Hedging the Foreign Currency Risk in Nigeria

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ABSTRACT

The management of currency risk exposure has become increasingly significant over the past decade due to the frequent emergence of numerous currency crises. The Nigerian national currency, the Naira, has experienced multiple exchange rate fluctuations over the past three decades. The currency's value has fluctuated significantly and rapidly multiple times, affecting both visible and invisible trade. It is prevalent today to observe numerous countries engaged in imports and exports, as well as consumers lamenting the detrimental effects of these trends, which are evident in the overall increase in prices of goods and services. Research indicates that numerous Nigerian foreign traders, especially within the small and medium sector, either lack fundamental knowledge regarding the management of foreign exchange risk or are doubtful about its effectiveness. From the perspective of corporate management, currency risk management is increasingly regarded as a product-oriented strategy to mitigate a bank or firm's exposure to significant exchange rate fluctuations.

Keywords: Exchange, Exposure, External, Capital, Investors

1.0 Introduction

According to Shapiro (1974), Hekman (1981), Jorion (1991), and Du (2010), investors face foreign exchange risk when they worry that their capital may not be able to buy as much in the future because of changes in the value of the currency they have. Enterprises may see an increase in their cost of capital as a result of the risk premium that investors seeking protection from unhedged foreign exchange risk demand (Du, 2010). Historical exchange rate regimes in Nigeria show that the country's open economy is vulnerable to naira value volatility. Citizens of other countries have the same legal protections as citizens of Nigeria, according to the Nigerian Investment Promotion Commission Act of 1995 (NIPC Act). Currency risk is frequently triggered by such occurrences (Hekman, 1981; Jorion, 1991; Du, 2010).

The market for currencies has grown more unpredictable in the last several decades. Currency problems are becoming more common as a result of globalization, and Nigeria is no exception. Have you heard of the time when the worth of one US dollar was more than that of the Nigerian naira? Nigeria, one of the most populous nations in Africa, has a varied economy that has gone through ups and downs throughout the years. In the past, the Naira was widely used and appreciated around the world as a currency that was pegged to the dollar. The currency and economy of Nigeria played a major role in the country being referred to as "the giant of Africa." One US dollar was only worth 0.894 naira (or 89 kobo) in 1983, which may come as a surprise to some, but the value of the Nigerian naira once exceeded that of the US dollar. The decline in crude oil prices is due, according to experts, to the country's limited ability to produce foreign cash. As a result, the government has a hard time supplying enough foreign currency, which prompts a series of actions meant to limit market expansion. Among the steps taken include the restriction of foreign exchange allocations to certain significant businesses, like the Bureau de change, the restoration of flexible exchange rate systems, and the ban on certain goods' imports.

The competitive exchange rate has been above the N430 threshold since 2021, negatively affecting both domestic and international transactions in a short period of time, and the Naira currency continues to be the target of extensive negative media scrutiny despite these initiatives (Adeniran et al., 2018). The importers' operations are made more difficult and expensive due to the considerable shortage of foreign currency. On the other hand, low adoption rates, unstable power supplies, dangerous working conditions, and unpredictability in government policy are some of the problems faced by the residential sector, which is still relatively undeveloped. It appears that the problem has been worsened by the government's increased emphasis on economic diversification, self-sufficiency, and independence, leaving the country's economy vulnerable to extreme and long-lasting inflationary trends.

It is believed that the effectiveness of the reinstituted flexible exchange rate policy will be enhanced by the effective handling of market fluctuations. There would be a market-determined rate and the government's continued influence on the market towards a "shadow exchange rate." With other macroeconomic factors taken into account, this will help the Naira by letting economic players, especially those dealing with imports and exports as well as consumers in Nigeria, face the full power of market forces (Olokoyo et al., 2019). To protect themselves from increasing exchange rates, end-users of foreign exchange, according to this study, will need to develop autonomous defensive tactics so long as this regime of exchange is in place. Therefore, similar to other market-oriented nations, the economy will need to adopt a dual strategy for dealing with the pressures imposed by foreign exchange. According to this policy, the authority has official say over how the exchange rate system is run, but other businesses and organizations, for-profit and non-profit alike, should take preventative measures by keeping a close eye on the dynamics of the exchange rate to avoid unforeseen financial setbacks. To lessen their impact from currency fluctuations, major industries, primarily in industrialized nations, have used this tactic. However, it's possible that some parts of the business community in developing nations like Nigeria lack the knowledge and tools to implement these corrective measures. Readers from all walks of life in Nigeria who are involved in currency exchange may find this article useful. Aside from helping people comprehend the nuances of the Naira/Dollar exchange rate, it also brings attention to the fact that people need to take responsibility for their own financial situation when it comes to currency swings. Also acknowledged is mastery of standard approaches and tools for managing foreign currency risk.

