Making the Capital Markets in Nigeria More Attractive for PFAs…Focus on Bonds

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To Discuss:

- **Safer products**
  - Credit enhancements on non-FGN bonds
  - Collateralized bonds
  - Bonds with Put provisions
  - Hedging devices, i.e., futures and options
  - Domestic, active CRAs; Demand more domestic CRAs; International Credit Ratings
- **More diversified products**
  - Zero coupon bonds
  - Infrastructure bonds
  - Bonds denominated in US Dollars or Euro
- **Products keeping up with Inflation, i.e., getting positive returns**
  - Index-linked bonds
  - Strategy: Mix of equities and bonds; monthly purchase, same amount
- **Better Corporate Governance**
  - CG ratings
  - CG enforcement by PenCom and SEC
- **Fair treatment and prices on NSE and OTC Markets**
  - Surveillance by NSE and SEC; Enforcement; Sanctions; Publicity
  - Better Liquidity for Bonds: Trading Platform
    - Market Makers, e.g., requiring MTN programs to require (at least 2?) dealers acting to make a market on each series of bonds issued
    - Four "I's": Increased International Institutional Investor demand (Reuters publicity)
- **Cheaper costs**
  - Reduced costs on CISs
  - Reduced commissions on purchases and sales of equities and bonds
  - Tax Waiver benefits

Safer Products

Credit enhancements on non-FGN bonds:

Trade-off: Expense to issuer paying for enhancement, e.g., +/- 3% one time fee*, BUT able to issue at lower coupon, e.g., 15% coupon vs. 16% coupon over 6 years, saving 1% per year.

- Partial or full guarantee, e.g., from IFC, USAID, GuarantCo, etc.; insured bonds

*Issuers need to be reminded that this fee should be 'amortized' over the life of the bond, e.g., a 6-year bond would incur 0.5% per year.

Safer Products

Collateralized bonds

Bonds backed by collateral locked in a warehouse, e.g., salad oil, by an oil manufacturer; pledged assets to be liquidated if default by issuer.

- Asset Backed Securities or Mortgage Backed Securities

Again, trade-off of greater safety for investor, thus higher credit rating, for additional cost to issuer… but could issue at lower coupon

Safer Products

Bonds with Put provisions

For example, a 15-year, 15% coupon bond issued with Put Provision, allowing the bond holder to "put" the bond back to the issuer within a 2-week window on the anniversary dates of the issuance, from years 7 through 12. Offset: normally the issuer may issue the bond with a lower coupon, as the put provision is a benefit to the investor and the investor is willing to accept that.

- In a higher interest rate scenario, e.g., in year 8 @18%, bond holders will get 100% principal returned and can re-invest in similar bond issues at 18%.
- In a lower interest rate scenario, e.g., in year 7 @12%, bond holders will hold bond receiving the higher-than-market rates, or can sell bond at profit.

"Turning a long-term (15 year) bond into a medium-term bond (7 year)" for investors.

Safer Products

Hedging devices, i.e., futures and options

- The use of hedging devices by investors will allow them to lower risk of inflation for example.
- The introduction of futures and options, e.g., interest rate futures; inflation-indexed options; foreign currency futures…may allow issuers to issue at lower coupons with the knowledge that hedging devices will effectively be a "credit enhancement", i.e., lowering risk, for investors.
- Issuers could also lower risk if issuing adjustable rate bonds, using the hedging vehicles to offset risk of rising rates.

Safer Products

Domestic, active (5) Credit Rating Agencies; Demand more domestic CRAs; Int'l Credit Ratings

It has been said that raising the CRA culture as well as having more CRAs in Nigeria would create a more competitive environment and provide higher quality ratings (not to say it is lower quality now).

The SEC has recently adopted a Rule that recognizes the ratings of international CRAs

- Again, paying an international CRA costs more for the issuer, but may be perceived as a 'credit enhancement' for investors, allowing the issuance at a lower coupon rate.

More diversified products

Zero coupon bonds

- These pay no interest; purchased at a discount; for example, a zero coupon bond issued today at 50 that matures in 5 years has an implied yield of about 14%, which will pay 100 (par value) at maturity.
- Good for meeting liabilities that are scheduled in a (e.g., 5 year) future period.
- As these bonds don’t pay interest, good for Shariah compliant investors.

More diversified products

Infrastructure bonds

- Bonds issued to develop infrastructure projects, e.g., for road development; water treatment plants; electricity grids; (government) housing…usually longer term funding requirements.
- Can be issued by States or Corporates
- Nigeria in dire need for such projects

More diversified products

Bonds denominated in USD or Euro

- Issuers can issue bonds in Nigeria in foreign currency; this may attract (domestic and international) investors concerned about the Naira depreciation.
- There is always a trade-off: Issuers would be happier to issue foreign denominated bonds if there were a currency futures or options exchange to use for hedging.
- Investors might find the foreign denominated bonds a good product for diversifying Naira portfolios.

