

Making Finance Work for Nigeria

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List of Abbreviations and Acronyms

ATTRRS	Accounting Transactional Recording and Reporting System
BPP	Bureau of Public Procurement
BPP	Bureau of Public Procurement
CAC	Company Affairs Commission
CBN	Central Bank of Nigeria
CPAR	Country Procurement Assessment Review
CPIA	Country Policy and Institutional Assessment
CPS	Country Partnership Strategy
CRMS	Credit Risk Management System
CSCS	Central Securities and Clearing Systems
CSOs	Civil Society Organizations
DMO	Debt Management Office
DPO	Development Policy Credit
e-FASS	Enhanced Financial Analysis and Surveillance System
ECA	Excess Crude Oil Account
EFCC	Economic and Financial Crimes Commission
EIA	Environmental Impact Assessment
EITI	Extractive Industries Transparency Initiative
FHA	Federal Housing Authority
FIRS	Federal Inland Revenue Service
FRB	Fiscal Responsibility Board
FRC	Financial Reporting Council
FSRCC	Financial Services Regulatory Coordinating Committee
FSS2020	Financial Sector Strategy 2020
GASAB	Government Accounting Standards Advisory Board
GDP	Gross domestic product
GIFMIS	Government Integrated Financial Management Information System
IFRS	International Financial Reporting Standards
IPO	Initial Public Offering
IPPIS	Integrated Payroll and Personnel Information System
IPSAS	International Public Sector Accounting Standard
LGA	Local Government Areas
M&E	Monitoring and Evaluation
MDAs	Ministries, Departments and Agencies
MFB	Microfinance Bank
NACRDB	National Agricultural and Co-operative Development Bank
NAICOM	National Insurance Commission
NASB	Nigerian Accounting Standards Board
NDIC	Nigerian Deposit Insurance Corporation
NEEDS	Nigeria Economic Empowerment and Development Strategy
NLSS	Nigeria Living Standards Survey
NSE	Nigerian Stock Exchange
PEMFAR	Public Expenditure Management and Financial Accountability Review
PENCOM	National Pension Commission
PPP	Public Private Partnerships
PSI	Policy Support Instrument
RTGS	Real-Time Gross Settlement
SAS	Nigerian Accounting Standards
SEC	Securities and Exchange Commission
SMEs	Small and Medium enterprises
TSA	Treasury Single Account
VFM	Value for Money

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Executive Summary

Nigeria's Vision 2020

With the return to democratic rule in 1999, Nigeria committed to leaving behind its history of economic stagnation, declining welfare and social instability. The new government started an ambitious economic reform program, outlined in the National Economic Empowerment and Development Strategy (NEEDS 2004-07), and succeeded in bringing about macroeconomic stability and the highest growth rates Nigeria has seen in decades. A historic debt relief deal was signed with the Paris Club of creditors leading to the cancellation of \$30 billion of the country's external debt and the re-channeling of around \$1 billion of annual debt service savings towards the achievement of the Millennium Development Goals (MDGs). An oil-price based fiscal rule helped de-link budgeted expenditure from the international oil price, placing Nigeria on a more stable fiscal path and away from the boom-bust years that had characterized its development history until then. The government's anti-corruption campaign also gained international recognition with the establishment of agencies such as the Economic and Financial Crimes Commission (EFCC).

Following the 2007 elections, the new government of President Umaru Musa Yar'Adua continued the reform process started by the previous administration and set a new target – Vision 2020 – to make Nigeria one of the 20 largest economies in the world by the year 2020. The government set out to translate this bold vision into action by realigning a number of different national strategies to targets set by NEEDS 2 2008-11, the President's Seven Point Agenda and the MDGs. A second round of policy strategy design and reprioritization was then initiated to determine specific areas of focus by sector.

Already prior to the 2007 elections the Central Bank of Nigeria (CBN) had taken the lead in developing a comprehensive vision for the financial sector, which resulted in the Financial Sector Strategy 2020 (FSS2020). FSS2020 remains the most developed of the sector strategies cascading from the broader Vision 2020 and the one that is at the most advanced stage of implementation. It represents a mammoth effort that the CBN has been competently driving since its inception and, through an extensive consultative process, has brought on board a number of government agencies, first among which the Federal Ministry of Finance, for enhanced coordination and ideas generation. Industry players, academics and other members of civil society have also been involved in the crafting of the strategy.

The Potential Contribution of Nigeria's Growing Financial Sector

Over the years the shallowness and weakness of Nigeria's financial sector has limited the country's growth potential. This became particularly evident after 1999, with the beginning of the economic reform process and the progressive stabilization of the country's economy. While the pay-offs of the reforms became self-evident – as evidenced by the more stable exchange rate, lower inflation rates, high external reserves, the maintenance of debt sustainability, etc. – growth was fuelled on a relatively narrow economic base: largely by the oil price boom, feverish activity in the telecoms and construction sectors and to some extent in the agricultural sector. Thus, despite good progress higher growth rates did not by and large translate into increased employment opportunities and did not result in a significant decline in poverty rates.

While the concentration of economic activity has been traditionally in the oil & gas sector (which contributes over 17% of GDP), the poor business environment has contributed to making the resurgence of the other sectors of economy, and particularly manufacturing, very difficult. Nigeria is 125th on the World Bank's Doing Business Report 2010 and its ranking has been falling. A key constraint to business identified by both the World Bank Enterprise Survey on Nigeria (2008) and diagnostic work included in this volume is the lack of access to formal financing for productive activities, especially in the manufacturing and small and medium-sized enterprise (SME) sectors. Most Nigerian entrepreneurs finance themselves through retained earnings and only a few very large enterprises benefit from reliable financing for their working capital or investment needs.

Despite the progress made through a number of reforms – including the banking consolidation exercise, the overhaul of the insurance and pension industries and the development of the sovereign debt market – the financial sector remains underdeveloped and has become a bottleneck to growth over the years. The mostly domestic-owned banking sector constitutes the largest component of the financial sector and lends primarily to the oil & gas (25.5% of total credit to the private sector in 2008) and telecoms sectors (16.7%). Hence, even if a large expansion in banks' private sector lending has been registered over the past few years, it has remained narrowly confined to particular sectors.

Nonetheless, bank credit remains the main source of external formal financing for Nigerian firms, as the development of the corporate debt and equity market is still in its early stages. The equity market is also dominated by the banking sector, which has recently accounted for between 65 and 75 percent of total market capitalization. Sovereign bonds constitute the bulk of the bonds issued and there continues to be little secondary trading. Insurance premiums are negligible compared to GDP and the sector fails to provide essential risk mitigation and savings instruments like property insurance or life insurance to a broad section of the Nigerian population. Pension funds are growing fast but, despite a relatively solid and advanced legal framework, lack diversified investment options thus failing to provide the impetus that such an important source of capital could have on the economy. Nigeria's housing finance market is almost

non-existent with less than 50,000 mortgages outstanding and there is a significant shortage of dwellings.

Such an underdeveloped and shallow financial sector hampers the prospects for economic diversification and employment creation in Nigeria. Given that higher growth rates will be required if Nigeria is to be among the top 20 economies by the year 2020 (Vision 2020), a concrete economic diversification strategy will be required. Moreover, if the country is to achieve the MDGs, economic growth must translate into more employment opportunities for ordinary Nigerians or else the impact of high growth rates on poverty reduction will remain contained, as has been the case thus far.

In achieving these growth aspirations the financial sector has a crucial role to play in more effectively mobilizing and allocating resources. This will entail providing access to finance to an increasingly large proportion of Nigerian enterprises and individuals. Deepening the financial system will help support enterprise productivity and facilitate the shift that many Nigerian firms find hard to make towards export-oriented activities, which are essential for the high growth rates needed for a sizable and sustained reduction in poverty. Improved access to financial services for the poor will help support their inclusion in the formal economy, while building much-needed human capital, thereby reversing the higher growth rates being accompanied by widening inequality.

Challenges in Making Finance Work for Nigeria

The past 18 months have been testing times for countries around the world and their financial systems. Nigeria has been no exception. While giants of the international financial industry came crumbling down the world over, many argued that Africa would generally come out unscathed from the global financial crisis. However, it is now clear that is not the case. While having been spared most first-round, contagion effects that could have been channeled through the presence of international financial groups, many African economies, Nigeria included, have suffered from significant second-round effects.

Although Nigeria entered the crisis with a healthy fiscal surplus of 5 percent of GDP and a clean slate post-debt relief, things turned around rather quickly, with the drastic drop in oil prices of around \$110 per barrel. The Naira depreciated considerably (from N117 to N190 to the US Dollar) before stabilizing at N150 per US\$. This had a significant impact both on government finances and the financial sector. The drop in oil prices and the currency depreciation had a significant impact on banks' balance sheets, particularly due to the loans extended to the downstream oil sector as well as the long exposures of oil importers, hit by the depreciating currency.

The volume of non-performing loans (NPLs) also started to rise with the crash of the Nigeria Stock Exchange (NSE). For quite some time, banks had adopted the practice of lending to third party nominees for the purchase of their own shares (margin loans). As part of the process of the successive rounds of share issuance over the past couple of years, Nigerian banks provided purchasers of their shares with margin loans. When the

value of the shares declined dramatically from their peak in March 2008, borrowers saw the value of their collateral decline and defaulted on their margin loans. The correction of the process on the Nigerian stock market was in part due to the pull-out of international investors – the result of the lower appetite for emerging market risk brought about by the global crisis.

In the last quarter of 2008 the CBN adopted a number of measures to make liquidity available to the banking system and to enhance scrutiny of the banks' situation, a task rendered all the more difficult due to weak accounting standards and poor corporate governance practices that saw many banks exploiting loopholes in the rules to avoid coming to terms with the full extent of their losses.

In June 2009, the newly appointed Governor of the CBN, declared that his first priority would be to focus on re-establishing confidence in the banking system, ensuring macroeconomic stability, supporting the development of a sound payments system, and supporting the role of the central bank as a catalyst for economic development. There followed an impressive set of actions dedicated to supporting the achievement of these goals.

Between mid-August and the end of September 2009, stress-testing conducted by the CBN of those banks that were the largest borrowers at the CBN's discount window showed a deteriorated situation that called for the recapitalization of in total 9 banks and the firing of a number of MDs/CEOs and other senior management of the troubled institutions. These banks held a sizeable proportion of NPLs associated with the oil sector, margin loans and well-connected individuals in default. Due to the aforementioned weaknesses in reporting standards, the full extent of the capital needs of these banks had been concealed and took many by surprise.

The situation, however, served to call the attention of the authorities and the public at large to importance of the stability of the banking sector and the crucial role of reliable reporting and disclosure to the development of the financial system in general. The forcefulness with which the CBN addressed the governance issues relating to the dismissal of the banks' CEOs and their insider lending, including the publication of lists of the banks' major defaulting borrowers served to demonstrate the commitment of the authorities to pursuing bad debtors, thereby reducing the risk that borrowers could default with impunity and the associated moral hazard.

Given the still-dominant role of the banking system within the Nigerian financial sector this publication takes as its point of departure the principles on which the recent major bank restructuring process was launched. The principles of this reform process are much enhanced transparency in financial reporting and disclosure – not least about relations between bank owners and their relations with their bank – and holding those perpetrating financial transactions responsible for their actions. Building on the principles set out by the Governor of the CBN on his appointment and the recent actions in the financial sector, this volume seeks to provide a clear and well-grounded

understanding of the Nigerian financial system and identify the best way to move forward.

It begins by considering the banking sector and then moves on to issues relating to improving access to finance to support Nigeria's economic growth vision. The second part of the study refers to issues relating to longer-term finance: both the sources of financing, such as pensions and insurance, and their uses in providing financing for resolving Nigeria's crucial infrastructure shortfalls in infrastructure and housing. The final part of the study returns to the fundamental 'plumbing' of the financial system focusing on the legal and regulatory foundation for creditor rights and corporate insolvency, instituting sound corporate governance standards for corporations and banks, and providing secure and low cost transmittal of payments and remittances. While it is difficult to identify a common theme running through this volume without compromising the diversity and nuance of the recommendations, the overarching theme supported by this volume is the importance of exchange of reliable information as the basis for financial transactions between unconnected third parties. Implementation of systems designed to strengthen accounting and reporting standards for banks and corporations, the registration of movable and immovable property, property liens and credit histories as well as exchange of information about prices, interest rates, fees and charges for financial services will considerably enhance the functionality of financial systems and prove crucial in establishing a trusted and robust market-based financial system in support of stable economic growth and development in Nigeria.

Key Recommendations for Implementation

The different sections of this volume assemble a number of recommendations and policy actions that aim to support the deepening of the Nigeria financial system in the short to medium term, while building a strong policy platform for longer-term reforms. What follows is a summary of the key recommendations. These are discussed at greater length in the various chapters of this volume and in further detail in supporting diagnostic studies.

Banking system reforms are core to strengthening the financial system

Given the size and influence of the banking system the importance of reporting reliable information about the financial situation of the banks to the supervisors and in statements by the banks; ensuring stability through professionally rigorous regulation and supervision; professional-management and sound governance cannot be over-emphasized. The crisis in August/September 2009 has revealed lapses in all these areas which the CBN is addressing with forcefulness and purpose. The CBN has moved expeditiously to improve reporting through special inspections, to strengthen bank governance through replacement of members of the executive boards of banks and to identify those responsible for the banks' poor lending portfolios, particularly those involved in insider lending. However, the agenda going forward is important and will require a concerted and sustained effort in the following areas:

- **IFRS:** Bringing bank regulation and supervision frameworks in line with international standards as part of a program designed to ensure full adoption of International Financial Reporting Standards (IFRS) by banks the authorities will engender the trust in the banking system -- a cornerstone for re-gaining broad-based trust in the financial system both at home and internationally. As part of the IFRS adoption process, both bank supervisors will need to revise current banking regulations so they are consistent with IFRS- and, most importantly, train bank inspectors to apply IFRS in the supervision process;

- **Improved Supervision:** Recent years' rapid growth and increasing sophistication of the banking system left the supervisors struggling to stay abreast with developments in the sector. An option which could be considered – and which has been used successfully in other countries – would be for the supervisors to temporarily increase and further build their capacity by utilizing the services of expert international auditing firms to provide hands-on training and inspection support. While the CBN is firmly committed to the adoption of risk-based banking supervision and consolidated supervision, implementation will take considerable training, and hands-on assistance with understanding and applying the new practices.

- **Strengthening Credit Culture:** Sound decision-making on credit-provision by banks depends on the availability of reliable credit information. This requires not only collection of information about bank borrowers, but also reliable means of establishing borrower identification and connectivity, not only among banks, but also encompassing information about borrowing from micro-finance banks and utilities. The latter is particularly important so that even smaller (potential) bank borrowers can benefit from greater availability of credit information and can thereby 'graduate' to become attractive clients for the banks.;

- **Land Administration Reform:** Current regulations limit the types of acceptable collateral for bank lending and impose a complex and expensive system of registration charges. Computerization of land and collateral registries, while taking time to implement, will prove vital in reducing the costs and delays on registering mortgages and liens. Reducing these costs will contribute to improving access to credit by enabling borrowers to use their real property as security for credit in a cost efficient manner;

- **Regulatory Convergence:** The international financial crisis has revealed how important it is for regulatory agencies to adopt common approached and exchange information in supervising local financial systems. Thus, in parallel with the implementation of consolidated supervision under IFRS, the authorities are advised to work towards greater coordination among the industry-specific supervisors within the financial sector. The implementation of convergent supervisory methods and prudential standards will move the financial services industry towards a set of consistent regulations and ensure against significant supervisory gaps.

Un-leashing economic growth through broadened access to financial services

As in many countries in Sub-Saharan Africa the formal financial system services only a small minority of enterprises and households. For both groups accessing the financial services – whether to deposit savings or receive remittances for households or in accessing credit in the case of enterprises – the role of the financial sector in stimulating broad-based growth depends on concerted efforts to increase financial inclusion, including:

- **Stimulating Microfinance:** Taking measures to further strengthen and stimulate the development of microfinance banks by enhancing their supervision, raising minimum capital and eligibility requirements for unit licences and easing geographic and operational restrictions. These changes will assist the authorities in weeding out the more serious micro-finance banks (MFBs) and thereby support them in their role in the forefront of increasing access.
- **Secured Transactions:** Reviewing and where necessary reforming legislation and regulation on collateral and registries. Access depends on being able to use movable property as collateral both for bank lending and particularly in leasing. This agenda refers particularly to the finalization and sign-off of the Leasing Law; the review of regulations applying to finance companies; and the improvements in the registry and legal system for liens on moveable assets.
- **Improving Data Collection and Dissemination:** As of now little is known about the Nigerian lending to SMEs in Nigeria, severely constraining policy-making. Simple changes, such as the expanding the CBN's monthly data collection to include leasing, factoring, loans under credit lines, etc. issued to SMEs could go a long way to improve the situation.

Continuing reforms in development finance

Nigeria has recently reformed and reduced the number of its development finance institutions. The reforms have taken various shapes. The Bank of Industry has been streamlined. Reducing its overheads and the number of clients has allowed the bank to break even and focus on providing services to a limited number of SMEs and cooperatives. The Urban Development Bank has been restructured and has managed to attract private sector capital which has instilled discipline and efficiency in its operations.

Making progress on rural and agricultural finance has proved more problematic. In the absence of commercial, private sector financial institutions government has intervened with support to the National Agricultural Cooperative Rural Development Bank (NACRDB). However, the NACRDB remains plagued by the usual public sector failures. The bank is highly politicized, has a poor repayment record, poor infrastructure and low staff capacity and morale. Given the fact that the bank is forced to lend at 8 percent (lower than the cost of its capital) it makes ever larger structural losses each year

which has brought the bank to the brink of insolvency. The FGN requested the World Bank to formally review the NACRDB's operations with a view to providing recommendations for its reform and restructuring.

The recommendations put forward for the two institutions are as follows:

- **BOI Profitability:** Making continued profitability of BOI a condition for management's continued employment.
- **BOI Development Program:** Ensure tight control to avoid expansion of operations and assess the feasibility of the sale of a majority private/development investor stake to allow BOI to develop and ensure prudent governance.
- **NACRDB Governance:** Improve the governance of NACRDB in line with minimal governance standards set for Africa DFIs by the Association of African Development Finance Institutions.
- **NACRDB Board Independence:** Provide operational independence to the bank board to allow it to operate on a commercial basis.
- **NACRDB Wholesaling Operations and Branching:** Focus on wholesaling operations and reduce some of the branch network by selling inefficient branches to licensed MFBs.
- **NACRDB Recapitalization:** Consider recapitalizing the NACRDB within the context of attracting private capital to an improved and restructured entity

Considerable potential for provision of reliable insurance services

The insurance sector in Nigeria is small, with premiums amounting to less than 1 percent of GDP. This in large part reflects the poor reputation of the sector, often cited for providing fraudulent policies and in failing to honor claims. Nonetheless, growth of a trusted insurance sector will be crucial in making important products accessible to consumers of financial services, both as regards non-life products and life insurance products to pension fund members and to strengthening the reputation of the financial system. Measures which would contribute to achieving this are:

- **Enforcement Capacity:** Strengthening law enforcement by checking that insurance companies apply reasonable pricing, terms and conditions for each key product, and ensuring that insurance companies honor minimum service standards, including claims payments procedures, are acceptable.
- **Supervisory Capacity:** Broad-based strengthening of NAICOMs supervisory capacity, including introduction of standards as regards accounting, solvency and reserving, supported by investment in information technology to enable regular reporting by insurance companies.

- **Enforcement Actions:** Cracking down on shaky practices within the industry will have an immediate impact by putting pressure on industry participants by way of example. This includes ensuring (a) that owners of public buildings, not least the public sector, purchase compulsory insurance – both fire insurance and public liability insurance – as stipulated in the law; (b) that insurance companies reliably honor the bone fide claims made by policy-holders; and (c) cracking down on fake insurance companies which are prevalent in the market for vehicle insurance cover.

Building on the success of recent pension reforms

The Nigerian pension industry has undergone substantial reform in recent years and the newly-established, fully-funded pension funds are accumulating considerable amounts of capital that can be productively channeled into investment in the economy. Given their medium to longer term investment horizon, pension funds provide natural sources of funding for Nigeria's considerable infrastructure investment needs. The following actions will strengthen the administration of the pension sector investments and thereby enhance Nigeria's growth potential:

- **Disclosure:** Requiring pension funds administrators (PFAs) to disclose key information to members and PENCOM using a uniform methodology describing investment strategies, changes in investment strategies, asset class specific benchmarks and performance relative to the selected benchmarks etc.
- **PFA Fees:** Supporting competition and consolidation among PFAs with regulatory measures, such as reducing charge ceilings for PFA fees, which currently (at 2 percent) are high by international standards and represent a serious drain on the value of assets available to provide for pension benefits.
- **Investment Choice:** Providing pension savers with a choice among alternative portfolio investment strategies by allowing an individual PFA to manage multiple portfolios. Implementation of fair asset allocation practices so as to ensure, for example, that all clients are treated equally when newly acquired investment instruments are distributed among their portfolios will be important in preparing for this reform.
- **Risk Diversification:** Facilitating diversification of pension investment risks by permitting a portion of pension assets to be invested overseas according to specified timetable and preconditions relating to the capacity of individual PFAs and pension fund custodians.

Further deepening of the capital markets

The local capital market has experienced considerable change and fast growth in recent years, particularly as concerns the deepening of the Government debt market. Among

recommended policy measures to further enhance the depth and liquidity of the domestic capital markets are:

- **Transaction Costs:** While steps have been taken to reduce transaction and issuance costs on the Nigeria Stock Exchange, these remain high and steps need to be taken to ensure further reductions.
- **Trading:** Dematerialization of all security certificates and integration of securities registration in one central securities depository would enhance the certainty of the trading process and also work towards prevent eventual lapses in registration and fraud.
- **Regulation:** Accelerated demutualization of the NSE and creating a separate self-regulated organization (SRO) will reduce conflict of interest and temptation for abuse by the broker industry. Establishing a strengthened SRO with clearly defined roles and responsibilities will improve oversight and confidence in the market.
- **Debt Management:** While considerable strides have been made in recent years, consolidation of debt portfolio management through a regular strategy of re-openings, buy-backs, switches and earmarking benchmark issues for primary dealers would deepen market liquidity and lead to the formation of so-called benchmark issues.
- **Information Disclosure:** Enhancing price dissemination consolidating already produced information on a single “official” homepage and ensuring that primary dealers make available two-way quotes and post trade information based on on-line trade reporting would enhance the effectiveness of the secondary market.

Enhancing finance of Nigeria’s considerable housing needs

Housing needs in Nigeria are huge. With one of the globally fastest urbanisation rates, housing needs are estimated at around 12-16 million units. Selected recommended priorities are:

- **Transaction Efficiency and Costs:** Reducing the time taken to achieve the necessary consents in property transactions and reducing the costs incurred in the process from the current level of 20-30 per cent of the value of the transaction to nearer 5 per cent. This is the single most important measure in increasing the availability of financing of housing in Nigeria.
- **NHTF:** Either abolishing the National Housing Trust Fund (NHTF) or significantly reforming it so as to redress the balance between contributors and borrowers.
- **PMI Capital Requirements:** Substantially increasing the capital requirement for Primary Mortgage Institutions (PMIs) and making loans through the NHTF, if it is to continue, only to those that meet this and other standards.

- **FMBN:** Putting the Federal Mortgage Bank of Nigeria (FMBN) on a stable financial footing and developing its role as the source of knowledge, statistics and expertise on the mortgage market, and facilitator of market improvements.
- **Mortgage Liquidity Facility:** Implementing a simple mortgage liquidity facility which would help pave the way for the use of covered bonds and mortgage backed securities in the longer term.

Governance as a lynchpin for financial sector development

Strengthening governance is probably the single most important area of reform for improving transparency and thereby trust in Nigeria’s financial system. The role of financial systems in allocating resources efficiently among alternative uses depends on independent decision-making by savers and investors who are unrelated third parties. The following measures are recommended as priority steps in strengthening governance:

- **IFRS:** Implementing international accounting and auditing standards for public interest entities. Adoption of IFRS both sends a strong signal to foreign investors, and, provided they are forcefully implemented will improve reporting and information exchange among market participants. The NASB supported by the new Financial Reporting Council, the coordinating body among regulators, should move immediately towards full convergence of SAS with IAS/IFRS, full adoption of ISA without modifications, and mandatory observance of these standards by “public interest entities” (listed companies and regulated financial institutions).
- **Ownership Disclosure:** Improving the disclosure of ownership. Ownership disclosure is a basic requirement for a strong governance framework. If ownership is not transparent, it is difficult to identify related parties, and (in the case of financial institutions) impossible to apply “fit and proper” tests. Addressing this problem will involve (a) reviewing annual reports and regulatory filings for compliance with disclosure regulations, (b) ensuring that regulators have adequate powers to require nominees to disclose beneficial owners, and (c) implementation of a rule where the CBN and the SEC can cancel the voting rights of “anonymous” shares until the ownership of those shares is clarified.
- **Regulatory Governance:** Improving the governance of the key regulatory bodies, by benchmarking their governance among the regulators and against best international practice and using findings to update the regulators’ policies and procedures. Importantly the NSE should undertake a thorough-going review of its own governance policies as part of its on-going governance reforms as it prepares for demutualization. Demutualization will raise new governance challenges; overcoming them will require strong oversight from the SEC.

Strengthening creditor rights

Deepening of the financial system depends on parties being able to engage with third parties in providing and taking security. Extensive measures are recommended to strengthen the creditor rights and insolvency regimes in Nigeria, encompassing both the legal and institutional frameworks. The most pressing needs relate to improving the registration of property and enforcement practices:

- Creditor rights and their enforcement will be strengthened by reviewing and simplifying methods of registering security over movables and immovables, and by implementing regulations for credit bureaus;
- Methods of enforcing the rights of unsecured creditors and of secured creditors should be simplified with court procedures made more accessible, timely and cost-efficient to encourage their use.

Modernizing the payments systems infrastructure

The authorities have embarked on ambitious program for strengthening the payments system and empowered the National Payments System Council (NPSC) to devise and implement reforms. This report suggests that the CBN reviews and streamlines the mandate, composition, organization and activities of the NPSC working groups. Among the recommendations made are:

- **RTGS:** Upgrading the functionality of the real-time gross settlement (RTGS) wholesale payments system consistent with best practice and standard RTGS functionality;
- **Retail Electronic Payments:** Developing a clear strategy to promote widespread use of retail electronic payment instruments and reduce the importance of checks. In this context it will important to encourage banks to strengthen collaboration in providing interoperability of switching platforms and rationalize the deployment of ATM and POS terminals;
- **Standards:** Enforcing standards for secure card technologies to reduce fraud and increase acceptance locally and internationally;
- **Mobile Payments:** Promoting development and use of mobile payment systems. The main issues to address include interoperability, security, convenience, pricing and establishing a regulatory framework which is balanced and appropriate – not so tight as to hinder innovation and adoption, or so lax as to open the door for fraud. Among the regulatory issue to be addressed are the use of agents and/or third party service providers, and managing the prudential risks involved in nonbank-led models of mobile banking;

- **CBN Payments:** Explicitly incorporating issues related to the securities settlement system in the CBN's payments strategy;
- **CBN Organizational Capacity:** Undertaking a review of the CNB's organisational capacity with a view to strengthening its payment system oversight responsibilities consistent with international best practice and market developments.

Enhancing the flow of and reducing the cost of transferring remittances

Remittances represent a large and growing market in Nigeria, and constitute the second source of foreign exchange earnings after oil exports. The market remains highly regulated and as a result a large amount of remittances are transmitted through informal channels. In 2008 the CBN disallowed exclusivity arrangements between money transfer operators and banks thereby creating greater competition in the provision of remittance transfer services, but more remains to be done to make formal channels for remittance transfers more cost-effective. Recommended policy actions include:

- **Information Disclosure:** Insisting that remittance service providers provide consumers with comparable, reliable information about the costs of making remittance transfers and introduce effective customer complaints-handling procedures;
- **Remittance Provider Competition:** Establishing a level playing field for all remittance service providers, guaranteeing access to new non-bank players by ensuring that non-bank remittance agents have fair and equitable access to payments infrastructure and all relevant payment services. Achieving this objective will involve introducing guidance regarding the use of agents and third-party service providers (facilitating mobile payments technology) and be much supported by introducing interoperability among payment system networks and transaction processing automation.
- **Regulation:** Strengthening oversight of remittance service providers as a prerequisite for liberalizing the market, including instituting either a licensing or registration regime for remittance service providers.

SECTION I. FINANCE AND DEVELOPMENT IN NIGERIA

The Link between Finance and Development

1. Making financial systems work better is already a widely shared goal amongst policy-makers in Africa. Presidents, prime-ministers, ministers of finance and governors of African central banks have signed up in principle and in practice to intensifying efforts to Making Finance Work for Africa. This is based on an understanding that strong financial systems have helped to deliver rapid growth and reduced inequality. .
2. Reducing absolute poverty in low-growth conditions is all but impossible for a market economy. From a long-term growth perspective, the major channel for sustained poverty reduction in Africa is a transformational increase in the share of the population that is working in the modern sector with advanced productive techniques. A more effective formal financial system would not only intermediate on a much larger scale, but in doing so it would help improve enterprise productivity and growth, not least in sectors that have the potential to contribute directly or indirectly to exports, especially exports of nontraditional goods and services.
3. Faster national economic growth is the only sure way to a sizable and sustained reduction and eventual elimination of absolute poverty. In addition improved access to financial services for poor people and people in rural areas would directly help improve their circumstances and help reverse what has, at least until recently, been a trend in the continent toward widening inequality and increasing growth rates without the concomitant reduction in poverty rates.
4. Agriculture accounts for a high proportion of output and even higher proportion of employment in many African countries. It will continue to form the backbone of the continent's economy for the foreseeable future. The required transition in this sector will require innovative rural financing to move towards larger scale, less labor-intensive, modern farms.
5. It follows that accomplishing this long term growth agenda needs the machinery of efficient mainstream finance that is also accessible to the rural poor. Only in this way will there be a ladder for them to climb. Of course, in addition to having access to effective financial services, the international and domestic private sector will only be able and willing to invest to the extent that complementary factors, including human capital and physical infrastructure, as well as other necessary conditions of the business environment are present.
6. Effective finance also has a role to play in contributing to these complementary factors. Innovative financing can spur infrastructure provision. And the legal and information infrastructures needed for effective finance also help improve the overall governance and business environment.
7. At the lower end of the scale, finance is relevant to helping ensure that human capital gets created. Investment by households and individuals in health and education

requires insurance, savings and sometimes borrowing services without which families are often unable to acquire the needed skills. So small scale financial services help support the creation of a skilled and healthy labor force, which is among the most important prerequisites for development and for the willingness of entrepreneurs to embark on the needed investments. Returning to the analogy of climbing a ladder these are the second and third rungs up the ladder – the part of the climb that small scale finance can help once the bottom rung has been reached.

What is the development objective of the financial sector?

8. A diverse and strong financial system is important for continued economic growth and development. It can ensure that risks in the economy are well spread-out among the various sub-sectors. A well-functioning financial sector will allocate capital to firms that are more efficient, competitive, sound and stable.

9. The objective of the financial sector should be to develop a more resilient, competitive and dynamic financial system drawing on best practices, that support and contribute positively to the growth of the economy through the business cycle. A solid financial sector strategy should also create a core of strong and forward looking domestic financial institutions that are technology driven and ready to face the challenges of liberalization and globalization.

10. While opportunities have emerged in this new environment, threats of the global marketplace are becoming more intensive, as global players and technology advancements are having an unprecedented impact on banking and financial services. Against this background, it is vital for the financial system, particularly the domestic financial institutions to be transparent, resilient and efficient if Nigeria is to ensure that its financial sector remains effective and responsive in the face of a more complex global and domestic environment.

Understanding the Financial Crisis and its Impact on the Poor

11. During the past eighteen months, financial markets around the world have been plunged into turmoil. The crisis has demonstrated just how integrated financial markets have become in the past decade. Not only did the contagion spread from the housing finance markets to the credit markets but the knock-on effects were soon felt in the stock market and the real sector. And the effects were not just felt in OECD countries but within months secondary impacts were being felt in the developing world through lowered commodity prices, reduced credit and capital available for development projects and markedly higher prices for government borrowing.

12. Over the past decade, the importance of the financial sector for growth and employment in Africa and the rest of the developing world has been widely acknowledged. A number of studies have illustrated the causal links between financial

sector deepening and growth. By the beginning of the 21st century there was little debate that a well-functioning financial sector would boost growth and poverty reduction efforts in the developing world. Now that the global financial crisis has hit we also see the corollary – the strong links between financial sector crisis and increasing poverty. The World Bank has estimated that the global economic downturn could pull some 46 million more people around the world below the \$1.25 a day poverty line and an additional 53 million below the \$2 a day threshold.

13. The financial sector is the brain of the economy. When it functions properly it allocates resources (in the form of savings and investments) to the most productive and efficient uses. Just as when the brain malfunctions the impact is seen in the rest of the body, a crisis in the financial sector will always have contagion effects and a significant impact on the real sector unless the situation is dealt with quickly and effectively. In this regard the financial sector can be seen as more important than any other sector of the economy. For instance, the impact of the food crisis that affected many, was restricted to people's ability to secure their nutritional needs. Whereas the financial sector crisis is impacting people's ability to buy food, to secure shelter, gain employment, educate their children and provide for their health care needs. The stability of the financial sector is now seen as vital not just for continued growth and prosperity but also for peace and political stability.

14. At this tumultuous time, it may be easy for policy-makers in both the developed as well as the developing nations to draw the wrong conclusions. Some countries are experimenting with government control of the financial sector, while others are introducing measures to limit financial innovation and altering the risk-reward ratio. All are considering new measures of regulation and oversight for the financial sector. At this juncture in time it may be opportune to review the links between financial sector development and growth and reach a consensus on what is important for Nigeria in terms of medium to long-term development of the financial sector.

