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Client Alert

Significant Progress Made Towards Unifying FX Markets in Nigeria

*On 14 June 2023, the Central Bank of Nigeria (CBN) issued a press release notifying all authorised dealers and the general public of operational changes to the foreign exchange market (the "**CBN Press Release**"). The operational changes appear to unify the market and enable the Naira to trade freely based on market forces. Prior to now, the CBN had maintained a fixed exchange rate regime, artificially preserving the value of the Naira at a specific rate and obligating banks and the public to conduct foreign exchange transactions at that rate, which did not accurately reflect the real market conditions. This in itself would not have been an issue (as many countries operate a fixed exchange rate regime) if CBN had been able to supply the official market with enough foreign currency to meet demand at that fixed rate. This fixed exchange rate system combined with an expanded list of ineligible transactions led to the expansion of the alternative or parallel foreign exchange market where the Naira was traded freely based on the interplay of supply and demand forces with a resulting wide disparity between the official rate and the alternative market.*

This client alert outlines the key changes set out in the Press Release and describes the potential impact on the market.

Elimination of Differentiated Exchange Windows

Previously, the CBN had created a number of foreign exchange windows, such as the Special Secondary Market Intervention Sales (SMIS) window[1] and the Small and Medium Enterprises window[2], to provide access to foreign exchange at different CBN fixed rates.

The CBN Press Release eliminates these windows in a clear move towards unification and a market-determined exchange rate. Now, foreign exchange trades are all mandated to occur through the Investors and Exporters (I & E) Window at a rate determined by economic forces and under a willing buyer willing seller model.

[1] This window was dedicated to the importation of raw materials and machines, agriculture, airlines, and petroleum products; invisible windows to cater to the procurement of foreign exchange for business and personal travel allowance, school fees, hostel allowance etc.
[2] This window was for trade for small scale imports.

Back to the "Willing-buyer, Willing Seller" Model

The CBN Press Release reverts to the "willing-buyer, willing-seller" model thereby reinforcing the original objective of the I & E Window (established in 2017), which was to promote trade liberalization and foreign investment in Nigeria. Originally, exchange rates were intended to be agreed between authorized dealers and their counterparties in the wholesale market, following the principle of willing buyer and willing seller. Subsequently however, the CBN required banks to transact only at its official market rate. The inevitable effect of having to adhere to an artificial rate that was not underpinned by a continuous supply of foreign exchange to meet the demand at that rate was the expansion of the alternative market and a growing gulf between the official rate and the prevailing market rate at which foreign exchange was available at that market.

Standardized Rate for Government-related Transactions

While the CBN Press Release effectively floats the Naira and establishes a single applicable exchange rate, it has retained a mechanism to determine a standardized exchange rate for government-related transactions. This rate will be based on the weighted average of the preceding day's executed transactions at the I & E window, limited to two decimal places.

By accessing foreign exchange at an average of market exchange rates, weighted by transaction volumes, the government is hoping to mitigate the risks associated with exchange rate volatility on government transactions.

Reintroduction of the Order Book

To ensure transparency, allow market depth visibility, price discovery, and efficient order matching and execution, the CBN Press Release reintroduces the Order Book[3] for foreign exchange trading. This reinstatement will, at a minimum, facilitate the seamless execution of trades.

Proscription of Trading Limits on Oversold FX positions

The CBN Press Release introduces changes to hedging foreign exchange by prohibiting trading limits on oversold FX positions, allowing hedging of short positions with OTC futures and reducing overbought positions to zero. The prohibition of trading limits and enabling of short terms hedges with OTC futures allows the authorized dealers more flexibility in managing their FX positions.

Reintroduction of Order-based Two-way Quotes

Under the revised system, market participants, including licensed banks and end-users, will provide buy and sell orders with specified quantities and desired prices for transactions. These quoted prices will represent the highest price a buyer is willing to pay and the lowest price a seller is willing to sell. In determining the final exchange rate, the Circular prohibits Nigerian banks from charging a spread above NGN1.00, ensuring that banks do not impose excessive spreads that could negatively impact the market.

In addition, all transactions will now be cleared by a Central Counter Party (CCP) to reduce operational or settlement risks. Entities such as NG Clearing Limited and FMDQ Clear Limited are expected to play significant roles in foreign exchange transactions going forward.

[3] This is an electronic list of buy and sell orders for a specific financial instrument (in this case currency). The Order Book System displays buy and sell orders, with their corresponding prices and quantities, enabling market participants to access supply and demand dynamics and make informed decisions.

Cessation of the RT 200 Rebate Scheme and the Naira4Dollar Rebate Scheme

The CBN has discontinued the RT 200 Rebate Scheme[4] and the Naira4Dollar Rebate Scheme[5], effective from June 30, 2023. These schemes were introduced in 2021 to address foreign exchange illiquidity and encourage the inflow of diaspora remittances and export proceeds repatriation. Between the floating of the Naira and the CBN's desire to combat illiquidity issues, the need for these incentives is no longer deemed necessary Importantly for government seeking to tighten public spending, discontinuing these initiatives is expected to result in some cost savings.

Implications for the Market

On the heels of the CBN Press Release, Bloomberg reported that the Naira dropped 21% to 600 per dollar, the biggest decline since 2016 to the weakest rate on record. By all indications, this is devaluation by another name. In truth though, the operational changes introduced by the CBN represent a move to align the position of the Federal Government with the commercial reality of the Nigerian market. And the general market sentiment is that it is a well overdue and much welcome move. The unification of trading windows and the free float of the Naira will amongst other things, reduce the opportunity for arbitrage in the market and potentially increase foreign investment by ensuring that investors can bring in and take out their capital through official channels with a market determined rate. From a practical perspective, there is also likely to be an increase in liquidity into the market not just from international investors but from remittances and exporters who previously had a disincentive to bring their foreign exchange into the country through official channels — although whether it will be sufficient especially in the short to medium term to meet the demand both for current requirements as well as the back log of held up orders, remains to be seen at this time.

An additional consideration is the ever-present rule that to access the official market – now the I & E window – the underlying transaction must be an 'eligible transaction' as reiterated by the CBN Press Release. This rule was one of the drivers of the alternative/parallel market and it is therefore likely that we will continue to see some level of activity outside of the official I&E window for transactions that are ineligible to access foreign currency via official means.

Conclusion

The market is optimistic that these reforms are here to stay and will help improve the investment climate in the country in the long term but there will inevitably be some pain in the short term as the market adjusts and some additional inflationary pressure is expected as a side effect. The additional inflationary pressure may however be a bit more muted than expected given that many importers and prices linked to the foreign exchange rate have been using the parallel market rate for some time now as that was where they could consistently source their foreign currency needs. That said, this devaluation is also occurring with the removal of the fuel subsidy so a double hit for Nigerian consumers (and also for some of our neighbours too by some reports). It is thus incumbent on the Government that alongside these operational changes, it introduces the necessary economic mitigants such as an increase in the Federal minimum wage, a cash transfer programme for the poorest sections of society, a reduction in certain taxes and revenue collecting schemes, to help cushion the effect of this devaluation.

[4] Under this scheme, the government would pay NGN65.00 for every USD1.00 repatriated and sold at the I & E Window for other third-party uses; and NGN35.00 for every USD1.00 being repatriated and sold in the I &E for personal use on eligible transactions.
[5] Under the scheme, recipients of diaspora remittances were paid N5.00 for every dollar remitted into Nigeria.