CEO Interview

FMDQ

In 2016, the Chief Executive Officer of FMDQ OTC Securities Exchange (now FMDQ Group), Mr. Bola Onadele. Koko, granted an exclusive interview with BusinessDay Media. In this piece, which was published on October 10, 2016, Koko shared insights on the dynamics of the Nigerian FX Market following the then recent liberalisation of the Market after fifteen (15) months of pegging the currency, and proposed four (4) broad actions the CBN had to implement to rejuvenate the ailing FX Market, and achieve the long-desired convergence of FX rates in a bid to promote unification of FX Markets in Nigeria.

The proposed solutions remain highly relevant seven (7) years later, and the piece is republished below as a call to action for the new Tinubu-led Administration!

The Central Bank of Nigeria finally liberalised the market (in 2016) after fifteen (15) months of pegging the currency. What is your assessment of the FX market's evolution ever since and where is the market at today?

A: Let us start with a bit of history to put things in context. The Central Bank of Nigeria (CBN) liberalised the foreign exchange market with the introduction of the inter-bank FX market in 1986. So we can say the FX market was born in 1986, exactly thirty (30) years ago. One expects some maturity from a 30-year old market. In the thirty (30) years, the market has sailed through their global competitiveness profile in phases primarily motivated by market practitioners i.e. bank treasurers. The treasurers, through their reputable association, Financial Markets Dealers Association (FMDA), previously known as the Money Market Association of Nigeria (MMAN), commenced phase two (2) of concerted market development work in 1995/1996, with the introduction of the two-way quoting system, spot fixing (the Nigeria Inter-bank Foreign Exchange Fixing (NIFEX)) and inter-bank trading of hedging products. The market had been punctuated in 1994 by the regulation of the market but the government learnt from the anomaly and, after twelve (12) months, introduced a more liberalised market than we previously had. They also had the wisdom to reintroduce the market, then tagged Autonomous Foreign Exchange Market, through a decree - the Foreign Exchange (Monitoring and Miscellaneous Provisions) Decree 1995 (now Act 2004). There is a significance to this. It was surprising – maybe shocking in fact - that despite the existence of an Act, the CBN managed to introduce a currency peg without a circular over a period of fifteen (15) months! That is a pointer to the state of our financial markets, banking industry and rule of law.

Moving along, we have all the market stakeholders - banks' CEOs, ex-banks' CEOs, corporate giants, lawyers, ex-CBN governors, top economists/financial market commentators (Bismarck Rewane, Doyin Salami, Zeal Akaraiwe, et al), the Nigerian Economic Summit Group (NESG), the FMDA and the media, especially BusinessDay Media, to thank for highlighting the pitfalls from the CBN's action and encouraging a return to a liberalised market. After fifteen (15) months, the CBN finally liberalised the market, in June 2016, with the world-class **Revised Guidelines for the Operation of the Nigerian Inter-bank Foreign Exchange Market**. This is probably the best Guidelines published by the CBN and the most ideal for the Nigerian economy. However, one must say the supporting structures, regulation and regulatory appetite/acceptance of the market operations, have not aligned with the philosophy of liberalisation. Regulatory appetite for attendant initial signs of market failure has been low and challenging to deliver on the Guidelines. Market participants are asking questions on the strategy and wondering how many more self-inflicting injuries we are willing to add on to our challenge. The first three (3) months have been below par, and without mincing words, the current FX market is illiquid as a result of low market confidence caused by lack of transparency and credible price formation. The spot market is disappointingly highly fragmented in the range of $/₦305 to $/₦360 and this may be even conservative.

> ***"In financial markets, timing is everything, and we need to understand the psychology of financial markets and act fast. The CBN FX market management needs a major paradigm shift to boost economic activities."***

Was the situation avoidable, given the collapse in crude oil prices? Indeed, given the complicated situation, what could the CBN have done differently? Would you like to also rate the CBN's actions in this regard? Could the CBN have done better in timing its actions?