2.0 Literature Review

2.1 Conceptual Review

2.1.1 Exchange Rate

The value at which the money of one country is exchanged for another is called the exchange rate. The relative value of one currency relative to another is also called the exchange rate. The value of one country's currency in relation to another country's currency is known as the exchange rate, according to O'Sullivan and Steven (2003). The financial concept of an exchange rate describes the price at which the currency of one country is exchanged for that of another. The value of one currency relative to another, most often the US dollar, as measured in relation to the Nigerian naira. Undoubtedly, the home currency is called the counter currency, and there is a direct quotation of foreign money as the base currency. The base currency in an indirect quotation is the home currency, while the quote currency is the foreign currency. Many monetary systems use the US dollar as their foundation currency and other currencies as their counter currencies.

The demand and supply processes in the foreign currency market determine the exchange values of various currencies. The market is open all day, every day (except weekends), according to Peter (2015), and there are a lot of buyers and sellers. Currency trading happens all day long. Forward and spot rates are the two main types of currency rates in the foreign exchange market. The spot exchange rate shows the current exchange rate, but the forward price or rate shows the rate at which a bank agrees to convert one currency for another on a certain date when they sign a contract with an investor. The current exchange rate that can be traded for another country's currency, with the goal of having the goods delivered on the earliest feasible value date. Two business days following the transaction date (T+2) is when spot currency transactions are settled in cash. These dates are used for normal settlements.

2.1.2 Foreign Exchange Risk

The potential for adverse monetary effects as a result of changes in the value of one currency relative to another is known as exchange rate risk, often known as foreign exchange risk. The possibility that changes in the value of a company's currency could have a detrimental effect on its financial performance or position is known as foreign exchange risk. A company's financial performance or status can be affected by changes in currency prices, which is known as foreign exchange risk. Foreign exchange risk can be categorized into three main types: transaction risk, economic risk, and translation risk. Foreign exchange risk is a major concern for businesses that trade internationally, whether they are exporting or importing goods. The exchange rate market, which is impacted by regulatory control or the demand and supply for currencies resulting from imports and exports, determines the domestic price of foreign currency, according to Demburg and McDougall (1980). The significance of pricing as a medium of trade is emphasized by this word. Because it is impossible to predict how long long-term changes in currency rates will last, Bartov and Bodnar (1994) state that hedging for future cash flows may or may not be useful. In addition, according to Brown (2001), the market should not be constantly informed about how firms manage risk. Therefore, new approaches to measuring the risk of foreign exchange have been developed, which go against the grain of common thinking. According to Jhinghan (2003), the demand for a country's currency has a major impact on its foreign valuation. The domestic demand for both traceable and non-traceable commodities would be boosted as a result of an expansionary fiscal policy that raises government consumption expenditure, as proposed by Manta (1999), and vice versa. The changes in the exchange rate are influenced by government budgetary policy as well. (From Isaac, 2015)

Hedging is a financial strategy that investors should learn about and use because of all the benefits it provides. Considered an investment, it shields one's wealth against risks that could erode its worth. Even so, hedging is no guarantee that investments will not suffer losses. If the opposite were to happen, however, profits from other parts of the portfolio would offset the losses.

According to Shapiro (1999), the policies, institutions, practices, regulations, and procedures that establish the relative values of different currencies are all part of the international monetary systems. A foreign exchange market wouldn't be needed if there was only one worldwide currency. In the foreign exchange market, one country's currency is traded for another's. Banks, FX brokers, and dealers all operate together as nodes in a complex electronic network that is the foreign exchange market. According to Shapiro (1991), it is not limited to just one country but may be found in every major global financial center. An exchange rate is defined by Adebayo (2004) as "the quantity by which one nation's currency can be traded for a unit of another currency."

