

**International Finance Corporation and National Pension Commission of Nigeria**

# **Alternative Asset Classes for Pension Funds**

**Impediments to Corporate Bond Development in Nigeria**

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# Agenda

- Introduction
- Institutional Infrastructure
- DMO and CBN operations
- Costs of fixed income transactions
- Issuers and Investors
- Market Support Infrastructure
- Conclusion



# Institutional Infrastructure

## ➤ Regulatory environment

- Transparency / consistency of regulatory process
- Application process
  - Complicated
  - Lengthy
  - Costly
- Present approval process is hybrid disclosure and merit based system
- Differentiate between equity and bond markets
  - Structure of underwriting
  - Prospectus and marketing requirements for equity offering vs. those for debt offering
- Co-ordination and co-operation strengthened
- SEC capacity acting as constraint
  - SEC self-funded



# Institutional Infrastructure (ctd)

## ➤ Tax

- Application of tax laws and regulations unclear
- Ensure tax neutrality between asset classes e.g. equities and bonds
- Address distortion created by application of interest withholding tax on FGN, state and corporate bonds
- Unable to obtain tax rulings in respect of new products
- Clarity of tax position in respect of PFAs' investments



# Institutional Infrastructure (ctd)

## ➤ Accounting

- Is Nigeria GAAP acceptable going forward?
  - Should there be complete consistency with international accounting standards - in particular in respect of IAS 32 and IAS 39 for banks and insurance companies?
  - No local accounting standard for derivatives
- Move to International Financial Reporting Standards ('IFRS') complicated by the need to develop:
  - (i) systems, and;
  - (ii) regulators' understanding of differences between results generated under Nigerian GAAP and IFRS.



# Institutional Infrastructure (ctd)

- Clearing and settlement for bonds
  - Current situation
    - Settlement is a form of delivery versus payment based on T+2 but.....
  - Issues
    - Present system operates manually
    - CSCS and CBN systems are not compatible
    - PDMM have intraday credit risk on CBN
    - PDMM have market risk in the event of counterparty default
    - Primary market settlement not operating efficiently



# DMO & CBN operations

## ➤ Government bond market

- Lack of deep, liquid benchmark yield curve impacts price discovery
- Liquidity in secondary markets away from PDMM may not be adequate
- Issuance calendar not strictly adhered to
  - Volumes can be adjusted shortly before, or even once, auction occurs
- Unforeseen risks to issuance program

## ➤ Market making

- Absence of active market making
  - Non PDMM operators consider that the secondary market is illiquid
- Primary dealer market makers not being monitored
- More than one group of primary dealers (DMO and CBN)



# DMO & CBN operations (ctd)

## ➤ CBN operations

- Need provision of funds for liquidity management
- Distortion in T/bill market due to excess bank liquidity e.g. inverse yield curve

## ➤ Banking market

- Excess liquidity in banking system (~65%); loans more cost efficient than corporate bonds
- Banks fuelling excess liquidity in the stock market through high yield margin finance

## ➤ Interbank market

- Does not appear to be functioning efficiently
- CBN operating as borrower of last resort (MPR – 2.5%)
  - puts a floor on the interbank rate (? implications for foreign exchange market if CBN borrowing rate is reduced).
- Bilateral repo market activity not well established
  - Informal repo market allows institutional investors to access liquidity but no market standards in place (procedures / documentation)





# DMO & CBN operations (ctd)

- Potential for market correction
  - Is this adequately factored in?



# Costs of fixed income transactions

## ➤ Transactions costs

- Primary bonds
  - Issuing House fee 1.50%
  - Underwriting: commitment fee (50bp) plus 7-9% on crystallized underwriting
- Secondary securities
  - Total fees (buy & sell) exceed 5%
- Stamp duty for debt issues
  - 2.5% to register Trust Deed plus further 2.5% due on conversion to equity for convertible issues
- Existing regulations forbid wholesale distribution
  - need to develop inter-dealer broker market
- Debt underwriting subject to same regulations as equity underwriting
  - requirement for 80% firm underwriting adds substantially to costs
  - application of equity-style fees to debt issues impacts on price competitiveness of corporate bonds



# Issuers and Investors

## ➤ Non-government issuers

- States constrained by requirements of DMO and CBN
- Few large well rated (non-bank) corporates willing / needing to tap market
- To date banks have shown most interest in issuing ‘corporate’ bonds

## ➤ Investors

- Pension fund administrators (‘PFAs’)
  - Listing requirement
  - Implications of ratings’ requirement for due diligence
- NDIC
- Banks
  - Large holders of government bonds due to excess liquidity
- Insurance companies
  - Regulatory arbitrage between PFAs and insurance companies’ solvency requirements
  - Challenged by level of receivables from brokers (NAICOM regulation not enforced)
- Retail
  - Banks issuing short dated notes backed by a pool of government bonds (with longer maturities) to retail investors - ? pseudo securitization



# Issuers and Investors (ctd)

## ➤ Rating agencies

- Is capacity of local agencies adequate to support corporate bond market development?
  - Have developed expertise in rating banks but to date no focus on pure corporates
- Economics may not presently justify investment by international rating agency

## ➤ Knowledge of fixed income products weak

- Credit culture poorly developed
- Overall, education and capacity issue in respect of fixed income products for regulators, market operators and retail investors



# Issuers and Investors (ctd)

## ➤ Product development

- Unable to obtain tax ruling in respect of new products
- Shelf registration guidelines included in ISA 2006
  - market operators not confident that use of shelf documentation will lead to lower issuing costs (believe that it will still be necessary to undergo full approval process).
- Outlook for MBS complicated by:
  - Land Use Act;
  - cost of taking security, and;
  - bankruptcy foreclosure process
- Outlook for REITS complicated by lack of tax exemption(s)
- Unregulated private placement market developing
- Derivatives
  - No Naira interest rate swap market; cross currency swaps dealt in short tenors
  - Presently no laws: futures & options; short selling; stock borrowing and lending
  - No local accounting standard for derivatives



# Market Support Infrastructure

## ➤ Data availability

- No entity charged with collecting data on market activity and end of day prices  
=> limited information dissemination

## ➤ Information dissemination

- Essential for price discovery
- Need to establish transparency in market

## ➤ Trade Association (?SRO)

- Existing associations e.g. MMAN, Association of Bond Dealers lack 'teeth'

## ➤ Other Issues

- Apparent lack of standards in the market e.g. standard documentation
- Perceived lack of understanding of common variables e.g. fees, tax



# Conclusion

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- Issuers and Investors
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