The impact of the global financial crisis on Nigeria

15. When the global financial crisis started unfolding it appeared that Nigeria would emerge relatively unscathed. Nigeria's housing finance market is almost non-existent with less than 50,000 mortgages outstanding. Foreign banks accounted for less than 4 percent of the total financial sector assets and Nigerian banks had virtually no exposure to sub-prime, credit derivatives or other international toxic debts.

16. In 2008, following several years of prudent macroeconomic management and high oil prices government finances were in good shape. The country had a large fiscal surplus equivalent to about 5 percent of GDP and savings in the excess crude account had topped US\$18 billion. Nigeria also benefited from the largest debt write-off in the history of the Paris Club reducing its external debt from US\$33 billion in 2003 to just US\$3.5 billion in 2006.

17. Among the many reforms that strengthened Nigeria's ability to withstand a global financial crisis was the banking sector consolidation that took place between June 2004 and December 2005. The CBN raised the minimum capital requirement of banks from N2 billion (US\$15.4 million) to N25 billion (US\$192 million) in June 2004 and banks that could not meet this requirement either merged or had their licenses revoked. By the end of the consolidation exercise in December 2005, the number of banks had dropped from 89 to 25. The surviving banks succeeded in raising large amounts of additional capital that significantly strengthened their balance sheets and the weaker banks effectively exited the market.

18. However, despite being in a better shape to weather the storm, the global financial crisis still impacted Nigeria's financial systems mainly through secondary effects. The crisis resulted in international investors reassessing their appetite for risk, hit by losses in developed markets and wary of perceived riskier markets they pulled their investments from developing country stock markets around the world and Nigeria was not spared. This triggered a sell off on the undoubtedly overvalued NSE resulting in losses of more than 70 percent from March 2008 highs.

19. As the financial sector crisis quickly impacted the real sector and the global slowdown resulted in oil prices moving sharply downward from a high of \$147 pb to a low of around \$39 pb. Falling oil prices and declining capital inflows led to a substantial reduction in foreign currency inflows and a sharp decline in the exchange rate, prompting the central bank to reintroduce temporary exchange controls and spend large amounts of foreign reserves defending the currency. Nonetheless the CBN was eventually powerless to halt the depreciation of the currency which moved from ₦117 to ₦190 to the US\$ before stabilizing around ₦150. Although many observers warned that this situation could have dire implications for Nigeria's banks, not all bank managers reacted prudently to the unfolding crisis and few could have guessed the magnitude of the banking sector crisis that unfolded in Nigeria in August 2009.

Nigeria's banking crisis and financial sector development

20. In the boom years that preceded the global financial crisis the Nigerian economy grew strongly averaging 8 percent for several years. Steadily growing oil prices, coupled with strong growth and prudent macroeconomic stewardship made Nigeria's stock market an attractive destination for both international and domestic investors. Between 2002 and 2008 the NSE grew ten-fold making it among the top performing markets in the world. As the banks went through a consolidation process they also raised equity financing on the capital markets. They were so successful that by 2008 banks accounted for about 70 percent of the NSE market capitalization, and several banks achieved capital leads well far in excess of the much increased minimum level decreed by the CBN. Several Nigerian banks achieved capital levels of over ₦ 100 billion (four times the decreed minimum level).

21. The boom brought with it the lure of easy money and attracted novice investors to the market hoping to make a quick buck. Nigerian banks were eager to finance the share purchases of such investors especially if they were buying bank shares. These so-called margin loans contributed to a growing “other” category that formed the largest category of bank lending in 2008. As long as the market continued to rise there were no problems but when the stock market dropped dramatically throughout the second half of 2008 most of the margin loans went into default.

22. Another important lending category was loans to the oil and gas sector. In a similar way as the oil price dropped by 70 percent many downstream oil sector loans became non-performing. The depreciation in the Naira then hit the oil importers who had huge exposures in US dollars related to the oil sector. Each imported oil at high prices, but accumulated losses as the price of refined oil products plummeted.

23. It should have been clear to the banking community that the party was over. However, Nigerian accounting standards allow banks and corporations the choice of valuing their assets either at market prices or at historical cost. The banks took advantage of this loophole to present accounts that overstated their profits. In order to cushion any adjustment to a new order, in September 2008, the Central Bank gave commercial banks the option to postpone recognition of losses on margin loans until December 2009. They also temporarily injected liquidity into the system through an expanded discount window at the CBN which was closed in July 2009.

24. Nonetheless, many banks preferred to declare record dividends at end-2008 in order to shore up their share prices (temporarily) rather than make provisions. Fearful of the impact of such practices on the viability of their peers, bankers also restrained their ending on the inter-bank market, where high rates became a permanent feature (18%, August 2009).

25. On August 14th 2009, the Central Bank Governor fired the CEOs of five major banks and injected ₦400bn (US\$2.6bl) into these institutions to compensate for the expected losses associated with ₦1.143bn (\$7.6bn) worth of NPLs – 41% of their total loan portfolios. An audit of the ten banks that borrowed most frequently at the CBN’s expanded discount window revealed that five of the banks were experiencing severe liquidity or insolvency problems as a result of their non-performing loan portfolio.

26. Unsurprisingly, most of the NPLs fell into the categories of margin loans or exposures in the oil & gas sector. This difficult situation is compounded by losses associated with lending to well-connected individuals, hitherto a common practice in Nigeria. So as to encourage recovery on these loans and diffuse pressure on the CBN, the CBN chose to publish the list of those companies and individuals identified as owing money to the distressed banks. Among these are the names of notable Nigerians from the country’s industrial and political elite. The Economic and Financial Crimes Commission (EFCC) was also brought in to force the defaulters to repay or face serious sanctions including imprisonment. The pursuit of defaulting bank debtors is particularly important to prevent a situation of moral hazard whereby such (larger) debtors could be seen to

benefit, as this would encourage them to continue ‘plundering’ the banks, thereby undermining efforts to build confidence in the financial sector.

27. Standard & Poor was quick to downgrade Nigeria’s sovereign rating to B+ from BB – due to the cost of the bail-out and dwindling oil revenues. The CBN guaranteed all foreign loans and correspondent banking lines to the bailed-out banks and provided cash to all its branches across the country. It also guaranteed all deposits in Nigeria announcing that it would not let any bank fail. With these measures the CBN successfully contained any fears that could lead to a run on banks.

28. Meanwhile the authorities have embarked on an initiative to increase transparency and strengthen supervision in the banking sector. The new CBN Governor appointed in June 2009 has made transparency and enhanced risk-management practices the priorities of his tenure. The newly elected NSE president has also placed transparency and governance at the top of his agenda. The President has also made a new appointment to the CBN Board and CBN has created a Deputy Governor position for Financial Surveillance Services, confirming the authorities’ commitment to clean up the system.

Nigeria’s Plans for Financial Sector Development

An Overview of Nigeria’s Financial Sector Challenges

29. Nigeria’s weak financial sector has been a bottleneck to growth, in particular, in the non-oil economy and has resulted in a lack of local financing for private sector development and very little access to formal financial services (especially savings) to rural communities. Despite significant consolidation in the banking sector, Nigeria’s financial system remains shallow and considerable benefits will result from continued financial deepening both in terms of higher growth and poverty reduction.

30. Nigeria’s financial system is characterized by limited diversity and missing markets. A World Bank Investment Climate Assessment (ICA) 2009, highlighted the lack of access to formal financial service providers experienced by the vast majority of Nigerian businesses. While banks’ private sector lending has expanded significantly over recent years, it is still well below that of comparator countries and averages for Sub-Saharan Africa.

31. Bank credit remains the main source of external funding of investment by Nigerian firms. Non-bank financial sector and capital market development remain substantially below comparator countries. Insurance premiums are negligible compared to GDP and the sector fails to provide essential risk mitigation and savings instruments like private health insurance, property insurance or life insurance to a broad section of the Nigerian population. Property and casualty insurance is primarily targeted at corporate customers. The equity market caters only to the largest firms and market turn-over is

largely driven by the banking sector, which has accounted for between 65 and 75 percent of total market capitalization in recent years. The bond market is weak with little secondary trading. The corporate bond market is virtually non-existent.

The CBN 13-point agenda

32. Nigeria's authorities have recognized the need to develop and deepen the Nigerian financial sector. Major reform activities in the financial sector started in 2004 with a 13-point reform agenda issued by the Central Bank of Nigeria (CBN). It aimed to transform the financial sector into a growth catalyst, focusing on increasing minimum capitalization for banks to N25 billion from December 2005 (see above). The financial sector reform efforts also witnessed the phased withdrawal of public sector funds from the banking sector, the adoption of a rule-based regulatory framework and an automated process for the rendition of returns by banks and other financial institutions through the enhanced Financial Analysis and Surveillance System (e-FASS).

33. A number of relevant laws were updated and enforced and the period saw a closer collaboration with the Economic and Financial Crimes Commission (EFCC) in the establishment of the Financial Intelligence Unit (FIU), and the enforcement of the anti-money laundering and other economic crime measures. It also witnessed the rehabilitation and effective management of the Nigerian Security Printing and Minting (NSPM) Plc to meet the security printing needs of Nigeria, including the banking system which constitutes over 90 percent of the NSPM's business. Two recent significant reform initiatives relate to the pension sector, including the establishment of the Pension Commission in 2004, and the creation of the Debt Management Office (DMO) in 2000 to oversee sovereign debt management. Both these new regulatory authorities were given direct reference to the office of the president and used their autonomy to quickly establish an impressive track record as professional regulators. The pension reforms involved the full recognition of fiscal liabilities and full funding of the Government's obligations as well as the establishment of a vibrant privately managed sector, while very effective collaboration between the DMO, MOF, SEC, NSE and private sector investors led to the development and rapid deepening of the market for government debt – a model for championing reforms worthy of emulation.

An Overview of Nigeria's Financial System Strategy (FSS2020)

34. Notwithstanding the successes achieved under the CBN's 13-point agenda and the above mentioned regulatory reforms, the Nigerian authorities were cognizant of the need to strengthen the financial sector and have developed a comprehensive, long-term, strategic plan for the development of the financial sector - the Financial System Strategy 2020 (FSS 2020). As of yet FSS2020 is the only component of the Government's broader Vision 2020 to be well-defined. The FSS2020 steering committee defined the vision for the strategy as follows; *“To be the safest and fastest growing financial system amongst emerging market countries”*.

35. FSS2020 aims to transform Nigeria’s financial system into a catalyst for growth by strengthening domestic financial markets, enhancing integration with external financial markets and developing an international financial centre. The objective is to turn Nigeria into Africa’s financial hub and one of the 20 largest economies in the world by the year 2020.

36. The strategy aims to build on the success of the recent financial sector reforms to promote greater stability, depth and diversity for the entire financial system. It covers all priority areas of the financial system. Although donor organizations including the World Bank have supported the formulation of FSS 2020 with substantive technical assistance, nevertheless it remains a home grown approach and is fully owned by the Central Bank and the Ministry of Finance.

Previous and ongoing support to FSS2020

37. The World Bank has been assisting the Central Bank of Nigeria (CBN) in developing the newly conceived Financial System Strategy (FSS) 2020 since 2006. To promote the development of FSS 2020 the CBN set up a coordination unit supported by experienced local consultants. The Steering Committee for FSS 2020 comprised all major stakeholders including the Minister of Finance, the CBN Governor and Deputy Governors, the Director General of the Securities and Exchange Commission, the Insurance and Pensions Commissioners as well as key private sector representatives. Importantly the process of putting together FSS 2020 – as sponsored by the CBN Governor – was highly consultative involving representatives of all the regulators, industry participants, academics, donors etc. From the outset ‘focus groups’ were organized for various sub-sectors¹. These met regularly and their findings were reported and discussed at a series of retreats.

38. The retreats and conferences resulted in the CBN defining an action plan for FSS 2020. The CBN also emphasized the need for further diagnostic work to set the baseline for FSS 2020 implementation process. This diagnostic work was seen as crucial in laying the foundation for the implementation process.

39. Crucial to the success of FSS 2020 so far is that the strategy and process have all along been owned and managed by the Nigerian authorities. In supporting the authorities in moving FSS 2020 from the drawing board to implementation the World Bank broadened its involvement beyond providing technical support to supporting the complex implementation and change management challenges.

40. World Bank teams supported the completion of diagnostic work in the following areas; capital markets, insurance, pensions, housing finance and social housing, SME access to finance, microfinance, creditor rights & corporate insolvency and the banking

¹ Namely, capital markets, housing finance, regulation and legal framework, insurance market, credit market, SME finance, money and FOREX markets, monetary policy, IT and communications and human capital as well as quality assurance.

sector. The remainder of this volume presents a summary of the diagnostic work undertaken to date in each of these sectors. The diagnostic work undertaken under the auspices of FSS 2020 is consistent with achieving the FSS 2020 vision. However, the focus is on defining a step-by-step process for implementing financial deepening consistent with these goals. Thus the diagnostics are by nature more short-term both in defining ‘quick-wins’ and in their broader recommendations.

SECTION II. BANKING DOMINATES THE FINANCAL SYSTEM

Structure of the Nigerian Financial System

Overview

The Nigerian financial system is diverse in its structure and operations and remains a dominant force in the region. At end-December 2008, the Nigerian formal financial system comprised the CBN, the Nigeria Deposit Insurance Corporation (NDIC), the Securities and Exchange Commission (SEC), the National Insurance Commission (NAICOM), the National Pension Commission (PENCOM), 24 deposit money banks (DMBs), 5 discount houses (DHs), 840 microfinance banks (MFBs), 113 finance companies (FCs), 99 primary mortgage institutions (PMIs), 5 development finance institutions (DFIs), 1,264 bureaux-de-change (BDC), 1 Stock Exchange, 1 Commodity Exchange, 73 insurance companies, and 3 pension funds (CBN Annual Report, 2008).

Table 1. Financial System Structure, 2008

	Count	2008 Assets (NGN billion)	% of Total Assets
Banks 1/			
Deposit Money Banks	24	15,920	89.88%
Non-Banks 1/			
Microfinance Banks	840	123	0.69%
Finance Companies	113	134	0.76%
Primary Mortgage Institutions	99	203	1.15%
Discount Houses	5	417	2.35%
Insurance 2/			
Life		15.75	0.09%
Non-Life		84.52	0.48%
Pension Funds 3/			
		815.18	4.60%
Total Financial System		17,712.45	

Sources:

1/ CBN

2/ AXCO

3/ National Pension Commission; data for 2007

The Commercial Banking System in Nigeria

Recent Developments

41. Commercial banks represent by far the largest part of the Nigerian financial sector accounting for over 91 percent of financial system assets as of December 2007 (**Error! Reference source not found.**). Following an increase in the minimum bank capital requirement to NGN 25 billion in 2006, the Nigerian banking system underwent a period of intense consolidation which reduced the number of banks from 89 in 2005 to 24 in 2008. Most of the banks that emerged from the consolidation exercise met the new requirements through mergers and acquisitions and by issuing new capital, nonetheless 14 banks failed to meet the new minimum capital requirements and were referred for liquidation by the NDIC.

42. The majority of banks in the country are under private domestic ownership. The government retains stakes in 4 commercial banks, of which only one (Unity Bank) is a majority stake. The ownership structure of the 20 domestic commercial banks is, with one exception concentrated in individual owners, with corporate investors in most cases as minority shareholders. This ownership structure reflects the widespread use of public offerings by banks to raise additional capital from private investors. Most banks also function as financial holding companies, with 21 banks having a total of 157 subsidiaries engaged in the full spectrum of banking, insurance and capital markets activities.

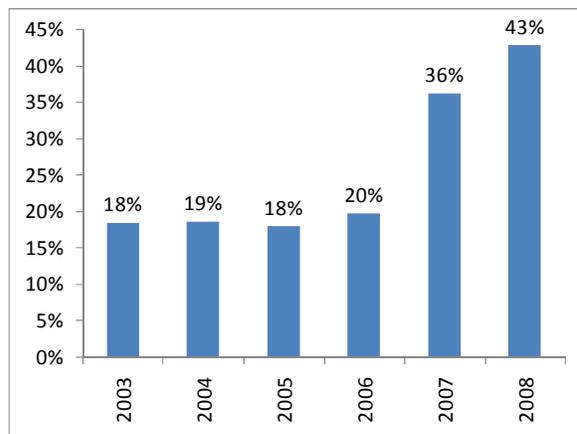
43. As a result of their dramatically increased capitalization and the need to generate returns to shareholders, banks have expanded very rapidly. This in turn increased competition, pushing banks to expand into new geographic areas, to open new branches, to offer new products and to start operating in new areas of activity, such as retail loans, insurance and brokerage services. In addition, as part of a regional expansion drive, about half of the existing banks have cross-border operations, including subsidiaries in Benin, Gambia, Ghana, Kenya, Sierra Leone, South Africa, Zambia, among other countries. Nevertheless, these cross-border operations are still relatively small. One exception is Ecobank, which although it is headquartered in Togo, has its largest operation in Nigeria and is a well-established sub-regional player.

44. The expansion of the system started as early as 2003, but the impact of consolidation and increased capital resulted in explosive growth between June 2006 and June 2008 (Figure). Bank assets expanded from approximately ₦ 4.4 trillion in 2005 to over ₦ 10.4 trillion in 2007 and reached ₦ 15.8 trillion in the last quarter of 2008. The year-on-year growth in bank credit to the private sector accelerated from 25 percent in July 2006 to over 92 percent in 2007, decelerating to 59.4 percent in 2008. In addition, the number of branches increased by 51 percent in that period

45. According to the CBN² the loan to deposit ratio reached 86.8 percent in the last quarter of 2008 a significant increase compared to the ratio at the end of 2006 of around 65 percent, reflecting rapid expansion in financial intermediation. By the end of 2008, according to IMF data, the ratio of claims on the private sector to GDP had risen to 28.9 percent from 12.8 percent in 2004, an increase of 126 percent in four years. This increase was in line with CBN’s stated objective: “By 2020, the Nigerian credit to GDP ratio will be among the top three of emerging markets, including access to credit for the productive SME sub-sector and 70% of the Nigerian population.”

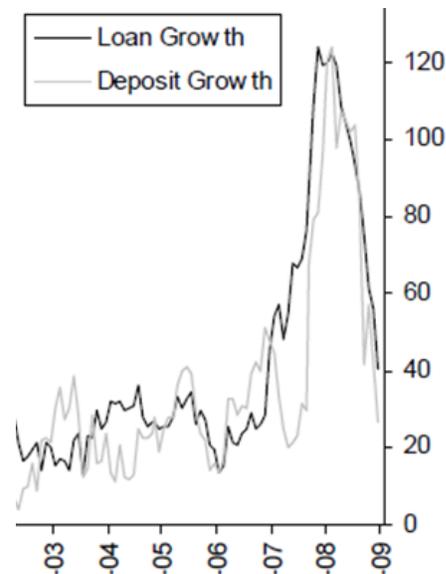
Figure 1: Explosive Expansion of the Banking System since 2006

Y-on-Y changes in Bank Assets / GDP



Source: IMF (IFS)

Growth in Loans and Deposits (% change, y-on-y)



Source: CBN

46. As discussed in further detail in the remainder of this chapter, a number of systemic risks have emerged in this environment of rapid growth and increased competition. Overall, the capacity and infrastructure required to adequately manage risks, both in supervision, accounting and auditing standards and practices, and banks’ internal risk management systems and governance has struggled to keep up with the dramatic growth of the system itself.³ As explained above, the global financial crisis exposed weak supervision and poor governance practices within the Nigerian banking system and resulted in a full-blown Nigerian banking crisis.

Soundness

² CBN (2008) “Economic Report for the 4th Quarter of 2008” Volume 3, Issue 4.

³ J.P Morgan, Nigerian Banks May 18th 2008.

47. A comparison of the Nigerian banking sector to banking sectors elsewhere in the world is difficult because the extraordinary speed of the system's expansion means that important indicators are changing rapidly. As of the third quarter of 2008, compared to other emerging markets and to other African countries, the Nigerian banking appeared to be relatively well capitalized (see Table 2: Key Financial Soundness Indicators, 2008 Table 2), but profitability indicators had deteriorated. Although bank regulatory capital to risk weighted assets amounted to 22 percent in Nigeria, compared to 12.5 percent in South Africa, 16.6 percent in Brazil and 13.9 percent in Ghana, the system was not as well capitalized as these numbers suggest, as banks took advantage of weaknesses in Nigerian accounting and auditing standards and weak banking supervision to systematically under-provision against bad loans and overvalue assets by marking to historical cost. It is also important to note that the Nigerian banking system remains highly segmented. Thus the increase in spreads between interbank rates and T-bill rates in 2008/2009 reflects concerns about counterparty risk in the interbank market.

Table 2: Key Financial Soundness Indicators, 2008

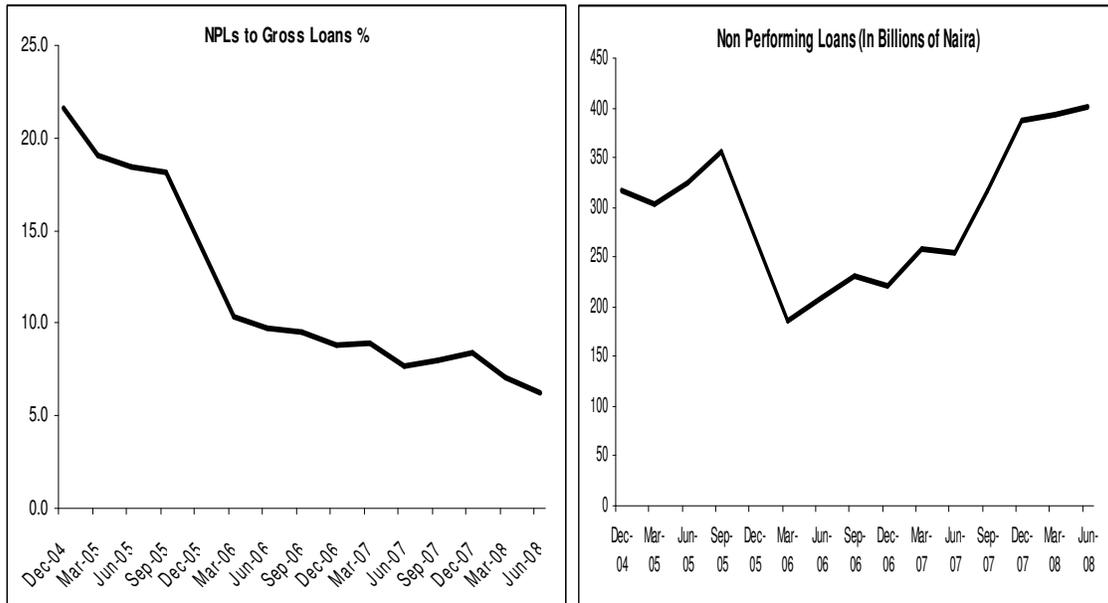
Country	CAR	NPL/Total Loans	ROA	ROE
Brazil	16.6	2.9	2.0	20.4
Ghana	13.9	7.6	2.8	26.0
Indonesia	16.8	3.5	2.6	26.0
Malaysia	12.6	5.1	1.6	19.7
Nigeria	22.0	6.1	2.4	13.9
South Africa	12.5	2.6	1.8	17.5

Source: IMF Global Financial Stability Report (April 2009). Latest available data. CAR refers to bank regulatory capital to risk weighted assets. ROA refers to return on assets and ROE to return on equity. NPL are non-performing loans.

48. By the end of 2008, return on equity was relatively low in Nigeria at around 14 percent compared to 26 percent in Ghana and Indonesia, close to 20 percent in Brazil and Malaysia and over 17 percent in South Africa. The deterioration of profitability indicators in the post-consolidation period was linked to the high levels of capital in the system and to increased competition⁴.

⁴ Nevertheless, it is interesting to note that return on assets is still substantially higher in Nigeria than in South Africa or Malaysia.

Figure 2: Non-Performing Loans in the Nigerian Banking System



Source: CBN.

49. The fall in nonperforming loans to total loans ratio which occurred after the consolidation of the system in 2006 mainly reflected the fact that bad loans were written-off as banks merged (Figure 2), and the impact of those bad assets that remained has been diluted rapidly by the expansion in the size of loan portfolios. Nonperforming loans were relatively high compared to Nigeria’s peers as only Ghana presents a higher ratio of NPLs to total loans. Although the NPL ratio has declined, the amount of non-performing loans has grown rapidly since early 2006 (Figure 2). Eventually the continued growth of these NPLs – while not yet reflected in the recorded data – resulting in particular from margin loans, exposure to the downstream oil sector and insider-lending – could not be contained and resulted in the banking crisis of August 2009.

Development and Efficiency

50. It is important to place the rapid expansion of the system in the context of the low level of development of the banking sector in the pre-consolidation period. Essentially, Nigeria was (and still is) “under banked”. International comparisons (**Error! Reference source not found.**) show a general tendency for the more developed banking sectors (in terms of the deposits and lending relative to GDP) to have relatively low ratios of costs to total assets, net interest margins, deposit interest rates, and interest spreads resulting in greater efficiency in intermediation. Nigeria’s banking sector does not appear to conform well to this tendency. Despite low levels of bank deposits and lending relative to GDP, Nigeria’s overhead cost ratio and net interest margins are among the lowest, and are comparable to those in Indonesia, Malaysia, and South Africa, all countries with substantially larger banking sectors. When looking at the evolution of some of these indicators over time, the reductions in overhead costs and interest margins observed after 2004 are consistent with the notion that the consolidation of the banking sector spurred

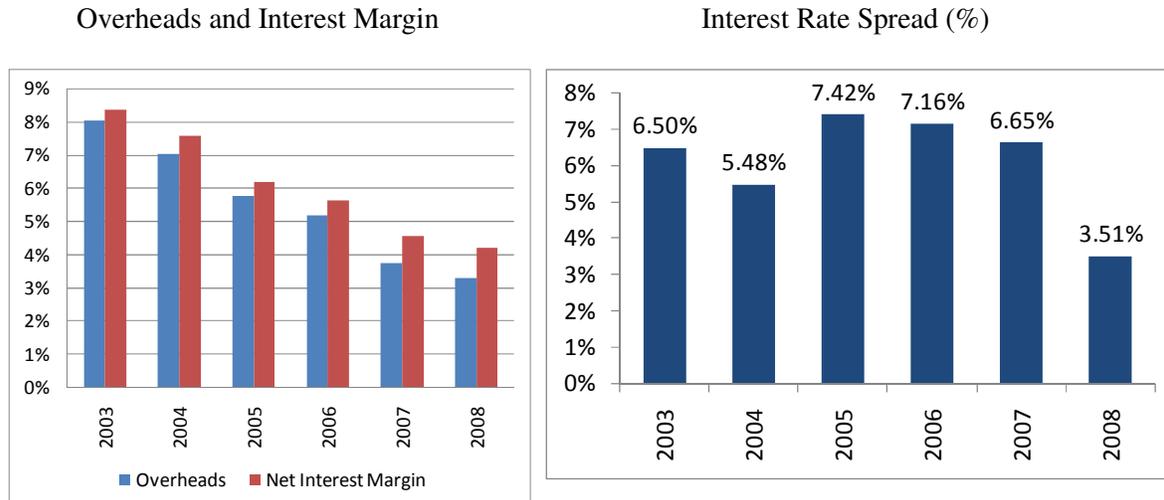
efficiency improvements (see Figure 4). The large banks created through consolidation might have been better able to exploit economies of scope and scale that improved their efficiency. However, there are reasons to be hesitant about drawing too firm a conclusion.⁵

Table 3: Banking Sector Development and Efficiency, 2008

	Net Interest Margin	Overheads / Total Assets	Cost/Income Ratio	Private Credit / GDP	Deposits / GDP	Lending-Deposit Spread (%)
Brazil	0.034	0.026	0.649	0.504	0.632	35.595
Ghana	0.084	0.076	0.661	0.150	0.210	
Indonesia	0.055	0.033	0.513	0.263	0.340	5.106
Malaysia	0.029	0.014	0.411	1.007	1.124	2.954
Nigeria	0.042	0.033	0.552	0.348	0.337	3.509
South Africa	0.027	0.025	0.505	0.796	0.662	3.513

Sources: For interest rates and spreads, IMF (IFS). For net interest margin, bank deposits to GDP, bank credit to the private sector, and overhead costs, World Bank Financial Structure Database. Net interest margin refers to the net interest revenue relative to total earning assets. Data on for all indicators data are for 2008.

Figure 3: Banking Efficiency Has Improved in Nigeria

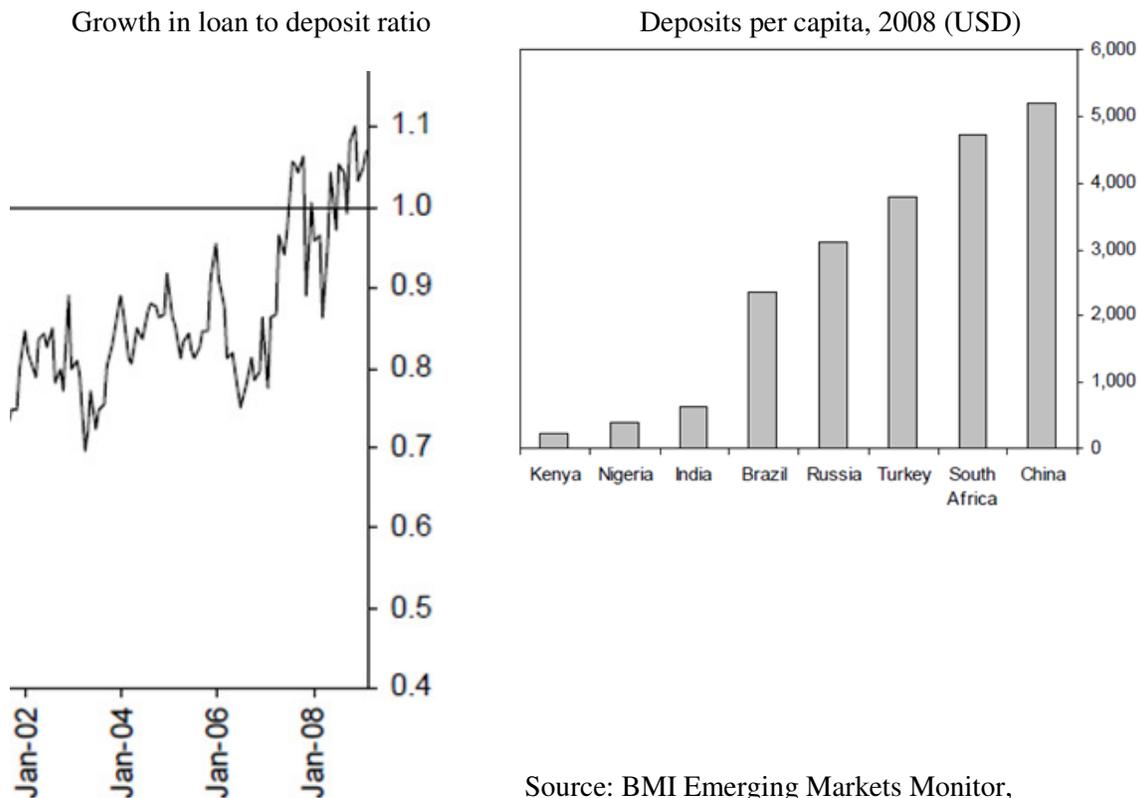


Source: Bankscope and World Bank Financial Structure Database 2008. The net interest margin is the net interest revenue relative to total earning assets. Overhead costs are divided by total assets. Interest rate spreads are from IMF (IFS).

⁵ First, there were reductions in costs and margins in 2003-2004, prior to the consolidation, and thus post-consolidation improvements could be viewed as the continuation of a trend that began for other reasons. Second, both the net interest margin and the overhead cost ratio have total assets in their denominators; since bank assets, and especially loans, were growing so rapidly, while interest income and overhead costs were relatively more stable, these two indicators had to decline by construction.

51. A fairer test of whether consolidation brought about improvement in banks' efficiency comes from the rates paid by banks for deposits and their interest spreads. By this measure, Nigeria is ranked below Malaysia, South Africa and, to a lesser extent Indonesia, though it does perform better than Brazil (Table 3). According to the CBN the weighted average interest rate on term deposits was 11.7 percent and the prime lending rate was around 16 percent in the fourth quarter of 2008, indicating that spreads have narrowed in recent periods⁶ (Figure 3). Interest rate spreads show a steady decline in the post-consolidation period, though the trend began before consolidation occurred. Intermediation, as measured by the ratio of loans to deposits, has also continued to improve, although the deposit base remains relatively small compared to other emerging markets (Figure 4). While these data cannot be used to establish a causal link between consolidation and improved efficiency, they do provide indicative evidence that there has been a general trend toward improved efficiency over the past six years.

Figure 4: Improvement in Intermediation



Source: CBN

Source: BMI Emerging Markets Monitor, Vol 15, No. 18

⁶CBN (2008) "Economic Report for the 4th Quarter of 2008" Volume 3, Issue 4. In early 2009, the CBN responded to the credit tightening following the international financial crisis by imposing caps on lending and deposit rates (at 24 percent and 15 percent respectively) charged by commercial banks, thus essentially fixing the maximum spread at 9 percent. These measures were temporary and were lifted again in July 2009.

A Weak Contract Environment for Financial Intermediation

52. A weak credit information environment and shortcomings in corporate governance contribute to increase the costs and risks of financial intermediation in Nigeria. The limited availability of mechanisms to track the credit history of borrowers exacerbates asymmetric information problems inherent to activities in the banking sector and increases the risks that banks face, particularly for retail loans as well as loans to small and medium enterprises. The CBN maintains a credit information system (with both positive and negative data), the Credit Risk Management System (CRMS)⁷, which suffers from a number of limitations that include the absence of scoring mechanisms and difficulties in providing unique identifiers (e.g. biometric national identification cards) for individuals⁸.

53. Furthermore, the lack of transparency and unreliability of corporate audited financial statements in Nigeria increase the risks and costs of financial intermediation by requiring more due diligence on the part of lenders and investors. Financial statements can be unreliable due to weaknesses in second and third tier accounting firms' practices and governance. In periods of rapid credit expansion and strong competitive pressures, these shortcomings may lead to excessive risk-taking by financial intermediaries.

