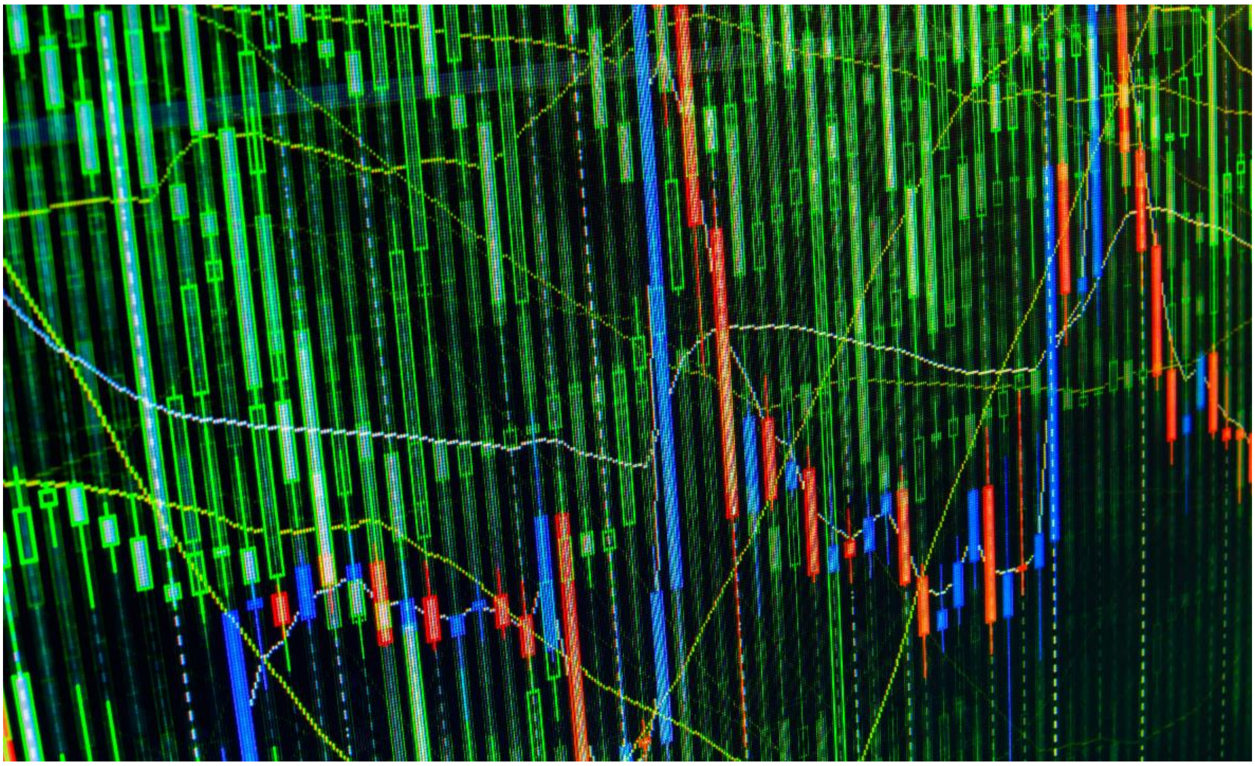

CBN Naira settled OTC FX futures market

Implications for your business

OTC FX Futures contracts qualify as derivative instruments under IAS 39. Accordingly IAS 39 require derivatives that are not designated as hedging instruments to be classified at Fair value through profit or loss.

The Governor of the central Bank of Nigeria (CBN) on Wednesday, 15 June, 2016 announced the adoption of a flexible exchange rate finally placing a lid on months of expectation and intense FX pressure in the economy.

A key provision of the new policy saw the emergence of a redefined Naira settled OTC FX futures market which kicked off activities this week.

Other provisions of the policy include:

- Corporate demand for FX are to be obtained at the interbank market which is now to be known as the Nigeria Interbank Foreign Exchange Market (NIFEX)
- Introduction of a full fledge single window for forex market replacing the initial limited window for critical transactions
- Registration of primary FX dealers to deal directly with the

CBN and other authorized dealers for large deal sizes

- Introduction of a two way quote via the FMDQ Thomas Reuters FX trading systems
- Possibility of CBN offering long tenured FX forwards which will create the much needed depth in the market

General policy implications

- The policy at initial application is a technical devaluation of the Naira as the currency exchange rate is now going to be largely determined by market forces based on the combined effect of the activities of NIFEX and OTC futures market
- Market driven FX rate is expected to free hoarded FX for the interbank market
- In the immediate term to medium term rates may appear high but a surge in the supply of foreign exchange following CBN's intervention may moderate rates
- There may be a near convergence between the parallel market and the official segments of the foreign exchange markets which in this case NIFEX, thus eliminating the incidence of round tripping and arbitrage
- The policy may stimulate growth in the capital market through increased foreign portfolio investments
- The appointment of FX dealers for the first time is expected to boost FX liquidity and deepen the interbank FX market
- Flexible exchange rate regime as well as introduction of long tenured FX forwards will encourage foreign direct investment as companies could hedge against future dollar needs
- Capital importing entities may be encouraged to bring in capital from their parent companies
- Likelihood of increased export of local products resulting in higher income from export proceeds for the banks
- Sustained rise in Letters of Credit (LCs) arising from high import volumes of petroleum products and other critical sectors
- Exports and remitters will be encouraged to sell their proceeds/funds at the interbank market