A: Absolutely. We could have avoided this by upholding the principles of financial markets. The persistent error of preventing the market forces to adjust to economic fundamentals was repeated against better judgement. The matter is not complicated. If the dollar earnings have dropped, doesn't it make sense to expect the exchange rate to adjust? The adjustment in itself helps to protect reserves, limit speculation and curb inflationary expectation. We would have moved on as though nothing happened. We should not have pegged the currency and we must learn, as a nation, never to peg the currency. We must also learn to allow market forces set the equilibrium price throughout the economy. Interventions in the market are fine, but only after the market has set the price, and note, there is a difference between professional intervention and interference. There are critical decisions that must be based on carefully thought-out processes. I am talking of rigour here, e.g. before pegging a currency, you must assess how much you have in reserves, the source(s) of the reserves, the source(s) of macroeconomic disequilibrium, your estimated annual FX demand, the likely outcomes of the policy, etc. You must know that once the rate is fixed, you will deplete reserves as well as cut off supply of FX flows through foreign portfolio and foreign direct investments, if the exchange rate is not appropriately priced. The Monetary Policy Committee (MPC)'s Communique always said the exchange rate was stable but the reality was that we had unmet demand in the market, which we saw, in June, was above $4bn! So really, the CBN scored an 'A' with the liberalisation, the Revised Guidelines, and in clearing the backlog in June, but the score in the implementation is low, maybe a 'D'. Unfortunately, it is the implementation that carries the highest weight and matters the most.

Anyway, rating the CBN is an academic exercise at this point. Quite frankly, the key success factor is supply of dollars to the economy and the scorecard is not looking good - too much reliance and focus on shrinking foreign reserves to meet potential demand, unprecedented gap between inter-bank and parallel markets, high inflationary expectation, high devaluation risk, lack of confidence, laying off of employees/increasing unemployment rates, loss of investments to Nigeria, delayed investments, etc. Discussion on how to address these challenges are really more pertinent. We must end our style of changing our dance only when the situation is calamitous. The currency peg went on for too long. Even '1994-Nigeria' could not go on longer than twelve (12) months. The current situation needs to be addressed before we collapse the economy. In financial markets, timing is everything, and we need to understand the psychology of financial markets and act fast. The CBN FX market management needs a major paradigm shift to boost economic activities. The Governor means well and wants the best for Nigeria but you can't control in a liberalised FX market. You must respect market fundamentals.

We are in a recession, companies are declaring losses, laying off staff, government getting less revenue, what is your prognosis? What should the CBN do now?

A: Very simple. We need to operate a liberalised FX market. Hope you got that – **operate a liberalised market**. We must live the liberalised FX philosophy. CBN was acclaimed over the first-class FX Framework (the Revised Guidelines). This Framework is not compatible with a control mind-set. A major paradigm shift is urgently required. We need understanding of how the FX market and financial markets work. The FX market appears basic but it is the nerve center of the economy. We can no longer continue to toy with the FX market and the economy. This market has been unnecessarily garroted for nineteen (19) months now and the CBN must, as a matter of urgency, do four (4) broad things: **1. Promote a liquidity enhancing market structure; 2. Institute market-friendly policies; 3. Promote menu of hedging products; and 4. Maintain a capital market-driven economic development agenda**. These are the solutions to the pervasive devaluation risk.

BDC/Parallel Market is at $/N480. Where is the inter-bank spot market? What are analysts and investors saying about the fair value of the Naira? What are the main concerns of potential investors today? Are we now talking about naira adjustment or is the demand now as a result of better management of the FX market?

A: It is pathetic that the BDC/parallel market rate has become the reference rate in Nigeria. It is indeed sad. Even though this market is also important, as some genuine transactions are executed here, it is a much smaller market than the inter-bank market and it is amazing that this market has better price discovery than the inter-bank FX market.