Exchange rate risk management should be a part of every country's decision about its exposure to foreign currencies, say Allayanmis, Hrigs, and Weston (2001). Knowing the economic actors and how to mitigate their risks is essential for dealing with currency challenges (Barton, Shenkir, & Walker, 2002). Finding the right amount of risk exposure and figuring out how much risk needs to be managed is a top priority for every organization. Following the 1973 collapse of the Bretton Woods system—which had tied the US dollar to gold—Paparioannon (2001) states that currency risk management became an international issue. Because it has nothing to do with day-to-day business, most companies delegate currency risk management to their corporate treasury. When it comes to controlling interest rate and exchange rate risks, the treasury strategy is usually overseen by risk committees, according to Ham (2002). This shows how important risk management solutions are to businesses (Issac, 2015). Currency risk, also known as exchange rate risk, is the potential for gain or loss due to changes in the relative prices of two currencies. Foreign investors and businesses with operations in more than one country bear this risk. Currency risk refers to the danger associated with changes in exchange rates. Recognizing the potential impact of currency risk on returns is vital when investing in foreign currencies or firms. Having a basic grasp of how to protect your portfolio from this type of risk will be useful as you pursue your financial goals. Currency risk, sometimes called exchange-rate risk or foreign-exchange risk, is a factor that can affect the value of a currency. Currency risk evaluates the possible gains or losses due to changes in the value of one currency relative to another.

Allocating funds to foreign firms or denominating them in foreign currency exposes them to currency risk. Because it affects how profitable your investments are, knowing this is crucial. Gains or losses on investments denominated in currencies other than the US dollar could be influenced by market circumstances when the money is converted. You can take steps to lessen the impact of currency risk while investing abroad, but it's impossible to completely eliminate it. To lessen the impact of currency risk, you can use a variety of hedging measures (Afolabi, 2021).

The danger that fluctuating currency rates bring to assets like stocks and bonds. Their investment strategy can include the use of derivatives like options or futures. Depending on the ETF, investments can lean more toward established markets, developing economies, or a mix of the two. One benefit of currency-hedged exchange-traded funds is that they protect investors from losses caused by fluctuations in currency values. Compared to exchange-traded funds (ETFs) that invest straight in foreign currencies or firms without risk management, hedged ETFs may be less susceptible to market volatility. However, investing in them might cost more money. For currency-hedged exchange-traded funds (ETFs), ongoing management costs can end up being higher than for regular ETFs. Even with them, you still run the risk of having your profits fall short of expectations or losing money because of currency fluctuations. If you want to buy currency-hedged ETFs, you'll need to find an online broker that doesn't charge any extra to trade ETFs. When buying and selling stocks, this can help lower brokerage expenses. Next, we need to choose the best currency-hedged ETF by comparing their respective performance. Give some thought to the fund's investment approach and the markets it intends to pursue. Before you trade stocks, be sure you've calculated the expense ratio and included any other fees. The next thing to do is think about how you can manage the investment by utilizing your own hedging tactics. For instance, this could involve using options trading tactics or taking both long and short positions in different types of international assets. But these methods could make currency risk hedging more difficult; hence, you should consult a financial advisor before doing anything.

Consequently, as financial markets and economies have become more globalised and liberalized, so too has the approach to managing foreign risks. Managing a portfolio actively and evaluating risks are now part of this. International trade is made easier through the preservation and management of currency. From 1997 forward (Anifowoshe”). According to Nwankwo (1991), keeping sufficient reserves to deal with unexpected drops in foreign currency inflows is a basic responsibility of foreign exchange. Nwankwo (1991) argues that a temporary reprieve allows the nation to address its internal concerns and take required actions to handle the external shock destabilizing the economy. Adebayo et al. (2004) found that although foreign exchange only makes up a small portion of a country's external reserves, it is usually the most important one.

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2.1.3 Types of Foreign Exchange Risk

Papaioannou (2006), Madura (1989), and Shapiro (1996) all classified exchange risk as one of three separate kinds. A commercial deal that doesn't go through. A form of cash flow risk, this arises when exchange rate variations impact exposure in transactional accounts, such as receivables (from export contracts), payables (from import contracts), or dividends that are repatriated from abroad. If the contract's currency experiences value fluctuations, the corporation finds itself exposed to direct transaction exchange rate risk. A mistake in the translation or problems with the books are additional potential explanations. There is a risk of incurring losses due to changes in exchange rates if a parent company's financial sheet includes a foreign subsidiary. Lastly, there's the chance of financial harm. This represents the danger that the present value of the company's future operational cash flows is vulnerable to changes in exchange rates. A company's income (from local sales and exports) and expenditure (from local inputs and imports) can be significantly impacted by fluctuations in exchange rates. Economic risk typically affects the current value of a company's future cash flows, which include both its local and overseas affiliates (Ibrahim et al. 2017).