Products keeping up with Inflation, i.e., getting positive returns

Variable rate or Index-linked bonds

- DMO has been talking about these forever; corporates and states should consider these.
- Trade-offs:
  - **Issuer pays more interest in higher interest rate environment, e.g., recent NPR move**
  - **Investors receive less interest in lower interest rate environment**
- Bottom line: Issuers pay interest at rates of inflation; investors receive rates of inflation.

Products keeping up with Inflation, i.e., getting positive returns

Strategy: Mix of equities and bonds; monthly purchase, same amount

- PFAs should keep their portfolios balanced, debt and equity and money market, to try to attain positive returns. Rebalancing efforts may be needed from time to time.
- Purchase equities and funds, same amount each month, average up and average down.
  - Positive returns not guaranteed.
- When futures and options are introduced, this will help enable investors to hedge investments, thus lowering risk, but at a cost of course.

Better Corporate Governance

CG ratings

- With the recent developments and importance of CG, some (international) CRAs are offering CG ratings, in addition to credit ratings.
- If this is something of great importance to PFAs, you should request these activities to be offered by domestic CRAs.
- It is well known that larger Pension Funds (e.g., CalPERS in USA) demand better or top level corporate governance from companies that they will consider for investment.

Better Corporate Governance

CG enforcement by PenCom and SEC

- PenCom has its Corporate Governance Code; SEC has its CG Code.
- Having regulations or guidelines are not enough…regulators must also enforce the Rules, not only make them.
- PFAs should demand this, if important for PFAs.

Fair treatment and prices on NSE and OTC Markets

Surveillance by NSE and SEC; Enforcement; Sanctions; Publicity

- PFAs should review price executions of transactions to ensure within range of trading
- The NSE, if applicable, and/or the SEC should perform surveillance activities on trades daily
- Surveillance may discover some market practices that are not compliant, and thus the customer (e.g., Pension Fund) is not getting best execution
- If non-compliant activities are found, those violators should be sanctioned, that *could* include reimbursement to the customer, and *should* include publicity to all.

Fair treatment and prices on NSE and OTC Markets

More Transparency and Liquidity for Bonds: Trading/Information Platform

- It is said that size matters, regarding the potential liquidity of bonds; unless non-FGN issuances substantially increase in size, we may not see 'liquidity' of these
- However, transparency also adds to the potential liquidity, thus, when an information/trading platform arrives in Nigeria, we may see liquidity improve somewhat
  - CSCS publishes daily settlement summaries of ALL bonds, FGN and non-FGN
- Market Makers may help, e.g., requiring Medium Term Note programs to have (at least 2?) dealers acting to make a market on each series of bonds issued
- Four "I's": Increased International Institutional Investor demand may help as well, through Reuters publicity for example

Cheaper costs

Reduced costs on Collective Investment Schemes; marketing schemes to attract investors or larger investments from investors

- Nigeria currently has flat rate pricing for CIS purchases and sales; typical CIS Fund Mgt. fee @ 1.5%/year
- It is common in some markets for CIS commissions (i.e., spread between bid and ask prices) to be discounted for 'bulk' purchases:
  - Breakpoints, i.e., the more the accumulated investment, the greater the discount; can apply to the 'family' of funds group
  - Letters of Intent, i.e., signed letter with CIS that purchaser will buy at least ___ units within a 12 month period
  - Holding of funds beyond 3 or 5 years, may allow the sale of funds at offer price, i.e., no commission, rather than sale at bid price

Cheaper costs

Reduced commissions on purchases and sales of equities and bonds

- Commissions are negotiable, therefore, shop around for best rate
- Executions are somewhat less transparent on the OTC market; test the waters
- A rule of thumb in the capital markets: the bigger order, or a bulk order, should demand a lesser % commission

Cheaper costs

Tax Waiver benefits

- The Tax Waiver, giving investors in ALL bonds equal treatment and the tax waived on capital gains and interest, was signed by the President in March 2010…but it has never been published in the Gazette
- Meanwhile, my understanding is that the FIRS is granting tax waivers, both to issuers and to investors, upon application

Summary

- Bonds are very flexible, for issuers as well as for investors
- Bonds (investments) can be:
  - made safer, by the issuer and by the investor;
  - more diversified as meeting issuers' funding needs and investors' investment objectives; and
  - structured to keep pace with inflation
- Market Operators, including Fund Managers, should re-think their cost structures
- Investors should have an overall investment strategy and perform their own due diligence when possible
- Regulators should make and enforce rules for easy and quick access for as well as for fair treatment of investors

Thank You

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