54. In addition, the high costs of contract enforcement in Nigeria, as well as inefficiencies in mechanisms for enforcement and registration of collateral and antiquated insolvency laws also increase the costs of financial intermediation. A recently completed report on insolvency and creditor's rights pointed to the need for an urgent reform in the insolvency and creditor's right regime in Nigeria⁹. The report highlighted that the procedures for taking and registering security in Nigeria are inefficient, in particular in as concerns excessively high filing fees that generate perverse incentives for banking practices such as inaccurate registration. Furthermore, the Nigerian legal framework is considered to be expensive and time-consuming to use and is also seen to typically favor debtors. These characteristics have important implications for the efficiency of the banking sector (increasing costs) and access to finance (reducing availability), as financial intermediaries will incorporate these weaknesses in the business environment when pricing risk.

Emerging Risks in the Banking System

55. The low level of development and relatively small size of the banking sector as a proportion of GDP before consolidation in Nigeria implied that there was scope for an

⁷ As of 31 December 2007, a total of 51,696 borrowers were registered in the system.

⁸ For further details see Chapter XX and "Access to Finance in Nigeria: Microfinance, Branchless Banking and SME Finance" World Bank/CGAP, November 2008.

⁹ World Bank (2008) Report on the Observance of Standards and Codes, Nigeria Insolvency and Creditor's Rights, World Bank, Washington, DC.

expansion in banks' balance sheets. Nevertheless, for this expansion to be sustainable, risks need to be adequately managed. This section will discuss some of the emerging risks in the Nigerian banking system broadly classified into four areas: bank supervision, operational risks, asset quality and transparency.

Bank Supervision

56. Bank supervision in Nigeria is still mainly compliance-based, an approach which has inherent shortcomings in its ability to identify problems early in the credit cycle. The CBN is moving to consolidated risk-based supervision, has recently announced the appointment of resident examiners to provide continuous supervision of banks, and has introduced real time transaction monitoring via the eFASS system. But efforts to modernize supervision and regulation will take some time to reach fruition. They will require intensive technical upgrading to support the retraining of the CBN and NDIC bank supervision departments' staff. The problem is particularly acute in Nigeria's case, where banks have rapidly introduced new products and have already expanded into capital markets and insurance markets, all of which require special supervisory skills. In combination, these factors have placed Nigerian supervisors in a "catch up" race with the banking industry.

57. Starting in July 2009, the CBN program of special inspections revealed a number of weaknesses in risk management, credit culture and corporate governance in the banking sector. The CBN was forced to rescue several banks with serious liquidity and insolvency problems. The CBN has announced that depositors will be protected and that it will move quickly to strengthen supervision and improve corporate governance in the banking sector.

Operational Risks

58. Information technology and other systems have become over-stretched as a result of the rapid expansion of the banking system. This problem is impacted in particular those banks which were formed by the merger of multiple institutions, which also face the problem of having to integrate disparate systems. Reports of internal and external fraud are rising, indicating an increasing incidence of internal control failures. Specialized professionals with experience in managing large complex financial institutions are in short supply, despite efforts to bring in experts from other countries.

Asset Quality

59. Historically worldwide credit booms have usually been followed by a deterioration of bank asset quality. Most Nigerian banks are either in the process of expanding into – or planning to expand into – new products and financial services where they have limited experience (including retail banking, SME finance, and infrastructure finance), increasing their potential exposure to weaknesses in their risk management systems. Moreover, during the recent expansion in private credit several Nigerian banks

became more exposed to second and third tier suppliers of goods and services for the oil and gas sector. The dramatic fall in oil prices since mid-2008 had a disproportionate impact on the credit quality of these borrowers because of their position in the supply chain.

60. Furthermore, the global financial turmoil has led to a reversal of capital flows to Nigeria (net equity outflows were estimated to amount to over \$3.4 billion in 2008) and precipitated a decline in the Nigerian stock market (over 60 percent in 2008), which has significantly affected Nigerian banks. Banks formed between 60 to 75 percent of the market capitalization of the NSE. The conglomerate structure of the banking sector exposes banks to direct and indirect losses from the recent sharp decline of the stock market. The magnitude of banks' exposure to the stock market via loans to their own and third party capital market intermediaries, and loans to corporate and retail customers used to finance share purchases is uncertain. Official reports suggest that it could amount to as much as 10 percent of total bank loans. In any case, losses linked to share lending are likely to appear in balance sheets with some delay, partly because in 2008 the CBN allowed banks to reschedule debt repayments and defer recognition of losses on margin loans until end-2009.

61. Finally, given the fact that most of Nigeria's banks were closely held by individual and family interests, there was a lack of checks and balances that might have been seen had the sector been structured around disparate corporate interests. A weak corporate governance and poor credit culture have allowed some banks to partake in insider lending and lending to related parties which has further weakened the banks' balance sheets.

Transparency

62. Financial statements in Nigeria are not prepared according to International Financial Reporting Standards (IFRS) (see Box 1). Discussions with the Nigerian Accounting Standards Board (NASB) and international audit firms indicate that the NASB has been reluctant to espouse a strategy of adopting rather than adapting IFRS. Adaption is not consistent with the FSS 2020 objective of making Nigeria an international financial center, as Nigerian standards will still be seen to sanction reporting standards that diverge significantly from international best practice. In addition, delays in fully implementing IFRS will hamper banking supervisors' ability to detect and anticipate emerging problems in the system.

63. For example, IFRS requires banks to provision fully for the expected present value loss from a troubled loan, whereas current bank regulations in Nigeria only require banks to take provisions over time (according to the days a loan has been overdue). This allows banks to defer recognition of the losses over time, masking the potential scale of losses. Moreover, Nigerian standards allow more scope for accounting for investments at historical cost rather than market value. This may allow banks to reduce reported losses by not recognizing that investments have undergone a permanent decrease in value.

64. Furthermore, IFRS requires full consolidation of subsidiaries and affiliates based on the risks to the parent posed by them and the degree of actual control exercised by the parent. For supervisors attempting to implement consolidated supervision, the lack of IFRS reporting may thus mask the “full picture” of a banking group’s operations and their risks, making a comprehensive supervisory assessment more difficult.

Box 1: Selected Differences Between Nigerian and International Financial Reporting Standards

Presentation of financial statements. These IAS requirements are omitted from SAS: statement of changes in equity, distinction between current and noncurrent classifications, information to be presented on the face of the balance sheet, income statement and notes to the financial statements and their structure, true and fair override, restricted cash, concession arrangements, and development stage enterprises.

Cash flow statement. There is no provision that the interest and dividends received and paid by financial institutions should be classified as operating activities.

Fundamental errors and changes in accounting policies, changes in accounting estimates. These concepts are not addressed in the local standards.

Income taxes. Recognition of current taxes not addressed in SAS, and required disclosures are very limited. There is a divergence in the recognition of a deferred tax on loss carry-forward and in the treatment of differences associated with investments in subsidiaries, branches, and associated companies.

Property, plant, and equipment. Provisions regarding the initial measurement are omitted.

Inventory. Limited disclosures required. The allocation of fixed overheads to each unit of production is not based on the normal production capacity.

Effect of changes in foreign exchange rates. Local standard based on an outdated IAS version, the treatment of foreign operations is substantially different.

Leases. A lease in favor of a contractor financing the development of landed property is excluded from the scope of the local standard. A specific standard relating to the exploitation of oil has been issued, which was excluded from the scope of IAS.

Disclosure in financial statements of banks. IAS requires disclosure of any amounts set aside for general banking risks as appropriations of retained earnings, while the SAS requires a mandatory provision to be raised.

Source: Report on the Observance of Standards and Codes, Nigeria Accounting & Auditing, World Bank 2004

65. In addition, banks and major accounting firms report that corporate audited financial statements in Nigeria may be unreliable due to weaknesses in auditing practices as exercised by second and third tier accounting firms’ practices and governance. The unreliability of corporate financial information not only increases the risks and costs of financial intermediation as previously discussed, but they also make it more difficult for bank supervisors to accurately assess the quality of borrowers. While some efforts are underway to improve auditing standards (for example, by establishing an effective disciplinary and de-licensing process for underperforming auditors), further efforts are needed to accelerate this process.

Policy Recommendations

For Nigeria to achieve its FSS 2020 objective of becoming an international financial center, and to address emerging risks in the banking system, it is highly desirable that the following issues are addressed:

In the short term, bank supervision needs to develop rapidly its capacity to meet the challenges posed by the rapid growth and increasing complexity of the banking system. For this purpose, it is recommended that efforts to implement risk-based supervision be accelerated. In this context, an option which could be considered – and which has been used successfully in other countries – would be for the supervisors to temporarily increase their capacity by utilizing the services of expert international auditing firms to provide hands-on training and inspection support. This approach would provide the banking system with supervision at the level of sophistication it urgently requires while bank supervisors receive intensive on-the-job training in risk- and IFRS-based inspection techniques, and assistance in supervising the complex new products being introduced by the banking sector.

Over the medium term, bank regulation and supervision frameworks need to be brought into line with international standards. Over the medium term, it would be desirable to mandate the use of IFRS by banks. The CBN has announced its intention that all banks report according to IFRS by end-2010. The effort to introduce IFRS is presently being led by the Securities and Exchange Commission and Nigerian Accounting Standards Board for all listed firms in the country. Bank supervisors' preparations for the impact of IFRS on the bank supervision framework are only at an embryonic stage. As part of the IFRS adoption process, both bank supervisors will need to adapt regulations to IFRS and, most importantly, train bank inspectors to apply IFRS in the supervision process. Realistically, this adaptation and training process may take several years to complete and it is therefore urgent that rapid progress is made in preparing a transition program for bank supervision and regulation.

In the short term, steps to enhance credit information systems need to be adopted. The lack of a fully functioning credit information system is not conducive to increased access to finance and exacerbates credit risk for financial intermediaries. In October 2008, the CBN issued licensing guidelines for credit bureaus in Nigeria, which should pave the way for development of a competitive credit information system in the country. A number of private companies of significant size are currently working on credit bureau initiatives in Nigeria. As at October 2009, two credit bureaus have been licensed and are operational, one in Lagos and one in Abuja. A third one has received approval-in-principal from the CBN.

In the medium term, establishing an efficient system of collateral registration is necessary to reduce the costs and risks of lending. Current regulations limit the types of acceptable collateral and impose a complex and expensive system of registration charges. Computerization of land and collateral registries is vital to reduce the costs and delays on registering mortgages and liens. Reducing these costs can contribute to access

to credit by enabling borrowers to use their real property as security for credit in a cost efficient manner. Creation of computerized land registers presents significant technical and legal problems (partly due to the uncertainties of title created by customary ownership laws), but these can be overcome. Further study of how other African countries¹⁰ are resolving these problems may provide useful inputs into designing a computerization strategy.

In the medium term, introducing new information technology could offer the prospect of improved contract enforcement. Offering speedy and predictable contract enforcement is a key feature of the financial sector in developed financial hubs. In Nigeria's case, installation of computerized case management systems would increase the overall efficiency of the courts by reducing paperwork and improving scheduling efficiency while simultaneously reducing opportunities for rent seeking by court employees who are now in a position to delay or obstruct cases by manipulating the movement of paper records.

¹⁰ For example, Uganda and Mozambique.

SECTION III. FINANCIAL INCLUSION

The Importance of Access to Finance for Nigeria's Development

66. **If Nigeria is to attain Vision 2020 and meet the Millennium Development Goals (MDGs), it must make a concerted effort to improve access to finance.** With a population of 140 million people, 55% of which are living below the poverty line (NLSS, 2004), Nigeria is not on track to meet the first Millennium Development Goal (MDG) of halving poverty¹¹. Although strides have been made in improving macroeconomic management and business environment over the past few years, Nigeria still faces several challenges, among which are poor infrastructure, low education and weak governance. Access to finance is also identified as a key constraint to the poor in securing their savings or to SMEs attempting to grow and expand their business. In a country where only one in ten working Nigerians is formally employed and underemployment is estimated at 70.5%¹², microfinance, SME finance and branchless banking are important in supporting growth and reducing poverty through employment creation.

67. **However, access to finance is currently very low for both the poor and SMEs.** Around 74% of the Nigerian population has never been banked, while only 7% of adults have a loan. Only 5 percent of firms have a loan, despite the fact that 80 percent of SMEs seek financing. These numbers place Nigeria among the bottom ranking developing countries for access to finance. The end result is that Nigeria is foregoing important opportunities for growth and poverty reduction.

68. **Despite the recent progress to improve access to finance, a number of reforms still need to be undertaken.** While the Government of Nigeria has made considerable efforts to improve access to finance, more needs to be done both in terms of regulatory and legal reforms as well as a concerted effort by the authorities to improve the financial infrastructure in support access to finance. The following sections give an overview of the state of microfinance (Section 2), SME finance (Section 3) and branchless banking (Section 4) in Nigeria as well as the state of infrastructure and the legal and regulatory framework (Section 5). The last section proposes a number of policy recommendations (Section 6).

The State of Microfinance in Nigeria

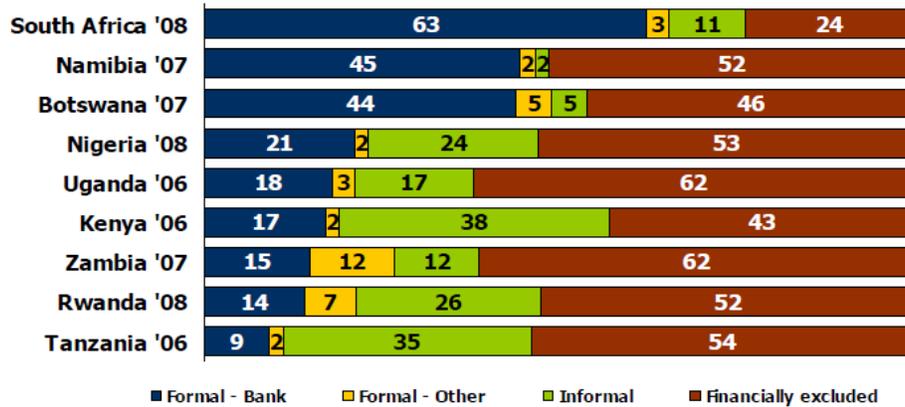
69. **A FinScope survey conducted by EFInA¹³ in 2008 estimates that that 74% of Nigerian adults have never been banked.** This is roughly equivalent to 64 million people. EFInA estimates also indicate that 53% of Nigerian adults are financially excluded: they are not served by formal or informal financial services providers (e.g. savings clubs, Esusu, moneylenders, etc.). This situation is similar to that of Tanzania, but it is considerably worse than that in countries like Kenya or South Africa (Figure 5).

¹¹ http://www.mdgmonitor.org/country_progress.cfm?c=NGA&cd=566

¹² Employment data: National Bureau of Statistics, Social Statistics in Nigeria, 2005.

¹³ 2008 FinScope Survey; <http://www.efina.org.ng>

Figure 5: FinScope Survey Cross Country Comparison

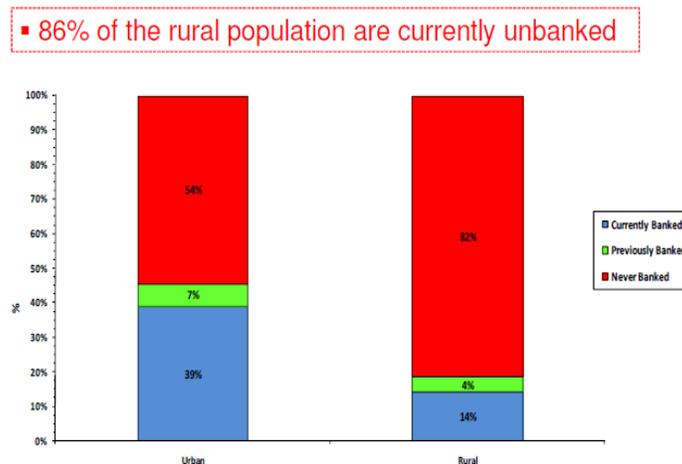


Banked, plus Formal Other = Formally Served
 Formally served, plus Informal Other = Financially Included

Source: FinScope surveys

70. **Given the number of financially excluded adults implied by these percentages, Nigeria emerges as a huge potential and as yet unexploited market for financial services.** While the salaried population has been targeted especially by the growing banking sector¹⁴, this is not the case for the rest of the population. Sixty one percent of the unbanked assert that they would like to have a bank account and cite reasons for their exclusion such as not having enough money or a regular income or that the bank branch is too far away. In addition, 86 percent of the rural population remain unbanked (Figure 6).

Figure 6: Access to Finance: Rural vs. Urban



Source: EFINA

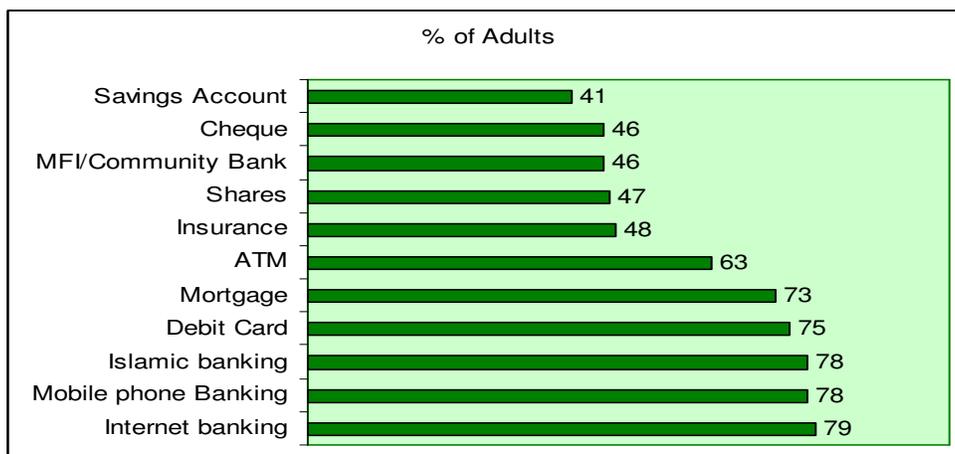
¹⁴ An estimated 71 percent (9.6 million) of salaried adults have access to a variety of banking services, such as savings and current accounts, insurance, ATM cards, debit and credit cards, etc.

71. **Providing wider access to finance in Nigeria could become an important vehicle for poverty reduction.** At present only 7% of adults have a loan and use it mostly to open or expand a business. Since a third of the population claims that its main source of income is its own business, it is evident how providing loans and other needed financial services to micro entrepreneurs could help reduce poverty.

72. **EFinA also elaborates a profile of the typical “unbanked Nigerian”** – a woman¹⁵, often with some level of secondary education, that lives in a rural area¹⁶ in the North East or North West regions of the country, with no or very low income (below N8,000) that comes mainly from farming, and is aged 18-34 years. This reconfirms the existence of a large potential market for financial services. The EFinA survey also shows that Microfinance Banks (MFBs) have yet to penetrate Nigeria’s rural areas. Only 3 percent of adults (2.6 million) currently use an MFB as their main bank and most beneficiaries are young males living in the urban areas of the South West, mainly Lagos.

73. **While access to finance is low, basic knowledge of financial services is even lower.** Based on EFinA’s survey, the level of financial literacy among Nigerian adults is extremely low for several types of financial products (Figure 7). This clearly suggests that marketing and consumer awareness should be a key element of any strategy aimed at building a more inclusive financial system.

Figure 7: Adults Unaware of Financial Products



Source: EFinA 2008 FinScope survey

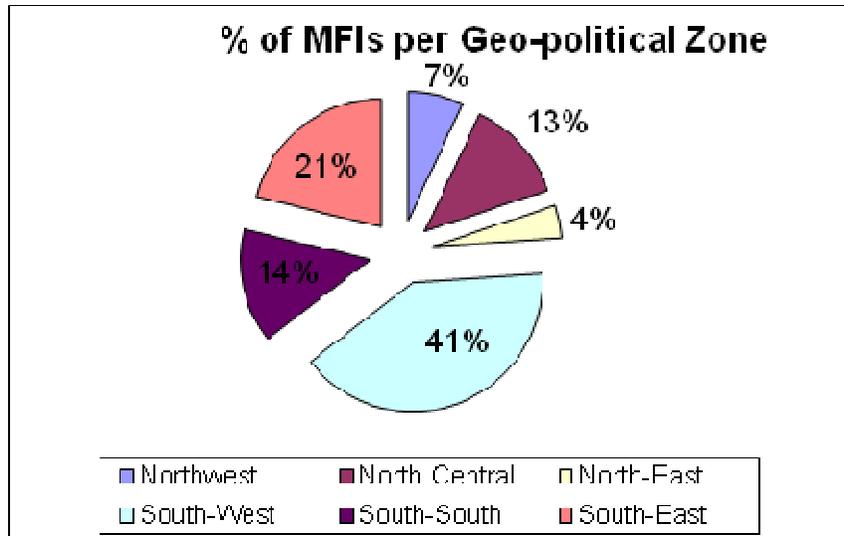
74. **Most of the 724 registered MFBs are concentrated in the urban areas of the South-West** (Figure 8), with only 4% of them located, in the poorer, less-urbanized

¹⁵ EFinA estimates indicate that 85% of Nigerian women are currently unbanked (2008 FinScope Survey).

¹⁶ 86% of the rural population is currently unbanked in Nigeria (2008 FinScope Survey).

North-East. Of the 724 licensed MFBs, 117 are new entrants¹⁷ that have come into the market following the issuance of the “Microfinance Policy, Regulatory and Supervisory Framework for Nigeria” (hereafter, the Microfinance Framework) by the CBN in 2005. The other 607 are converted Community Banks¹⁸ that were relicensed under the new Microfinance Framework, but have too little capital to overcome the problems that have plagued the sector since its birth in the early 1990s.¹⁹

Figure 8: Most MFBs concentrate in and around Lagos



Source: Central Bank of Nigeria, 2008.

75. **Overall, the microfinance sector in Nigeria is quickly expanding but problems are beginning to emerge** (Table 4). The CBN has granted approvals in principle to another 94 entities, which will increase the total number of MFBs to 818. Based on CBN interim reports (June 2008), assets for the MFB sector have grown 136 percent since 2005, while equity has increased by 248 percent, resulting in a better

¹⁷ Among the new entrants are internationally experienced microfinance organizations, e.g. ACCION International, Shorebank, K-REP (Kenya), BRAC (Bangladesh), and the DAI group. Ten Nigerian commercial banks (e.g. Ecobank, Zenith, UBA) have also launched microfinance services, with seven establishing MFB subsidiaries and three creating microfinance departments within the bank.

¹⁸ Community Banks (CBs) were introduced in the early 1990s to serve rural areas and lower income groups. By 1995, they numbered 1,355 and an array of organizational weaknesses and governance problems became apparent. Bank failures reduced the sector significantly and only 881 CBs remained by 2002. Following the issuance of the 2005 Microfinance Framework, the CBN allowed CBs to relicense provided they fulfilled the MFI requirements. As of the December 2007, only 232 CBs had fully qualified and 375 were pending a final approval by the CBN.

¹⁹ In comparison to neighboring countries, savings and loan cooperatives are conspicuously invisible on the landscape of formal financial intermediaries in Nigeria, while several NGO microcredit programs have been in operation since the late 1980s or early 1990s. Though the number of viable microcredit NGOs is small, these organizations seem to have developed a viable model of making very small loans to rural populations, particularly women. The five largest microfinance NGOs include COWAN, LAPO, SEAP, DEC and FADU, and combined they serve 550,000 borrowers and manage a total loan portfolio of NGN 4.9 billion (US\$ 40.6 million).

capitalized sector. As of August 2008, the average capital adequacy ratio was 37.3 percent. The CBN also reports that the quality of new loans is satisfactory while old loans from the legacy community banks are less than satisfactory. Even among some of the new entrants, there are early signs of repayment problems, with 10 percent of the total portfolio in arrears for more than 30 days. While they often bring capital and talent to the industry, many MFBs remain very small, inexperienced, inadequately capitalized and heavily focused on urban markets.

Table 4: A Growing Microfinance Industry

	#	Loan Portfolio	Deposits
Microfinance Banks (=607 CBs converted to MFBs + 94 MFB approvals in principle + 117 new entrants)	818	N 33 billion (N 96 b in assets)	N 50 billion
Selected largest NGOs (550,000 borrowers)	5	N 4.9 billion	0

Source: Central Bank of Nigeria, 2008.

The State of SME Finance in Nigeria

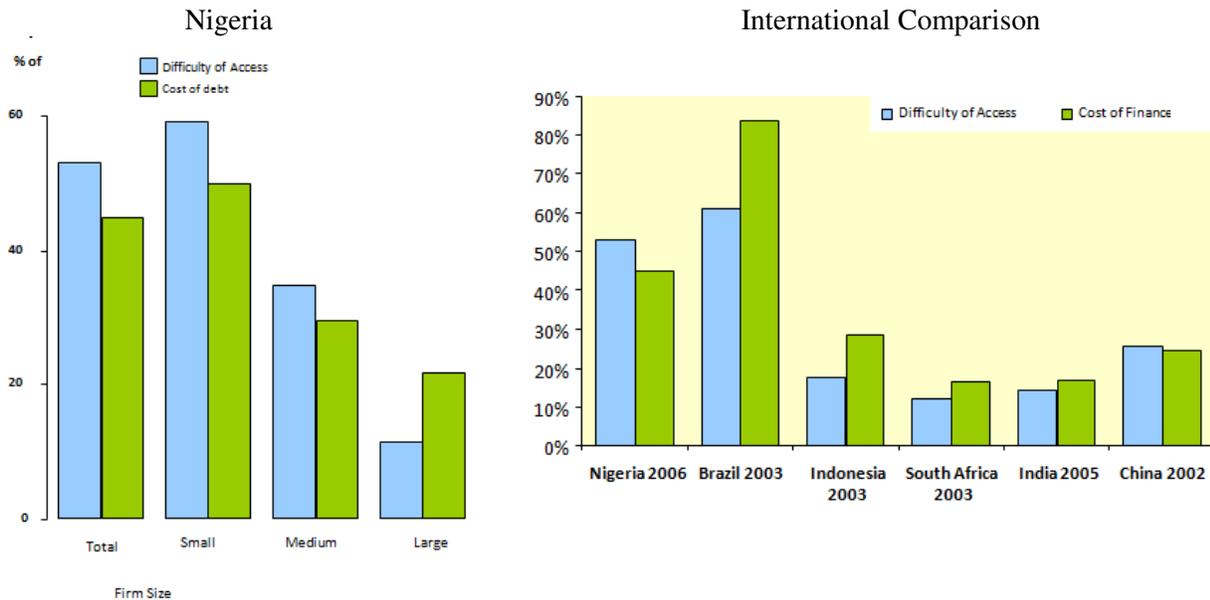
76. **The development of a robust SME sector would be a viable means to create jobs and reduce poverty in Nigeria.** Following years of Dutch Disease and loss in international competitiveness, the Nigerian SME sector is fragile, operating in a business environment that presents considerable challenges (e.g. poor infrastructure, low skills, weak governance). This caused the overall share of SME contribution to GDP growth to halve (from 8.4% to 4.6%) between 1980 and 2005²⁰. The SME sector in Nigeria is much smaller than in other developing countries, with MSME (including microenterprises) accounting for close to 50 percent of GDP (compared to 80% for many developing countries) (National Bureau of Statistics). Manufacturing as a whole is estimated to account for less than 5% of GDP, with SMEs accounting for half of this.

77. **The most recent World Bank Investment Climate Assessment (ICA) study (2008) identifies low access to finance as the second most important constraint for Nigerian SMEs,** ranking after the electricity shortage. Only 5 percent of SMEs have a loan, despite the fact that 80 percent of them seek financing. Financing constraints depend on the size of the firm. About 59 percent of small firms report difficulties in accessing finance compared to 35 percent of medium firms and 11 percent of large SME firms (Figure 9

²⁰ Malik, A. & F. Teal, "Towards a More Competitive Manufacturing Sector", in Collier et al., 2008.

78. Figure 9). The difficulties of Nigerian SMEs in obtaining finance are similar to those of SMEs in Brazil but are much worse than those in India, China, South Africa, and Indonesia (Figure 9).

Figure 9: Access to and Cost of Finance



Source: World Bank ICA Report (2008)

79. **Most of the SMEs requiring finance do not apply for it.** The 2008 ICA study notes 80 percent of SMEs that did not apply for financing would actually like to have a loan/line of credit²¹. The main reasons Nigerian SMEs give for not applying for loans are: short loan maturities, inaccessible collateral requirements, high interest rates and cumbersome application procedures. Nigeria has the shortest average loan maturity (21 months) among comparison countries, such as Kenya, Brazil, China and India. Shortage of suitable collateral is also a deterrent, since every loan of over NGN 10 million (US\$ 86,000) must be collateralized with land or buildings²². However, evidence shows that, despite firms' perceptions, the cost of finance compares favorably with that of the aforementioned countries (Figure 9).

80. Consequently, most Nigerian SMEs tend to rely heavily on their own funds. Most SMEs use retained earnings and their own funds (70% of firms) for financing, while bank lending is very low (1% of firms). Supplier credit is also low, accounting for only a quarter of SME financing (Table 5).

²¹ This represents a stark difference when compared to large firms, for which the figure is 20%.

²² Smaller loans also require some form of collateral per market practice. SMEs report that unacceptable collateral or co-signers are the most likely reason (over 50% of firms) for rejection of their loan application.

Table 5: Sources of SME Finance in Nigeria²³

Percentage of financing from:	Total	Small	Med.	Large
Own Funds/Retained Earnings	70%	70%	71%	61%
Borrowed from banks and other financial Institutions	1%	1%	2%	2%
Purchases on credit from suppliers and advances from customers	25%	25%	25%	35%
Borrowed from family, friends and other informal sources	4%	4%	2%	1%

Source: World Bank ICA Survey (2008)

81. Results are similarly low for other credit products like overdrafts and lines of credit, often a preferred way of providing working capital to SMEs. Only a small percentage of Nigerian SMEs have access to a line of credit (4%) or an overdraft (8%). When compared with global experience, SME finance from financial institutions in Nigeria seems particularly limited (Table 6).

Table 6: Sources of Financing: International Comparison

Percentage of short term financing from:	Nigeria 2008	Brazil 2003	China 2003	India 2005	Indonesia 2003	Kenya 2007	S. Africa 2003
Internal Funds/Retained Earnings	70%	44%	13%	47%	38%	73%	66%
Borrowed from banks/financial Institutions	1%	30%	27%	32%	16%	7%	17%
Purchases on credit from suppliers/advances from customers	25%	15%	2%	9%	4%	17%	12%
Borrowed from family, friends and other informal sources	4%	5%	8%	9%	20%	3%	1%
Issued new equity/debt	-	4%	12%	2%	2%	-	1%

Source: World Bank ICA Survey (2008)

82. **Access to credit also varies by economic sector.** The firms with the highest access are those in the food industry, while the garment sector attracts the lowest volume of credit (World Bank, 2008). Nigerian financial institutions would seem to have a clear preference for lending to sectors with shorter turnaround times.

83. **A popular credit option among SMEs is equipment leasing.** Between 2003 and 2007, the Equipment Leasing Association of Nigeria (ELAN) recorded a quadrupling of leasing volumes granted by its members²⁴. A total of NGN 242 billion (US\$ 2 billion)

²³ This table refers only to short-term financing. For long-term financing, supplier credit is not an option, so firms tend to rely on own funds over 90 percent of the time.

²⁴ This substantial growth is especially significant given the lack of a leasing law and judicial use of the Hire-Purchase Act when dealing with leasing cases in Nigeria. The leasing law was recently sent back by the President to the National Assembly for revision, while the Hire-Purchase Act (introduced in October

was recorded in 2007, out of which approximately 20 percent was in the form of operating leases and 80 percent were financial leases. However, only 30–35 percent of this amount went to SMEs, which are mostly served by smaller leasing companies and face higher costs of funding²⁵. The fact that such leasing is growing in spite of the high costs involved is a clear indication of the lack of financing alternatives. Like in many other developing countries with weak systems for enforcing liens on moveable assets, leasing is a widely used form of financing in Nigeria as the ownership of the item tends to remain with the lessor and, upon non-payment, repossession of the asset does not require legal action.

84. Factoring is a much less common form of finance for SMEs in Nigeria. Most factoring is granted by banks to companies in the oil sector or large corporate clients. In other sectors, where the value chain is not as well understood, banks perceive higher risk in providing factoring finance to an SME. However, recently finance houses have been moving into short-term working capital loans for SMEs, providing some factoring and purchase order financing.

85. The Government has attempted to make finance more readily available to SMEs in a variety of ways. The Small and Medium Enterprises Equity Investment Scheme (SMEEIS)²⁶ was initiated by the Bankers' Committee and became operational in 2001. As of end-December 2008, SMEEIS investments totaled NGN 28 billion (US\$ 194.4 million) in 333 companies, out of a total NGN 42 billion (US\$ 291.6 million) in the SMEEIS fund. In an attempt to enhance the performance of the scheme some banks decided to establish specialized venture capital companies with the Securities and Exchange Commission (SEC) to manage the funds. Although in early 2008, the low level of funds invested and changing national priorities led the Bankers Committee to discontinue SMEEIS and transfer the balance to a Microcredit Fund, most of the newly created venture capital funds are still in operation. The lessons learnt from this experience could prove useful for banks aiming to target SME investments and there is evidence of more banks beginning to offer better tailored services to SMEs building on this venture capital fund experience (e.g. Diamond Bank, Oceanic Bank, Ecobank).

86. Two development finance institutions are also active in SME lending in Nigeria. The Nigerian Agricultural, Co-operative and Rural Development Bank (NACRDB), created to serve the rural poor, has 300,000 clients among SME (with loans

1968) severely limits the recourse a seller has against a purchaser who defaults to the point that after a percentage of payments has been made the seller loses all rights of recovery. This in effect discourages buyers to repay.