Economic, Translational, Tax, and Transactional Exposure are the four main types of foreign exchange risk (Lambe, 2015). The economic risk of future profits or losses due to changes in exchange rates is measured by economic exposure. Translation exposure is the potential gain or loss from a transaction's foreign exchange settlement. Thus, tax exposure results from variations in exchange rates that incur tax liabilities, as only realized foreign exchange losses are deductible for income tax computation and only realized gains generate taxable income. Exposure to the risks of changes in currency rates or changes in a company's or financial institution's (like a bank's) declared economic status is the basis for the measurement. The potential impact and level of risk posed by fluctuations in exchange rates is evaluated by financial institutions.

2.1.4 Management of Foreign Exchange Rate in Nigeria

Commercial banks acted as middlemen for Nigerian exporters and kept foreign currency in accounts until the Central Bank of Nigeria (CBN) was established in 1958 and the Exchange Control Act was passed in 1962. Currency transaction between countries is made possible by the foreign exchange rate. The three main types of exchange rate regimes are as follows. Rigid exchange rate pegs and flexible exchange rate regimes are two extremes of the same coin when it comes to exchange rate systems. For their pre-independence currencies, forty European nations used gold weight as the primary unit of measurement from 1928 to 1929 (CBN, 2020). From 1959 to 1967, the Naira's exchange rate was regulated to be equal to the British pound sterling. This allowed for a large amount of the native currency to be exported and caused major inefficiencies in the interbank foreign exchange market (PwC, 2020). Nowadays, it's impossible to know for sure how you'll pay the bills. In international trade, the British pound was the de facto preferred currency until 1973, when the Naira replaced it. During this time, Nigeria's currency policy of fixed floating rates was reestablished. The framework made international trade much safer and cheaper to conduct.

Within a single currency intervention framework, the value of the Naira is what determines the exchange rate in Nigeria. In 1986, Nigeria instituted a policy of flexible and freely fluctuating currency rates. The direction that the currency rate takes is now determined by the market. The value of the currency can rise and fall with comparison to other countries' currencies without interference from the government (CBN, 2020). The controlled or dirty floating system allows the central bank and market authorities to participate in unofficial pegging, reduce daily volatility, or fight current market tendencies in the foreign exchange (FX) market. One way the central bank can intervene in a clean float system is by purchasing and selling currency values. This would assist reduce the uncertainty associated with exchange rate predictions (FMDA, 2019). To achieve a stable exchange rate and prevent