Specific OTC FX Futures Implications

1. The Naira-settled 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 foreign currency (notional amount) on the maturity date i.e. the settlement date). On the maturity date, both parties will transact on the settlement date at the forward rate agreed initially. The party that would have suffered a loss with the spot FX rate will be paid a settlement amount in Naira

2. A key advantage of the OTC FX Futures exchange is the fact that it gives players the ability to spread out their future FX demand which is based on future spot FX rates by being able to lock down those future FX need right now. It therefore creates the much needed flexibility in business decisions. Currency Forward contracts eradicates the uncertainties that were hitherto faced by corporates with respect to transactions with FX coloration.

   Entities are able to conveniently determine when to access the spot FX market and safely cut out variability in the FX market.

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3. It is important to note now that there are currently two FX markets. The Spot FX market and the Futures FX market. Entities can now compare rates in these two markets and make informed decisions based on the one that is more attractive. For example assuming the current 3months OTC FX futures rate is $/N270 and the current FX spot rate is $/N283. The entity can borrow dollar now for its transaction and simultaneously enters the OTC Futures market as a buyer for a duration of 3months which basically is hedged against the dollar amount borrowed at the spot rate of $/N283. At maturity, if the spot rate is now $/N285, the buying entity has succeeded in transacting its dollar business at N270 instead of N283 irrespective of what the current exchange rate is (assuming zero interest rate on dollar borrowed).

As the market become very active the Spot FX rate may come very close to very short term FX Futures rate like the one (1) month Futures rate

4. In simple terms when entities heavy in commodity transactions envisage an increase in the value of foreign exchange currency, they can buy FX in the futures market. In the same vein when they envisage a decrease in the value of the foreign currency in the futures market, they will sell FX in the futures market

5. Furthermore, using the OTC Futures market, entities are expected to regularly monitor the market and should exploit the opportunities that would arise when the market is perceived to be in normal Contango or backwardation as the case may be. Entities can then buy or sell FX forwards when they perceive that the market will be in normal Contango/normal backwardation (the futures price will be higher/lower than expected spot price)

6. Currently based on the OTC Futures quote for 6months, 9months and 12months the bias is that Naira is going to gain significantly against the dollar in the comings months.

Backwardation – Negative trend term structure. Futures prices are lower than the current spot price
Contago – Positive slope term structure. Futures prices are above the spot price

Settlement

The Nigeria Inter-Bank Settlement System Plc (NIBSS) will be responsible for clearing all transactions Inter-bank OTC FX futures. NIBSS collects initial and variation margins to be posted at various times over the life of the futures contract and settle the party to be compensated on the maturity date

Accounting implications

1. **Recognition**
OTC FX Futures contracts qualify as derivative instruments under IAS 39. Accordingly IAS 39 require derivatives that are not designated as hedging instruments to be classified at Fair value through profit or loss. The implication of this is that fair value changes resulting from mark to market gains and losses will be recorded in the entity's income statement. At the contract initiation the value of a futures contract is zero. Subsequently, the value will either become an asset or a liability depending on the performance of the futures as it is marked to market on the exchange. Consequently all participating entities in the futures exchange must either have a derivative asset or liability at each reporting date if the futures is yet to mature

At each reporting date an entity must determine the current fair value of all instruments it has classified at fair value through profit or loss.

2. **Measurement**
At each reporting date an entity must determine the current fair value of all instruments it has classified at fair value through profit or loss. For instruments that have no market, the entity must determine fair value using a valuation technique. Futures are exchange traded and as such already have a market where its fair value is determined unlike Forward contracts. Since futures are marked to market it is expected that it would be marked to market against the futures price in the market that has the same tenor as the futures contract in the books. Where the mark to market is against the NIFEX FX spot price as it's currently practiced in the Nigerian case, for the purpose of IFRS 13 fair value measurement, the entity must determine its fair value for any active futures derivative by bench marking against a current futures price with same tenor in the Futures exchange and not the NIFEX market. The implication of this is that entities may still have additional adjustments to profit or loss if the current futures price differ from the Spot FX rate at the reporting date

3. **Policies and procedures**
Entities who will be participating in the OTC FX market are therefore expected to review their FX and financial instruments policies in line with applicable IFRS standards and regulatory and compliance requirements. Accounting procedures must now reflect activities such as margin postings, marking

to market and approval processes/limits

4. **Disclosures**
As required by IAS 1 significant accounting policies will have to be updated in the financial statement to capture these new contracts. Other relevant disclosures such as fair value hierarchy of the instruments, notes to the accounts relating to the derivative asset or liability and IFRS 7 risk management will have to be revised and updated. Particularly, entities must have robust disclosures on how risks arising from holding these instruments are managed. Also if these instruments are being used as hedging instruments (even if the arrangement do not qualify for hedge accounting) entities must disclosures the risk strategies around this. Sensitivity analysis and other market analytical tools will be needed to fully capture IFRS 7 disclosure requirements in this regard

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