You asked about the spot FX market. I am disappointed to say that I do not know the current levels. I was a trader in 1991 and if you asked me then for the spot FX level or asked my co-traders (Rasheed Olaoluwa of GTBank or Nimi Akinkugbe of IBTC, as then known), we would have given you the spot FX rates, and even if not the same figure, the difference would be negligible. In Nigeria today, twenty-five (25) years after, we have a highly fragmented spot FX market – almost six (6) markets with sub-market rates ranging from $/₦305 to $/₦370! How can you present such a fragmented market in an economy that should be working 24/7 to make its financial markets globally competitive? There is no single spot FX rate in Nigeria. Spot FX has six (6) sub-markets, as I said. The first sub-market is the CBN rate (which is ₦50 - ₦60 away from the actual market). At this level, the CBN sprinkles tiny flows to the market and probably less now, where the International Oil Companies (IOCs) are forced to sell to petrol importers. We need to talk more about this. The second sub-market is the FMDQ Close, which does not reflect the right market sentiments due to the pressure on the banks. This rate is close to the CBN rate because the closing period is dominated by CBN transactions with the banks at discounted rates! The third sub-market is the FMDQ NIFEX, which is suffering as the Reference Banks are bashful in advising their views of the right spot FX level. This is where the OTC FX Futures settle. The fourth sub-market is the real spot FX level which is at $/₦350 – $/₦360. Most transactions settle here, with two (2) or more cheques flying around to support the transactions, thereby promoting unethical behaviour!

The fifth sub-market is the $/₦340 rate at which the International Money Transfer Organisations (IMTOs) buy the remittances from Nigerians in the diaspora, and the sixth sub-market is the rate at which exporters desire to sell their dollars – expect this to be nearer the BDC/parallel market. You cannot blame the exporters because the pricing of their export products is benchmarked nearer the more transparent parallel market. We cannot run a credible FX market with such fragmentation. We cannot build a thriving economy without a reliable FX market. We liberalised the FX market and must hold on to the creed. We must support the philosophy with the right market structure. Our FX market operated with an average daily turnover of $1billion prior to 2015. It is currently down to c. $100 million. I do not understand the real effective exchange rate (REER) that is showing Naira at $/₦320. It is meaningless to me. I am an economist and a financial markets architect. I respect principles that make sense. A market that lacks transparency and nurtures high devaluation risk is a failed market to me.

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Demand is beginning to far outstrip supply. I do not believe Naira should be trading at $/₦480. This is self-inflicting and it is disappointing. The potential investors are interested in trading liquidity on the back of transparency and credible price formation. The equilibrium rate will emerge as the market trades. There is no need for any regulatory adjustment. It has never worked and will not work.

How can the FX market be rejuvenated? What is the solution to these many markets and many rates?

A: I already gave the four (4) broad areas above. Specifically, we need to operate a single FX market and stop these many markets with their different rates. It is very puerile and unexpected of a Nigerian market integrated with international markets. We need an FX market where banks trade on two-way quoting (2WQ) basis, in a transparent manner. Banks should be free to buy from all FX sellers and sell to their customers at market rates for price discovery. They should be permitted to sell to the BDCs and their customers allowed international use of their Naira bank cards with revised reasonable limits at rates determined by the banks. Let the banks buy FX from IMTOs at market rates to encourage Nigerians to remit dollars home. Banks should also trade on the provided screens to promote the price discovery to the foreign investors – our main source of inflows at the moment. Clients should be onboarded on the systems as directed by the CBN. Any Client that is not on the systems by December 31, 2016, should not be allowed to transact in the market in 2017.

CBN does not need to be involved in any way. The market should determine its trading technique, its 2WQ spread and trading methods. These factors should be decided and operated to allow for a credible exchange rate. CBN does not need to provide any guidance on rate. If CBN does not like the rate in the market, it should intervene by selling dollars to the market at the current market level, not at a lower rate. It can also offer market-priced hedging products – OTC FX Futures, Forwards and Options. The banks should start trading on firm 2WQ basis. No need to segregate markets e.g. IOCs to petrol importers. The ₦145 per litre pump price is not a cap. Nigerians need to appreciate this. It is a deregulated market and the pump price will be impacted by the FX rate and crude oil price. The FX rate should not be managed to achieve the ₦145 price. If the FX rate or crude oil price goes up, then the pump price may go in the same direction and if these two (2) variables come down, the pump price should come down. Higher pump price will cause Nigerians to adjust and buy less fuel, causing suppliers to import less, thereby freeing dollars which will flow to other sectors or users. This is how effective allocation of resources works in the economy. Our current approach of suppressing the exchange rate to achieve the pump price is indirect subsidy. The economy will not grow on the back of subsidy. Higher pump price will also lead to the development of alternative transportation, which will provide opportunities. Is it not disappointing that we cannot boast of a world-class private sector-owned ferry service in Lagos? Some other states with natural water paths deserve quality water transportation.

