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CBN Prohibits the Use of Foreign Currency Denominated Collaterals for Naira Loans

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Introduction

On the 8th of April 2024, the Central Bank of Nigeria ("**CBN**") issued a circular with reference number BSD/DIR/PUB/LAB/017/004 (''**the FCY-Denominated Collateral Circular''**). The CBN stated in the FCY-Denominated Collateral Circular, that it had observed the prevailing situation where bank customers make use of foreign currency (**''FCY''**) as collaterals for Naira loans. The CBN stated that this practice is prohibited except in cases where the foreign currency collaterals are either Eurobonds[1] issued by the Federal government of Nigeria or Guarantees of foreign Banks including Standby Letters of Credit[2]. The CBN's directive mandates that all existing FCY-secured loans, other than those exempted, be wound down within a 90-day window. The CBN also warned that Banks failing to comply with this requirement will have these FCY-secured loans risk-weighted 150% for the computation of their capital adequacy ratio.

This is not the first indication of the CBN's stance on FCY-secured loans. In a confidential letter written by the CBN, dated the 17th of August 2023, and addressed to a Nigerian commercial bank (the "Bank"), the CBN warned that FCY-secured loans are not only fraught with the risk of currency mismatch, but are also capable of limiting FX liquidity in the market, thereby creating FX scarcity and exerting pressure on the exchange rate[3]. The CBN referred to its circular, earlier issued in 2015, titled *"Currency Substitution and Dollarization of the Nigerian Economy"[4],* where it warned Nigerians against pricing goods and services in foreign currency, stating that these practices had the tendency to undermine the country's economic stability.

The CBN then directed the Bank to quit issuing Naira overdrafts secured by FCY and swiftly substitute the FCY collateral on current overdrafts with alternative asset types within a two-week timeframe. The CBN further stated that where the FCY cannot be substituted within that timeframe, the facilities should be unwound.

FCY-Denominated Collateral Circular-the Implication for Commercial Banks

The Capital Adequacy Ratio (''**CAR**'') is a measure of a bank's ability to fulfill its commitments. Alternately termed the Capital-to-Risk Weighted Assets Ratio (CRAR), this metric juxtaposes capital against risk-weighted assets, and can be used by the CBN to assess a bank's susceptibility to collapse. It serves the dual purpose of safeguarding depositors' funds, while fostering the resilience and efficacy of the banking system.

The CAR is determined by dividing a bank's eligible capital by the sum of its credit risk weighted aggregate (RWA), operational RWA, and market RWA, and thereafter multiplying the sum by 100. Therefore, an increase in a bank's credit risk average would invariably decrease the bank's CAR.[5]

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[1] Eurobonds are bonds issued offshore by governments or body corporates denominated in a currency other than that of the issuer's country. They are usually long-term debt instruments and are typically denominated in USD.
[2] Letters of Credit are contractual commitments by the foreign buyer's bank to pay once the exporter ships the goods and presents the required documentation to the exporter's bank as proof.
[3] Nairametrics: 'Leaked CBN letter to a bank reinvokes 2015 circular banning Naira overdrafts secured by foreign currency deposits' <https://nairametrics.com/2023/08/22/cbn-directive-bans-naira-overdrafts-secured-by-foreign-currency-deposits/>
[4] CBN's circular on currency substitution and dollarization of the Nigerian economy. <https://www.cbn.gov.ng/Out/2015/BSD/Circular%20on%20Currency%20Substitution%20final%20.pdf>
[5] See the CBN's guidance notes on Regulatory Capital. <https://www.cbn.gov.ng/out/2015/bsd/1.revised%20guidance%20notes%20on%20regulatory%20capital.pdf>

According to current CBN regulations, international banks and Domestic Systemically Important Banks (D-SIBs) must adhere to a minimum CAR of 15%, whereas other banks, such as national and regional ones, are required to maintain a minimum CAR of 10%.

Whilst the CBN stated that all FCY-secured loans be wound down within 90 days, it however offered no guidance as to how this should be done. Rather, the FCY-Denominated Collateral Circular prescribes that any non-compliant exposure in the above regard be subject to a 150% risk weighting for the computation of the CAR in addition to other regulatory sanctions.

The FCY-Denominated Collateral Circular is expected to have an expansive implication on the banking sector as the extant regulation will undoubtedly, affect loan structuring, bolster risk assessment and management framework and ultimately enhance a vibrant economy.

Options for Compliance

As earlier stated, in the absence of specific guidance on the acceptable procedure to wind down subsisting FCY-secured loans within the 90 days window, recourse may be had to the CBN's suggestions as provided in its afore-mentioned letter of 17th of August 2023:

i. **Substitution of FCY collaterals:** Parties to an FCY-secured loan agreement can decide to substitute the FCY collaterals with other tangible or intangible assets which have similar value with the FCY collaterals. This could be done via an addendum to the loan agreement, stating the assets which would be used in place of the FCY collateral. The advantage of this option is that it keeps the loan active while taking the loan out of the category of FCY-secured loans.

ii. **Prepayment and release of FCY collaterals:** The parties to an FCY-secured loan agreement could agree to the prepayment of the loan, subject to the prepayment clause and the implications of prepayment in the loan agreement. Under this option, the borrower would pay the outstanding sum of the loan after which the FCY collateral would be discharged. Where the borrower is unable to pay the outstanding sums under the loan agreement within the CBN's 90-days window, the FCY collaterals could be sold by the agreement of parties and the proceeds applied towards the settlement of the outstanding loan amount. This would effectively wind down the loan agreement.

Conclusion

The FCY-Denominated Collateral Circular marks a significant step in the CBN's proactive attitude to suppress the potential risk associated with extensive use of FCY collateral, which aims to foster a more firm and sustainable banking environment in Nigeria. The directive, aimed at deepening liquidity in the foreign exchange market comes at a time when the Naira has made significant recoveries from the sharp dip recorded at the start of the year.

For banks especially, understanding the implications of this directive is crucial. Compliance with CAR requirements is paramount, as it serves as a measure of financial stability and resilience.
As the banking sector navigates these changes, proactive measures and strategic decisions will be essential to ensure regulatory compliance while maintaining financial health and stability. Collaboration between banks and borrowers, along with clear communication and compromise, will be key to successfully navigate this transition

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