



Central Bank of Nigeria

GUIDELINES FOR FX DERIVATIVES IN THE NIGERIAN FINANCIAL MARKETS

March, 2011

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FINANCIAL MARKETS DEPARTMENT

GUIDELINES FOR FX DERIVATIVES IN THE NIGERIAN FINANCIAL MARKETS

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1.0 Introduction

Development of the Nigerian financial markets and assurance of financial system stability are two of the four reform pillars of the Central Bank of Nigeria (CBN). The CBN has therefore articulated various financial markets reforms after a series of sensitisation workshops with market operators. The reforms cover products, practices, regulation and supervision. The objective of the CBN is to make our financial markets global, organised, liquid and diversified. The development of the financial markets will enhance the transmission of monetary policy and minimize risk to financial system stability.

In support of the various initiatives led by the Authorised Dealers, over the years, in deepening the Nigerian inter-bank foreign exchange market, the CBN is releasing these guidelines on risk management products Authorised Dealers are allowed to offer to their customers and the modalities under which the CBN intends to boost the trading liquidity in these products.

The Authorised Dealers are expected to be professional in their conduct in ensuring the efficient operations of the FX market. It is imperative to mention that the FX market is under the CBN jurisdiction and Authorised Dealers should avoid causing a shutdown of the market for any reason. Also, unprofessional conduct by the staff of the Authorised Dealers shall not be tolerated.

2.0 Approved Products

The approved hedging products are FX Options, Forwards (Outright and Non-Deliverable), FX Swaps and Cross-Currency Interest Rate Swaps. Notably, Authorised Dealers are now allowed to offer European-styled FX call and put option contracts to their customers and in the inter-bank market. The CBN shall grant approvals for Authorised Dealers that qualify to engage in Options. Details on the approval process shall be released in due course. All hedge transactions with the customers must be backed by trade (visible and invisible) transactions.

3.0 Prudential Guidelines on FX Options

The Financial Policy & Regulation and Banking Supervision Departments of the CBN will be developing detailed prudential guidelines on FX Options. These will cover qualifying criteria, limits, capital adequacy charge, spot-hedge position limits (in the absence of a developed inter-bank options market), accounting, returns, staffing requirements, market risk management standards, internal controls standards, etc. Authorised Dealers shall apply to the Banking Supervision Department for approvals to deal in FX Options after which they shall be required to make presentations to the CBN. This presentation shall cover: strategy, treasury competence, trading systems, market risk management, internal controls, etc.

4.0 FX Forwards (Outright and Non-Deliverable)

Outright FX transactions have always been approved by the CBN. In order to provide hedging opportunities for customers (investors) with long-term perspectives and providing customers with a choice as to where to bank and where to hedge, the CBN is now allowing Non-Deliverable Forwards (NDFs). All hedge transactions with the customers must be backed by trade (visible and invisible) transactions. All settlements of NDFs shall be in Naira.

The maximum tenor allowed for FX Forwards and by implication FX Swaps and Cross-Currency Interest Rate Swaps is now extended to five (5) years. Authorised Dealers may seek specific approval for longer tenors.

As the NDFs will require benchmarks for settlement, the FMDA is expected to ensure appropriate governance over the inter-bank spot market.

5.0 Trading Liquidity in Cross-Currency Interest Rate Swap (CCIRS)

With the anticipated external interest in financing infrastructural gaps in Nigeria, the CBN is supporting the Authorised Dealers with CCIRS trading liquidity. The CBN shall be willing to provide hedges for CCIRS to support projects with long-term foreign exchange exposure. All CCIRS requests to the Financial Markets Department (FMD) of the CBN shall therefore be project-backed. The FMD shall issue detailed guidelines on the CCIRS structures offered by the CBN. Until otherwise determined, the CBN shall not deal in synthetic CCIRS and therefore principal amounts of the currencies (Naira and US Dollar) will have to be exchanged.

6.0 Trade-Backed Requirement

The CBN objective for boosting the trading liquidity in the FX derivatives market is to offer risk management support to the exchange rate risk exposures of the end-users. Therefore, Authorised Dealers are to ensure that their customers are hedging trade (visible and invisible) -related foreign exchange exposures in their obligations and not speculating on the Naira.

The minimum trade documents that a end-user shall present before it can engage in a derivative trade are:

-Visible Trade:

- Form M
- Pro forma Invoice
- Managing Director/Chief Executive and Chief Finance Officer's Statement of Provisional Eligible Transaction

-Invisible Trade:

- Form A
- Demand Note/Invoice (as appropriate)
- Agreement/Certificate of Capital Importation/Official Documentary Proof (as appropriate)
- Managing Director/Chief Executive and Chief Finance Officer's Statement of Provisional Eligible Transaction

For enhanced market liquidity, Authorised Dealers can engage in the approved FX derivatives products with their customers and other Authorised Dealers.

To encourage competitiveness in the pricing of the hedging products, end-users will be allowed to execute their hedging transactions where they receive the best prices/rates and are not compelled to hedge with the Authorised Dealer holding their trade documents.

Authorised Dealers holding an end-user's trade documents will send written confirmations on the end-user's trade documents in its possession to another Authorised Dealer that intends to hedge the end-user (i.e. hedging Authorised Dealer).

This confirmation to the hedging Authorised Dealer will be at the request of the end-user to the Authorised Dealer in possession of the documents. A copy of the request will be forwarded by the end-user to the hedging Authorised Dealer. Authorised

Dealers in possession of trade documents must not delay the confirmation of the trade documents in their possession to the hedging Authorised Dealers.

7.0 Accounting & Market Valuation Methodologies

Authorised Dealers will be required to maintain confirmations of all their transactions in FX derivatives and record same in their books as off-balance sheet ledger entries. Authorised Dealers are expected to carry-out daily valuations of their positions in all the FX derivatives applying mark-to-market or mark-to-model methodology.

8.0 Financial Statements and Returns

All FX derivatives will be recognised as off-balance sheet exposures in their financial statements and CBN returns. The Banking Supervision Department shall review the set of returns submitted by the Authorised Dealers and may request additional returns to capture all hedged and un-hedged foreign exchange exposures.

9.0 Supremacy of the Guidelines

These Guidelines supersede the Guidelines for FX Derivatives and Modalities for CBN FX Forwards dated January 2011.

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