currency arbitrage, Nigeria used a variety of floating regimes. A pegged regime held the exchange rate at a constant value relative to the British pound sterling (GBP) from 1959 to 1967. Devaluation of the British pound the next year made the US dollar more attractive.
Following the dollar's depreciation in 1972, the British pound's parity was temporarily halted; the fixed parity system was re-established the following year (CBN, 2020). The fixed parity to the US dollar and the GBP basket were then restored in order to preserve the effect of the 1974 depreciation of the basket component. Prior to 1978, when the seven currencies comprising the Import Trade-Weighted basket were used to create exchange rates, this system was used. Olokoyo et al. (2019) and PwC (2020) state that the following foreign exchange markets were established: the Officially Unified Market in 1987, the Secondary Foreign Exchange Market (SFEM) in September 1986, the Autonomous Foreign Exchange Market in 1995, and the Interbank Foreign Exchange Market in 1999. Retail Dutch Auction System (RDAS), Wholesale Dutch Auction System (WDAS), and Interbank Rate System (IRS) were all operational from 2002 to 2015. According to the CBN (2020), the controlled floating exchange rate system was established in June 2016. Along with the IFEM, the RDAS was brought back in 2013. The CBN reinstated the Interbank and WDAS procedures to establish the value of the naira in 2014, as oil prices began to level off (CBN, 2020).
In order to stabilize the economy in 2015, the CBN instituted a managed-floating exchange rate policy in reaction to the unpredictable changes in global crude oil prices (Adeniran et al., 2018). A two-way quote mechanism was introduced to the interbank foreign exchange market in 2016. The Nigerian central bank suggested loosening rules and monitoring of previous policies in 2017 when it created the Investors and Exporters (I&E) foreign exchange market, with agent banks being designated as middlemen in international trade (IMF, 2020). Through the interbank market, the CBN injected huge sums of money into the foreign currency market in 2018. Because of this, the main financial markets of the economy were able to absorb excess liquidity and stabilize the exchange rate. In 2019, the Central Bank of Nigeria launched the Naira for Dollar initiative. In 2020, in reaction to the economic impact of the COVID-19 pandemic, the CBN lowered dollar sales to BDCs and instituted a standardized system of currency rates for both the interbank and parallel markets. Reducing demand and increasing currency liquidity are the goals of this strategy. New rules for diaspora remittances were announced by the Central Bank of Nigeria (CBN) in 2021 (CBN, 2020), one of several measures taken by the bank that year to relieve demand on Nigeria's limited foreign exchange reserves.
As part of its opposition to the dollarization of the Nigerian economy, the Central Bank of Nigeria (CBN) outlawed the sale of foreign exchange (FX) to Bureau de Change in 2022. The Central Bank of Nigeria (CBN) announced in many circulars that they will stop selling foreign currency to deposit money banks (DMBs) at the end of 2022. The central bank of Nigeria still steps in to set and maintain a steady exchange rate from time to time, even though the international financial system is constantly and significantly changing (World Bank, 2021; FMDA, 2019).

2.1.5 Hedging Foreign Exchange (FX) Risk in Nigeria

2.1.5.1 Problems of Hedging Foreign Exchange (FX) Risk in Nigeria

Companies, banks, and investors involved in global commerce and transactions face a significant threat from foreign exchange (FX) risk. Variations in exchange rates pose a threat to assets, liabilities, and cash flows denominated in foreign currencies due to their potential impact on their value. The use of financial instruments to reduce risk, known as hedging, is a common method on a global scale. But hedging foreign exchange risk effectively isn't easy in Nigeria due to a number of factors. These problems stem from the country's unstable economy, outdated regulatory structure, lack of sophisticated financial tools, and high transaction costs. A thorough analysis of these matters will be provided in this article, which will shed light on the underlying structural and macroeconomic variables that hinder successful hedging of foreign exchange risk in Nigeria.

1. **Economic Instability and Fluctuating Exchange Rates**

Because of its reliance on oil exports, Nigeria's economy is quite sensitive to changes in the price of oil on a worldwide scale. Due to the correlation between oil income and the country's foreign exchange reserves, the Nigerian naira (NGN) experiences significant volatility due to this dependence (Adeniran et al., 2018). When oil prices are falling, the CBN has a harder time keeping the currency stable since they have less money on hand. Additional variables, such as inflation, political unrest, and external economic shocks, amplify this volatility. Hedging becomes more complicated for companies and investors due to the unpredictable nature of foreign exchange prices. Significant variations in the value of the naira are a reality for businesses engaged in import and export activities, particularly those dealing with notable currencies such as US dollars, euros, and others (Olokoyo et al., 2019). It becomes more difficult and expensive to price hedging instruments like options and forwards when exchange prices shift unpredictably. Companies are more vulnerable to foreign exchange risks and hedging solutions lose some of their allure due to the increased volatility's unpredictable hedging costs.

2. **Underdeveloped Financial Markets**

The underdeveloped state of Nigeria's financial markets is a major obstacle to foreign exchange risk hedging in the country. The range of financial instruments available for hedging is limited due to the lack of a strong and liquid derivatives market. Businesses in industrialized nations can tailor their hedging strategies to their unique needs by making use of a wide variety of sophisticated financial instruments, such as forward contracts, futures, options, and swaps (FMDA, 2019). There is a rather shallow market for these instruments and their accessibility is limited in Nigeria.

Unfortunately, trading infrastructure is often insufficient even when these instruments are available. Foreign exchange futures market activity is low among local financial institutions, and international investors are wary of becoming involved for fear of lack of transparency and liquidity. Nigerian companies have little tools to protect themselves from currency fluctuation risks due to the country's weak derivatives market.