We need to stop being denominator managers, FX demand management should stop. All the unfriendly rules contribute circa ₦100 to the exchange rate. I will therefore advocate that they are all rescinded with a single circular. These actions will reduce the pressure on the BDC/parallel market and trigger a downward movement in the parallel market rate, moving it closer to the inter-bank rate. The unification of markets is critical. Transparency in rates and credible price formation will improve market liquidity and reduce the devaluation risk. We keep operating 'inter-bank fixed rates' causing wide gaps with the parallel market, which after a while, is followed by an increase in the 'inter-bank fixed rate'! So we got the market fixed at $/₦199, then somehow frozen at $/₦282, and the market now gyrating at $/₦315. Each time, by an invisible hand! Note that when inter-bank was fixed at $/₦199, the parallel market was at $/₦220 - 360, so inter-bank moved to $/₦282 (below parallel market rate) and the parallel market was rotated at $/₦350 - 380, and now that we have inter-bank fixed at $/₦315, the parallel market is at $/₦480. So what is your guess? That the inter-bank will move soon? This is why devaluation risk remains ubiquitous. CBN should allow free trading of the Naira out of this fixed rate dogma. We need to conquer the devaluation risk to witness unprecedented inflows from FPIs and FDIs. The asset yield levels are comparably high enough to attract FPIs. The opportunities are enormous to attract FDIs but they will not close the deal if they think the inter-bank rate will move up, soon after, to the new fixed rate!

The CBN took off about 85% of FX inflow in the form of oil proceeds and has created a new market for funding petrol import. No one knows who trades at this market and at what rates. This market is not transparent and could encourage leakages. What should the CBN do?

A: CBN should simply end all these market disruptions and allow the IOCs and oil service companies to sell to the banks. The CBN has drained the inter-bank FX market of dollar flows and yet expects the rate to be stable. This is paradoxical and conflicting. The sources of FX inflow left with the banks are export proceeds and foreign investments. Unfortunately, both lines will not sell when there exists circa ₦150 premium between the inter-bank and parallel markets.

It appears the FPIs are very critical to the solution, is this not the hot money an economy does not need?

A: Honestly, the FPIs are critical to our equation and we need to engage them as strategic partners. There are other sources but they cannot react as quickly as FPIs would. FDIs will take a longer time. We have a chance just because yields are low in Europe and across the pond. Nigeria is able to offer 22% per annum. on one-year Treasury bills so that positions us for portfolio inflows but only if we do the right things, as already articulated above. The FPIs can supply more than the dollars we need to get the FX market liquid and get the economy working again. It is a wrong perception to label FPIs as hot money. All monies can be hot. Even Nigerian investors and savers' monies can be hot! Any capital can be hot if the environment is unconducive. We cannot mismanage the financial markets and then turn around to say that foreign investors are hot money and not accommodating. That's turning logic on its head! If I remember correctly, Michelin and some other companies, have exited Nigeria due to some challenges. Guinness Nigeria PLC has just declared a loss for the first time in fifty (50) years, and why? – because of the FX situation in the country! We cannot continue to watch the destruction of the economy. If FPIs are hot money, we are the ones turning the heat on unnecessarily. Don't Nigerians switch their savings or investments, and rightly so, to foreign currency when the fundamentals do not add up? Is that not hot money behavior? Let us face reality. FPIs can remain in your country for over twenty (20) years and even forever, if you do the right things; if you allow market principles to operate; if you allow market to adjust when prices should adjust; if you do not change the rules every day; if you do not introduce controls when you are a liberalised market; if you do not fix the rate when market should devalue; if you operate a market structure which aligns with your philosophy, etc. Even if some FPIs exit when market adjusts, new ones will come in and we will maintain a core. Some FPIs are in the Nigerian Stock Exchange market, have they exited? I will not mince words; we need FPIs now and we need to engage them professionally and in a strategic manner. A stitch in time saves nine. We need to remain in the Morgan Stanley Composite Index (MSCI). We need to get back to the fixed income indices especially the JP Morgan Index. The CBN should be focused on supporting The Nigerian Stock Exchange (NSE) and FMDQ OTC Securities Exchange (FMDQ) in ensuring the financial markets are globally competitive.