²⁵ Of the estimated 250 leasing companies in Nigeria, most are non-financial companies that do not accept deposits (and are not regulated by the CBN). These companies typically face high costs of funds, as they borrow at commercial rates from the banking system (22-30% per annum). This brings the final cost to the SME customer to 35-50%.

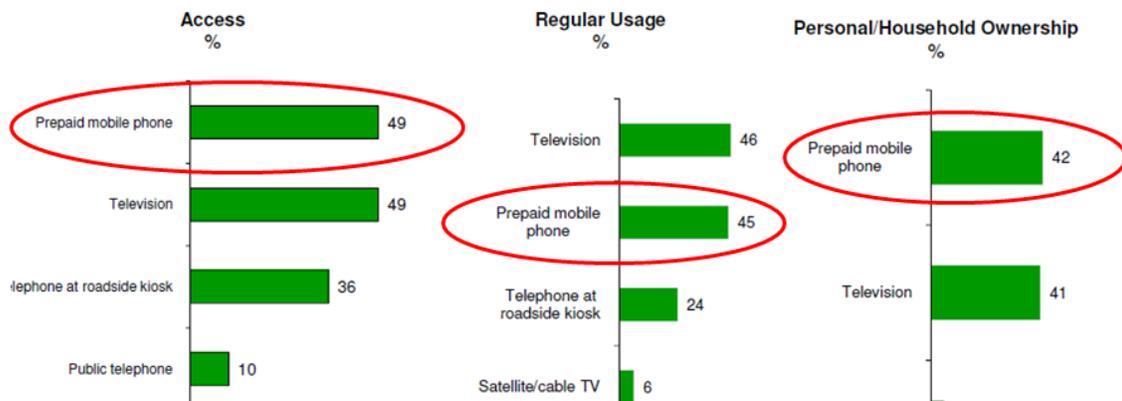
²⁶ The scheme required all banks to set aside ten percent of their annual after-tax profits for investment in SMEs. These could take the form of loans or equity, although a mandated 9% interest rate cap on loans reduced incentives to lend and led banks to seek equity investments in SMEs. SME equity investments are generally quite problematic, given due diligence requirements and difficulties in exiting the investments through the sale of shares. These problems surfaced in the SMEEIS Scheme too and were further compounded by the banks having little experience in identifying suitable SMEs.

from NGN 250,000 to NGN 5,000,000). With capped and subsidized interest rates, NACRDB has continuously generated losses and has had to substantially reduce its new lending²⁷. A more successful, but also more modest attempt by the government to support SMEs is the work carried out at the Bank of Industry (BOI), which has committed 89 percent of its portfolio in loans to 65 small and medium enterprises.²⁸ However, BOI’s portfolio growth is limited by a small equity base, lack of deposits and lengthy process for loan disbursement²⁹.

The State of Branchless Banking in Nigeria

87. **Branchless banking is the delivery of financial services outside conventional bank branches using information and communications technologies and nonbank retail agents.** Due to its potential to radically reduce the cost of delivery and to increase convenience for customers, branchless banking can expand coverage to previously underserved segments of the population. In particular, as mobile phones in Nigeria enjoy a high penetration rate³⁰ (Figure 10), mobile banking could be a viable option to improve access to finance.

Figure 10. Relatively High Mobile Phone Penetration



²⁷ In 2007, NACRDB provided approximately NGN 1.7 billion (US\$ 14.7 million) in loans, which was less than its non-interest expenses of NGN 2.7 billion.

²⁸ Data as of June 2007 from the BOI “Delivering our Mandate” publication dated July 2007.

²⁹ BOI’s loans are in the range of NGN 10–200 million (US\$ 86,000–1,700,000) with a 3 to 7 year tenure, 1 year moratorium and interest rates capped at 10 percent. In 2007, BOI’s total assets were NGN 23.6 billion (US\$ 203.4 million).

³⁰ Figures available differ widely. Senge & Miebi argue for an 80% penetration rate (“Nigeria has achieved 80 percent phone penetration—NDUKWE”, October 20, 2008) whereas EFINA suggests that 53% of adults have access to a mobile phone, 48% use it regularly but only 2% of people use it for banking transactions.

88. **Nigerian financial institutions, mobile network operators and private switch operators are paying an increasing amount of attention to branchless banking.** Although electronic payment transactions currently account for less than 1 percent of all payment transactions in Nigeria, they are increasing rapidly. The value of funds transferred electronically in July 2008 was nearly double the amount transferred in January 2008. Growth is expected to continue as banks scale up prepaid/debit card issuance and expand ATM/POS networks and as private switch operators increase the offer of electronic payment services (e.g. bill payment, retail payments, funds transfer, etc.)³¹.

89. **A number of branchless banking initiatives are being rolled out in Nigeria.** Interswitch reports that already more than 18 million debit/credit cards and 8 banks, 5 microfinance banks and one mobile network operator currently use its electronic funds transfer platforms. E-Tranzact, another private switch operator, is about to launch an ATM “cardless transaction” product (called “CardlexCash”) by which money can be sent to even unbanked mobile phone subscribers via an SMS³². MoneyBox is also preparing to launch a savings and payment system based on deposits made through scratch cards³³.

90. However, much of the success of branchless banking will depend on educating potential customers. At present as many as 78 percent of adults (67 million) have no knowledge of what mobile banking entails (Figure 7). Financial literacy should then become an integral component of any strategy aimed at expanding access to finance in Nigeria.

Financial Infrastructure and the Regulatory and Legal Framework for Access to Finance

Regulation and Supervision of Microfinance in Nigeria

91. **The 2005 Microfinance Framework presents the CBN’s vision of a microfinance industry that serves multiple purposes,** such as providing financial services to the poor, mobilizing savings for intermediation, increasing productivity and employment for the poor, administrating and channel government microcredit programs, and rendering payment services for government agencies. In addition, the Framework envisages the creation of industry support organizations, industry associations, a deposit insurance scheme, a liquidity facility, and state-funded wholesale programs.

³¹ The main branchless payment instruments currently available in Nigeria include large-value credit transfers, checks, retail electronic debit and credit transfers and payment card systems. Electronic purses (a form of stored value cards), internet-based banking along with mobile payment services have recently been introduced.

³² The SMS will contain information which, together with a code provided separately by the sender, can be entered into an ATM machine to convert the electronically stored value into a cash withdrawal. “E-Tranzact to Launch ATM Mobile Cardless”, Daily Independent, October 21, 2008.

³³ The system will permit electronic value stored on a mobile phone to be used to pay bills, buy mobile airtime and send money. Customers will be able to cash in value at agent locations as well as at the Nigerian Postal Service (NIPOST)’ s approximately 3,000 branches.

92. **The CBN has created the MFB as a form of non-bank financial intermediary (NBFI).** The CBN created the MFB licenses to encourage existing institutions and future investors to house their microfinance operations within a fully regulated and supervised non-bank financial institution, in line with models used in other countries. The MFBs have a mandate to provide deposit, credit and payments services and the regulations allow individuals and corporations, both national and foreign, to own an MFB. This has made the MFB license an attractive option to a range of actors that aspire to offer financial services through an NBFI. It will also likely increase the already significant variety of institutions operating with an MFB license.

The CBN guidelines for establishing a MFB provide two license options:

- Unit MFB – operates within the local government area in which it is registered and must have a minimum capital of NGN 20 million (US\$ 172,000).
- State MFB – can operate in all parts of the State in which it is registered, is subject to a minimum capital requirement of NGN 1 billion (US\$8.6 million) and must cover at least two-thirds of a State before applying for a license to expand in another State.

As of September 2008, almost all (98.9%) of the MFBs were classified as unit, with only nine classified as state MFBs.

93. **The prudential regulations provide specific guidelines in all important areas.** These include prudential and non-prudential measures to manage risks typically associated with microfinance institutions with lower capital requirements. For example, MFBs are not allowed to engage in complex financial services that have currency, counterparty, or political risks. Capital adequacy requirements are set under the assumption that most of the MFB loans will be unsecured and that capital is therefore a critical component of credit risk management³⁴. Liquidity ratios are also established at conservative levels of 20 percent of deposit liabilities. Risk concentration is controlled by a limit on individual loans to no greater than 1 percent of unimpaired shareholder funds (5 percent for a group borrower). Provisioning requirements for portfolio in arrears are aggressive and in line with international best practice, requiring 100 percent loss provisions for loans over 90 days in arrears or restructured. The regulations also contain a definition of “microloans” with a maximum loan size of NGN 500,000 (US\$ 4,300). Since early 2008, depositors in MFBs are also protected by the Nigerian Deposit Insurance Fund for amounts up to NGN 100,000 (US\$ 862).

94. **The supervisory function of the CBN is structured into two departments: Banking Supervision and Other Financial Institutions (OFID).** The Banking Supervision Department carries out the supervision of banks and discount houses while OFID supervises finance companies, MFBs and other non-bank financial institutions.

³⁴ The capital adequacy ratio is set at a risk-rated 10:1 ratio and there are strict guidelines for establishing reserves and for dividend pay-out policies.

95. **Within the microfinance sector, the CBN divides responsibilities between OFID and the Development Finance Department (DFD).** OFID is responsible for licensing, regulation, supervision, and ensuring compliance with regulatory guidelines for MFBs. DFD is responsible for capacity building for MFBs and their clients, development of the sector, policy formulation and implementation and sensitization. These distinct roles may conflict in practice, especially when it comes to designing regulations to promote the CBN's vision of the sector. The long term efficacy of the CBN as the regulator will have much to do with how well it can reconcile the promotional and supervisory roles of its two departments.

96. **The supervisory process involves both on-site and off-site arrangements.** Offsite supervision is based largely on the monthly reports that MFBs are required to send to OFID, consisting of detailed financial statements and 24 supplementary schedules. Only some MFBs are submitting reports electronically to OFID, while most submit hardcopies and a significant number of MFBs do not report at all. The system is cumbersome and overwhelming for OFID, given the large number of MFBs and the level of detail they are required to submit on the monthly reports. Moreover, the move to an electronic filing system is slowed by the fact that many MFBs lack basic information systems.

97. **The CBN intends to develop a risk-based supervision approach to the MFBs, going forward.** The regulations outline a basic CAMEL rating model as an appraisal tool and OFID staff stress the importance of assessing management capacity. Conspicuously absent, however, is a commitment to public disclosure of performance data. The CBN publishes sparse and only consolidated balance sheet data for MFBs in its annual supervision report. However, transparency should become a key element of the CBN's strategy, if the microfinance sector is to become a vibrant one capable of performing its role in serving the poor.

The Public Credit Registry & Private Credit Bureaus

The Public Credit Registry

98. **The CBN maintains a credit information system called the Credit Risk Management System (CRMS).** The CBN Act 2007 established the CRMS³⁵ and empowers the CBN to obtain monthly bank reports on all loans with a minimum outstanding balance of NGN 1 million (US\$ 8,620). Banks are required to make status enquiries on any intended borrower to determine his eligibility and are penalized for non-compliance. The CRMS is a web-enabled database that provides a credit history³⁶ of borrowers in the system plus a profile on the total liabilities a debtor has acquired within

³⁵ This system was set up as a result of the rise in non-performing credit portfolios in banks during the 1980s and 1990s. The existence of "predatory debtors" in the banking system who abandoned debt obligations in some banks only to contract new debts in other banks was also cited as a factor.

³⁶ Both positive and negative data is maintained on any borrower as well as historical trends.

the banking system, with information dating back to 1994. As of 31 December 2008, fewer than 30,000 borrowers were registered in the system.³⁷

99. **The effectiveness of the CRMS is reduced by a number of issues.** Firstly, the absence of loan classifications or any scoring mechanism limits the benefits that the system provides. Consequently, a debtor may have different classifications in different banks with no sharing between them. Secondly, the lack of a unique identifier for individuals poses a significant challenge. In Nigeria there are various forms of personal identification (including a national ID), but all have limited coverage and none is fully reliable³⁸. When a bank enters a new borrower into CRMS, a new ID is generated, which becomes obligatory for use by all banks. However, duplicates sometimes get past the different filters and that the database contains some ID errors. Thirdly, the Microfinance Framework indicates that the current CRMS shall be expanded to accommodate MFB clients. In effect, this would lower the information threshold for reporting the CRMS from the current NGN 1 million (US\$ 8,620) to less than NGN 50,000 (US\$ 431) for MFB loans, jeopardizing the ability of the system to cope with such an expansion without dramatically increasing ID duplicates and lowering the quality of information.

The Private Credit Bureaus

100. **Access to finance is also hindered by the lack of reliable credit information on borrowers.** In October 2008, the CBN issued Guidelines for the Licensing, Operations and Regulation of Credit Bureaus in Nigeria (“Credit Bureau Guidelines”). The guidelines limit bank ownership of a bureau to 10 percent of its total paid-up capital³⁹. A credit bureau is permitted to collect customer information related to determine such customer’s “overall debt exposure and repayment behavior”⁴⁰. The ability to access credit bureau information is restricted only to lending entities or individuals and only for a “permissible purpose” such as to obtain credit scoring, information on borrower’s existing loan facilities or opening a new account as part of KYC principles. Banks must obtain credit reports from at least two credit bureaus before extending credit. With a number of private credit bureaus now being launched, this requirement should be feasible in the short- to medium-term. Under the new Guidelines, a consumer has the right to inspect (at a credit bureau) his or her credit information and to request an investigation of any information such consumer considers inaccurate.

101. **The introduction of credit bureaus could help Nigeria develop a fully functioning, competitive credit reporting industry in the short term.** A number of private companies are currently working on credit bureau initiatives in Nigeria. These initiatives are at various stages of development and only two bureaus for now are operational. As mentioned, a third one has received approval-in-principle by the CBN.

³⁷ Data verbally provided by CBN staff. No published data could be accessed.

³⁸ The 2008 EFINA survey reports that 39% of Nigerians have a national ID card, while 14% have passport. Making identification more problematic is also the widespread practice of altering names by use or habit, while birth dates and addresses tend to be unreliable.

³⁹ Banks may only invest in a single credit bureau.

⁴⁰ Guidelines for the Licensing, Operations and Regulation of Credit Bureaus in Nigeria, October 2008, Section 5.2.

Having private credit bureaus exchange client identifier information through the use of biometric IDs should help solve this rather intractable problem in a relatively short period of time.

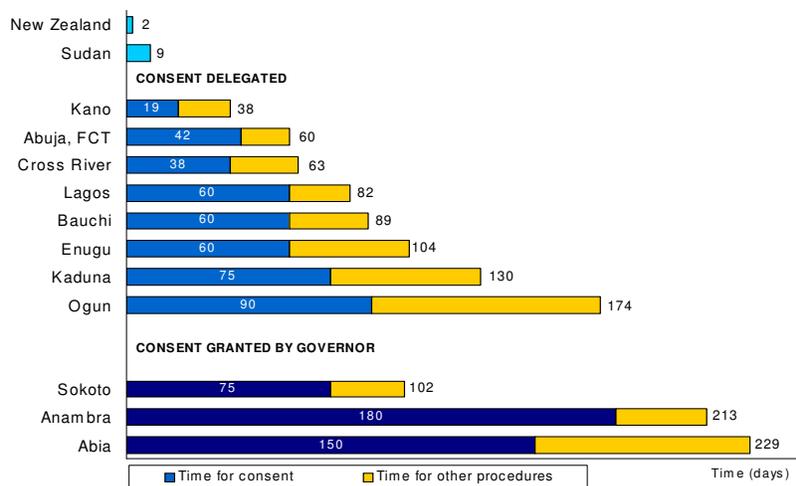
Collateral and Company Registries – Supporting Access to Finance for Enterprises

Mortgage Registry

102. **The mortgage registration system in Nigeria makes it hard for SMEs to obtain a loan.** Mortgage financing is an important component of SME finance. SME loans are often guaranteed by real estate (e.g. the home of the owners; the company's warehouse or office). In Nigeria, the Land Use Act of 1978 vests ownership of all land in the Governor of each state, who is entitled to allocate land for development through 99 year leases. Thus ownership of land is in reality a “right of occupancy”, which is recognized through a certificate of occupancy. All transactions in property are subject to complex requirements (including the Governor’s consent), which add a significant amount of time and expenses to the registration process. In addition, there is a complex system of waivers, derogations and special deals so that the full impact of the charges may be mitigated for the privileged few.

103. **Nigeria is one of the most expensive countries for property registration in the world.** The 2009 World Bank Doing Business report ranks Nigeria at number 176 (out of 181 countries) for registering property. The registering process entails 14 procedures, 82 days and costs of 21.9 percent of property value. Variations across Nigerian States are also very significant (Figure 11).

Figure 11: Time to Register Property in Nigeria by Selected States

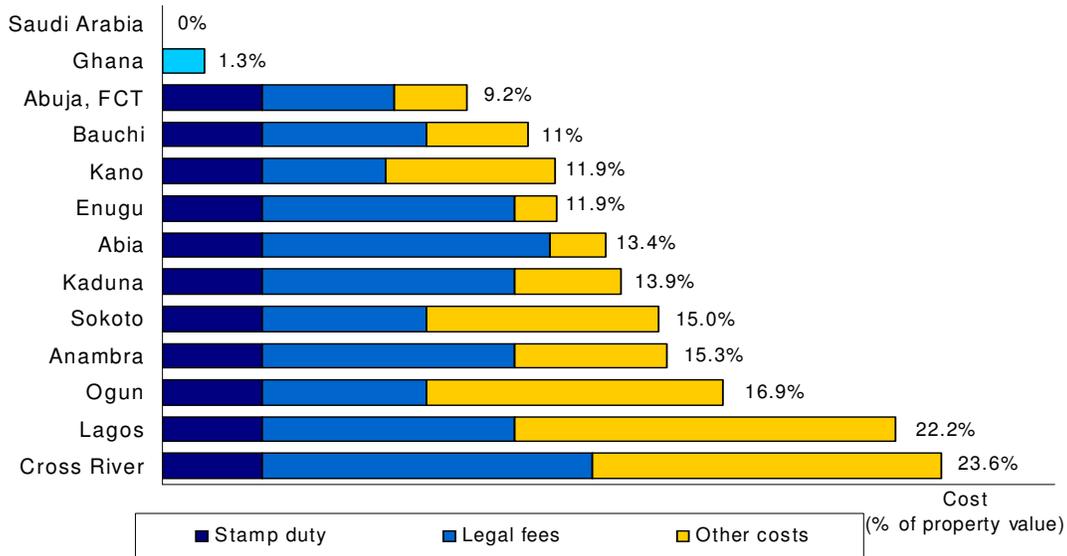


Sources: World Bank, Doing Business in Nigeria 2008.

104. **Information held by land registries is often inaccurate and of little use.** This is because mortgages are typically registered only before legal action is taken. Mortgages should be registered at the lands registry of the state where the property is registered and, in the case of a corporate borrower, also at the Corporate Affairs Commission (CAC)

registry⁴¹. However, there is a widespread practice of taking but not registering security over land (mortgages), especially for short-term borrowing. This is because the cost of registration can easily negate any potential profit on the loan. If the cost of registration were instead to be passed to the borrower, the cost of the loan would become prohibitive. Once again, overall costs vary widely by Nigerian state (Figure 12). This practice leaves lenders completely unprotected from a legal viewpoint, although it could be argued it signals the borrower's commitment to give the real estate as security. Given these complications, short term working capital loans or overdraft facilities guaranteed by mortgages are simply not available to lesser known or younger SMEs, even if they have real estate to offer as collateral.

Figure 12: Cost to Register Property by Selected Nigerian States



Source: World Bank, Doing Business in Nigeria 2008.

Collateral Requirements and Lien Registry

105. **Collateral requirements coupled with the costs of property represent a serious constraint for access to finance in Nigeria.** According to CBN regulations, every loan of over NGN 10 million (US\$ 86,000) must be collateralized with land or buildings. Smaller loans also require some form of collateral. Additionally, not all forms of collateral are equally accepted by banks. Their preference is determined by present and anticipated transaction costs in establishing and enforcing property rights, the ease of liquidation, and the position vis-à-vis other creditors in case of insolvency. These various market preferences coupled with CBN regulations limit access to credit to SMEs. Furthermore, they provide an incentive to companies that lack acceptable collateral to seek financing in informal credit markets with less stringent collateral requirements but higher costs of lending.

⁴¹ Land registries are not interconnected with the CAC registry making searches for any security unreliable.

106. **The lack of a reliable lien registry for moveable assets makes equipment or asset financing for SMEs very difficult** (with the exception of leasing), because there is no method of establishing what, if any, claims exist on these assets. The CAC maintains a registry where claims against the assets of companies can be registered, but these are general claims on total assets of the company (i.e. debentures), and individual assets cannot be singled out. Furthermore, the registration is limited to companies while sole proprietorships, most partnerships and individuals are excluded. As noted in the recent World Bank Report on the Observance of Standards and Codes (ROSC) in respect of Nigeria’s insolvency and creditor rights (ICR) system, banks generally have a low level of confidence in this registry.

Company Registration

107. **As opposed to property and collateral registration, the incorporation process is reasonably agile, making it easier for companies to “go formal”.** Although it varies among states in Nigeria, the company registration system⁴² is relatively effective and cheap, making it easier for SME to become formal enterprises. This improves their chance to access finance as banks often require SMEs to become formal companies prior to establishing credit relationships. In many developing countries this process may be so time consuming and costly that it becomes a significant obstacle to SME finance. However, evidence from the Doing Business in Nigeria 2008 Report would place Nigeria on a better foot than the average Sub-Saharan African country (but still lagging behind the developed world).

Retail Payment Systems and Branchless Banking Infrastructure

108. **The CBN has put considerable efforts into upgrading the infrastructure for branchless banking in Nigeria,** for example by reconstituting the National Payments System Committee (NPSC) and its technical sub-committees and directing banks to amend the exclusive clauses in their agreements with international money transfer operators leading to higher level of competition and lower costs for remittance services.

109. **However, the restriction of disbursement of remittances to bank branches limit the geographic outreach of pay points.** About 35 percent of bank branches are located in Lagos and Abuja and this restriction considerably undermines competition and the institutional capacity to leverage other non-bank networks and improve the outreach of the branchless banking infrastructure to the public in general.

110. **Similarly, the legal and regulatory framework relating to payment system aspects of remittances has not been updated.** Consequently, the current framework does not permit non-bank operators and networks to operate in their own right.

⁴² The CAC is the agency in charge of registering and regulating the formation and management of companies in Nigeria. Although the state offices can register business names, applications for company registration must still be forwarded to the Commission’s Abuja headquarters, where they are processed.

Despite having installed a real-time gross settlement (RTGS) system in 2006-07, critical RTGS related processes are still not automated in the CBN. The RTGS was commissioned to support the instantaneous, reliable, and secure transfer of balances and payments through automated processes. However, as yet the payment system meets neither international standards for risk mitigation and efficiency nor the needs of users. Currently, the provision and repayment of intraday liquidity is not automated in the RTGS system. Non-automated processes often result in intraday credit spilling over into overnight lending. In addition, connectivity issues between the RTGS system and the banks' internal systems still do not permit straight-through-processing.

111. Lack of interoperability among privately operated switches for retail payments produces significant inefficiencies. The CBN recently established the Nigerian Central Switch (NCS)⁴³ to promote interoperability between different privately operated retail payment systems. However, despite the 2003 Guidelines on Electronic Banking in Nigeria that encourage private switch operators to interconnect, private switches are still not interoperable⁴⁴. This results in significant inefficiencies, such as the deployment of multiple ATMs and POS terminals to the same high-traffic areas, while leaving others underserved, and the inability of customers to use access points that are not part of their bank's network. The CBN has privately informed all licensed private switch operators that they must connect to the NCS. However, the NCS is still not operational and reports indicate that the private switches are delaying interoperability until the operational guidelines of the NCS are clarified because they see the payment services provided to banks by the new switch as in competition with those they provide

112. Nigeria's payments system is still very paper-based. Checks are used for wholesale as well as retail payments and currently account for over 90 percent of non-cash payments⁴⁵. The Automated Clearing House (ACH) facilitates the electronic clearing and settlement of local checks on a multilateral net basis, at t+1. It also facilitates direct debit and credit transfers. However, existing rules do not adequately delineate the rights, responsibilities, and obligations of participants, including customers, in the use of these instruments.

113. Nigeria has a very low rate of ATM penetration. The CBN estimates that there are approximately 7,000 ATMs in the country, translating into only one ATM per 20,000 individuals. Given low levels of inter-operability among payment providers, the actual

⁴³ The switch is owned and operated by the Nigerian InterBank Settlement System (NIBSS) that was established in 1993 to settle interbank funds. The NIBSS also provides a number of payment services to banks, including bulk payments (e.g. salary disbursements) and dividend payments. NIBSS is owned by each of the 24 commercial banks and the CBN. Many of the commercial banks also have ownership interests in the private switches.

⁴⁴ Currently, there are five private switching companies operating in Nigeria. The largest one is Interswitch and has an estimated market share of more than 90%. All 24 commercial banks are connected to it. The others are Cards Technology Limited (CTL), Valuecard, E-Tranzact and 3 Line.

⁴⁵ This becomes particularly significant because, despite the harsh punishment envisaged by the Dishonored Check Act, according to NIBSS 13 percent of checks are returned unpaid. Of these, 3 percent are returned for insufficient funds. The remainder is returned for technical reasons such as inadequate signature or illegibility.

penetration rate may be even lower. This low penetration may be explained by the high cost of ATM operation⁴⁶. However, ATM transactions still represent over 90% of the value of all electronic fund transfers in Nigeria.

114. Point-Of-Sale (POS) penetration is also extremely low in Nigeria. For the first seven months of 2008, POS transactions represented 4 percent of the value of all electronic fund transfers in Nigeria. At the end of 2007, Nigeria had approximately 6,700 Point-of-Sale (POS) terminals. The POS penetration rate represents a ratio of less than 50 POS terminals per 1 million inhabitants. This is an extremely low penetration rate compared to other countries in Africa – 130 POS terminals per 1 million inhabitants in Zimbabwe, 350 in Egypt, and 14,000 in South Africa.

115. The high penetration levels of mobile phones represent a great potential tool to provide financial access to a much larger segment of the Nigerian population by using mobile technology. As of June 2008, Nigeria had four licensed mobile network operators (MTN, Glo, Zain (formerly Celtel), and Mobile Telecommunications Limited with approximately 50 million mobile telephone subscriptions.⁴⁷ In addition, another four licensed CDMA mobile network operators (Starcomms, Visafone, Reltel and Multilinks) had approximately 4.8 million subscriptions. Although this number undoubtedly includes inactive mobile subscriptions and customers with double lines, it represents a penetration rate of approximately one mobile phone per three individuals. While mobile transactions represented one tenth of 1% of the value of all electronic fund transfers. In the first 7 months of 2008, they represented 7.5 percent of the total number of funds transfer transactions⁴⁸, indicating promising customer uptake although for small value transactions.

Consumer Protection, Deposit Insurance, Insolvency and Creditor Rights

116. The principal consumer protection body in Nigeria is the Consumer Protection Council (CPC). Its functions include “speedy redress” and awareness campaigns and its definition of consumer extends only to individuals and not legal entities. The CBN nevertheless has expressly recognized the Consumer Protection Commission Act’s authority over the provision of financial services⁴⁹. However, in practice, protection of financial services consumers is rarely addressed by the CPC, which reports only 16 complaints related to “financial matters” from 2000–06

⁴⁶ Operating an ATM is very costly because of the need for frequent replenishment (due to the limited capacity of the machines and the low value of the highest denomination note, i.e. NGN 1,000); the difficulty and cost of sourcing adequate quantities of ATM-fit notes and monitoring machines for jams; the need to maintain alternate sources of electricity at all ATMs because of the unreliability of electricity supply; and the cost of physically securing both the ATMs and their generators.

⁴⁷ Nigerian Communications Commission, available at <http://www.ncc.gov.ng/index5.htm>

⁴⁸ This figure excludes intra-bank funds transfers initiated by a bank and processed through the core settlement system. The percentage of mobile funds transfer is higher than both POS and internet transactions, which were 2.19 percent and 2.93 percent, respectively.

⁴⁹ Guidelines on Electronic Banking in Nigeria, CBN, Section 3.0f.

(inclusive).⁵⁰ The CBN included data privacy provisions in the Guidelines on Electronic Banking in Nigeria and publicly invites consumers to lodge complaints directly with the CBN Supervision Department regarding financial issues. Moreover, the draft Mobile Payments Guidelines envisions a separate consumer protection body dedicated to protecting consumers of mobile payment services.

117. The Nigerian Deposit Insurance Corporation (NDIC) insures all deposit liabilities of licensed banks and other deposit taking financial institutions. Required premiums pursuant to the original act equaled 15/16 of 1 percent of deposits. In January 2008, the NDIC moved to a "risk-based" premium based on perceived exposure to pay out and started requiring MFBs to pay premiums equal to half of 1 percent⁵¹. The NDIC has been criticized for duplicating supervisory efforts with the CBN and for its limited supervisory capacity⁵².

AML/CFT Regulations

118. In June 2006, Nigeria was removed from the list of non-cooperative countries in combating money laundering and the financing of terrorism. Nigeria is a member of the regional FATF-style body for Africa, the Inter-Governmental Anti-Money Laundering Group in Africa (GIABA). The CBN is responsible for regulating AML/CFT procedures and the Economic and Financial Crimes Commission (EFCC) is responsible for enforcement.

119. Anti-Money Laundering and Countering the Financing of Terrorism (AML/CFT)⁵³ is currently addressed by a number of regulations, often in conflict with each other. The primary regulation governing AML/CFT is the Money Laundering (Prohibition) Act. Secondary documents governing AML/CFT include (i) the CBN's Know Your Customer Manual for Banks and Other Financial Institutions in Nigeria, (ii) the Advance Fee Fraud and Other Related Offences Act, (iii) the Guidelines on Electronic Banking in Nigeria, and (iv) a wide array of circulars and other documents issued by the CBN. An example of conflicts includes the MLPA forbidding banks to open non-face-to-face accounts and the KYC Manual allowing that. Moreover, the aforementioned regulations all require different amounts and types of information for the purpose of opening an account (e.g. names, date of birth, type of business, photo, etc.). The recently produced draft mobile payments guidelines also provide for AML/CFT requirements, often in contrast with those of other aforementioned regulations.

⁵⁰ Statistics of Complaints Received by the Consumer Protection Council from 2000-2006, Digest of Statistics 2006, Federal Ministry of Commerce and Industry, p. 30.

⁵¹ Deposit accounts are insured up to NGN 100,000 (US\$ 862). MFBs pay slightly higher premiums than commercial banks based on the insured amount. This difference may be justified given perceived risks.

⁵² The NDIC has 43 examiners for commercial banks, which are shared for supervisory efforts with the CBN on an annual basis. Moreover, it has only 33 for approximately 700 Microfinance Banks.

⁵³ A more extensive discussion of AML/CFT regulations in Nigeria can be found in the CGAP/World Bank report on "Access to Finance in Nigeria", 2009.

Conclusions and Recommendations

120. Despite dynamic and growing microfinance, SME finance and branchless banking sectors that seem geared up for a huge expansion of access to finance for Nigerians, some inhibitors could hinder this growth process. The following recommendations are meant to tackle the issues arising:

Microfinance

- **Publish historic financial statements, financial and outreach performance data and interest rates of all MFBs on the CBN website.** This will enable clients, managers, investors, and wholesale lenders to exert their expectations about performance in the market, while policy makers will be better informed about the performance of the market.
- **Prioritize supervision efforts on the largest MFBs.** This may be accomplished with a multi-tiered approach to supervision that applies different levels of supervision according to the size of the MFB.
- **Develop off and on-site supervision tools and training programs.** Given the large number of MFBs subject to CBN supervision, priority should be given to developing off-site monitoring capacity;
- **Align all MFB wholesale lending programs with a market-based model .** Subsidized funding schemes (such as federal level Microfinance Fund, the framework sets a target of two-thirds of state and local governments developing funding facilities for the MFBs) may compromise the integrity and viability of the MFBs. It will also be important to coordinate approaches for wholesale lending from Federal Government, State Governments, and Funder programs;
- **Raise the minimum capital requirement for unit MFBs.** The minimum capital requirement for unit MFBs is currently too low to support sound and efficient microfinance institutions. This has permitted the birth and continued operation of a large number of undercapitalized and weak institutions. On the other hand, high state MFB capital requirements have created incentives for explosive growth and high risk-taking;
- **Ease geographic restrictions on MFB expansion.** Easing geographic restrictions in the CBN microfinance guidelines will ease pressure where MFBs are currently concentrated and allow MFBs to grow, and capitalize, where market opportunities exist. The geographic restrictions associated with the unit and state licenses have concentrated the most aggressive MFBs in urban areas and may limit the growth opportunities of both small and large MFBs as the sector develops;
- **Promote capacity building initiatives aligned with MFB needs, CBN requirements, and funder programs.** Given explosive growth and the young age of the industry, MFBs face acute needs for capacity building;
- **Allow acquisitions and mergers without geographic restrictions.** Mergers and acquisitions can help successful MFBs expand their operations to underserved populations while salvaging weak MFBs that are struggling to operate on their own. However, geographic restrictions currently in the Framework may impede beneficial specialization, consolidations and mergers;

- **Promote the development of a single MFB industry association.** A strong industry association can facilitate orderly dialogue between the MFB sector and the monetary authorities and assist with dissemination of market information.