In addition, there is insufficient connection between global financial systems and Nigeria's financial markets. Because of the lack of integration, Nigerian companies are unable to get into global financial markets. This means they miss out on better hedging opportunities and potentially better pricing on foreign exchange contracts.

3. **Regulatory and Policy Limitations**

An important obstacle to effective hedging of foreign currency risk is the regulatory structure in Nigeria. Limits on certain imports, limits on foreign exchange dealings, and capital controls are only a few examples of the stringent limitations on foreign exchange transactions that the Central Bank of Nigeria (CBN) has applied on multiple occasions (CBN, 2020; KPMG, 2020). While these policies have good intentions—to stabilise the naira and control the supply of foreign currency—they often cause businesses to face more uncertainty and make their efforts to reduce foreign exchange risk more difficult.

Official and parallel market exchange rates may differ as a consequence of the CBN's foreign exchange policies that create a dual exchange rate system. Discrepancies between government and market rates make effective hedging challenging for enterprises in this context. Hedge funds lose some of their effectiveness if they use the official rate for hedging but conduct their transactions at the higher parallel market rate.

In addition, hedging can be made more complicated by legislative demands regarding capital restrictions, which can make it harder for enterprises to transfer funds in and out of the country. As a result of these rules, companies can have trouble paying off hedging contracts, especially ones with international counterparties (IMF, 2020). Because of this, counterparty risk is increased and corporations are unable to employ hedging methods for the long term.

4. **High Transaction Costs**

Compared to many other markets, the cost of hedging against foreign exchange risk in Nigeria is much higher. High transaction costs are caused by a combination of variables, including limited market liquidity, wide bid-ask gaps, and significant fees charged by financial intermediaries. The foreign exchange market in Nigeria is not very liquid, thus it might be expensive for corporations to buy forward contracts or other derivatives. corporations also may have trouble finding fair-priced counterparties (AFDB, 2019; FMDA, 2019).

To compensate for the risk they see in Nigeria's financial system, financial institutions often charge high premiums on hedging instruments because of the country's unstable economy. These costs can reduce the financial benefits of hedging, which is particularly true for SMEs, which may not have the resources or power to negotiate better terms (World Bank, 2021).

Another reason international investors avoid hedging their Nigerian ventures is the country's high transaction expenses. Due to the high hedging costs and lack of assurance about the naira's stability, investors often limit their investment in Nigerian assets or forego hedging altogether. The FX derivatives market becomes even less liquid as a consequence of this reluctance to hedge, leading to a vicious cycle wherein fewer participants lead to higher costs and fewer hedging options.

5. **Deficiency in Expertise and Awareness**

Foreign exchange risk hedging is an area in which many Nigerian businesses, particularly SMEs, are woefully unprepared. Utilizing complex financial products for hedging purposes calls for knowledge of financial markets, risk management, and regulatory requirements. Businesses often avoid hedging activities because they lack the necessary skills, leaving them exposed to currency volatility. Hedging is an important tool for risk management, yet few Nigerian businesses understand its relevance (CBN, 2020). Some businesses, especially those focused on the home market, might not realise the dangers of currency fluctuations until they suffer huge losses. The complexity and perceived high costs of hedging can discourage even risk-aware organizations from taking action (World Bank, 2021).

This issue is made worse by the fact that Nigeria is severely lacking in qualified financial consultants and specialists who focus on foreign exchange risk management. Many businesses are vulnerable to changes in currency rates because they do not have access to the expert advice and direction needed to adopt effective hedging plans.

2.1.5.2 Solutions to Hedging Foreign Currency Risk in Nigeria

Both Allen (2003) and Jacque (1996) state that in order to make good decisions on currency risk management, a set of operational best practices must be put in place. To lessen the impact of potentially dangerously fluctuating currency rates in Nigeria, one can use the following strategies.

1. **Swapization:** According to Aneto et al. (2018), "swapization" occurs when two countries decide to exclude a third-party valuing standard, like the US dollar, that is irrelevant to their interests in the current global framework from their bilateral trade and instead base certain aspects of their trade on the direct exchange of their national currencies. When one country lends another its currency and asks the receiving country to deposit the same amount as collateral, the two countries enter into a currency swap.