What can be done to attract FPIs in the quantum required and for attracted capital to stay?

A: The short-term solution is boosting FX market confidence through the right market structure, friendly regulation/policies, liquidity risk management products (FX call options) and the right business attitude. The medium-term solution should have the CBN, Nigeria Investment Promotion Commission (NIPC), Securities and Exchange Commission (SEC), NSE and FMDQ develop a Foreign Capital Attraction Plan to pitch and woo foreign investors across the continent from Asia to America. All the parties must deliver on their responsibilities. Long-term solution is to make all sectors in Nigeria business-oriented!

What should the CBN do now and what type of FX Market do we require now to support the economy?

A: The CBN should articulate its strategy (high asset yield to attract FPIs) and sequence things appropriately. They should start by doing all to reduce the devaluation risk and boost market confidence. It is imperative that its operations should be financial markets savvy. I have said this over the years and will say it again, CBN needs to upgrade its financial markets franchise considerably. The FX market required to support the economy is one that is truly liberalised and designed to suit the structure of the Nigerian economy. Our FX market should appreciate the presence of the informal market and ensure that they have access to FX.

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Are the OTC FX Futures helping the situation? Has it met the expectations of the CBN and FMDQ?

A: The OTC FX Futures, as designed, is meant to help the situation, however, liquidity and devaluation risks have limited its success in attracting FX inflows. It has helped in smoothening the FX demand, thereby reducing frontloading of FX requirements. This is a major expectation of the CBN. Local FX buyers will continue to hedge if they are able to source the required dollars at maturity of the contracts. For a new product, it has met FMDQ's expectations, in terms of acceptance. The innovation has ushered the idea of hedging in a structured manner, in line with global standards. The next phase is the introduction of a central counterparty (CCP) clearing house to protect all stakeholders involved in hedging products. In terms of pricing, we hope the CBN will normalise the curve as soon as possible to allow higher trading activity in the market.

Would we not have devaluation with all your prescriptions? Will it not cause the price of petrol to rise and add to inflationary pressures?

A: Naira has already devalued by circa 50%, which appears to be a reasonable adjustment. Indeed, Naira is receiving support at this level. We should be talking of depreciation and appreciation, which is normal in currency movement. At a point, customers will start resisting the products and adjustments will take place. The high cost of goods produced at this exchange rate will provide opportunities for local production. If the right things are done professionally, we will stabilise the exchange rate at the right level.

Are we even sure the petrol importers are getting the right quantum of dollars required? There is shortage of dollars in the country. Nigerians do not want petrol shortages and annoying queues. What price did we buy petrol in 1980, 1990, 1993 and 2000? I remember the riots in 1993 or 1994, and the Occupy Nigeria protests about two (2) or three (3) years ago. We have come to accept that we have to pay a price for past mismanagement. We will reduce our demand if petrol gets expensive and will become more efficient and prudent. Nigerians will start carpooling and will work on reducing wasteful trips. Railway transportation will become attractive for FDIs to take care of the masses. We all use the trains in London and other countries. Anyone who believes that this is beneath them can continue with the petrol cost. Such alternative transportation will cause the demand for petrol to drop, with less dollars going towards importation and foreign reserves increasing. Let the FX market work and all other things will fall into place. Do not use the anomaly of a sector or irrational management of one situation to destroy the whole economy. If the FX rate is stable and crude oil price goes up, won't we buy petrol at a higher price? When Dangote's refinery starts production and sales, will Nigeria sell crude to the refinery at a lower rate (***another subsidy***) rather than export the crude to earn dollars at the international price? We need to start thinking and acting as rational economic agents. Why don't we have dollar support for kerosene and diesel? There is nothing special about petrol. One may even argue that diesel is more important. We need to run Nigeria as a PLC with all of us as shareholders interested in high returns. We need to promote local production and those that have ultra-import biased taste can enjoy the high FX rate.