SME Finance

- **Improve data collection and dissemination.** At the moment, policy making for the sector is severely constrained by the lack of data, while most of the data available is gathered by surveys of external organizations. Simple changes, such as the CBN expanding open item code 10860 of the Monthly Statement of Assets and Liabilities (MBR 300) to leasing, factoring, loans under credit lines, etc. issued to SMEs could go a long way to improve the situation;
- **Establish a credit information system.** The issuance of guidelines and the licensing of the first two credit bureaus is an important step forward. The CRMS should also be established as a separate unit within the CBN to supplement existing CBN off-site supervision, while the incorporation of all MFBs data in the CRMS should be reconsidered, as this could compromise its operations and lower overall quality of information. Instead, such data could be handled by private credit bureaus;
- **Increase the use of checks as a credit and payment instrument.** Checks have limited acceptance in Nigeria, given low confidence and limited enforcement of the Dishonored Cheques Act. Given advances in electronic payments, the use of checks as merely a payment medium will continue to decrease. However, in the meantime post-dated checks can serve as de facto credit instruments, particularly for inter-company transactions and supplier credit. Meanwhile, expanding the use of credit cards could allow SMEs to sell more and take advantage of credit card receivables financing;
- **Promote introduction of new products for SME finance.** CBN and SMEDAN are well placed to facilitate this discussion with the private sector;
- **Leverage SMEEIS experience.** To be more effective, the funds could be modified to incorporate debt financing in addition to the existing equity structure while maintaining their venture capital approach. To increase funding available to these venture funds, the government could consider fiscal incentives on earnings, promoting listing (and trading) of participations in the funds through the exchange, and approaching donors and quasi investors for “matching” funds;
- **Review and where necessary reform legislation and regulation on collateral and registries.** This refers particularly to the finalization and sign-off of the Leasing Law; the review of regulations applying to finance companies; and the improvement of the registry and legal system for liens on moveable assets;

Branchless Banking

- **Promote interoperability of the retail payment system.** The CBN should clearly define the role of the NCS and in particular whether it will be permitted to compete

with private switches in the payments products sector. Operational guidelines should be drafted;

- **Ensure that mobile payments guidelines address key issues.** These include the use of agents and/or third party service providers, including qualifications and liability and managing the prudential risks involved in nonbank-led models of mobile banking;
- **Ensure that the mobile payments guidelines addresses consumer protection challenges unique to mobile banking.** These include whether mandatory disclosures may be provided via a subscriber's mobile phone; how a customer would prove transactions if a lost phone means a lost SMS record; the customer duty of due care and negligence; how to resolve a case of mistaken recipient identity; how to protect data privacy; etc.

SECTION IV. LONG TERM SAVINGS AND INVESTMENTS

Development Finance Institutions

Introduction

121. In Nigeria as in many other developing countries there is a sense in which the commercial financial sector has failed to address the needs of the poor. After several decades of post-Independence financial sector development the proportion of the population with access to a bank account or formal financial services of any kind remains at 16 percent. Moreover access to finance for SMEs and rural populations as well as finance for infrastructure development remains extremely limited. Within such a context it is natural to ask whether there is a larger role for public sector interventions in the financial sector to fill such obvious gaps. Discussion on SME access and infrastructure financing are presented elsewhere in this document while this sector considers the role of development finance in Nigeria with particular regard to rural finance.

Avoiding market failures

122. The underlying justification for the state playing an active role in an essentially private financial sector can be stated in terms of the economist's concept of market failures. In a complex and multi-faceted economy such as Nigeria's there are many ways in which the power of markets may prove deficient. Here are the main ones that are relevant to this discussion.⁵⁴

- *Limited competition:* Although there are a relatively large number of banks and other financial institutions operating in Nigeria, these cannot be said to work in a fully competitive manner. Instead there are various market segments such as banks serving large corporate clients, those working closely with large foreign companies, those involved quite closely with specific regional communities and various market segments. Banks in different segments also work more or less closely with the political system with some relying from time to time on political connections to try to gain a competitive edge. Segmented competition results in limited competition which in turn is seen in the persistence of high charges and poorer products and services than are technically possible. This weaknesses of the competitive process can apply at all levels of the financial market and may be particularly serious in remote rural communities where one provider may face major operational problems but very little competition.
- *Imperfect Information.* Financial transactions almost always involve a forward-looking perspective and so require an assessment by both lenders and borrower of future possibilities that may affect the profitability of the borrowing enterprise(s). Such assessments are inherently much more difficult in economies such as that of Nigeria where there is an underlying volatility associated with the dependence on oil combined with a non-trivial concern about inflation, other aspects of

⁵⁴ This section from "Development Finance and the Gaps in Finance", Alan Roe, Oxford Policy Management, October 2009.

macroeconomic instability and possibly political stability as well. Where this underlying volatility – or the fear of it – combines with weak information about the true financial condition of potential bank clients, the banks and non-bank financial institutions (NBFIs) can be expected to be highly conservative in spite of a wide array of instruments designed to manage their risks (e.g. high levels of required collateral, a very narrow group-based approach in MFI lending etc.).

- *Externalities.* There are a variety of ways in which the desirable innovation of one single bank or NBFI may be discouraged (or still-born) because the benefits of that innovation cannot be appropriated in sufficient volume by the originator: i.e. they under-provide desirable new services that they are able to identify. This is especially true of financial services such as ATMs, mobile phone banking and creditor information services where networks of cooperating banks and regulators are needed to reap the full benefits of those services. Market players may be able to organise the necessary degree of cooperation to establish the associated networks and reap the benefits of the so-called network externalities. But it is much more likely that various degrees of government and regulatory involvement will also be needed to enhance the market. Externalities also have significant potential to exert negative influences on financial sector development. In particular, the failure of any one bank in an economy characterised by imperfect information will have an impact well beyond the pain of any single bank failure. This is because parties who are not affected by the failure may assume that other financial institutions may also be unsafe and reduce their engagements with the financial sector accordingly.

123. The existence of these various market failures creates a clear necessary condition for state intervention. But it is very important to emphasize two points at the outset. (i) the existence of market failures does not constitute a sufficient condition for state intervention and (ii) where it is decided to involve the state in resolving the market failure there are good and bad types of state intervention associated both with the likely costs to the state budget and also with the probability of the intervention succeeding in its objectives.

124. As a broad rule of thumb, government interventions of a type that have a high probability of failure (based on objective analysis and/or the experiences of the past or in other countries) should be avoided. Where there are two or more alternative interventions that can address the same market failure, the one that involves the lower budgetary cost should normally be preferred. It is also worth noting that government capacities in countries like Nigeria are always low relative to the skill base and other capacities that can now be mobilised in banks and other market players. So it is always a good idea to try to design government interventions that piggy-back synergistically on the (larger) capacities of market participants and involve the relatively limited deployment of skilled but scarce civil servants. Credit guarantees that make full use of the credit assessment skills of private commercial banks are a good example of this basic proposition. The

chronic failures of the many state interventions of the 1970s and 1980s are still well known and should not be forgotten.

125. Within this context, the Nigerian experience with development finance institutions (DFIs) has been mixed. There exist a wide range of successful institutions such as the Urban Development Bank, the moderately successful Bank of Industry and the disastrous Nigerian Agricultural Cooperation and Rural Development Bank (NACRDB). This section highlights the lessons emanating from Nigeria's recent DFI experience focusing on the NACRDB as at the time of writing the bank is being considered for restructuring and more policy lessons may be drawn from a negative as opposed to a positive experience.

Origin and Evolution of the NACRDB

126. The Nigerian Agricultural Bank Ltd. was incorporated on 24 November, 1972 and renamed Nigerian Agricultural and Cooperative Bank (NACB) Ltd. in 1978. The bank had (and till today still has) two shareholders, the Federal Government of Nigeria through its "Ministry of Finance Incorporated" (MOFI), which holds all FGN investments, and in this particular case 60% of the shares, and the CBN, which holds 40% of the shares.

127. The bank was mandated to provide loans for agricultural purposes to Nigerians. The mandate of the bank, i.e. lending activities, as laid down in the memorandum and articles, was believed to be sufficient to operate it as a financial institution. As a consequence, no banking license was sought from the CBN, very much in line with the predominant belief at that time that all that Development Finance Institutions (DFIs) would need to assist in the development of agriculture and poor farmers by granting low interest loans to boost their production and thus increase their incomes.

128. Up to the end of the 1990s, the bank provided its services through its network of 67 branches, which were assisted and supervised through six zonal offices and its head office in Kaduna. It achieved a considerable outreach, provided a range of short, medium and long term loans to clients, and was the most important provider of long term agricultural loans. Despite good agricultural loan appraisal skills of the its staff, the bank was hampered by an inadequate governance structure, insufficient emphasis on selection of clients, poor loan recovery, concentration on government structures and partnerships, and an inadequate range of products. Provisions against bad debts were never made and accounts of the bank were not made available to the general public.

129. As a consequence of this situation, the repayment rates have been far below the levels that could sustain the bank. In the absence of published figures and a functioning Management Information System (MIS), it is generally believed that the recovery rate of loans was around 30%, with somewhat higher rates in the northern parts of the country and from smallholders. There is also evidence that a vast number of large-scale loans to

the politically well-connected private sector were granted in contravention to sound banking procedures, for non-viable and non-feasible projects, without adequate collateral, and without much intention from the borrowers to repay such loans.

130. The People's Bank of Nigeria (PBN) was created in the early 1990s as a Grameen Bank replicator through a decree of the military government⁵⁵. It essentially provided micro credit up to NGN 250 000 per client at a 'service charge' of 20% for short term loans and offered ordinary savings through a pass book remunerated at market rates. In 2000, the NACB, the PBN and the risk assets of the "Family Economic Advancement Programme" FEAP were merged into the Nigerian Agricultural, Cooperative and Rural Development Bank (NACRDB). Legally, the former NACB, through a Special Resolution passed on 20 December 2000, enhanced its mandate, acquired the PBN and took over the risk assets of the FEAP.

Current Status of the NACRDB

131. The NACRDB – in many dimensions – does banking in the way that it should not be done. It is not set up as a real bank, and therefore cannot get the capital it needs from depositors. Its owners have not paid in the share capital that the bank needs: the FGN because revenues have recently dried up and the CBN because it is not satisfied with the bank's performance. As it provides credit at interest rates lower than its cost of capital, it makes structural losses which implies that it cannot raise capital from the markets.

132. The bank has two shareholders (CBN and MOFI), which have little control over the banks operations while the Federal Ministry of Agriculture and Water Resources (FMAWR), is requested to approve all board decisions even if it was not represented at the board meeting. Key staff positions are appointed by the Minister without a competitive recruitment process. The bank is forced to lend in accordance with the predominant paradigms of equitable distribution over geopolitical zones, which runs against commercial and economic considerations. Even branches that have shown their incompetence in lending and recovery are allocated fresh funds for lending because of an erroneous belief that a geopolitical zone must disburse its share.

133. The interest rate cap (8 percent) imposed on the bank has established the NACRDB as a federal institution to enable farmers to access a subsidy derived from Nigeria's oil wealth. In Nigeria, and elsewhere, it is impossible to prevent the elites from capturing such subsidies and inescapably, interest rates attract the "bad and ugly" of the market⁵⁶. Some observers go as far as assuming that much of what was said publicly about the mandate and services of the bank has been no more than lip service rather than reality, with the main interest not being to assist the poor which never benefit from low interest rates, or to promote agriculture, but to allow, in the extreme case, followers and

⁵⁵ See World Bank: Rural Finance in Nigeria. Integrating new approaches. Agriculture and Rural Development Unit, Africa Regional Office. Washington DC, April 4, 2008. Report No. 44741-NG.

⁵⁶ Babagana Mustapha: Rural Finance Services Supply in Nigeria: NACRDB Role, Experiences and Challenges, p. 20.

cronies to access these services at rates lower than market and to make political capital from championing the interests of smallholder farmers.

134. As the interest rate is far below what the bank needs to survive, it has made losses in almost all eight years since inception resulting in a consumption of more than NGN 10 billion since inception. One of the shareholders (CBN) refuses to inject fresh capital as this is perceived to encourage the bank to make further losses. Moreover, the CBN has not been able to ensure the same degree of compliance with the law from this bank that it has obtained from private banks. From this perspective, the bank is an anachronism in the financial sector and even among African DFIs.

135. The low interest rate also prevents the bank from developing and cultivating its own client base. The subsidies coupled with lax recovery make the NACRDB the first port of call for would-be borrowers. Once these cannot get the loan they want, most likely because the bank's funds dried out, they turn to other banks and accept more expensive loans with higher repayment enforcement.⁵⁷

136. The bank's products are insufficiently diversified and are not responsive to client needs. The bank provided useful services at inception, i.e. a combination of agricultural and non-agricultural loans which were terminated on the basis of a Presidential fiat. The intermediation model is old-fashioned and violates good banking principles. Whereas normally, banks do everything to intermediate many small deposits of short maturity into larger and longer term loans, the NACRDB receives single large transfers of long term money from treasury which it intermediates into small and short term loans. Deposit mobilisation is credit driven, clients save the barest minimum to be eligible for loans and putting more emphasis on mobilising voluntary deposits is not possible because of the lack of a banking license and inadequate physical infrastructure.

Repositioning of NACRDB

137. NACRDB is not currently fulfilling its intended mandate to farmers or the rural economy and needs to be repositioned to meet its original objectives. To effectively reposition the bank to meet its mandate in a viable and sustainable manner, it will be necessary to: (i) carefully analyze the necessary conditions for successful repositioning; (ii) come up with viable options for such repositioning; and (iii) subject the options to critical assessment before choosing the most viable one.

138. *Conditions for Repositioning NACRDB:* Three important factors of failure or under-performance of any DFI can be isolated. These are governance; operational independence to determine services, products and interest rates; and recapitalisation. For NACRDB to be viable and sustainable, these three areas must be addressed by its shareholders as a matter of urgency. Otherwise, no further investments into the bank

⁵⁷ World Bank: Rural Finance in Nigeria. Integrating new approaches. Agriculture and Rural Development Unit, Africa Regional Office. Washington DC, April 4, 2008. Report No. 44741-NG, p. 15.

would make either economic sense or produce the results that the government wants, i.e. a gradually increasing access to high-quality services for farmers and rural entrepreneurs at affordable costs for borrowers, and without forcing the government to pour in fresh capital every now and then.

139. *Governance*: this is probably the single most important issue to be addressed. A recent case study on the corporate governance of the NACRDB⁵⁸ found that the bank shows poor compliance with the minimal governance standards set for African DFIs⁵⁹. Assessing the bank in terms of the 39 governance standards set for DFIs, the bank shows full compliance on 15%, partial compliance on 31% and non-compliance on 54% of these standards.

140. *Operational Independence*: NACRDB management, under the guidance and supervision of its Board of Directors, should have operational independence to determine the services and products that the bank offers to its clients and the interest rates it charges for its products and services. The independence to decide on the level of interest rates to be charged by the NACRDB for its products and services is indispensable for improving services, outreach, profitability and sustainability. After a long period of politicised debate about the need for low interest rates for farmers, many farmers now officially claim that these are really needed to keep on producing, even knowing that this is not the case. Smallholder farmers further tend to believe that they do not get much of the wealth created from oil revenues, and therefore want the interest rate subsidies to be retained, their last and only share of the ‘national cake’.

141. Basically, there are two options on how to proceed at this point. The first one would be to grant independence and freedom to a newly constituted board to set the level of interest rate for all NACRDB products that are necessary to make the bank profitable on the basis of the costs and risks incurred by each type of loan.

142. The second option is to maintain the current practice of interest rate subsidy on NACRDB products. Should the FGN decide to adopt this option and deny NACRDB management the independence to price its products based on market principles, it should be prepared to fully assume the associated costs of its policies and compensate the NACRDB each year on the operational loss incurred, as do other governments in Africa with similar banks⁶⁰.

⁵⁸ World Bank: Case Study on the Corporate Governance of the Nigerian Agricultural, Co-operative & Rural Development Bank (NACRDB). Washington DC, May 2009: Financial and Private Sector Development Vice Presidency & Finance and Private Sector Development Unit

⁵⁹ Association of African Development Finance Institutions (AADFI): Prudential standards, guidelines and rating system for African Development Banks and Finance Institutions. African Development Bank, Tunis, 2008. The NACRDB is a member of the AADFI.

⁶⁰ The Government of Lesotho created the Lesotho Post Bank to mobilize deposits in rural areas from the un-banked and under-banked. As the bank was not permitted by government to grant loans, in view of the negative experience in the past, the bank incurred losses each year. At the end of each financial year, the Ministry of Finance therefore transfers to the bank the exact amount of the losses incurred.

143. *Recapitalisation:* There is a need for further capital injection into the bank. Using the un-audited management figures for 2008, the shareholder funds amounted to NGN 4.7 billion, or 15% of total liabilities and shareholder funds/assets. It should however be expected that the net result as stated by the auditor will lead to lower equity funds, especially after making adequate provisions. In addition, the current balance sheet does not adequately address the pension liabilities of the company, which are probably under-funded to the tune of NGN 3.2 billion. An amount of NGN 1.4 billion representing a loan to River Basin Authorities may also have to be provided for. An amount of NGN 3-4 billion is further needed for the completion of the MIS installation, training, professional staff to be recruited and consultancy services. The exact amount of capital injection will depend on the business model proposed below and adopted for the bank.

Options for Repositioning NACRDB

144. The objective of the repositioning exercise as well as for the bank should be to gradually increase access and outreach to a range of high-quality financial services for farmers and rural entrepreneurs at affordable costs for borrowers, and to become self-sustainable in the medium-run without requiring frequent capital injections from shareholders. Six possible options for repositioning NACRDB are discussed below.

145. *Option 1 : No Change:* The NACRDB, and its predecessor, the NACB, have now existed for 37 years, and the bank has now operated eight years with interest subsidies. The lobby group in favour of interest rate subsidies is quite strong, and it is much easier for politicians to argue publicly in favour of such subsidies rather than against. The probability that nothing will be done can therefore not be totally excluded. Would this option be pursued, by intention or by default of taking no action, its impacts would be: (i) a constant further decay and continued slow death of the bank, with eternal dependency on federal government to cover the losses incurred; (ii) a continued liability for the deposits taken by the bank for the owners; (iii) a missed opportunity of making a difference in agriculture, and at best a marginal impact on agricultural and rural development; and (iv) a continued high political leverage, which implies that the bank remains subject to political decision making. In view of the banking laws and as a consequence of the deposit liabilities, the shareholders are required to inject about NGN 2-3 billion per year to cover the losses incurred. Over a period of five years, this option would require an amount of NGN 10-15 billion, including some additional capital for lending. To this would have to be added the contingent liabilities (pension liabilities) and the amount needed to cover the under-provisioning of loans.

146. *Option 2: Closure:* The NACRDB is regarded by many in the industry as provider of distorted financial services and the originator of turmoil as regards the right levels of interest to be charged on loans. By some persons in government and banking supervision, the bank is seen as a sick institution that is an unnecessary drain on scarce public resources. Many competitors and followers of clear banking doctrines would prefer to see the bank disappear quickly from the landscape. The main impacts of such a decision

would comprise: (i) a loss of assets, in particular loans outstanding, as many borrowers would hardly pay back knowing that the company in liquidation could hardly pursue all debtors; (ii) a missed opportunity of making a difference in agricultural and rural development; and (iii) obligation to cover the costs of liquidation of the bank, in particular payment of retrenchment packages to about 1500 staff.

147. Taking into account also the pension liabilities of about NGN 3.2 billion, a realistic assessment of the net and realisable value of assets (NGN 20 billion), the net liabilities incurred (NGN 26 billion), and staff retrenchment costs of NGN 2 billion, this option would probably require the shareholders to provide an additional NGN 11 billion to cover all present liabilities, plus about NGN 3 billion to cover the operational cost for staff salaries etc. before the final closure. Financially, this option would certainly be one of the less expensive ones for the shareholders and technically the easiest option.

148. *Option 3: Transformation to Wholesale Financial Institution:* There is an enormous demand for wholesale lending operations in Nigeria. Many states run their own agricultural and rural development programmes, and have involved the NACRDB as provider of financial services, while others only borrowed the loanable funds for onlending from NACRDB. Many MFIs in Nigeria are prepared to expand their services, but lack the funds to increase their lending operations. One might argue that these institutions have better retail systems than the NACRDB and operate under less complicated conditions, and would therefore be better managers of loan operations, and should thus receive the funds to provide their essential services. While at present many MFBs are not much involved in enterprise and farm lending, some of them are, and are likely to become more active lenders in the future.

149. Another high demand exists among universal and microfinance banks for term funds. Almost all banks are short of term funds for term lending, and most of their equity funds are tied to cover fixed assets and risks. The use of equity funds for risk covering will certainly become more important in the future, when the Basle II Accord is adopted in Nigeria. The risks incurred by the NACRDB as wholesaler only would be marginal, as this would involve only lending within the financial sector, and on the basis of sound eligibility criteria. The risks would be a bit higher in the case of MFIs, but most of this could be addressed through the use of sound eligibility criteria, close follow-up, solid reporting models and mortgage on land and buildings and pledge of portfolios plus domiciliation of accounts as collateral. Models for simple and un-bureaucratic refinancing term lending do exist, and models for refinancing portfolio expansion have even become a standard operation for many banks and DFIs.

150. This option would imply the closure of all zonal and branch offices and massive retrenchment of staff, as not more than about 50-70 staff would be needed for such operations. One alternative to the closure of branches would be their transformation into MFBs. Similar experience exists in Nepal, where the state-owned Agricultural Development Bank of Nepal transferred more than half of its remote rural branches to well-performing credit unions. This model was quite successful, as it reduced the burden and losses of the Agricultural Development Bank of Nepal, maintained the outreach of

formal financial institutions, did not lead to massive lay-offs and significantly improved service delivery at these ex-branches and credit unions⁶¹. Converting or selling the branches to MFBs would have the added advantage that it would lessen political and social resistance to the change.

151. This option would effectively terminate all deposit liabilities for the shareholders. Balancing assets and liabilities (NGN -6 billion), and adding pension liabilities (about NGN 3 billion) and retrenchment costs (about NGN 2 billion), minus eventually NGN 1-2 billion for the sale of branches, or saving retrenchment costs, the amount to cover liabilities would be around NGN 10 billion, to which the cost of fresh loanable funds of NGN 20-30 billion would have to be added⁶². The impact of this option would be an enhanced outreach and loan volume by the financial institutions served. For the FGN, it would principally not matter whether these borrowers have been reached directly by its own institution, or indirectly through the facilitation of its own institution. This approach could also claim that it is quite innovative for Nigeria, corresponds to proven demands, and contributes to financial deepening and the development of financial markets.

152. *Option 4: Downsizing:* The NACRDB started with 201 branches in 2001, plus the six zonal offices and the head offices. Management, board, shareholders and the Ministry of Agriculture could in the past not conclude on the best approach to reduce costs by closing branches. Plans discussed included a reduction of branches to one per state, one per senatorial district and to three or four per state. None of these proposals has real merits. With only one branch per state (total of 37 branches) or senatorial district (101 branches), the branch network would be thinned to an extent that transaction costs (in terms of cost per Naira lent) for the bank would substantially increase and consume much of the savings realised from reducing staff. On the other hand, the transaction costs for the clients would increase substantially, especially for smallholders, who would spend much more than currently on transport costs to the bank premises. A further inconvenience arising from the wider distance between clients and bank would be that the opportunities to mobilise savings would decline significantly.

153. As shown above, the operational deficit of the bank is structural, and the thinning of the branch network cannot remove the structural constraints. A more sensitive approach to the closure of branches would be to set targets for each branch in a collaborative effort between management and branch staff, and to give branches a time frame to achieve these. If it is shown that the staff in a branch cannot achieve these

⁶¹ The GTZ has widely accompanied and supported the process, and has, through its “Rural Finance Nepal” project (RUFIN) published a large number of papers on this transformation process. See also: Devendra Pratap Shah: Reforming an Agricultural Development Bank. Insights from an ex Bank CEO in Nepal. Kathmandu, August 2003: GTZ.

⁶² It is quite difficult to estimate the demand for these services. LAPO alone would require an annual amount of NGN 1.2 billion to meet its expansion plan targets. The demand of all MFIs may conservatively be estimated at around NGN 3 billion. The demand of state development agencies interested in borrowing for their own lending schemes may be somewhere around NGN 4-6 billion in the near future. The demand for term loans is practically insatiable under the present economic and market conditions, and could within a few years exceed easily NGN 20 billion. These assumptions would however be subject to an interest rate slightly lower than average cost of funds by the targeted financial institutions.

targets, and that all efforts to turn a branch around (such as bringing in experienced staff from other branches, special problem audits, etc.) would not lead to satisfactory results, such branches should then be closed, even against any public pressure.

154. The impact of such selective branch closure would be a marginal reduction of operational costs (savings of staff and administrative costs in the closed branches minus the marginally increasing operational costs in adjacent branches taking over these clients), a marginal loss of deposits, a marginal loss of earning assets due to a declining recovery rate from clients in affected branches, and a short-term increase of operational costs for the severance package and of bad debt provisions.

155. *Option 5: Transformation to “Rural Bank of Nigeria”*: The NACRDB has inherited a dual structure from its predecessors NACB and PBN. Although it is meant to exclusively serve rural areas, it is represented in all state capitals of the federation, as well as in Abuja and Lagos, where farming is definitely not the main occupation of inhabitants. Branches maintained in these locations tend to be much larger than the rural ones, have higher operational costs, but do not excel in terms of savings mobilised, loans disbursed, repayment rate, and profitability. Instead, many, if not most incur losses bigger than in rural areas, and branches there are unable to compete with universal banks and MFBs for deposits. It further appears that in many, probably in most cases, the probability to turn these branches around is rather low.

156. It is therefore recommended under this option that the NACRDB concentrates entirely on and exclusively serves rural areas. It is a fallacy to assume that banks need urban branches by nature of their existence, either to mobilise larger volumes of deposits or to reach the larger scale clients, from where they can generate the profits needed. Many banks with universal banking license have shown that rural areas can be profitably served, and that banks with only rural branches do not need to have urban branches to survive or make profits, and this in both developing as well as in industrialised countries. The opportunities appear in particular high in Nigeria, where all the 25 universal banks concentrate on urban areas, leaving many rural areas devoid of formal banking⁶³, a vacuum waiting to be filled by a service provider with national coverage. The successful turn around of former state-owned DFIs in Tanzania and Mongolia may serve as evidence that the concept is right, and that agricultural banks can be successful even in thinly populated countries⁶⁴.

⁶³ The banking density in rural areas was about one branch per more than 50 000 inhabitants in 2005. This may not have significantly changed since then.

⁶⁴ See Robert Dressen, Jay Dyer and Zan Northrip: Turning around state-owned banks in underserved markets. In: Small Enterprise Development, vol. 13, no. 4, p. 58-67 (December 2002), which describe the restructuring exercises of the Microfinance Bank of Tanzania and the Agricultural Bank of Mongolia (‘Khan Bank’). See also: Jay Dyer, Peter Morrow and Robin Young: Case study: The Agricultural Bank of Mongolia. Paper presented at the Shanghai Poverty Conference (Scaling up poverty Reduction); Robin Young & Robert Vogel: State-owned retail banks (SORBs) in rural and microfinance markets: A framework for considering the constraints and potential. Washington DC, January 2005; USAID; CGAP: Information Note on Microfinance and Rural Finance. Washington DC, January 2004; James A. Hanson: Public Sector Banks and their Transformation. Washington DC, January 2004; World Bank (www.worldbank.org/wbi/banking/bankingsystems/psbanks/); George R. G. Clarke, Robert Cull & Mary Shirley: Empirical Studies of Bank Privatization: Some Lessons. Paper presented at “The Role of

157. *Option 6: Privatisation:* The easiest and probably one of the cheapest options would be to privatise the bank entirely⁶⁵. Potential shareholders could comprise a single strategic investor, e.g. one of the newly incoming banks, plus some of the domestic universal banks without an extensive branch network or without an extensive agricultural and micro and small enterprise portfolio. Some of the domestic universal banks might be interested to keep the NACRDB alive as otherwise the pressure on them to engage much more in agricultural and SME lending would certainly increase exponentially, and it might fit much more into their corporate philosophy to externalise a limited risk without ‘contaminating’ their ‘normal’ banking business in their existing branches. In addition, some of institutional investors traditionally participating in the equity of ex-DFIs⁶⁶ might be also interested to buy shares and become an important, but not predominant shareholder for a limited period of time⁶⁷.

158. The value that the present shareholders could probably expect from the sale of the bank would be limited to a symbolic one Naira. The reasons are that the additional pension liabilities and portfolio risks not fully provided for, plus an unidentified risk of understating the deposit liabilities, would certainly consume the equity funds that existed at the end of 2008. Any additional loss that might occur in 2009 might eventually be offset against undervalued fixed assets, in particular the branches in state capitals. If the NACRDB would be acquired by another bank, it is highly likely that the pension liabilities would have to be entirely transferred to the FGN, and any amount realised from the sale of shares could be used to cover these liabilities.

159. The most crucial point would be to undertake the negotiations with the required discretion to avoid loss of asset quality arising from massive default. The probability of this happening would increase significantly if a reputable institutional investor would enter as investor. Shareholders should also be prepared to shoulder the cost of a management firm hired to prepare the take over and overhaul the bank. Looking at the speed of transformation in the universal banking sector since the beginning of the recapitalisation exercise in 2005, it should not be excluded that the restructured bank with private shareholding would within a short time exceed the lending targets of the old state-owned NACRDB. There is also a high probability that the privatised bank would not be

State-Owned Financial Institutions: Policy and Practice”, April 26-27, 2004, Washington DC. Washington DC 2004: World Bank (www.worldbank.org/wbi/finsecpolicy/stateowned2004/); Hans Dieter Seibel, Thorsten Giehler & Stefan Karduck: Reforming Agricultural Development Banks. Eschborn 2005: GTZ (also available from: http://www.uni-koeln.de/ew-fak/aef/working_papers.htm).

⁶⁵ There has been a recent (Jan. 2009) case in West Africa (Burkina Faso), where a commercial bank (Ecobank) purchased the entire shares of a development bank (‘Banque agricole et commerciale de Burkina’).

⁶⁶ These may comprise the Kreditanstalt fuer Wiederaufbau, International Finance Corporation, Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden N.V. (FMO), Association française de développement, Deutsche Entwicklungsgesellschaft, Rabo Bank, Crédit agricole de France, and others. These usually invest up to a maximum of 20-40% of the total share capital, provided that government does not hold a majority of shares.

⁶⁷ Most of the above institutions tend to determine ex ante their approximate exit point, when they want to sell off their shares. This could be 3-8 years after acquiring the shares, depending on the policies of each investor.

profitable within the shortest period of time, and that it might take over some of agricultural lending of the investing domestic universal banks.

160. The inconvenience of the approach would be that there would be no guarantee that agriculture would still be served three years after the privatisation, in case the strategic investor and the investing universal banks would not have found a way to make agricultural and rural lending profitable, or if the old 'national cake' and 'democracy dividend' syndromes would turn out to be too contagious and prevent the successor from making profits from farm lending.

161. Privatisation may well prove to be the most feasible and viable option, with the optimum between outreach and viability and the lowest costs for FGN, but there are five critical points. The first is whether govt. would transfer ownership over the NACRDB to a third party. The second is whether there is sufficient interest to buy shares of NACRDB. The third is how long the privatised bank would remain active in agricultural lending, as private shareholders are often driven by profit motives, and may not have the endurance to find the right approaches to make agricultural lending profitable. Under fierce competition, the new owners may not see agriculture promising enough when compared with trade, construction, oil extraction, private consumption, etc. The fourth issue is how long the privatised bank would keep its rural branch network instead of concentrating on urban operations as all other universal banks. The fifth point is public resistance, which is likely to be the highest apart from total closure of the bank. Farmers may fear an increase of the lending rate and more pressure on repayment. This seems to point at the need to retain a blocking minority for the FGN and to make some critical points explicit conditions in the sales agreement, but such safeguards are not very effective in legal terms as they are not actionable in the courts. In addition, it would be very difficult or even impossible to sell the bank to an investor under such terms and conditions.

Bank of Industry (BOI)

162. The BOI demonstrates that DFIs can be successful in Nigeria. It is a relatively small banks with assets of less than N24 billion. The bank serves only a few clients: 181 SMEs and light industrial operations and about 50 cooperatives. Despite a cap on its interest it managed to produce a small profit in 2006 (the last year for which accounts are available) of N1.3 billion. This is largely due to the high repayment rates and the limited overheads of the bank.

The Nigerian Insurance Industry

Summary

163. At present the Nigerian insurance industry is underdeveloped compared to its peers of emerging nations. The industry has not grown in the last 35 years after allowing for inflation. Consumers are relatively uneducated on the benefits of purchasing insurance products, and many informed policyholders have doubts whether their claims will in fact be paid. As a consequence, the Nigerian market place is significantly underinsured, both in absolute terms and compared to its peers – developing countries with similar GDP per capita (see Tables 1 and 7). In fact only Bangladesh has a smaller insurance premium per capita than Nigeria.

Table 7: Nigeria’s Insurance Industry – International Comparison

2006	NIGERIA	CHINA	INDIA	MALAYSIA
POPULATION (MILLIONS)	140	1,310	1,080	26
PREMIUM INCOME (USD)	\$0.7 Billion	\$61 Billion	\$26 Billion	\$7 Billion
PREMIUM/ CAPITA (USD)	\$4	\$47	\$24	\$281
PREMIUMS/ GDP	0.7%	3.5%	3.6%	5.6%
AVERAGE PREMIUM/ COMPANY (USD)	\$6 Million	\$1,172 Million	\$834 Million	133 Million

Source: FSS2020 Insurance Sector Report 2007

164. The Nigerian Government intends to grow its insurance industry in such a manner that the purchase of insurance products provides a significant safety net to individuals, businesses and Government, thereby playing an increasingly important role in stabilizing the Nigerian economy. This is summarized in the FSS2020 objective: *“To become the insurance market of first choice in Africa. Noted for its high level of capacity, transparency, efficiency and safety. And attain the 15th position in world insurance premium generation by the year 2020”*.

165. If the insurance industry is to play a greater role in Nigerian society by providing relevant insurance products in line with international markets, it will also importantly reduce the need of the Nigerian Government effectively acting as the insurer of last resort, as is presently the case – by way of example, when a building under erection

collapses and kills a number of workers, families of deceased petition the Government for financial assistance. Under Nigerian law, such an event should have been covered by insurance.

166. The Nigerian Ministry of Finance has started to address this matter. The major initiative in 2007 was to increase the capital requirements of insurance companies to a minimum of USD \$16 million. The impact of this regulation was to more than halve the number of insurers from 103 to 49. The remaining insurers are larger and are more likely to conduct insurance business in a more professional manner.