The idea of swapization, a financial derivative made up of forward exchange rate contracts, was to reduce the costs of keeping a foreign exchange reserve and make trade between counterparties easier. By agreeing to return to the market rate on the maturity date, this economic agreement eliminates the need for Nigeria and China to obtain US dollars in order to swap currencies. In order to fix payment imbalances, the parties might use this commercial agreement to balance their surpluses and deficits in the two currencies.Obiah Mmadubuike et al. (2021) compiled a list of eight different methods and tactics for hedging.

Outside Methods: The parties to a forward contract have committed to exchanging a certain amount of the underlying asset for another quantity at a future date and price. A forward contract is an agreement to trade a certain amount of an asset for a fixed price at a future date that is set at the beginning of the contract.

To mitigate the effects of currency risk, these are the most popular methods currently in use. Businesses have the option to use forward contracts to secure their expected foreign currency payments and future receivables. There will be no surprises in the cash flows because the exchange rate for the future transaction is already set. What happens between the dates of the contract and the transaction, therefore, is irrelevant. So, you shouldn't be worried about losing money during the trade. The date of future settlement can be a fixed date or it could fall anywhere in a range that has been previously agreed upon.

2. **Currency Futures:** Two parties enter into an agreement to purchase or sell a certain quantity of currency at a predetermined price on a future date through the trading of futures contracts on standardized exchanges. Because they are traded on a controlled exchange, futures contracts are more liquid than forward contracts. To hedge against currency depreciation, one can buy futures, and to hedge against currency appreciation, one can sell futures. As a result, trading currency futures can help smooth out fluctuations in the value of one currency relative to another, reducing the risk of Foreign Exchange Exposure.
3. **Currency Options:** The right to purchase or sell a certain currency at a set price and for a set period of time is what currency options are all about. The ability to buy or sell a currency without actually having to do so is a fundamental aspect of the foreign exchange market. The current exchange rate will determine how the option holder may use it. The chance to purchase or sell the money will pass if he or she does not take action. For offering this option, the "writer" of the option receives payment. The related cost is known as the premium. The exercise price, also known as the strike price, is the predetermined rate at which the holder is able to purchase or sell the currency. The most common types of options are call options, which give the holder the power to buy, and put options, which can be used to sell. In this case, investors can profit from currency options. An Indian firm might profit from purchasing US dollar capital goods from the US in three months using a currency call option. Two outcomes are possible. If the value of the dollar drops, the company can save money by buying dollars at the current market rate instead of the higher strike price. Second, if the currency appreciates, the exchange rates will work against the company because the spot rate will be higher than the strike price, allowing it to buy US dollars at the strike price through the option. Thus, in either case, the company can buy the products at a reduced price.
4. **External Debt:** If you take on foreign loans, you reduce your exposure to currency swings. This idea is backed up by the fact that it is related to the International Fischer Effect. At some unspecified point in the future, a business may anticipate receiving a certain amount of Euros. If the local currency increases value compared to the Euro, the firm can lose money. If a company borrows money in Euros for the same amount of time and then converts it back into dollars at the current market rate, it can reduce its exposure to currency risk. After the company receives the Euros, they can repay the loan in those currency. This proves that the corporation can completely eliminate its exposure to changes in currency rates.
5. **Cross Hedging:** By holding a negative position in two currencies that are positively correlated, one can "cross-

hedge" their investments. In cases where it is not practicable to hedge a specific foreign currency, this tool can be useful. Companies can reap substantial benefits from cross hedging because the use of a foreign currency has no effect on the hedging effects.

6. **Currency Diversification:** An investment strategy known as "currency diversification" involves holding assets denominated in several currencies. No correlation between currency pairs is necessary for diversification to reduce risk. It will pave the way for global expansion, protect against currency changes, and take advantage of pricing gaps.
7. **Internal Techniques:** A "netting" occurs when two or more exposures in the same or different currencies are used to offset each other in the event that the expected movement of exchange rates causes a gain or loss on one position to be offset by a gain or loss on the other.

