Thought Leadership

MANAGING FOREIGN EXCHANGE DENOMINATED LIABILITIES: ISSUES AND OPTIONS

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"For years, the dollar's role as the major global currency has been termed an 'exorbitant privilege'." — a phrase coined by French Finance Minister and later President, Valéry Giscard d'Estaing.

Nigeria, has for years resisted the need to diversify its economy hence it was inevitable that what was initially considered as an 'exorbitant privilege' is now being seen as a hindrance to effective business operations. Though there are various reasons for Nigeria's economic decline, it is impossible to ignore the fact that the root cause for the current economic stagflation is inexorably linked to the foreign exchange (FX) trap.

While the FX situation persists, its impact on the demand side is felt mostly in terms of the currency mismatch, convertibility, and exchange rate issues for both executed and executory commercial contracts. Clearly these commercial arrangements span different flavors but it is possible to aggregate them under 2 broad categories: (a) annuity type payments such as debt repayments, dividend payments, technical fees, royalty fees, management fees; and (b) transactional-one-time payments e.g. freight costs, plant and machinery imports, equipment supply etc.

Below, I succinctly consider the disproportionate FX risks currently experienced under these 2 broad categories and proffer practical solutions which, in my experience, may prove to be useful mitigants for those corporates/individuals presently caught between a rock and a hard place.

Understanding the FX Dynamics

With oil prices hovering above $100, exchange rate pegged at N155 and significantly liquid financial institutions, all pre-2015, firms especially large corporates, manufacturers, oil, gas, power, aviation, and hospitality firms became generally more aggressive in incurring dollar denominated liabilities. Servicing these obligations at inception was relatively easy because of significant liquidity, predictable exchange rates and relaxed exchange controls, however, the recent FX volatility exposed the obvious risks associated with incurring dollar denominated liabilities without having the appropriate business model or risk mitigants embedded into such commercial arrangements. Arbitrary FX allocation, FX scarcity due to subsisting low oil receipts, rate fixing, multiple rate regimes and outright illiquidity are just some of the problems encountered by those currently saddled with dollar denominated liabilities and it was inevitable that these issues would come to the fore in a highly dollarized economy such as ours.

Practical Alternatives

In my view, the FX dilemma calls for pragmatic approaches that can mitigate FX risks or at least shape the conversation before incurring dollar denominated liabilities.

Though I have generalized these options without bias as to whether the dollar denominated liability is an annuity type payment or a one-time transactional payment, it is noteworthy to mention that some approaches may better suit certain FX liabilities scenarios while others can only be retrofitted to specific FX situations.

1. Hedging Products

Hedging is a technique or strategy that comes as a form of investment designed to avoid market volatility. The principal financial instrument used in hedging is derivatives. In Nigeria, the CBN approved a number of derivatives products which are FX Options, Forwards (Outright and Non-Deliverable), Swaps (Cross-Currency and Interest Rate Swaps)[1] and Naira settled OTC futures. The most popular hedge choices are the forward contract, the Naira Settled OTC futures and the cross-currency swaps.

a. Forwards

Forward contracts are agreements made to sell and deliver FX at an agreed price at a point in the future. This could either be outright forwards or non-deliverable forwards (NDF). The Forward contract enables the business to protect itself from adverse movements and the scarcity of FX by locking in at a predetermined exchange rate until an agreed date.

b. FX Options

An FX option is similar to a forward contract. Under a FX Option rather than purchasing a forward contract, a party purchases an option in which it would have the right but, not the obligation, to buy the currency at the pre-determined price.

c. Naira Settled OTC FX Futures

The Naira-settled OTC FX Futures contracts are NDF whereby parties agree on an exchange rate for a predetermined date in the future, without the obligation to deliver the underlying US Dollar (notional amount) on the settlement date. On the settlement date, the parties to the OTC FX Futures contracts are assumed to have transacted at the Spot FX market rate and any differential between the contract rate and the Nigerian Inter-Bank Foreign Exchange Fixing (NIFEX) Spot rate on the maturity day is cash-settled in Naira.

d. Swaps

A swap is a derivative contract where the parties agree to exchange future cash flow obligations. A swap generally comprises two forms of derivative contract, the interest rate swap and the currency swap.

i. Interest rate swaps

Under an interest rate swap, the parties will swap a fixed rate interest obligation under a loan for a floating rate interest obligation. In an interest rate swap one party pays an amount calculated at a specified interest rate and a hypothetical principal amount (sometimes called the "notional amount"), while the other party ("swap counterparty") pays an amount calculated at a different interest rate based on the same notional amount.

[1] Guidelines for FX Derivatives and Modalities for CBN FX Forwards

ii. Currency Swaps

In cross-currency swaps, one party borrows one currency from, and simultaneously lends another currency to, the second party. Cross-currency swaps are a combination of spot and forward transactions. They generally involve a spot purchase and forward resale or a spot sale and forward repurchase of two currencies. The exchange rate for the forward delivery is fixed upon signing the contract and thereby obviates the risk of currency fluctuations over the life of the investment.

2. Exchange Bartering (Payment in kind)

Under this arrangement, existing monetary payment (e.g. fee remittance) obligation is settled by way of exchange of goods and services. Exchange Bartering enables an obligor to settle the existing fee remittance obligation without requiring cash payments to be made. The goods or services are valued to ensure the cash value of the consideration is commensurate to the fee remittance obligation.

3. Refinancing

Refinancing presents a viable solution for mitigating currency mismatch and resolving default scenarios in loan agreements especially as a large percentage of debt exposures of Nigerian banks and corporates are Dollar denominated loans. The current scarcity of Dollars, coupled with the inability of the borrowers to access Dollars at favourable rates exposes most lenders to default. Given this, the parties to loan transactions are going back to the renegotiate the terms of their loan agreements with a view to refinancing the loans. Typically, refinancing may be achieved in several ways including the plain vanilla refinancing which involves the change of mode of repayment by converting from an amortized repayment to a bullet repayment or extending the tenor or redenomination of Dollar loan to Naira loan.

4. Dedicated Payment Account

The use of dedicated payment account will be useful for repayment of loan and other foreign currency obligations. Under this arrangement, the obligor pays the Naira equivalent of the foreign obligations into a dedicated account at an agreed exchange rate. Payments made in the dedicated payment account would offset existing dollar obligation. To ameliorate the convertibility risk, the obligor agrees to provide surplus Naira to augment any payment shortfall.

Conclusion

As the FX crisis lingers, the market will most certainly continue to evolve and the question whether these solutions are real or synthetic will definitely be tested. In choosing an option or a combination of options, it is important to state that the viability of each option depends on the idiosyncratic business fundamentals of each company and on its negotiating position.

Hopefully the crisis will abate but, unfortunately, not without a robust, cohesive, and properly articulated blueprint by the Government.

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