The Investment Case for the Insurance Sector

167. The insurance sector is a key part of the financial sector. In developed markets, the insurance sector accounts for a significant portion of the total economy. In collecting relatively small premiums from many individuals in the economy, insurers are able to pull together, like no other institution, a large pool of funds that could be invested for short or long term periods. Insurance businesses are split mainly into Non-life and Life; Non-Life Insurance representing short term funds and Life Insurance representing longer term funds.

168. As insurers provide long term financing, the development of the sector is important for deepening and broadening the domestic financial sector, as well as the generation of higher savings rates and therefore greater economic development. The Insurance sector is critical to the ability of emerging and transitional economies like Nigeria to grow and develop, as well as provide a reliable cover for risk to the citizens. Insurance provides stability by allowing large and small businesses operate with a lesser risk of volatility or failure. Insurance is also seen as a compliment to government's security programs and the emphasis being placed on greater private ownership and responsibility.

The Current Insurance Market in Nigeria

History

169. Nigerian insurance commenced around 1920 when Nigeria was a British Colony. It continued in various forms through Independence (1960), Federation (1963) and Civil War (1967-1970). The State-owned National Insurance Corporation was established in 1969, and marked the beginning of establishing a modern insurance industry. Indigenous insurance companies were established from the 1980s.

Key statistics

170. In 2008, gross premiums written were a total of Naira 178 billion (around USD 1.48 billion). In 2006, there were 103 primary insurance companies in Nigeria. This number has since been reduced to 49 as a result of regulations which came into being in March 2007, which significantly increased minimum capital requirements, up from around \$1 million to N2 billion (\$16 million) for life companies, and to N3 billion (\$24 million) for non-life insurers. Other key financials are presented in Table 8. Reinsurers

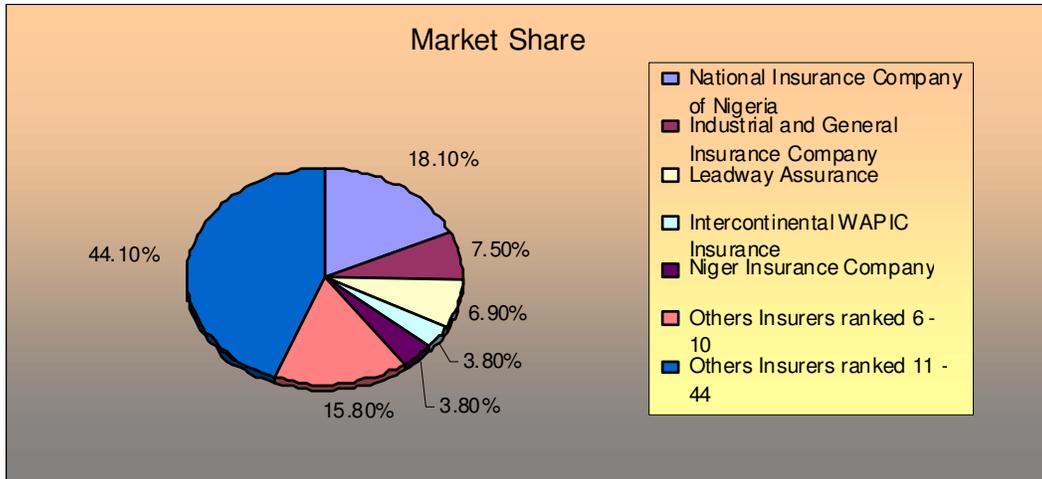
require a minimum capital of N10 billion (\$80 million) for a composite license, the impact being that of the 5 reinsurers operating in 2006, only one remains. The capital has been injected by the owners of insurance companies, many of whom are banks, and through a consolidation process of smaller insurers, whereby the merged entity has become sufficiently large to meet minimum capital requirements. The industry is almost entirely Nigerian owned – there is little overseas investment in direct insurance. Large risks are generally reinsured internationally. Whilst not registered in Nigeria, Swiss Re and Munich Re are active in the Nigerian reinsurance market.

Table 8 : Nigerian Insurance Industry Financial Performance, 2006

Average size of underwriter	N706m
Market Dominance (10 largest)	62%
Life premium	16%
Non-life	84%
Loss ratio (life)	31%
Loss ratio (non-life)	28%
Management and Marketing expenses (life)	47%
Management and Marketing expenses (non-life)	51%
Underwriting profit/premium	55%
Price/earnings	1.6-9

171. Figure 13 illustrates that the market is not concentrated and there is still room for more companies who can meet the minimum requirement to enter. In 2006, 38 of the 49 licensed insurance companies had premiums of less than \$15 million, which does not give them the economic scale required to deliver professional insurance services. It is clear that more consolidation is still required to grow and professionalize the industry.

Figure 13: Insurance Market Share by Company, 2008

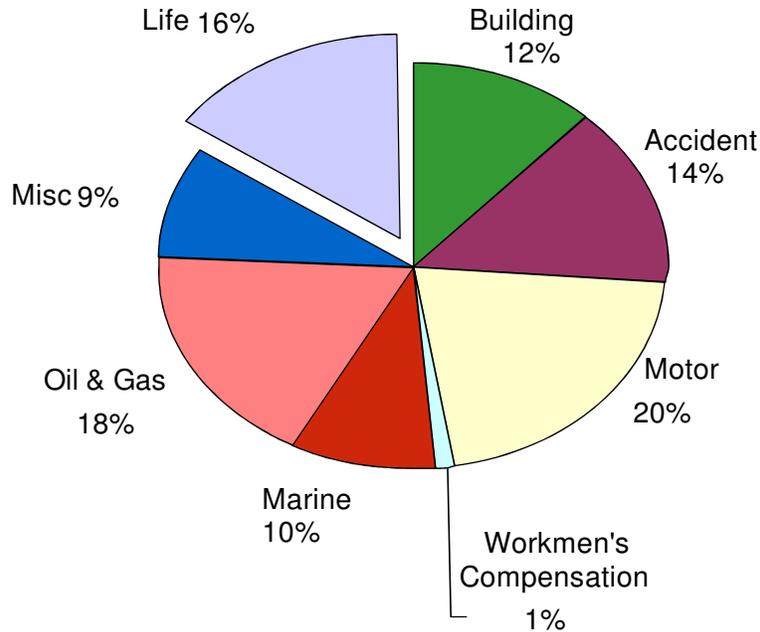


172. Recently concerns have arisen about premium growth in 2009, as corporate spending on insurance products could slow in line with decelerating economic growth. Some Nigerian companies have cut their insurance budgets on existing policies, in a bid to support their earnings and cash. The Nigerian insurance industry is largely corporate-driven, with corporates representing about 80% of total industry generated premiums. A further critical risk to premiums is late payment, particularly by existing clients. The potential effect of this on insurers' liquidity, and on their investments, could be significant.

Insurance products presently being sold

173. The key non-life products are fire, motor, general accident, oil & gas, and marine/aviation business. Agricultural insurance is written through Nigeria Agricultural Insurance Corporation, with annual premiums less than USD 1 million. Most of the business written is in the compulsory classes of business, with Government departments being the major customers of compulsory insurance products. The life insurance industry products are endowments, term insurance and some long term savings plans. A breakdown of the industry by product is presented in Figure 14.

Figure 14: Insurance Products



Source: Nigerian Insurance Association 2007.

174. Products are largely distributed through independent brokers, although some companies do use dedicated agency forces. There also seems to be significant “leakage” of insurance cover to other jurisdictions. By way of example, the Nigerian oil and gas industry is significant, and yet only \$125 million of gross annual premiums are written to insure these assets. By inference, most of the insurance cover for these assets is taken out in countries other than Nigeria.

Possible New Products for the Nigerian Insurance Market

175. The Nigerian market requires few additional mainstream products. One area in which there may well be a demand for new products is at the lowest economic entry point into the insurance market. The non-life products which could be offered are at the beginning of the wealth spectrum: micro-insurance and agricultural insurance such as the index-based agricultural insurance developed by the World Bank, as currently on offer in Malawi, Mongolia and in Vietnam. Index-based agricultural insurance is not as yet a major insurance product in any country. The life insurance market is particularly underdeveloped in Nigeria.

176. Two products which could add significant value are:

- Term life and total and permanent disability (“TPD”) cover for those Nigerians who recently commenced their individual pension accounts under the Pension Reform Act 2004. Presently, term cover is taken out relatively rarely in conjunction with the pension product, and TPD cover does not seem to be offered at all; and

- Simple funeral (endowment) insurance, particularly for women, targeting the lower socio-economic groups. Many women seem to be left destitute when the (usually male) main breadwinner dies.

177. These life insurance products are available in the marketplace; however they are expensive, and they are simply not sold in sufficient quantity to make an impact on the Nigerian economy.

Management of Insurance Companies

Skills and Capacity of Managers and Directors

178. CEOs and senior managers of insurance companies appear to have a good grasp of insurance concepts, including underwriting, claims, reinsurance and customer service. On the financial side, annual accounts are of a high standard, with many companies providing detailed notes to the accounts in line with international standards. There seems to be a major “disconnect” between the knowledge publicly displayed by senior executives and directors, and the application of that knowledge to the daily running of insurance businesses: claims ratios are low by international standards indicating a lack of “value for money” of insurance products for consumers, manual administrative processes remain in place and expense ratios are unsustainably high by international standards. Existing evidence strongly suggests that the level of insurance knowledge is not high at the lower levels of management and staff. A key reason for this lack of professional development of staff and junior management is that insurance companies, at an average of \$15 million of annual gross written premiums, lack the economic size to invest in education, systems and procedures.

Risk Management

179. Risk management seems to be ad-hoc: companies do not employ full time risk managers. This is hardly surprising given the lack of economic size of insurance enterprises. One exception is reinsurance: the risks seem to be well understood by senior management, risk retentions seem to be well calculated and effective reinsurance cover seems to be in place. Risk management, however goes much further than establishing an appropriate reinsurance cover, and this seems to be lacking in most respects.

Recent Market Development in Light of the recent Consolidation Efforts

180. Market consolidation has come about as a result of significantly increasing minimum capital requirements. This has had the beneficial effect of reducing the number of insurance companies from 103 to 49, and reducing the number of indigenous reinsurers from five to two. The remaining insurers are therefore larger and better capitalized. They also seem to be better managed and more professional. Insurance company CFOs advised that they were now investing heavily in upgrading systems and procedures, and in educating staff. It remains to be seen whether these investments were

effectively carried out, and have a lasting impact on increasing the applied professionalism of Nigerian insurance companies.

FSS 2020 – the Long Term Strategy for the Industry

181. The major recommendation contained within the FSS2020 report is to catapult the Nigerian insurance market into the dominant player in Africa, and into a world-class insurance market.

182. The Nigerian Government wishes to concentrate initially on “quick wins”, which by definition will have an immediate impact on growing the insurance industry. Most of the “quick wins” relate to additional activities, or a redirection of present activities being carried out by the insurance regulator, NAICOM. In order to achieve this, NAICOM requires significant assistance and investment in capacity building. The additional NAICOM activities, which then translate into major “quick wins” are as follows:

Review Products: Group Life, Fire Insurance and Public Liability Insurance

183. A review of products on offer is a prerequisite to insisting that compulsory insurance be paid by all parties and closing the “insurance gap” which is the difference between the number of people who purchase insurance products and the number who fail to do so. Review the terms, conditions and pricing of existing insurance products, to ensure that they represent value for money, initially concentrating on group life products (largely for PENCOM’s clients) and insurance of public buildings. This product review would include pricing and establishing acceptable minimum service standards to be provided by insurance companies, ensuring speedy claim evaluation and quick claims settlement procedures.

184. There are presently no detailed mortality tables for Nigeria, with a “standard” pricing approach being used for all insured. On the international insurance market, separate mortality tables have been developed for males and females and for smokers and non smokers within those categories, the reason being that females generally outlive males by seven years, and non smokers generally outlive smokers by seven years. The development of these mortality tables would provide more appropriately priced life cover for Nigerians, particularly for female non smokers.

Ensure that Nigerian Companies Have Compulsory Insurance Cover for Existing Buildings and Buildings under Construction

185. This aspect of law enforcement needs to apply to both existing buildings and buildings under construction. Compulsory insurance cover refers to both fire insurance and public liability insurance. Reports show that on the average, 10% of public buildings are insured against fire, and public liability insurance is negligible.

186. It is suggested that a NAICOM officer could be appointed as manager of this initiative, who would then work with selected insurers or the insurance association. Present distribution channels (agents/brokers) of non life insurance companies could be used in a targeted campaign to inspect key commercial buildings, determine whether there is insurance cover, and assist in ensuring that such cover is effected. As part of the initiative, NAICOM would need to follow up with enforcement measures against companies refusing to take out such insurance cover.

Crackdown on (Lack of) Claims Payments

187. In the past, a major criticism of Nigerian insurance companies has been that they do not pay claims in full and in a timely manner. This matter has been addressed partially by the consolidation exercise, which means that, generally, the smaller and less professional insurance companies no longer operate in the market – the remaining licensed insurance companies which have met the much higher capital requirements tend to be more professional. Naicom has also stepped in to take over companies that they consider have failed to meet minimum operating standards. They have improved their operations and installed better management practices before returning them to their original managers. Even NICON, the largest most politically important insurance company, has not been spared this fate.

188. Nonetheless, it is important that part of NAICOM's on-site inspection focuses on the fair payments of claims. This activity could be carried out by initially reviewing complaints already lodged with NAICOM by disaffected policyholders, on-site inspections specifically targeted on claims files: investigating claims rejected by insurance companies and reasons for the rejection of claims, and also checking on service standards in claims departments against a pre-determined industry benchmarks. In addition, NAICOM officers could determine the procedural ease with which claims can be made (for example by phantom calling), and the speed at which claims are paid. NAICOM may wish to outsource this function, perhaps to a couple of recently retired directors/executives from the insurance industry.

Crackdown on “fake” Insurance Companies

189. “Fake” insurance companies operate in Nigeria, selling compulsory motor insurance policies. These companies sell policies that are only pieces of paper purporting to be insurance policies, on letterheads which are quite similar, or identical, to letterheads of licensed insurance companies. These “fake” operators pay no claims; their sole purpose is to supply a policy paper at a lower cost than the cost of a genuine insurance policy with a licensed insurance company. The “policy” is then used by the buyer to secure / renew a vehicle license.

190. CEOs of insurance companies individually advised that they felt that this is a significant issue, with educated guesses ranging from 60% to 80% of all compulsory motor “policies” being issued by fake operators. They advised that in many cases

individual state motor department officers direct car owners to fake operators, who are physically present in those motor registries.

191. If these educated guesses are correct, and 60% to 80% of motor policies are issued by fake operators, then it is likely that this activity is organized and perhaps even institutionalized in certain parts of the country. A crackdown on such operators may require not only the involvement of NAICOM, but also the involvement of Nigeria's Economic and Financial Crimes Commission, the EFCC.

Dedicate a senior NAICOM officer to work with Government Departments to establish compulsory insurance cover

192. Government ministries, departments and agencies are required, by law, to take out compulsory insurance. This relates in particular to building insurance, to public liability insurance and to life insurance for its employees. In many cases, this insurance cover is not taken out. Frequently, when the insurance cover is taken out, the department does not pay the premium – the Government is by far the largest debtor to the insurance industry. One way to address this matter would be to dedicate a senior person at NAICOM to work with the various Government departments on establishing the two major types of compulsory insurance, group life cover and public building liability insurance.

Dedicate a senior NAICOM officer to work with PENCOR, to find an acceptable manner in which to collect life insurance

193. PENCOR has been successful in getting Government departments and major companies to establish pension funds for each of their staff. According to legislation, these same employees are also required to have life insurance cover – however such cover has not been put in place to any significant degree, thus leaving them underinsured.

194. It is therefore suggested that a combined PENCOR/ NAICOM team be created to examine the mechanisms for establishing and implementing a mutually acceptable process of collecting insurance premiums relating to pension remittances. As PENCOR is an independent organization, success of this initiative includes convincing PENCOR management that it is in the interest of its clients to take out effective insurance cover, which would include not only life cover but also total and permanent disability (TPD) cover.

Enablers to the quick wins: NAICOM Capacity Building

195. In developing the Nigerian insurance industry and in a sustainable manner, NAICOM's role will need to expand significantly. In order to do so, NAICOM will require substantial assistance, otherwise it simply cannot fulfill its expanded role.

Assisting with Law Enforcement

196. In order to enforce the law, NAICOM will require significant technical, logistical and project management support. In respect of law enforcement, assistance to NAICOM may include consulting actuaries to check that pricing, terms and conditions are acceptable (where they are not determined by law) for each key product, and an operational consultant to ensure that minimum service standards, including claims payments procedures, are acceptable. Further support may require external consultants, specializing in project management, and also assisting with the establishment of specialist insurance procedures checking on such matters as claims payments.

Improving current supervision procedures

197. Improvement in supervisory procedures are fundamental for effective supervision of the insurance industry. NAICOM needs assistance in many areas, including the development of plans for:

- Effective off site monitoring;
- Effective on site inspections;
- Financial analysis of insurers;
- Supervision of financial conglomerates; and
- Supervision of insurers operating internationally.

198. The design of such plans and their implementation is likely to require significant support.

Acquire IT Hardware and Software

199. NAICOM's IT systems are rudimentary at best. There is no automatic feed of information from insurance companies to NAICOM, and off site monitoring calculations (including early warning systems calculations) are largely carried out manually/ via spreadsheet. Data is kept manually.

200. To be a fully effective regulator, NAICOM needs to install electronic data feeds from insurance companies for its quarterly/ annual returns, including a computerized analysis of data such as calculations of ratios pertaining to early warning systems. Standards as regards accounting, solvency and reserving need to be introduced, before such ratio analysis becomes meaningful. Staff time will then be better spent on information analysis and taking remedial action.

Staff training

201. Whilst NAICOM does have very capable staff, training of staff in all matters pertaining to insurance, including training on new systems, procedures and IT equipment, is paramount in increasing the NAICOM's effectiveness. A detailed training plan needs to be developed, with the underlying objective of ensuring that within a certain time period NAICOM's staff will acquire the skills needed to regulate the growing insurance industry. In terms of applied regulatory capacity, NAICOM will need to be in a position

to enforce the laws and regulations, in such a manner as to ensure that Nigeria has a world-class insurance industry environment. In order to fulfill this objective, staff training will need to be a high ongoing, priority matter, and would need to be carried out as part of a comprehensive staff development plan.

Recommendations with a Longer Term Effect

202. The “quick wins” referred to in Section 3 above are effectively a band aid solution. In order for the insurance industry to grow sustainably key reforms need to take place. Three of the key initiatives are outlined below.

Revision of the Legal Framework

203. In order for Nigeria to become an international participant in the insurance field, it needs to replace its insurance legislation in its entirety, using an insurance framework law as the new approach. Replacement of the existing legal framework is a significant endeavor, involving international legal and regulatory consultants in addition to Nigerian legal and regulatory experts. It is imperative that this process builds in a full and complete knowledge transfer so that Nigerians are able to administer and enforce their new legal framework without external assistance.

Consumer Education

204. The Nigerian population at large is generally unaware of insurance products and the benefits that can be obtained as a result of purchasing insurance policies. Consumers do not understand that they can underpin and safeguard their wealth against unforeseen adverse circumstances to both their possessions (e.g. stolen car, fire destroying their home and possessions), and their lives (e.g. accidental death of breadwinner). A concerted education program ought to be undertaken to educate consumers on the benefits of purchasing insurance products, and their right to making a claim.

Upgrade the Accounting Framework for Insurers

205. The Insurance Act does not stipulate the accounting approach – generally, Nigerian accounting standards, as opposed to international accounting standards (IFRS) are used. Nigerian insurance companies continue to use historical cost accounting. The impact is that this represents cash flow reporting rather than accounting for profit. This is likely to result in a mis-statement of profit, particularly for life insurance companies. At times of growth, the value of life insurance savings policies will be consistently understated.

The Nigerian Pension System and the Private Pension Industry

Objectives of FSS2020 for the pension industry and achievements reached

206. FSS2020 emerged shortly after the enactment of the 2004 pension reform act. As a result, the FSS2020 did not initially cover the pension industry; PENCOM became involved only recently in the process. The achievements of pension reform—including the emergence of a strictly regulated and supervised defined contribution pension sector, an extension of coverage, and the establishment of PENCOM as an institution of regulatory excellence—happened outside of the FSS2020. The continued success of the pension industry depends on developments in capital markets, public debt management policies, the insurance industry, and interagency cooperation, issues which are central to the FSS2020 agenda.

207. The current tools for retirement savings in Nigeria are not many in number and the few available are underutilized. The emphasis of the society on family care allows people to live with their children in their old age thereby reducing the need for a retirement savings. However, as modern medicine advances and with increasing life-expectancy, this system will become increasingly demanding on the newer generations.

208. Nigerian society is already experiencing a gradual cultural change, which is doing away with the concept of family dependence. Introduction of a structured & robust pension system is therefore very timely to equip the society in dealing with such future challenges.

Pensions affect society in different ways

209. Firstly, pension provision helps with poverty relief by providing the retired segment of the society with income to support themselves thereby ensuring a minimum standard of living in old age as well as bringing about solidarity between generations. It also acts as a savings vehicle which allows people to redistribute income across their lifetime and additionally, promote long-term savings by the younger, economically active strata of the society encouraging them to adopt a savings culture.

Background and the 2004 reform

210. The national provident fund of Nigeria, the country's first nationwide social security arrangement was established in 1961, shortly after independence. The fund provided a safety net for private sector workers and civil servants who were not part of the public pension scheme. It also administered a non-contributory (budget financed) pension scheme for eligible civil servants and managed revenues and expenditures related to other areas of social security. Due to design and management problems, the national provident fund failed to achieve its objectives. It was replaced in 1993 by the National Social Insurance Trust Fund (NSITF). At the time of the reform, NSITF was obliged to

establish a pension fund administrator (PFA) to manage its assets and liabilities. The chain of legal successions left the accrued liabilities intact; pension entitlements were not adjusted to available resources even when there were clear signs of financial distress.

211. NSITF was designed as a mandatory system for formal sector employees, including civil servants. Due to the high level of informality in the economy, the large share of population involved in subsistence farming, and the low average taxable personal income coupled with a very skewed income distribution, the system functioned as mandatory only in name and left the overwhelming majority of the population without social security coverage.

212. As the finances of NSITF came under strain, it began to default on benefits or paid only with considerable delay and after imposing physical hardship on beneficiaries of having to petition and queue in person often and for long durations. This resulted in political pressure that led to the 2004 reform. Policymakers modeled the reform on the Chilean reform of 1981 in the belief that privately managed schemes would be more efficient and less vulnerable to political interference than publicly provided and managed schemes. They also expected that mandatory individual privately managed pension savings accounts would promote the development of financial services in the country.

213. The objective of the 2004 pension reform was to enable the pension system to honor its past and future liabilities, while gradually reducing the burden on the budget. These objectives were to be achieved by:

- a) Creating a well-regulated mandatory private pension system,
- b) Bringing all federal civil servants and public employees and all private sector employees working in enterprises with more than five employees into the system
- c) Turning the implicit pension debt accrued by NSITF into an explicit debt to future pensioners.

214. Although it is too early to assess whether the outcomes of the 2004 pension reform have been successful, it appears that two objectives have already been achieved: (a) creating a uniform scheme (legal construct) for all mandatory pension arrangements, and (b) operating the new system along laws and regulations which are mostly in line with international best practice. The extent to which past pension liabilities will be honored remains to be seen. At the time of closing the old NSITF scheme to new contributions, there was neither an actuarial valuation of the system's total accrued liabilities nor the establishment of the net present value of individual entitlements. Since the aim of such a valuation would have been to determine the level of contributions needed to ensure that promised benefits will be paid, and if there are enough funds to pay the promised benefits if future payments were to be stopped, it becomes difficult and uncertain to track how much is being owed to whom.

Basic information

215. Currently, there are 25 licensed PFAs, administering 25 retirement saving accounts (RSAs) plans and a large number of approved schemes, including closed pension funds. As of January 2008, total pension fund assets—including both legacy defined benefit and defined contribution funds as well as RSAs—were approximately N700 billion. Of these funds, N180 billion are in RSAs, and approximately N320 billion are in approved schemes, most of which are occupational defined benefit schemes underwritten by sponsoring employers.

216. An additional N70–200 billion of contributions paid on behalf of federal employees is being withheld at the central bank until the identity of the covered employees is verified and multiple registrations resolved. (The uncertainty is because the multiple registrations have not yet been resolved; therefore the actual amount which will be transferred to PFAs and back to the treasury is still unknown.) Approximately N10–12 billion of new contributions flow into the system every month, a certain percentage goes to RSAs and the remainder of which is deposited in approved schemes.

217. The PFA market, as in other countries with mandatory defined contribution schemes, is highly concentrated. The future growth of membership depends on first, the capacity of government agencies (tax authority, Ministry of Labour, and others) to enforce the registration of labour contracts, wage reporting, and collection of contributions, and second, on the adoption by states of the provisions of the 2004 pension reform act. Since it is unlikely that reforms in these areas will be undertaken soon, leading to a rapid growth in membership, the PFA market should be viewed as saturated. Consolidation is likely within the next 12 to 24 months. Mergers, acquisitions, and exits would probably happen even sooner if PENCOR adopted a regulation reducing the ceiling on asset management fees.

218. Prior to the pension reform, there was only one bank offering custody services in Nigeria, mostly to foreign investors. Since then, subsidiaries of four banks have been licensed as pension fund custodians. In order to limit the number of competing pension fund custodians and to improve the safety of their operations, PENCOR established a policy of gradually increasing licensing requirements, applicable to both potential new licensees and incumbent pension fund custodians. Pension fund custodians can serve more than one client, which can be either RSA schemes or approved (legacy) schemes. It is important to note that currently in Nigeria only pension funds are legally mandated to have independent custodians.

Transparency, Equity and Governance

219. The pension reform act and the guidelines on investments establish quantitative limits for portfolio composition. Presently, PFAs universally apply the exact limits established by the guidelines, without further specifying their targeted risk/return profile and the corresponding portfolio structure. Currently, a PFA is not allowed to manage multiple portfolios, forcing all RSA members to hold the same portfolio. PENCOR

intends to reform this provision in the future, allowing PFAs to manage multiple portfolios. However, PENCOT plans to wait until it strengthens its supervisory capacity and until capacity of PFAs grows and participants become more financially literate. This cautious approach is understandable.

Box 1: Allocation rules

Fair allocation rules need to cover all plausible situations, some of which are trivial, others less so. One situation is when several clients want the same percentage of their new contributions to be invested in the shares of a specific firm, but the supply is inadequate to meet the demand. Fair allocation requires that all clients receive the same percentage of shares at the average purchase price. A more difficult challenge occurs when various clients starting from different places want to reach the same overall target, but the supply of shares at a given price is inadequate to meet the demand. Another situation is when clients' desire changing the maturity of existing bond portfolios, and just a part of the required amount of new issues can be bought at the primary auction. This is far from an exhaustive list of possibilities. PFAs should consider the list of possible situations and the allocation mechanisms to be applied in dealing with them. PENCOT will also need to supervise whether the agreed allocation rules are indeed observed.

Both PENCOT and the PFAs are aware of these issues and claim that fair allocation rules are adhered to. However, neither the relevant regulations nor the PFAs' operating rules define or make any reference to allocation rules. It is recommended that PENCOT adopt and enforce explicit regulations for fair allocations. This will increase the confidence of participants in the market.

Securitized real estate investments could become another instrument for long-term investments. Currently, however, the legal and technical conditions (such as the existence of a reliable registry of land titles, strong property rights, and methods of valuing assets) are grossly inadequate to support this instrument.

220. In addition to increasing individual choice and responsibility—an important goal of reforms introducing mandatory private pension schemes everywhere—PFAs with multiple funds can more easily avoid engaging in short-term investment strategies. PFAs are concerned that once switching between providers is possible, participants will switch on the basis of short-term returns (and those benefiting from fees will encourage participants to do so). Thus, even if high quality long-term instruments become available, PFAs may not increase the proportion of such instruments in their portfolios for fear of temporarily underperforming their peers and losing participants to competitors. Although a valid concern, this can be addressed by allowing an individual PFA to manage multiple portfolios, allowing participants' choice within their existing PFA. PFAs may manage and administer RSAs and approved schemes. This means that they may serve more than one client, emphasizing the importance of the issue of fair asset allocation to ensure that all clients are treated equally when newly acquired investment instruments are distributed among their portfolios.

Legacy pension schemes

221. Approved (legacy) pension schemes do not have to observe the same investment regulations as do RSA schemes. Many legacy schemes have significant unsecuritized real estate investments in their portfolios, often represented by buildings and land occupied by the sponsoring employer. It is unclear whether PFAs managing legacy schemes are prepared to manage property, but this is not likely to be their comparative advantage. It is also unclear how realistically these properties are valued, and how much PENCOM is able to supervise this sort of investment. The sponsors of defined benefit schemes underwrite pension liabilities and are therefore liable to make up all underfunding.

222. PENCOM should consider taking a more stringent approach to direct investment in property, since such investments may come dangerously close to the concept of “book reserves” (unsegregated corporate assets accounted towards pension liabilities) and may not be in line with international best practice. In future securitized infrastructure investments (infrastructure bonds) may also become an alternative instrument. It will take some time, however, to develop reasonable projects, elaborate user fee and tariff policies, securitize the investments and make them marketable to institutional investors such as pension funds.

223. Foreign investments can provide an opportunity for diversification and a “soft landing” in case of a sudden decline in domestic asset prices. While there are reasons to prohibit or restrict overseas investments—including the expectation that the pension funds will help to develop Nigerian financial markets—the concern is that Nigerian pension fund managers are not able to undertake the necessary analyses of overseas investment opportunities, exchange rate risks, and the lack of capacity of the regulator to oversee investments abroad. However, the benefits of investing overseas are likely to outweigh the drawbacks. Allowing overseas investments would enable PFAs to diversify their portfolios, which is becoming increasingly difficult in Nigeria with its small supply of financial assets.

224. Moreover, legacy schemes are already allowed to invest abroad and some already do so. There is no reason to disallow the new, more strictly regulated and supervised RSAs from investing overseas. It is recommended that PENCOM, in consultation with PENOP (the industrial association of PFAs and pension fund custodians), prepares a timetable for permitting overseas investment, specifying a set of preconditions for the industry as a whole and for individual PFAs and pension fund custodians. PENCOM and the industry would then be encouraged to start discussing details of such investments, including rules for valuing assets, for appointing foreign sub-custodians, for currency hedging, and the like.

Measures needed to reduce high fee rates in Nigeria

225. The pension reform act and the relevant PENCOM regulations and guidelines on fees set forth the types and level of fees the pension fund industry can charge. Asset management fees are limited to 2 percent of assets; custodians can charge 0.6 percent of

assets while PENCOR is entitled to a regulatory fee of 0.4 percent. PFAs can also charge an administration fee of up to N100 per month. Asset management fees, custodianship fees, and administrative fees are subject to VAT levied 5 percent. Currently, RSAs pay the maximum permissible rate, while legacy schemes pay significantly less.

226. These fee levels, especially 2 percent for asset management, are very high compared to mature markets, but are not out of line with fee levels seen in other, newly emerging pension fund markets. The industry is young, assets under management are small, and the costs of complying with the regulatory requirements are high and include significant upfront investments. In Nigeria, PFAs have special tasks—which in other countries are done by public agencies—that increase operating costs.

227. However, in the long run maintaining a 2 percent asset management fee will lead to unacceptable welfare losses. For example, over a typical active (contributory) period, a 1 percent annual asset management fee may decrease benefits by 20–40 percent. PFAs have not started to compete on asset management fees yet (due to the reasons cited) and PENCOR does not see a need to reduce the fee limit as it expects that competition will force fees down. Whereas this liberal, market-friendly approach is generally commendable, it is important to continuously check market developments, and to analyze financial statements of PFAs to understand why expenses are so high and to ensure that fees are not excessive. Moreover, when the expected market consolidation occurs (and it is believed that there will many fewer PFAs than today's 25), the chance of collusion to keep fees high will be greater.

228. Comparing asset management fees and understanding their long-term welfare impact requires higher levels of financial literacy than comparing administration fees. Most PFAs currently charge N100 per month administration fee, the maximum permitted by the pension reform act, although some have already lowered this fee slightly, to between N95 and N90. Although PFAs claim that this fee is insufficient to cover administrative expenses, it is nevertheless high by international standards, especially for low wage earners, who may thus be discouraged from participating. This easily understandable type of fee is expected to be the first to fall due to competition.

229. Brokerage fees, which are paid in addition to the asset management fee, are deducted from the PFA members' assets. While brokers charge most clients about 1 percent of the value of assets, under an agreement with PENCOR they can charge PFAs no more than 0.5 percent of asset values. These fees will have to decrease further in the future, as institutional investors in mature markets rarely pay more than 10–20 basis points in commissions. The regulator will need to monitor PFA behaviour to ensure that they do not generate extra fees by churning (creating more equity trades than necessary, resulting in a high turnover, and higher fees paid to brokers which, in some non-transparent manner, may then be shared between brokers and managers of PFAs).

Subcontracting third parties

230. Currently, only PFAs are allowed to manage the assets of the RSA schemes and the approved pension funds, and not third parties. This is understandable, as at the time of pension reform the financial services industry was not experienced and developed enough to manage the new pension funds. Once the market matures, outsourcing asset management to specialized service providers (PFAs or other, equally qualified, investment professionals), especially in the case of cross-border and real estate investment, would help boost returns while reducing risk. PENCOR may wish to consider allowing outsourcing, especially if overseas investments become permissible. Investing successfully in foreign markets requires knowledge, which may not be available locally. In many emerging pension markets, foreign investments are managed through foreign advisory mandates, by outsourced mandates, or through foreign mutual funds. Such approaches also help to transfer knowledge.