2.2 Theoretical Framework

2.2.1 Financial distress

Smith et al. (1985) found that when high-leverage companies have cash-flow problems or are on the verge of bankruptcy, they would participate in risk hedging to help ease their financial distress, which in turn increases shareholder value (Muff et al., 2008). Reduce the likelihood of financial distress costs for a firm by hedging risk and reducing volatility in cash flow. The likelihood of suffering discomfort and the costs connected with that distress are two variables that determine the benefit of minimizing this cost in risk management. Risk hedging is increasingly beneficial as the likelihood of distress increases. Researchers have thus far relied on metrics based on a company's borrowing capacity or leverage to depict financial hardship. According to Muff et al. (2008), studies conducted by Froot et al. (1993) and Smith et al. (1985) provide theoretical support for the claim that increased use of financial derivatives is associated with a higher chance of financial distress.

2.2.2 Underinvestment

When a company can't afford to invest in capital because it doesn't have enough money on hand or because borrowing money is too expensive, it's in a state of underinvestment. As cash flows reduce by one dollar, businesses cut capital expenditures by around 0.35 dollars. Underinvestment occurs when a highly leveraged company is forced to make poor investment decisions and miss out on profitable investment possibilities. Research by Mayers and Smith (1982), Bessembinder (1991), Smith et al. (1985), and Froot et al. (1993) suggests that underinvestment can be reduced by effective risk management (Charumathi & Kota, 2012). This happens when bondholders are swindled because management is too busy trying to maximise its own riches to invest in safe projects. Hedging can help reduce the disparity between bondholders and equity investors caused by changes in cash flow and the high costs of borrowing money from outside sources (Charumathi & Kota, 2012).

3.0 Conclusion and Recommendations

3.1 Conclusion

Many factors contribute to the difficulty of hedging FX risk in Nigeria, including the country's volatile currency, its immature financial markets, regulatory constraints, high transaction costs, and a lack of risk management experience. The exchange rate volatility in Nigeria is worsened by the country's heavy dependence on oil exports, which connect its currency to the ever-changing global oil prices. This makes hedging more difficult and expensive, particularly for businesses that deal in international trade. In addition, hedging techniques are hindered by the nation's regulatory framework, which is characterized by foreign exchange limitations and a dual exchange rate system. In addition, businesses are less likely to use efficient risk management techniques due to the shortage of qualified financial experts and the high costs of hedging products. There are a lot of businesses in Nigeria that could lose a lot of money due to currency volatility.

3.2 Recommendations

To mitigate these challenges, several essential measures can be implemented to enhance the environment for hedging foreign exchange risk in Nigeria:

1. The integration of more intricate derivatives, including as futures, options, and swaps, ought to be Nigeria's financial market improvement priority. By working together, the public and private sectors might strengthen the foreign exchange derivatives market, making it more liquid and easier for businesses to access. A more robust derivatives market would provide companies with more tools to reduce their exposure to foreign exchange risk.
2. The Nigerian government's central bank, the CBN, has to concentrate on creating a clearer and more reliable system to regulate currency exchanges. To reduce uncertainty, businesses would benefit from clearer and more simplified foreign exchange regulations, particularly those that pertain to hedging instruments and access to foreign currency. To make hedging tactics more effective, exchange rate policies must be streamlined and a more unified exchange rate structure must be implemented.
3. Thirdly, Nigeria should do a better job of connecting to foreign financial markets so that companies can hedge their bets. This might mean making it easier for foreign investors to participate in Nigeria's financial markets, lowering restrictions on the flow of capital, and creating incentives for international financial institutions to set up shop in the country. More efficient and diverse hedging tools, as well as more liquidity, would be available to more people through better integration.
4. To lower transaction costs associated with hedging foreign exchange risk, the Central Bank of Nigeria and financial intermediaries should work together. Reduced costs and wider bid-ask spreads are possible outcomes of measures that encourage competition in the financial sector, which can achieve this goal. In order to help small and medium-sized businesses (SMEs) save money and have better access to financial services, we should encourage more financial service providers to specialize in foreign exchange (FX) hedging. 5. We should launch capacity-building campaigns to raise awareness about the importance of FX risk management and provide companies with training on effective FX hedging strategies. Workshops, seminars, and consulting services can be offered by educational organizations, financial institutions, and the government to help businesses, particularly SMEs, improve their financial literacy and risk management skills.
5. By endorsing PPPs, the government may help bring about hedging solutions tailored to Nigeria's unique economic situation. To better address the needs of businesses in Nigeria's uncertain economic climate, the country can draw on the knowledge of local market participants and foreign financial institutions to develop specialized hedging instruments.

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