank OTC FX Futures i.e. collect initial and variation margins and settle the party to compensate on the expiry date.

All trading of OTC FX Futures contracts are executed on the FMDQ Futures Trading & Reporting System ("**FFTRS**").

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[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 Investors' & Exporters' FX Window.

Trading (FMDQ Securities Exchange Ltd)

- Futures Contracts executed on FMDQ Futures Trading & Reporting System (Order Book)
- CBN publishes OTC FX Futures 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 OTC FX Futures 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 Naira-settled OTC FX Futures

- The introduction of the OTC FX Futures 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 OTC FX Futures improves the business planning practice of end-users and FX sellers, as the future exchange rate is guaranteed through the OTC FX Futures
- 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 OTC FX Futures 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 OTC FX Futures contract sold by the CBN. Upon maturity of the OTC FX Futures contract, the end-user will access the Spot FX market
- The OTC FX Futures 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 OTC FX Futures for capital protection
- The envisaged increase of supply of US Dollars due to the OTC FX Futures offered by the CBN in the Spot FX market causes the Spot FX rate to moderate
- OTC FX Futures which are non-deliverable are ideal for FPIs and even Foreign Direct Investors (FDIs). OTC FX Futures 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 increases the liquidity in the OTC FX Futures market (by selling OTC FX Futures) when $/₦ Spot FX rate starts dropping. This causes the Spot FX rate to drop further

Settlement Analysis for Naira-settled OTC FX Futures Contracts

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

Day 1: September 1, 2018 - Bank A buys a 3-month OTC FX Futures contract from the CBN on the FFTRS with the following details:

- Buyer: Bank A
- Seller: CBN
- Notional amount: $1,000,000.00
- OTC FX Futures Rate: $/₦360.00
- Benchmark: NAFEX
- Expiry Date: November 28, 2018
- Initial Margin: 5% (payable by both parties)
- Maintenance Margin: 75% of Initial Margin
- Settlement Currency: Naira

The OTC FX Futures 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 OTC FX Futures 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 OTC FX Futures) which is the OTC FX Futures rate.

CBN is assumed to have transacted (sold USD in the Spot FX market) at $/₦362.00 which is higher than the OTC FX Futures 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 OTC FX Futures) which is the OTC FX Futures 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.