Reserve fund

231. The pension reform act requires PFAs to set aside 12.5 percent of their net operating profit in a reserve fund. However, the law does not specify the purpose of this reserve fund. Therefore, it is unknown under what conditions these reserves would be called, at what level they should be limited, and what is supposed to happen before their build-up and after their depletion. Neither PENCOR nor the PFAs understand the rationale for the reserve fund, suggesting that it may have been introduced for political reasons or, perhaps, as an anchor for a future, more elaborate, guaranty provision. It is recommended to clarify the purpose of the reserve fund. If it serves no justifiable purpose, it should be removed from the law. Otherwise, its purpose and operating rules should be clearly communicated.

232. It should be noted that the PFAs' operating profits bear no systematic relation to any type of risk borne by scheme members. If the provisioning rule is intended to set aside funds to cover the future introduction of guaranteed returns, benefit levels, or salary replacement rates, it should be emphasized that international experience in this area has, at best, been mixed. In general it is inadvisable to introduce any contingent liabilities and implicit defined benefit aspects into the defined contribution RSA schemes. If regulations fail to align PFAs' long-term interests with those of its members, or if the capital of PFAs and pension fund custodians is insufficient to cover losses due to fraudulent, dishonest, or careless conduct, then it is unlikely that reserves built up by the PFAs will be sufficient to protect the members' future retirement incomes.

Voluntary savings

233. The Pension Reform Act allows for voluntary RSA funds which can be withdrawn tax-free after five years (or anytime sooner, subject to paying the 10 percent flat personal income tax), regardless of the contributor's age. In general, promoting voluntary pension savings is a commendable policy. In a market where other financial service providers are less well-regulated, voluntary RSAs could become an attractive

savings instrument, taking the place of bank deposits, mutual funds, and direct investments. Discussions with both PENCOR and PFAs confirm that this is indeed happening. In this respect, two issues need to be raised. Defined contribution pension funds (in the accumulation phase) differ from mutual funds in their social policy objectives and the interest the government takes in their proper functioning. Pension savings are meant to ensure income security in retirement, and investment regulations of such savings are typically more stringent. In order to provide sufficient incentives to contribute, preferential tax treatment granted to pension savings and/or withdrawals are also a commonplace.

234. A concern is the room that voluntary pension savings accounts open up for money laundering. It is advisable that, to preserve the pension industry's reputation, PENCOR pays particular attention to this issue. It is recommended that as a condition for enjoying tax privileges, policymakers consider rules limiting withdrawals until the account has been active for a minimum period of time, or the account holder reaches a specified age. It should be noted that in many countries, voluntary pension savings enjoy tax incentives which are different from those granted to mandatory contributions, accounts, and withdrawal products.

Taxation

235. Currently, RSA pension contributions, investment earnings, and withdrawals are tax exempt. This EEE (exempt-exempt-exempt) treatment is quite unique and suboptimal both from a pension and a tax policy perspective. There are two issues. First, by uniformly exempting all withdrawals from income tax, there is nothing to influence individuals to convert the pension funds into annuities. Since annuities are the best way of ensuring an income for life (eliminating the risk of outliving one's retirement savings), they should be tax-favored (preferably through the income tax regime)—or even mandated (some aspect of the pension system has to provide income for participants for life, otherwise it fails to meet its basic function). Although regulations can mandate phased withdrawals—by mandating indexation policies, minimum or target withdrawal periods, or amounts—which makes benefit payouts more like an annuity, in terms of pension policy this approach is still inferior to encouraging conversion to annuities.

236. Favourable tax treatment is impossible, however, if phased withdrawals receive the same tax treatment as lump-sum payments. Thus, it is recommended that PENCOR, in coordination with the Ministry of Finance, consider subjecting withdrawals from RSAs to income tax (and, later, giving partial or full exemption only to annuity products, once they become available). In the countries where personal income tax is levied at progressive rates, smaller withdrawal units, by falling into a lower tax bracket, result in a lower tax burden. This discourages most participants from withdrawing more than they need for a given period. Since Nigeria has a flat personal income tax rate, this approach will not change incentives, and explicit product-specific tax incentives will need to be introduced if the authorities are to pursue the above suggestions.

Funding levels of legacy defined benefit schemes

237. Approved pension schemes are mostly employer sponsored defined benefit schemes where the sponsor carries all underwriting risk. These schemes are also supervised by PENCOM although many of the regulations—notably investment regulations—do not apply to them. Defined benefit schemes should be fully funded at all times, and funding shortfalls should be corrected. The financial soundness of defined benefit plans hinges on three factors: (a) the reliability of the actuarial projections concerning liabilities towards current and future beneficiaries, (b) the expected value of assets as influenced by the level and certainty of contributions and investment returns, and (c) the extent to which the maturity and liquidity of the scheme’s assets ensures the serviceability of benefit payments.

238. The pension schemes sponsored by large, foreign corporations probably pay due attention to the soundness of their schemes and have the financial strength to supplement pension fund assets in the case of a shortfall. However, given the lack of an actuarial profession in Nigeria—the outcome of the underdeveloped insurance market—it is questionable whether managers of other types of firms are capable of assuring their schemes’ financial soundness. This is particularly troubling, given the aggressive investment strategies pursued by approved schemes, making them very vulnerable to unexpected or quick asset price depreciations on the domestic and overseas equity markets. Compensating for large-scale shortfalls in funding ratios may also prove to be beyond the capacity of the sponsoring entities.

State level pension legislation versus federal pension law

239. The pension reform act covers all formal sector employees who work for companies employing more than five people and federal civil servants and public employees. Information regarding the freedom states enjoy in terms of pension policy seems somewhat contradictory. PENCOM’s view is that states have to observe the federal law and that they can diverge from its principles and provisions only to the extent that they do not contradict the federal law. However there is nothing in the pension reform act that would appear to place it higher in the statutory hierarchy than legislation passed by state legislatures. Indeed, at least one state has already passed new legislation which is markedly different than that of the pension reform act.

240. As the pension reform act reflects international best practice in most aspects, it would be beneficial if states would follow this law. Understandably PENCOM is encouraging states to follow the federal model. However, PENCOM’s power of persuasion may be insufficient to influence state legislators. Therefore, it is recommended that the PRA be explicitly elevated to become the applicable public sector pension law in every state. If the constitution does not allow this, PENCOM and other stakeholders will have to continue with the campaign of persuasion. Otherwise, differences and segmentation may lead to regulatory arbitrage, regulatory and supervisory inefficiencies, and lack of a harmonized sector development policy.

Interpreting legislation versus systemic stability

241. The pension reform act, in line with case law traditions, allows PENCOM to exercise substantial flexibility in interpreting the law and in establishing precedents. In certain cases, however, it appears that PENCOM's interpretations are not consistent with the letter of the law. Although driven by sound judgment and a concern for the efficient and safe investment of retirement savings, the regulator may in effect create uncertainty. While this outcome may be understandable—especially given how the pension reform act evolved and how complicated it may be to amend it—uneven application of the law presents a grave risk to the system, as flexibility may be dangerous in the hands of a less well-trained and well-intentioned set of regulatory personnel. It is advisable that whenever legal hindrances to market development or sound investment strategies are encountered but cannot be overcome within the confines of the letter or spirit of the law, PENCOM works to amend the act.

Mandate and independence of PENCOM

242. PENCOM was established to formulate and oversee pension policy in Nigeria as well as to regulate and supervise the private pension industry. It is unusual to appoint a financial sector regulator to formulate and oversee pension policy. The regulatory function and the policy formulation function require different skills, expertise, modes of operation, and level of independence. Whereas policy formulation is at the heart of the government, prudent regulation and supervision require a high level of independence from political interference. It is likely that requiring PENCOM to serve both roles will lead to undesirable compromises, as their objectives and means can easily be contradictory. Pension policy is intimately linked to tax policy, tax administration, labor markets, wage policies, fiscal management, social policy, health insurance and many more such issues in which PENCOM has no expertise and for which PENCOM cannot be made responsible. For this reason, it is recommended that PENCOM is relieved of its policy formulation and oversight function, and that this mandate is delegated to where it belongs: the relevant line ministry (for example, the Federal Ministry of Finance or the Federal Ministry of Labor).

243. PENCOM consists of full-time commissioners who are required to have considerable expertise as a condition of their appointment and part-time commissioners whose experience may be relevant to financial sector regulation and supervision (Central Bank Nigeria, Security and Exchange Commission, and Ministry of Finance) or to overall policy formulation. In some instances (Nigeria Labor Congress, Nigeria Union of Employers, Nigeria Employers Consultative Association) membership of PENCOM resembles a forum for consensus building more than a financial regulatory authority. Such varying level of expertise, nature of political versus professional stance and, in general, the exceedingly broad representation is likely to hinder PENCOM's functioning as an effective regulator and is at least partly explained by the policymaking mandate. Limiting the commission's current membership to the Federal Ministry of Finance, the Central Bank of Nigeria, and the Security and Exchange Commission, and augmenting it with representatives of National Insurance Commission, PENOP, and the federal tax

authority, would enhance the professionalism of the commission. This measure, combined with shedding the policymaking mandate is expected to improve PENCOM's independence as a financial regulator.

244. In addition to the above measures, it is also recommended that PENCOM strengthen its professional cooperation with respected foreign regulators and institute an advisory body comprising internationally-recognized experts. This would provide PENCOM with important policy advice concerning market development and regulatory issues. This would also strengthen PENCOM in the face of potential political pressure to abandon its prudent practices.

PFAs' and PENCOM's Relationship to Financial Service Providers and Other Regulators

Life insurers

245. The Nigerian insurance market is very small in terms of overall and per capita premiums and is fraught with many problems, including the presence of fake insurance companies and un-segregated reserves across the life and non-life business lines. Life insurance policies are available, mostly in the form of group term life insurance, taken out by employers for their employees. Prior to the enactment of the pension reform act, private sector employers were required to take out life insurance policies for their employees. The pension reform act extended this mandate to the federal government. While it is within PENCOM's mandate under the pension reform act to enforce the requirement that employers take out life insurance plans for their employees, the insurers themselves and the products are regulated and licensed by the National Insurance Commission, the insurance regulator. According to the National Insurance Commission, compliance is less than full, which is an issue that PENCOM needs to pursue.⁶⁸

246. Life insurers, according to the pension reform act, can be licensed as PFAs. PENCOM, in recognition of the inadequacy of this regulation, requires life insurance companies to set up separate legal entities if they wish to manage pension schemes. This is a commendable policy. However, it is recommended that the prohibition of life insurers' direct involvement as PFAs be reflected in the law. In addition to this already existing role, life insurers are also expected to provide annuity products, which the retiring pension scheme members may purchase with their accumulated pension funds. Currently, the life insurance providers are not yet prepared to enter the market for annuity products. This is reflected in the request of the National Insurance Commission that pension funds not be required to purchase life insurance on behalf of their members for at least three more years. Putting the Nigerian annuity market on a healthy footing—which will have to include consolidation of viable insurers, many exits, and the presence of international firms—will take longer than three years. More time will be needed to establish a reliable track-record before retirees can reasonably be obliged to purchase annuities. Since the objective of pension policy is to ensure security of retirement

⁶⁸ It is unclear how PENCOM is supposed to force compliance in the absence of reliable tax, labor force or contributor databases.

income, the lack of reliable annuity products undermines the rationale of the entire pension reform. It is recommended, therefore, that the reform of the life insurance sector commences without delay, drawing on international best practice and expertise.

Mutual funds

247. The mutual fund industry is underdeveloped, while PFAs offer services in relation to fund management that are not the same as would be expected from a well-regulated investment fund manager. Over time, the two industries should become one, and be supervised by the same agency, and thus observe the same basic fiduciary standards (although the products offered may differ). A similar argument applies to pension fund custodians. The custody market other than for pension funds does not exist at present. Mutual funds, insurance companies, and the like are not obliged to employ custodians. One of the prerequisites to the development of these markets is to ensure the safe custody of assets. If and when employing custodians becomes a legal requirement, pension fund custodians will be the only players prepared to serve in this role. Here again PENCOM could cooperate with the market and prepare for the development of the fund management industry.

Other regulators and self-regulating organizations: National Insurance Commission, Securities and Exchange Commission, and the Nigeria Stock Exchange

248. The regulatory and supervisory cooperation between PENCOM and other entities active in financial market oversight appears to be limited and mostly formal. Better cooperation would help to increase the efficiency and effectiveness of oversight. While it is recognized that PENCOM cannot influence the institutional structure and decision-making processes of the National Insurance Commission, the Securities and Exchange Commission, and the Nigeria Stock Exchange, it can propose that these institutions include PENCOM representatives on their boards. It is important that regulations are discussed among regulators, and, whenever possible, a common, or at least universally accepted approach, applied. In addition, the team recommends that the regulators carry out joint supervisions, applying an agreed methodology and sharing information, observations, decisions, and recommendations with sister agencies. To coordinate interagency cooperation, it is recommended that a joint operational committee be established with a mandate to agree on supervision timetables, methods, and notification protocols.

Expected developments in the near future

249. Consolidation among PFAs is likely during the next two years, especially if aided by regulatory measures such as reducing charge ceilings and allowing switching. Recent years brought asset price appreciation in the equity market, which many experts describe as a bubble. The recent decline in asset prices may well have left defined benefit plans underfunded, forcing sponsors to provide additional financing. To reduce the risks of underfunding, it is recommended that PENCOM undertakes an extensive review of its regulations concerning defined benefit schemes. This review should include but not be limited to (a) risk-based regulation of funding levels, (b) review of the time within which

schemes are expected to correct insufficient funding levels, and (c) portfolio regulations to be applied to RSA schemes.

The Nigerian Capital Market

Recent Developments

Equity Market

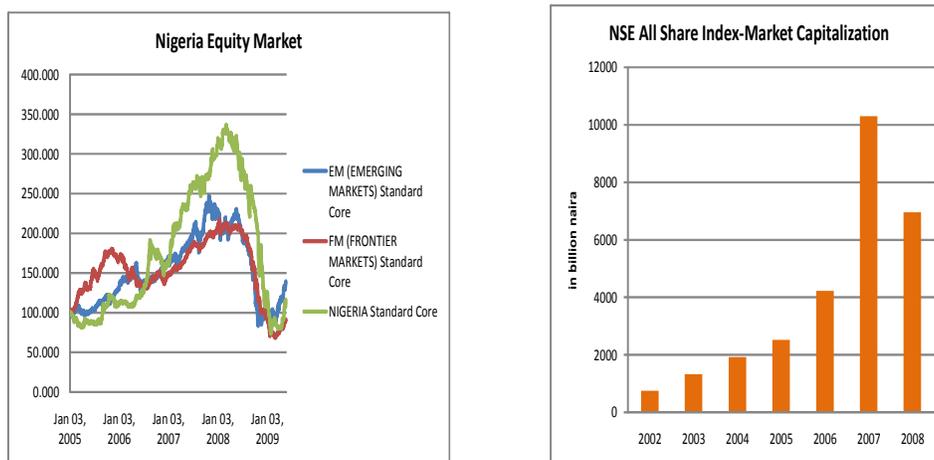
250. Until March 2008, the Nigerian equity market experienced tremendous growth due to structural changes in the financial system. In part this reflected increases in the minimum capital requirement in the banking and insurance sectors. Stock market capitalization grew from N749 billion to N10,301 billion from 2002 to 2007, an increase of 1,275 percent. During the same period, the volume of shares traded increased from 6.7 billion shares to 138.1 billion shares per day.

251. In early 2008, the Nigerian Stock Exchange (NSE) became one of the most over-valued exchanges in the world. On a price-earnings (P/E) basis, the NSE traded at 58 times the earnings of the underlying companies.⁶⁹ This contrasts with the average P/E ratio of 24 for the 56 emerging markets that the S&P/IFCG index tracks. The high valuation multiple or “overheating” of the NSE was driven by the banking and insurance sectors. Banks and insurance companies account for 19 of the top 20 companies by turnover volume. Additionally, banks represent 15 of the top 20 companies in terms of market capitalization. By and large these two sectors drove approximately 75 percent appreciation in the NSE All-Share Index in 2007. Apart from this the overheating was also fuelled by bank credit as banks were engaged in the practice of lending against share purchases (margin loans).

252. Since March 2008, the stock market started witnessing sharp decline with Nigeria All Share Index losing more than 60 percent of its value. The correction (from very high price/earnings ratios) was triggered inter alia by foreign investor withdrawal, and led to margin calls and increases in required collateral, precipitating further declines. The magnitude of the fall in the Nigeria stock exchange is illustrated by the fact that market capitalization in early 2008 was around \$110 billion (N13 trillion) and by mid-February 2009 it had fallen to \$ 32.5 billion.

⁶⁹ The S&P/IFCG P/E ratio of 58 is substantially higher than the P/E ratio reported by the SEC of 15.7. The major difference is that the S&P/IFCG index adjusts for liquidity and market capitalization, which serves as a better proxy for market activity. In contrast, the official P/E ratio reported by the SEC takes in to account smaller stocks that rarely trade and hence gives less indication regarding valuations in the market.

Figure 15: Nigeria Equity Market and Market Capitalization



Source: MSCI and Nigeria Securities and Exchange Commission

253. This also reflects the inherent weaknesses in the market owing to its heavy reliance on few sectors resulting in fewer opportunities for diversification. In this context the high costs of issuance and trading curtails the interest of more companies from listing on the NSE and stifles liquidity. The number of listed companies grew only from 195 to 213 during 2002-08. The overwhelming majority of IPOs in recent years have been in the banking sector. Therefore, the key driver of growth on the NSE have been changes in regulation (that is, raising capital requirements for banks and insurance companies) which have led to public offerings in an effort to satisfy the new minimum capital requirements. Although fees relating to initial public offerings (IPOs) and trading were reduced in September 2008, they are still much higher than average transaction costs in other emerging markets.

Domestic debt markets

254. Nigeria's domestic debt market has grown steadily since the issuance of Federal Government of Nigeria (FGN) bonds was resuscitated in 2003 after an 18-year hiatus. The stock of FGN bonds outstanding has increased from N73 billion in 2003 to N1,445 billion as of December 2008. Bond issuance at the state level has been much more lackluster with only nine new issues since 2000, of which only two are still outstanding. The corporate bond market has been even more anemic, declining from 40 corporate debt issues from 1990 to 2002 to only 12 issues between 1999 and 2007 (face value of about US\$178 million), of which 4 remain outstanding.

Federal government debt

255. Government issues of FGN bonds have grown strongly, with banks being the most active players in the market. Domestic government debt increased by approx 75 percent from 2003 (N1,330 billion) to December 2008 (N 2,320 billion) as a result of the

FGN bonds issued by the Debt Management Office (DMO). Government securities include treasury bills (with maturities of 91, 182 and 365 days), treasury bonds, FGN development stocks, FGN bonds (with maturities between 3 and 20 years) and Special Purpose FGN bonds. These instruments are primarily held by intermediaries, (i.e. limited number of retail investors) with banks holding roughly 50 percent of the debt stock, the Central Bank of Nigeria (CBN) holding about 25 percent and the rest held by institutional and foreign investors. Trading (mostly as OTC trading) is also mostly concentrated within a professional market, with 79 percent of primary dealer secondary market activity carried out with other primary dealers, 16 percent with domestic clients, and 5 percent with foreign clients in 2007.

Table 9: Domestic Government Debt by Instrument, 2002 to 2008 (N billion)

	2002	2003	2004	2005	2006	2007	2008
Treasury bills	733.8	825.1	871.6	854.8	695.0	574.9	471.9
Treasury bonds	430.6	430.6	424.9	419.3	413.6	407.9	401.2
Development stocks	1.63	1.5	1.3	1.0	0.7	0.6	0.5
FGN bonds	-	72.6	72.6	250.8	643.9	1,186.1	1,445.6
Total	1,166.0	1,329.7	1,370.3	1,525.9	1,753.3	2,169.6	2,320.3

Source: Debt Management Office.

FGN bonds

256. FGN bonds are Federal Government of Nigeria securities issued under the authority of the Debt Management Office (DMO). No FGN bonds were issued in the local market during 1986–2003. Since 2003, the DMO has been regulating the activities of the FGN bonds market, while the CBN has been acting as the issuing house and the registrar. According to the DMO, the aim of the FGN program has been to: (a) help the government fund its deficits in a way consistent with macroeconomic stability and fiscal prudence and to subject it to the discipline of the market; and (b) provide a benchmark yield curve that serves as reference for bond issuance by other bodies such as state governments or corporate bodies to facilitate rapid development of the economy.

257. Sound debt management strategy and implementation have enabled the DMO to make significant strides in overhauling its debt profile. In particular, the government has made significant progress in extending the maturity of its outstanding debt. At the end of 2003 all government debt had a maturity of less than one year and about two-thirds of the debt stock was in 91-day t-bills. As of September 2007, nearly half of the domestic government debt had a maturity of three years or longer and less than one-third of the debt outstanding was 91-day t-bills.

258. The DMO's strategy is also aimed at creating benchmark issues around the three and five years maturities, while gradually extending the domestic debt portfolio toward longer maturities. At present, each issue is a single issue, as the central bank auction system does not allow for re-opening of existing debt. Until the operational difficulties in

re-opening issues are resolved, the DMO has resorted to an interim solution of establishing shelf-registration, so that effectively securities are re-opened. The DMO is also considering moving to tap sale to build up larger issues as well as make bonds with identical maturities and coupon rates fungible. The DMO sees buy-back programs and reverse auctions as another future activity. An auction calendar has also been introduced to increase transparency and consequently enable market players to plan their cash flow accordingly, which should lead to a more stable FGN Bond issuance program. It should be noted that federal government bonds are tax exempt while other bonds have a withholding tax of 10 percent. The justification for this is not clear and it could actually complicate the use of the government bond yield curve to price other bond types.

Corporate Bond Market

259. In contrast to the equity and government bond markets, the corporate bond market has stagnated. There were only 12 corporate bonds issued between 1999 and 2007 (face value of US\$178 million), of which four remain outstanding. While demand is high for corporate debt among institutional investors, firms do not view the bond market as an attractive way to raise capital. The high fees (particularly when including underwriting fees) levied by regulators and intermediaries, the long approval time for an issue (four months for a bond issue as compared to a few weeks for a bank loan), and disclosure rules that are similar to the requirements for equities make corporate bonds an inferior financing option compared to bank loans. Additionally, equity financing has been a competitive alternative due to the explosive growth of the equity market and domestic banks have also been able to get attractive pricing on offshore issuances (as opposed to the local market) due to high demand for African securities by investors seeking to diversify portfolios.

Access to international capital markets

Eurobonds

260. Prior to the onset global financial crisis in 2008, Nigerian banks took advantage of the favorable global credit environment in early 2007. However due to reduction in global equity and increased risk aversion the terms on which banks will be able to access these markets are likely to remain less attractive in near term. Two successful bank issues—Guaranty Trust and First Bank—took place in 2007. The Guaranty Trust issue was for US\$350 million, with a 5-year tenor and an 8.5 percent coupon. The First Bank bond raised less capital (US\$175 million), but has a 10-year maturity at a 9.75 percent rate.

Table 10: Eurobond Issuances in 2007

Issuer	Announced	Coupon	Amount, US\$ million	Maturity	Ratings, S&P/M/F
Guaranty Trust	January 2007	8.5%	350	29/01/2012	BB-/NR/B+
First Bank	March 2007	9.75%	175	30/03/2017	BB-/NR/B+

Global Depository Receipts

261. Local banks raised funds by issuing global depository receipts (GDRs). Six Nigerian banks raised a total of US\$2.05 billion from GDRs in 2007. These were Guaranty Trust (US\$750 million), Diamond Bank (US\$500 million), Access Bank (US\$300 million), UBA (US\$300 million), FCMB (US\$100 million), and First Bank (US\$100 million). The Guaranty Trust and Diamond Bank GDRs are listed on the London Stock Exchange, while the other four are unlisted.

Investor Base

262. The development of diversified and active investor base is a key challenge in the Nigerian capital market that is largely dominated by banks. The problem has been exacerbated further as a result of the global financial crisis, as foreign investors who became very active in 2007 have in large part withdrawn from the Nigerian equity and bond markets. In addition limited supply of instruments has forced pension funds, insurance companies, and banks to follow nearly identical investment strategies with little opportunity for diversification. Thus the ongoing financial crisis calls for intensified efforts on behalf of the Nigerian authorities to deepen the domestic capital markets and strengthen the domestic institutional investor base.

Banks

263. Domestic banks are major players in both local equity and debt markets. Banks hold around 85 percent of total T-Bills and T-Bonds amount. This concentration may be explained by excess liquidity, the fact that T-Bills and T-Bonds are eligible in fulfilling the 30 percent liquidity ratio, the role of banks in the primary market and especially recently due to increased risk aversion owing to financial crisis. The extent of investment by banks in equities has been exposed by the events surrounding the restructuring process initiated by the CBN in August, 2009. Clearly banks' exposure to the market was in part a result of self-interest in stimulating (through lending, so called 'margin loans') the demand for their own shares. As has been demonstrated by the crisis this was a recipe for borrower distress and accumulation of non-performing loans in the time of a market down-turn. The concentration of banks investment in long term bonds also raises concerns about their exposure to market risk and the need to introduce market risk-based capital requirements to allow better monitoring and management of the risk exposure.

Pension funds

264. Since the reform in 2004, pension funds are a growing industry with assets at around N 1.00 trillion in July 2008 from N 815 billion at the end of 2007 and 25 pension administrators. They are regulated and supervised by an independent body, the National Pension Commission (PENCOM).

265. Pension funds can only invest in domestic securities with a cap of 25 percent in equities so they are natural investors in government bonds. However, their exposure to government securities low at around 20 percent of their assets. Currently around 35 percent of pension assets are invested in commercial paper and bankers' acceptances, which illustrates the lack of available instruments. Valuation of portfolios is at historic cost given the low volume of secondary market activity and lack of transparency. These are major concerns for the growing pension industry illustrating the importance of improving price dissemination mechanism.

Insurance

266. Currently the insurance industry is not a significant institutional investor, with assets under management estimated at N 2 billion. However, during the consolidation process in early 2007, the industry raised about N90 billion in new capital through primarily equity offerings. There are now 71 insurance companies (down from 108), of which 26 companies offer life insurance, 43 companies offer non-life insurance, and two companies offer reinsurance products. The companies offering life insurance, in particular, can be expected to play a much more active role in the equity and bond markets with the funds that have been raised as of late.

Mutual funds

267. The mutual fund industry in Nigeria is still small (N 53 billion in assets and 36 funds at the end of 2007) but its weight in the financial sector is increasing with an average of annual growth rate of 58 percent since 2004. Most publicly offered collective schemes invest in equities owing to outstanding performance of equity market until recently and the fact that equity investments are tax exempt. Currently there are only two public collective schemes investing in fixed income: a money market fund (assets of N 1.12 billion) and bond fund (N 2.3 billion).

268. The dominance of banks in Nigeria makes the development of mutual funds a key challenge. Particularly for money market mutual funds that in many markets are substitutes for checking accounts or time deposits. Recent negative developments in equity market may become a trigger for growth in fixed income mutual funds. Keeping in mind the importance of this industry in creating a vibrant secondary market for government securities, it is important that the authorities assess changes in existing obstacles that include: an unfavorable tax regime for fixed income mutual funds; and eventual regulatory costs to register a public mutual fund.

Intermediaries

269. The Nigerian capital market operates with a complicated licensing structure with a significant number of specialized categories of intermediaries. Nearly every category of intermediary has its own association and/or institute. This fragmentation gives rise to complicated stakeholder structure in industry-wide strategic initiatives such as FSS2020. Further there is scarcity of skilled human resources both in the securities industry and among regulators. The creation of new regulators, the establishment of the new pension fund industry, and more generally the drive to expand into new products and markets by the newly consolidated banking sector has exposed the shortage of skills in the new environment. Although regulatory capacity could be enhanced through technical assistance, such industry-wide skills gap will be more difficult to resolve in the near term.

270. The SEC is pushing for consolidation in parts of the securities industry through raising capital requirements for market participants. The minimum capital requirement is expected to be N 1billion for brokers, N2 billion for issuing houses and market makers, and N2 billion for registrars. However, resistance by smaller firms to the proposed minimum capital requirements makes the timing of any change uncertain. Further due to profitability within the industry it is uncertain to what extent the raised requirements would lead to consolidation in the near term. The SEC is already imposing risk-based capital requirements on firms.

Brokers

271. There is a clear need for consolidation in the broker industry. If one compares the number of trading members on NSE (about 200) with the number of certified stockbrokers (about 600), it is clear that most firms operate with very few professionals, most likely supported by staff that do not have the required qualification. Since the SEC requires firms to have at least two licensed brokers and NSE rules specify that all member firms must operate at a minimum of two geographical floors (for example, on the main floor in Lagos and on the Abuja NSE affiliate floor), there are clearly resource constraints for smaller firms. Also, the NSE and CSCS IT systems appear to be a problem for small brokerage firms that do not have in-house IT systems. Although fixed costs and economies of scale are strong arguments for consolidation, it would seem that the smaller brokers are not actively seeking merger partners.

Registrars

272. Recently, the registrar industry has been under heavy criticism, with many market participants viewing it as a bottleneck to IPOs. The problem stems from the increase in the number of IPOs and particularly the large number of small retail investors that now subscribe to them. Also the lengthy allocation processes, uncertainties about the extent to which subscriptions have been filled, and lengthy pay back times for non-filled subscriptions have been subject to criticism. The registrar industry is still largely paper based; streamlining procedures and moving to more modern technological solutions is badly needed.

Primary dealers

273. The main intermediaries in the bond market are the primary dealers, which also have market maker obligations. Two groups of primary dealers operate—one for the money market (t-bills and the like) and one for the bond market—but the two groups are nearly identical in practice. There are around 20 primary dealers consisting of banks and discount houses. In spite of success of Primary dealers in providing stable demand for T-Bonds, short-comings (e.g. wide bid range) relate to the fact that secondary market is still at an incipient stage. In addition there is need for stricter rules for PD's participation in the auction, given their exclusive access to the primary market. The DMO is currently in the process of review primary dealers rules and obligations.

Custodians

274. There is no strong tradition for custodian services in the Nigerian market. A specialized custodian industry for pension and mutual funds has been introduced.⁷⁰ Otherwise, the custodian industry is heavily concentrated, with one major custodian mainly serving foreign (institutional/professional) investors.

Rating agencies

275. Two domestic rating agencies operate in Nigeria, but no international rating agencies.⁷¹ Until recently, the agencies undertook non-solicited ratings based only on public information. However, due to lack of adequate information, they now provide ratings only on demand. Banks are the main purchasers of the ratings (normally an international and a local rating), as pension legislation requires banks to have two (annually updated) ratings for their shares to be eligible investments. All corporate bond issues also require two ratings as a condition for listing. Nonetheless, the main source of income for the agencies is from consulting and producing sector reports, not from providing ratings.

Market Infrastructure

276. The main infrastructure organizations in the securities markets are the NSE and the CSCS. In addition, the DMO is increasingly offering infrastructure solutions for trading in the government bond market, partly with the CBN, which also offers money settlement services through the RTGS payment system. Finally, the Abuja Securities and Commodity Exchange (ASCE) offers trading in commodity contracts. However, the settlement infrastructure has not developed at the same pace as other areas in the capital market, in particular the T-Bills and T-Bonds settlement mechanism is segmented by being processed in separate settlement systems. These shortcomings can become a serious obstacle for market development, if reforms continue at the current pace in primary and secondary markets for government securities.

⁷⁰ See chapter on pensions for description of intermediaries in these two industries.

⁷¹ An additional agency has been registered, but is not operating.

Nigeria Stock Exchange

277. The NSE is the main Nigerian exchange and in principle covers all types of securities. The NSE is a non-demutualized exchange with a very large number of smaller broker members. The main market on NSE is the listed equities market consisting of 212 listed equities. Market participants are generally satisfied with the operation of NSE automated trading system which is an off-the-shelf order driven trading system. NSE does not have a well-specified disaster recovery plan or back-up system although progress under way in establishing this function.

278. The governance structure of the NSE needs to be strengthened as the current structure of a traditional self regulated organization owned by its members creates inherent risk of management entrenchment and failure to act in public interest. Measures to improve governance around the world have involved strengthening government oversight, demutualizing of exchange, and separating the regulatory function from the trading function. Demutualizing the NSE and creating a separate self-regulated organization would reduce conflict of interest and improve oversight.

OTC Market

279. The government bond market is now de facto OTC, although government bonds are still listed on the NSE. The development of the OTC debt market benefited from number of factors including the government intention of developing a benchmark yield curve, the pension reforms that created a large new institutional investor group with appetite for government bonds, a highly liquid banking system that was keen to create an OTC debt market outside the NSE and strong foreign investor interest until recently.

280. Currently the OTC market functions through an off-the-shelf platform that will be used both for the primary and secondary market. Issues that need to be considered in this context are development of functional design of the market architecture – in consultation with market participants, CBN and SEC – that would be supported by the trading platform and linking the planned secondary market architecture to the upgrades required in both the CBN's depository for T-Bills and CSCS for T-Bonds.

The Central Securities Clearing System

281. The CSCS operates independently with NSE holding less than 30 percent of its shares and is regulated by SEC. Although market participants express satisfaction about the CSD system, the system is being fully used for registrar functionality. The market will be well-served by further rationalization in the settlement and depository activities and a move towards mandatory dematerialization of certificates for listed companies. Any strategy in this context should examine options for the integration of the registrars and the CSCS.

Regulatory Framework

282. The Nigerian capital market and its participants are regulated by a patchwork of institutions with uneven powers, competence, and status. The SEC regulates capital markets, the NSE regulates its members, the National Pension Commission (PENCOM) regulates the pension industry, the National Insurance Commission (NAICOM) regulates the insurance industry. The DMO regulates both the primary and secondary market for federal government debt and the CBN and the Nigerian Deposit Insurance Corporation (NDIC) have regulatory and supervisory authority over banks. While there is a standing coordinating body for regulators of financial industry, it is less active. Stronger cooperation among the regulators is needed particularly as the financial industry move to conglomerate structures.

