CBN revises NOP to curb foreign currency exposures

Yesterday, **the CBN issued a circular, noting the growth in foreign currency exposures of banks through their net open position (NOP).** Effectively, the CBN sees an incentive for banks to hold excess long FX positions, exposing themselves to exchange rate volatility and increasing risk. In response, the apex regulator has introduced prudential requirements to manage these risks and avoid losses.

The prudential requirements are as follows:

1. **Prudential Requirements**
    a. The NOP limit of the overall foreign currency assets and liabilities taking into cognizance bothe those on and off-balance sheet should not exceed 20% short or 0% long of shareholders funds unimpaired by losses using the Gross Aggregate Method.
    b. Banks whose current NOP exceed 20% short and 0% long of their shareholders fund unimpaired by losses are required to bring them to prudential limit by February 1, 2024 (today).
    c. Banks are required to compute their daily and monthly NOP and foreign currency trading position (FCTP) using templates provided by the CBN.
    d. Banks are also required to have adequate stock of high-quality liquid foreign assets, i.e. cash and government securities in each significant currency to cover their maturing foreign currency obligations. In addition, banks should have in place a foreign exchange contingency funding arrangement with other financial institutions.

The prudential requirements stipulate a 0% limit on NOP, implying that banks must retain FX assets only up to the value of their total FX liabilities, otherwise, a 20% short position i.e. excess FX liabilities up to 20% the value of the bank's unimpaired shareholder's funds.

The immediate impact of this policy is that any banks currently running long FX positions will be forced to sell down their excess FX positions to comply with the directive. In theory, this should increase FX liquidity, if only briefly, while also reducing the demand from banks for FX in the near term at least.

It is also important to highlight that the calculation for NOP is mandated as using the Gross Aggregate method, which includes both on-balance sheet items such as loans and securities, and off-balance sheet items such as cross currency swaps and forward contracts.

A potential implication of this policy is that banks may have to resort to creative methods in order to meet FCY obligations, such as accessing offshore credit through bilateral partners, otherwise they could be forced to source their FX at prevailing market rates on a case-by-case basis.

In terms of the new policy's effect on earnings, banks will likely report significant realised FX gains in their 1Q earnings figures, as they sell down their excess currency positions. However, in the coming periods, they will likely record weaker unrealised FX gains as well as some trading losses related to having to purchase FCY at the prevailing rate from the open market.

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Furthermore, the circular also highlights other requirements, namely:

2. Other Requirements

a. Banks should borrow and lend in the same currency (natural hedging) to avoid currency mismath associated with foreign currency risk.

b. The basis of the interest rate for borrowing should be the same as that of lending i.e. there should be no mismatch in floating and fixed interest rates, to mitigate basis risk associated with foreign borrowing interest rate risk.

c. With respect to Eurobonds, any clause of early redemption should be at the instance of the issuer and approval obtained from the CBN in this regard, even if the bond does not qualify as tier 2 capital.

d. All banks are required to adopt adequate treasury and risk management systems to provide oversight of all foreign exchange exposures and ensure accurate reporting on a timely basis.

e. Banks are expected to bring all their exposures within the set limits immediately and ensure that all returns submitted to the CBN provide an accurate reflection of their balance sheets.

The CBN's instructions could potentially reduce the banks interest earnings, as the CBN has asked for rate harmonisation in order to mitigate basis risk. This would likely mean a more volatile rate for currency based borrowing and lending, potentially limiting their ability to maximise returns on foreign currency positions.

Due to the short timeline for the implementation of these new requirements, some banks may be unable to fully comply within the stipulated timeframe, thus some forebearances may be requested from the CBN to allow the banks to come into compliance.

Overall, we believe that this new policy could potentially see in excess of N3.5 trillion ($2.4 billion) worth of foreign currency be offloaded from some banks' books. However, it is unlikely that all of that liquidity would make its way into the market, as banks with international subsidiaries will likely offload their currency positions on to other subsidiaries.

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Ecobank Transnational Inc	D, K, L
FBN Holdings PLC	D, I, K, L
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