Inflation is high at close to 18%, interest rates at 25% per annum, and exchange rate heading to $/₦400; we are in a recession. Seriously, how do we get out of this?

A: It is simple. In my limited wisdom, we should first take care of the FX market. Note that I did not say exchange rate. '***Supply before Rate***'. Let businesses be able to source FX. Make parallel market irrelevant to the psyche. This will drive devaluation risk out and pricing will be at inter-bank rate and not the volatile parallel market rate. Can you imagine some people were already using ₦500 to translate the dollar? Let the inter-bank market become the reference rate once again and ensure the market is liquid. NIFEX should become market-aligned again. CBN should be leading the initiatives to source FX flows (supply) not issuing circulars to manage demand, which is stoking the fire. It should focus on the numerator and not the denominator. After the economy starts working again, inflation will start trending down, giving credence to lower interest rate. It has happened before and it can happen again. Our recession is self-inflicted and we can get out of it fast. The FX market is all we need to fix and fix fast! In addition, CBN and SEC should drive financial market development projects as these have huge potential for private sector-led job creation.

I am sure you know we would not close this interview without asking you this last question: What is your take on the '41 items'?

A: This is about understanding the difference between short-term and medium-/long-term solutions. It is also about understanding that foreign investments made through FX purchases need to be monitored and repatriated when required. It requires an assessment of the damage to the market versus impact on the exchange rate. Again, I will ask for the objectives. Whilst some of them may be laudable, what about the objective to make parallel market highly irrelevant? Do we want to continue with demand management? It is a fundamental principle for me that fiscal strategies are not mixed with monetary policy. If we need to ensure the items contribute to the development of the economy, why not have them contribute to the CBN Fund, ensure they don't crowd out other sectors for credit – so invariably, no banking credit to the items.

I perfectly understand the need to promote local production, but I will like it done in the most structured way. The programs need to be seamless and easy to access. I will like to see all commercial farmers and manufacturers able to access single-digit interest rate over thirty (30) years and supported with rebates on FX rate for importation of equipment. We do not need to rupture the FX market over this long-term solution. This initiative will be through an Economic Development Fund promoted and managed by the CBN. All CBN intervention funds will be securitised out of its balance sheet and moved to this Fund. By operating a Fund, multilateral agencies will be more amenable to support and contribute to the economic development agenda. This Fund will invest in the long-term debt papers of our commercial farmers and local manufacturers. It will also underwrite the FX rebate. This will make our agriculture and local manufacturing highly competitive. Hardly will any imported good be able to compete with our locally-produced goods.

I will plead to throw one (1) more item into the Fund to empower Nigerians in their home ownership dream. This initiative will support housing projects, the construction sector, mortgage industry and the debt capital market. CBN should provide bridge finance of 180 – 360 days to primary mortgage institutions (PMIs)/mortgage banks, because they are unable to attract deposits, for on-lending to Nigerians as long-term mortgage loans. The CBN funds will be repaid through the sale of the mortgages by the PMIs to the Nigerian Mortgage Refinance Company (NMRC). It is time to get the economy working for Nigeria and Nigerians.

Mr. Bola Onadele. Koko
Chief Executive Officer, FMDQ
October 10, 2016

Watch this space for Koko's upcoming 2023 exclusive interview with BusinessDay Media, where he will address pertinent issues about the Nigerian Financial Markets and more...