283. Further the regulators have less emphasis on risk based methods and regulations. A major tool for the regulators during last couple of years has been increased minimum capital requirements to push for necessary rationalization and modernization of the industry. This started with banks, then the insurance industry, and now has turned to the capital market intermediaries. The current regulations also do not contain adjusted market risk-based capital requirements. Stock brokers are required to observe simple maximum exposure rules regardless of market risk. Similar requirements are made of the banks. Although this is not an imminent source of risk, as maturities for fixed coupon bonds increase and market grows, banks may assume considerable market risks.

284. As for accounting and reporting, the SEC is fully behind the adoption of international financial reporting standards rather than adaption (and dilution) of the rules. The SEC has also issued corporate governance code; NSE-listed companies must adhere on a “comply or explain basis”. However, market participants and the rating agencies complain that companies are very reluctant to give more than the bare minimum required information to the market, thus providing weak foundation for research and analysis.

285. In the secondary market for government debt the developments have been so fast and recent that there may be regulatory gaps or overlaps to be addressed. First, the new role of financial intermediaries as debt market intermediaries and the fact that different supervisor may be following up the same activity conducted by diverse types of intermediaries. Second, the supervision of market conduct and trading systems may also be subject to gaps and overlaps. The lack of regulation on pre or post trading price dissemination for OTC trading, are an obstacle for supervision and portfolio valuation. Also it is not clear which institution would be in charge of monitoring eventual market malpractices by market makers. The DMO has the capacity to suspend PDMMs if they do not comply with their commitments but there are no established administrative sanctions that typically would be under the scope of securities market regulator.

286. Third, the legal framework for more sophisticated market activity and products that includes repos, short selling and their supporting settlement infrastructure and risk management schemes need to be developed. Finally, more specific regulations on fixed

income mutual funds, especially money market mutual funds are needed, particularly if a shift is expected from equity to fixed income collective investments.

International and Regional Perspective

287. There are strong international ambitions for the Nigerian capital market in the overall FSS2020 strategy including enhanced integration with external financial markets and building an international Financial Centre. Less emphasis is placed on sub-regional cooperation such as regional exchange alliances and a common ECOWAS or WAMZ capital market. While developing a strong regional base would be useful as a precursor to establishing more worldwide relations, fear of Nigeria dominance among neighbors could be a hindrance.

288. In ECOWAS the cooperative fora for the exchanges and regulators are strongest in UEMOA countries, but also exist in WAMZ. From a technical point of view it is opportune time to build an alliance spanning the whole of ECOWAS. Both NSE and BVRM – a multi-country exchange alliance network spanning eight UEMOA countries – use the same trading and settlement systems. Ghana does not have electronic systems, but has had talks about sharing systems with Nigeria. Lately, Nigeria is considering new system solutions that will make linkages more difficult and cooperation discussion between Nigeria and Ghana seems to have lost momentum. Other technical aspects that would need attention are creating parallel CSD cooperation and regional payment system cooperation connecting the central banks' RTGS payment systems. In this context the Nigerian RTGS system which is still a single currency system would need to be upgraded.

289. The drive for regional infrastructure solutions and efficiency gains will be driven by the interests of banks and broker/dealers in establishing regional coverage. Regional exchange and CSD cooperation is not just about achieving economies of scale, but is also a means for facilitating regional coverage for market players. Equally important in establishing regional cooperation is the institutional investor base. In most countries investment rules, for example pension funds rules, still limit the possibility for diversification through regional investments thereby putting constraints on regional initiatives.

Recommendations

290. For Nigeria to develop its capital markets in line with the FSS2020 vision of strengthening domestic financial markets, enhancing integration with external financial markets and building an international financial centre, it is important that following issues are addressed.

Over the short-term it is recommended that following be addressed:

Fees associated with IPOs and trading needs to be reduced further.

291. The SEC, NSE, and market players agreed to reduce the fees relating to IPOs and trading in September, 2008. The costs of an IPO was trimmed from roughly 4.5 percent to 3.2 percent (excluding underwriting). The costs of trading were cut from 2.5 percent to 2.0 percent (sell side) and from 2.3 percent to 1.8 percent (buy side). However, costs are still much higher than the average transaction cost of about 0.5 percent for a professional trade in emerging markets. The high cost of IPOs appears to have discouraged companies from raising capital on the NSE in cases where there has not been an overriding regulatory imperative. Further reduction in fees is necessary to encourage new listings and to increase market liquidity.

The registrar infrastructure needs to be strengthened along with mandatory dematerialization of certificates.

292. The SEC has taken a number of steps to address market concerns relating to the poor performance of registrar industry, including by; (a) raising the minimum capital requirement, (b) forbidding registrars to be registrars for affiliated companies; (c) demanding that the registrars upgrade their procedures and use of modern technology, and (d) making it mandatory for new IPOs to be fully dematerialized in the Nigerian central depository (CSCS). Major progress will be achieved once the subscription process itself is made electronic for which one of the key prerequisite is making electronic signatures legally binding by Nigerian law. Dematerialization of all certificates and integration of securities registration in one central securities depository would enhance the infrastructure for the securities market.

Establishment of a sector wide investor compensation fund is needed to boost confidence in the market.

293. The purpose of investor compensation schemes is to protect investors from loss in the event of fraud or insolvency of an intermediary. As OTC trading increases the NSE compensation fund will be inadequate. A law addressing this has been drafted. It is unclear whether there are plans for merging the two compensation funds. The NSE investor protection fund was reorganized through incorporation during 2007 to secure more independent operation, but it is still linked to trading at the NSE and does not cover OTC trading.

There is a need to accelerate the process of demutualization of NSE and to make governance more transparent.

294. Demutualizing the NSE and creating a separate self-regulated organization (SRO) would be appropriate to reduce conflict of interest and improve oversight. On the one hand reducing broker dominance would improve the exchange's credibility as a strong SRO. On the other hand, the tendency internationally is to transfer many self-regulatory functions to other bodies, thereby avoiding potential conflicts of interest between the profit motive and the SRO functions. Therefore, a review process and agreement on how the NSE should conduct its regulatory functions as an SRO will be necessary as NSE progresses with demutualization.

Consolidate debt portfolio management strategies aiming at benchmark building through a regular strategy of re-openings, buy-backs, switches and earmarking benchmark issues for PDMMs.

295. The re-opening strategy that the DMO is already implementing is a key in building market benchmarks. However, it will only be complete and fully effective if it is accompanied by a complementary set of tools to manage outstanding issues: buy-backs and exchanges to reduce concentration of maturities at a particular date or support more liquid benchmarks. Such a strategy is currently under consideration by DMO

Consider improving the articulation of Primary Dealer Market Maker (PDMMs) obligations in the primary and secondary market

296. There is need for stricter rules for PD's participation in the auction, particularly given their exclusive access to the primary market. In terms of secondary market, the requirement to quote in all 20 outstanding T-Bond issues seems excessive and difficult to enforce. Market making schemes in developed countries do not ask for two-way quotes in more than 4 to 5 benchmarks, and generally they are all on-the-run. In addition the legal framework of operations that support market makers' risk management such as repos securities lending and short selling should be considered a priority. Without such operations it is doubtful that a true market-making scheme can operate.

Enhance price dissemination and consider the design of the market architecture for OTC trading of T-Bonds before making a decision on the new trading platform.

297. Dissemination of closed trades and two-way quotes on electronic bulletins that the industry is already using (e.g. Reuter) is needed to improve competition and establishing framework for mark to market valuation. Earlier DMO had plans to introduce an end of day reporting scheme to be published on its web page: but the introduction of the scheme was postponed waiting for the launch of new trading system.

Over the medium term it is recommended that the following be addressed:

Adopt a plan for full transition to IFRS in order to improve transparency and disclosure standards in the market.

298. For accounting and reporting, the SEC stands firmly in favor of adoption of the International Financial Reporting System rather than the adaptation of the rules. Adoption will ensure that the accounting system for Nigerian banks and corporations moves efficiently to international standards and that these entities and the accounting profession reap the full benefits arising from international recognition of the improvements achieved by adherence to international accounting and disclosure standards.

Focus issuance policy in T-Bonds towards benchmark consolidation in 3, 5, 7 and 10 year maturity before further diversifying the instruments offered.

299. The DMO already has outstanding issues at the standard maturities up to 10 years. Recently a 20-year bond was also issued with plans to eventually issue indexed bonds. These plans raise the issue of a trade-off faced by most DMOs that have a limited amount of debt financing requirements between liquidity in key benchmarks versus variety of instruments offered. An additional problem is the uncertainty on the pricing of the 20-year T-Bond given lack of reliable secondary market prices for the shorter maturities. Current challenges of increasing liquidity in the secondary market for T-Bonds, speak in favor of benchmark consolidation (current 3, 5, 7 and 10 year maturities) before new instruments are offered to the market.

Analyze options to establish incentives for fixed income, particularly money market mutual funds, in order to diversify investor base.

300. In general, countries that have developed a non-bank institutional investor base successfully rely both on pension funds and on mutual funds, as high dependency on pension funds can lead to low secondary market activity in T-Bonds because of their buy-and-hold nature. Currently, purely fixed income funds cannot be developed in Nigeria because the Investor's Act requires that all mutual funds have a portion of their portfolio in equities. In addition, more specific regulations on fixed income collective schemes, particularly MMMFs' are needed, including diversification rules, rating quality of issuers, portfolio duration, asset valuation rules, fee structure, redemption rules and relations with affiliated parties.

Consider taking a decision on the harmonization of C&S platforms to T-Bills and T-Bonds and establishing neutral governance arrangement in upgraded C&S platform.

301. The current institutional split in the settlement of T-Bills at CBN and T-Bonds at CSCS is a serious obstacle for market development. There is a need to establish unified model for T-Bills and T-Bonds settlement. It is important that the same level of services and equivalent business rules are applied provided for both T-Bills and T-Bonds (e.g. repos on T-Bills and T-Bonds should have same business and settlement rules) so that market participants perceive both settlement systems as a single system from a functional perspective. Further there is a need to establish a neutral governance arrangement in the upgraded C&S platform with representation from all groups of market participants.

Evaluate and address gaps and overlaps between different regulatory agencies in order to define clearly the competences and issues of coordination in secondary market activity.

302. Secondary market developments have come about so quickly that there are regulatory gaps and overlaps that need to be addressed, particularly in the area of the new role of financial intermediaries as debt intermediaries, supervision of market conduct and trading systems and development of legal framework for C&S that takes into account legal arrangements in the payment system.

Housing Finance

Housing in Nigeria

303. There has been rapid urbanization in Nigeria as in other emerging markets. The proportion of the population living in urban areas has increased from 10 per cent in 1952 to 20 per cent in 1970 and 38 per cent, 1993 and 48 per cent today. It is forecast to increase to around 60 per cent over the next few years.

304. Nigeria is one of the most urbanized countries in sub-Saharan Africa, with 48 per cent of its population inhabiting cities. The city of Lagos alone is estimated to have around 10 million inhabitants, although estimates vary considerably. This makes it the most populous city in sub-Saharan Africa and one of seven cities in Nigeria with populations above 1 million. The United Nations has forecast that by 2010 the greater Lagos urban area will be one of the world's largest cities with a population exceeding 20 million.

305. Nigeria compares itself with the “BRIC” countries – Brazil, Russia, India and China. Comparative data on urbanization are shown below

Table 11: BRIC Countries Urbanization Rates

<i>Country</i>	<i>Urbanization Rate</i>
Nigeria	48%
Brazil	84%
Russia	73%
India	29%
China	40%

By any standards housing conditions in Nigeria are poor. Various studies have estimated that there is a shortage of 12 -16 million units. Most people, probably over 80 per cent of the population, live in informal housing – structures of varying degrees of permanence on land on which they have no ownership rights. The property is often very poor quality and lacks basic facilities.

306. The Nigeria household survey 2004 showed that 61 per cent of the population had access to an improved water source. This average masks different positions in urban areas (83 per cent) and rural areas (42 per cent). Similarly, 60 per cent of the population had access to sanitation facilities; the average for urban areas was 72 per cent and rural areas 50 per cent.

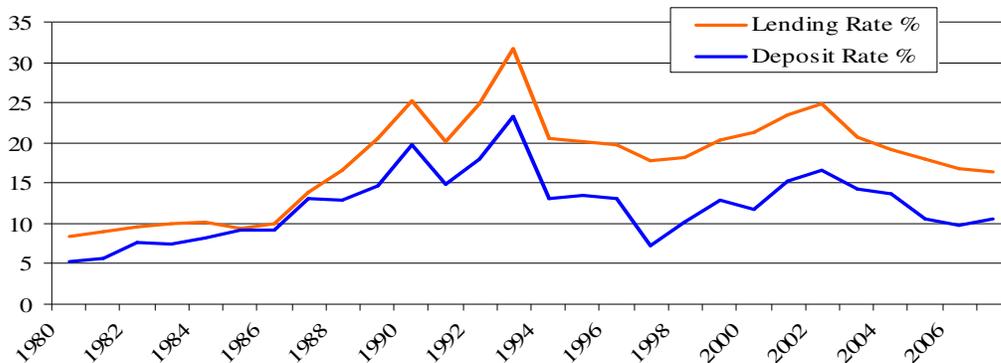
307. In the more formal sector there is a shortage of properties, and accordingly rents and house prices are very high. The market is predominantly in plots rather than in completed housing units. The cheapest apartments for sale in the suburbs of Lagos cost ₦2 – 3 million (\$17 – 25,000). The cheapest houses on the outskirts of Lagos are around

₦5 million (\$43,000), while in Lagos itself the figure is nearer ₦10 million (\$86,000). The high house prices have led many employers to provide housing directly for their staff.

308. Nigeria is currently enjoying rapid economic growth. Real GDP per capita rose by 8 per cent in 2007 and is forecast to increase by 9 per cent in 2008.2 key related macroeconomic variables – the rate of inflation and the general level of interest rates – are relevant to housing finance. Loans to finance house purchase need to be for relatively long terms, and long term financing is difficult, if not impossible, in a high inflation/high interest rate environment.

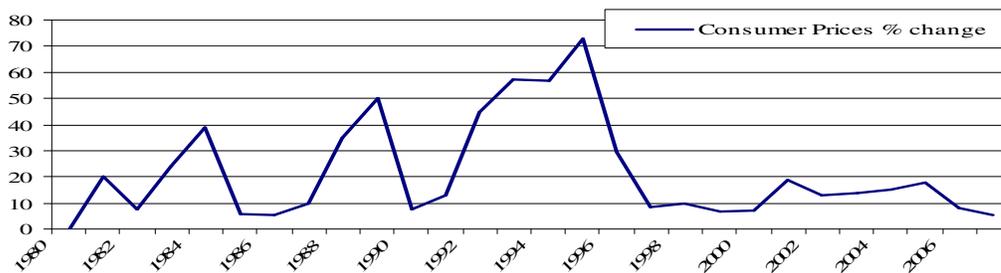
309. Nigeria has suffered from inflation and high interest rates. The situation has improved significantly in recent years. The prime lending rate has fallen from 25 per cent in 2002 to 16 – 18 per cent over the last few years. Inflation has fallen from double figures to around 6 per cent. Inflation is forecast to be in the 7 – 9 per cent range over the next few years.

Figure 16: Lending and Deposit Rates 1980-2007



Source: EIU Database

Figure 17: Inflation Rate 1980-2007



Source: EIU Database

Housing Finance Framework

310. There are three sub-sectors of the Nigerian housing finance market:

- The informal sector – by far the largest.
- The formal open market sector, which is largely confined to the upper income groups in the major urban centers.
- The subsidized sector, a subset of the open market sector, which benefits from cheap loans from the National Housing Trust Fund.

This section sets out the framework. The next three sections examine the sub-sectors in turn.

Legal system

311. Generally, the Nigerian legal system in respect of mortgages and property follows the English common law system. However, there is a significant exception in respect of land ownership. Nigeria's Federal system of government means that different laws already apply to land transactions in different parts of the country. There is a separate land registry in each state.

Land ownership

312. The Land Use Act 1978 vested the ownership of all land in the governor of each state. This is enshrined in the Constitution. The governor can allocate specific pieces of land to individuals or corporate bodies for development. This would usually be on a 99 year lease. An individual's ownership of land, a "right of occupancy", is recognized through a "certificate of occupancy" for the period of the lease less one day. This "right of occupancy" is transferable, with the consent of the Governor. However, over the last few years the original owners of the land have increasingly challenged the terms under which the state acquired their land under the 1978 Act, and have been successful in some court actions. This creates uncertainty.

313. Where land is allocated for development then it is a condition that development takes place within two or three years. If development does not take place then the state can take back the land. However, whether or not this is done is fairly arbitrary, which creates further uncertainty. Notwithstanding the 1978 Act it is understood that in practice some 70 per cent of land is held on a customary basis. It is assumed that that such land cannot be transformed into individual ownership or used as security without being subject to the 1978 Act.

Title registration

314. Nigeria has a network of land registries in each state. The basic structure is sound. However, the administration is not. Work has begun to computerize the land registries. Where they are computerized then someone searching can be reasonably confident that the register is correct. Where they are not computerized there is no guarantee that the file will be correct.

The Federal Capital Territory is in the process of implementing a new computerized title registration system which includes cadastral mapping using GIS. This was a valuable by-product of the work done to plan and build the City. All title documents are being scanned in, and Certified True Copies of titles can be printed out on secure, numbered paper instantly. Likewise, title searches, which used to take several weeks, can now be carried out instantly. The Land Registry office has also made great strides to eliminate any opportunities for corruption or bribery by implementing a series of security features into the system and by eliminating any cash payments. Significant progress has also been made in Lagos State, assisted by support from the British Council and the Land Registry in England and Wales.

Governor's consent and registration charges

315. All transactions in property, including sales, leases, mortgages and other charges, are subject to complex requirements in respect of Governor's consents and registration, and to charges which cumulatively are the highest in the world. Understanding the charges is far from easy, and indeed there seems to be an equally complex system of waivers, derogations and special deals so that the full impact of the charges may be mitigated, albeit at the expense of some other facilitation payments being made.

The following description is largely drawn from the World Bank publication *Doing Business in Nigeria* and relates specifically to a \$32,000 property in Lagos.

- The charge for obtaining Governor's Consent varies from state to state. In Lagos state the basic fee is 8 per cent of the value of the property, but this is increased to 15 per cent where the property is resold within ten years.
- The Land Registration fee is typically 3 per cent of the value of the property.
- Stamp duty is also 3 per cent of the value of the property.
- There are various fixed fees which typically will be between ₦15,000 (\$130) and ₦25,000 (\$210).
- Legal fees are on a sliding scale and average 7.5 per cent of the value of the property. If an estate agent is used then each party employing the agent pays 5 per cent.

316. The 2007 World Bank Doing Business report put Nigeria at number 173 (out of 178) in the country ranking of registering property, with 14 procedures, a duration of 82 days and costs of 22.2 per cent of property value. These figures are a considerable improvement on the 2006 figures of 16 procedures, 274 days and 27.1 per cent, reflecting a concerted effort by the State of Lagos to reduce costs and simplify procedures. Nigeria's performance in respect of registering property is by far its worst. Nigeria was in 108th place in respect of doing business generally.

Nigeria compares itself with the "BRIC" countries (Brazil, Russia, India and China). Each scores much better than Nigeria. The following table shows the position.

Table 12: Time and cost to register property, BRIC countries

	<i>Nigeria</i>	<i>Brazil</i>	<i>Russia</i>	<i>India</i>	<i>China</i>
Number of steps	14	14	6	6	4
Time (days)	82	45	52	62	29
Cost (per cent of value)	22.2%	2.8%	0.3%	7.7%	2.6%
Ranking (out of 178)	173	110	45	112	29

Source: *Doing Business*, World Bank, 2007.

Enforcing collateral

317. The ability of a mortgage lender to realize its security is rightly regarded as important in the development of an effective mortgage market. It is the security of the property that allows a lower rate of interest to be charged than for unsecured loans. The arrangements in Nigeria are not straightforward. It is understood that arrears are very low on the mortgage lending that has taken place. More generally there is a culture that accepts that debts have to be paid and that default on a mortgage loan results in losing the mortgaged property.

318. The power of sale is governed by the Property and Conveyance Law of 1959 (applicable in the West) and the Conveyance Act of 1881 (applicable in the East and the North as a statute of general application). This is a non-judicial process which does not require the bank to go to a judge to get formal authorization to initiate proceedings against a defaulting creditor. Under this regime the rights of borrowers can be quite limited. There are reports of property auctions being organized on the same day as the notice appears in the newspaper. There are also reports of brutal means being used to evict defaulting borrowers.

319. A new bill has been under discussion that would set a stricter framework and ensure more rights for the borrower. The bill offers a series of options for the sale of the property ranging from auction to an agreed sale process. Whilst the stronger consumer rights should be welcomed, it is not clear that the proposed bill achieves a balance between a quick and efficient resolution of enforcement with the rights of the borrower.

It also lacks considerable detail, with no definitions of basic terminology such as what constitutes a default.

The Informal Sector

320. It is important not to lose sight of the informal sector which constitutes the vast majority of the population and housing in Nigeria. Most people live either in traditional villages in the rural areas or in informal settlements in the major urban areas. These settlements are very visible in Lagos and the other major cities, and are similar to those found in other parts of Africa. In urban areas the housing is invariably poor quality, lacking the basic amenities, and overcrowded. The people living in this housing work in the informal economy and probably have no connections with any formal financial institution.

321. Housing in this sector of the economy is usually built by the owners. A very primitive construction can be built quickly, overnight if necessary. More substantial homes are constructed over a period of years as the owner can afford to pay for materials or occasionally for some professional help. Building a substantial dwelling is likely to take ten or more years on this basis. Rotating savings and credit associations (ROSCAs) play a role by providing short term loans to their members.

The Mortgage Lending Market

The environment for mortgage lending

House purchase on the open market is difficult. In summary:

- Absence of clear property and security rights.
- Mandatory Governor's Consent to property transactions.
- Inefficient land management systems.
- High costs of property transactions.
- Inadequate sources of cheap long term funding.
- Inadequate structure of housing delivery.

While these factors are all a problem it is necessary to assess their relative importance and the extent to which they can be influenced in seeking to prioritize policy initiatives.

The supply of housing and house prices

322. The land ownership system acts as a deterrent to new house building. Land for development is allocated by state governors through an opaque administrative mechanism, which is not responsive to demand. When a developer acquires a plot of land he is liable to pay high fees up front. While spatial planning exists in theory, in practice there is a free for all, which means that land for housing has to compete with land for commercial use.

323. The position is accentuated in Lagos, the major urban centre, by a number of special factors. The most popular parts of Lagos are on an island where space is already constrained. Lagos has been booming which has led to a huge influx of population. There is no mass transport system so people either have to live close to their work or face a lengthy drive in traffic conditions that can best be described as chaotic. More recently, the unrest in the Niger Delta region has led multinationals to pull their staff back to Lagos.

324. The market in Lagos and the other major urban centers consists almost entirely of plots, rather than completed new houses or of second-hand houses. A plot or plots are offered for sale with either no services or with some services up to a gated community with full security. The buyer buys the plot and then builds the property himself or engages a builder to do it. The process is necessarily lengthy and in many ways unsatisfactory. In a large estate there will be properties at varying stages of development for many years.

325. There is a limited amount of sales of newly completed houses. Developers are not easily able to finance the construction process. This is partly due to inefficiencies in the building industry and shortages of materials and skilled labor. These combine with high interest rates to make the construction process expensive. What “speculative” building there is tends to be at the top end of the market. There seems to be almost no market in second-hand houses, perhaps reflecting the cultural tendency for homes to be kept within families.

Mortgage lenders and products

326. Despite the unfavorable environment there is a reasonably efficient and rapidly growing mortgage market in Nigeria. Loans are provided by the retail deposit banks, and to a much lesser extent by the primary mortgage institutions. Loans are financed by retail deposits. The maturity mismatch is largely mitigated by use of the adjustable rate mortgage, loans rates typically being tied to banks’ prime lending rates. In most countries a key element of the underwriting process is examining the financial history of the borrower, particularly in respect of his record in repaying other loans. Bankers regard this as the single most important piece of information that they need in order to underwrite loans effectively. In Nigeria this was not possible until recently. The CBN has recently licensed the first two credit bureaus, one more is awaiting full licensing and more are expected to apply for licenses in the near future.

327. Lenders require the borrower to have clear title for that property and will normally take a legal mortgage, although in some cases they may use an equitable mortgage. To further protect themselves lenders will normally deal with borrowers only from certain specified employers – typically the public sector and large corporations. Mortgage repayments are made by deduction from wages, and there may also be some informal support from the employer.

328. There is no reliable figure for the size of the mortgage market. A best guess is around ₦100 billion (\$850 million) and 40,000 loans. United Bank for Africa is probably the market leader. Skye, Diamond, Access and PHBI are other banks that promote themselves as having a significant role in the market.

Interest rates

329. The rate on mortgage loans had long been capped at the Central Bank Minimum Rediscount Rate + 4 per cent. This led to banks increasing the level of charges and fees imposed on loans to maintain their margins, and more generally the cap falling into disuse. In February 2008 the cap was abolished with immediate effect. This should lead to greater transparency in the rates charged to consumers.

330. Currently the open market mortgage rate is 17 – 18 per cent, roughly the same as prime lending rate, and a spread of 3 – 4 percentage points over money market rates. The spread is not unreasonable given the problems of mortgage security and the early stage of development of the market. However, the high mortgage rate acts as a deterrent to some potential borrowers and puts a heavy repayment burden on those who do borrow. As the market expands units costs are lowered and the extent of the potential risk becomes clear, and hopefully favorable. These should lead a narrowing of the spread although the scope for this is limited. However, mortgage rates will be more affected by the general level of interest rates. The effect of lower mortgage rates on monthly repayments is usefully illustrated by comparing the annual payments on repayment mortgages for varying terms at rates of 7.5 per cent, 10.0 per cent, 12.5 per cent and 15 per cent.

Table 13: The impact of high mortgage rates on repayments

	7.5 %	10.0 %	12.5 %	15.0 %
Repayments on \$30,000 loan				
Interest only	\$2,250	\$3,000	\$3,755	\$4,500
25 year repayment	\$2,690	\$3,310	\$3,960	\$4,640
10 year repayment	\$4,370	\$4,880	\$5,420	\$5,980
5 year repayment	\$7,320	\$7,900	\$8,430	\$8,950

331. A borrower with an income of \$10,000 would be committing 25 per cent of income to repayments on a 25 year loan at 7 per cent, but a prohibitive 46 per cent with an interest rate of 15 per cent. If a 10 year loan is the maximum term available then repayments increase to 60 per cent of income. Lengthening the mortgage term to 25 years would be sufficient to make formal mortgage finance loans a viable option for middle income groups in most African countries.

Avoiding the costs and delays

332. As explained above, the complicated, time consuming and costly processes that apply to property transactions. In any country where these circumstances apply, there are two predictable outcomes:

- The volume of transactions is lower than it otherwise would be.
- Various devices are used to circumvent the procedures and minimize the fees.

333. These apply in Nigeria. It is impossible to estimate the extent to which activity is suppressed but there certainly must be some effect. In respect of “workarounds”, in the massive informal sector no fees are paid at all as people have no ownership rights and transactions in property are not registered or reported. There are sales and purchases of existing homes in the informal sector, but it is impossible to make a realistic estimate of the volume.

In the formal sector a variety of devices are used, all with their risks:

- Deliberately reporting a lower value of the property than the true value of the transaction. The authorities try to deal with this by valuing properties themselves and also by having a minimum value for particular areas.
- The lender having an equitable mortgage (i.e. he holds the deeds and does not register a charge against the property) rather than a legal mortgage. The risk for the lender is that taking possession is more difficult.
- Properties being owned by corporate bodies with changes in ownership being effected by sale of shares in the company.
- The buyer giving the mortgage lender a power of attorney.
- The lender taking security over assets other than land, and only taking security over land when the time arises to realize that security – prevalent in the commercial sector but much less applicable to residential property.
- The unofficial sale of the right to “own” or occupy a house, with the legal title remaining with the previous owner.
- Including compulsory arbitration clauses in mortgage contracts.

It also seems to be the case that developers are able to negotiate waivers or deferment from certain taxes or charges.

334. The overall result is very unsatisfactory. It seems that most pieces of land are not registered – it is understood that in Lagos just 80,000 titles are registered whereas the number should be 4 – 5 million. The main effect of the plethora of controls and taxes is that transactions either do not happen or happen in the informal sector, and where transactions are in the formal sector they are costly and time consuming, partly because of the efforts that are made to mitigate their effects.

The Subsidized Mortgage Market

335. Alongside the mortgage market described in the previous sector is a subsidized mortgage circuit involving a government agency, a provident scheme and a network of primary mortgage lenders:

- The Federal Mortgage Bank of Nigeria (FMBN) administers the provident scheme and also has other functions, although at present it is not a mortgage bank.
- The National Housing Trust Fund is a compulsory provident scheme the proceeds of which can be used only for house purchase.
- Primary mortgage institutions (PMIs) disburse subsidized loans financed by the NHTF, often combined with open market loans funded by retail deposits.

FMBN – structure and role

336. The FMBN has a long and chequered history and has been charged with implementing various government policies, historically with little success. Its name is something of a misnomer, as it is not a mortgage bank in the normally accepted sense of the expression but rather the body that manages the NHTF and loans made under the scheme, and has a number of related responsibilities.

337. Technically, the bank is 50 per cent owned by the Federal Government, 30 per cent owned by the Central Bank of Nigeria and 20 per cent owned by the National Social Insurance Trust Fund. However, only the Federal Government has contributed any capital. It is the intention that the capital base of the Bank should be increased to ₦100 billion (\$850 million) million but it does not seem that this has been done. As a financial institution the bank is supervised by the CBN.

It now describes its role as being to:

- Enhance the NHTF and encourage PMIs.
- Facilitate of land transactions by helping to secure improvements to the titling process.
- Facilitate quick foreclosure where this is necessary.
- Facilitate access to the capital markets by mortgage institutions.

The Bank has been involved in the various initiatives to improve the functioning of the mortgage market, and can be seen as the “champion” for mortgage finance within government.

Financial position of FMBN

338. The financial position of the FMBN is difficult to assess, but it is certainly not healthy. It seems to have an accumulated operating deficit of \$67 million and in the last two years for which figures are available (2005 and 2006) the decrease in “other net

assets”, which may well be a proxy for losses, has been more than double gross earnings. This suggests a high cost base. There are 600 staff, one head office, eight zonal offices and 38 state/district offices. Conversely, its income is limited. The following table reproduces statistics from a table included in the *Report of the Presidential Technical Board on FMBN Restructuring*.

Table 14: Federal Mortgage Bank of Nigeria, Financial Summary, End-2006

	₦ million	\$ million	per cent
Capital employed			
Capital fund	(636)	(5)	(9)
Long term deposits	220	2	3
Long term loans	6,676	57	95
Capital loans	750	6	9
Total	7,010	60	100
Assets			
Mortgage assets	12,068	103	172
Fixed assets	2,530	21	36
Long term investments	17	-	-
Working capital	17,411	149	148
Other net assets	(25,015)	(214)	(356)
Total	7,010	60	100
Gross earnings	2,730	23	

The table would seem to suggest that the Bank has negative net worth.

National Housing Trust Fund (NHTF)

339. The Housing Fund was established under decree No 3 of 1992. The employers of all employed Nigerians, and self-employed workers, earning more than the minimum wage are required to deduct 2.5 per cent of wages and pay the amount into the NHTF. The accounts are held in the names of the individuals who should receive annual statements. Contributions receive a rate of interest of 2 per cent. By law, the Government and financial institutions are required to contribute to the scheme. The contributions plus interest are repayable at age 60 or on death. After contributing to the scheme for six months workers are entitled to a mortgage loan of up to ₦5 million (\$43,000) at a rate of 6 per cent for 30 years. The loan is for a maximum of 90 per cent of value, so the borrower needs to have a ₦500,000 (\$4,300) deposit. The loan must be used for house purchase, house expansion or building on a plot which is owned.

340. Applications for loans are made through the PMIs. The PMI checks that the application is in order and forwards all the documentation to the FMBN which duly checks it. The processing time is between four and nine months. If the application is accepted then the necessary funds are paid by the FMBN to the PMI at a rate of 4 per

cent, giving the PMI a spread of 2 per cent. The PMI may make an additional loan at a market rate of interest if the borrower requires more than ₦5 million (\$43,000).

341. Money from the NHTF is also used by FMBN to make estate development loans (EDLs) to private developers and state housing corporations at a rate of 10 per cent over 24 months. Usually these loans are made to finance construction of properties which are then sold to buyers with 6 per cent loans. The land is often provided free. The properties must be sold for no more than ₦5 million (\$43,000). At first sight this is an attractive scheme to potential home buyers. After saving just 2.5 per cent of their income for six months they can borrow ₦5 million (\$43,000) at an interest rate of 6 per cent, which compares with an open market rate of 17 per cent, to buy a house at significantly below market value. In addition, the house purchase is exempted from some taxes.

342. However, the scheme has never, and can never, work in the way outlined above. The amount raised through contributions is not sufficient to fund loans for more than a tiny proportion of those eligible for loans. The scheme is in effect a compulsory regressive tax in that the majority of workers could never earn sufficient to be able to afford to buy a house. They are being forced to contribute part of their income to a scheme, receiving a return well below the rate of inflation, to finance cheap loans for the better off, most of whom are probably civil servants. The regressive nature of the scheme has recently been worsened as the loan terms have been considerably improved – the rate of interest has been cut from 9 per cent to 6 per cent, the loan ceiling increased from ₦1.5 million (\$13,000) to ₦5 million (\$43,000), the maximum term increased from 25 to 30 years and minimum borrower contribution reduced from 20 per cent to 10 per cent.

343. The scheme has also faced practical difficulties. A loan can be obtained only if the borrower can produce clear title to the property he is buying. This is impossible in the majority of states and accordingly no loans have been made in those states. Loans can be made only through PMIs and there are no PMIs in at least 10 states. In such cases a potential borrower can apply to a PMI in another state, but it seems unlikely that this happens to any significant extent. Many PMIs do not qualify to distribute loans. The FMBN will not disburse more through a PMI more than 25 per cent of the PMI's capital, and it requires a bank guarantee for the loans it does disburse.

344. The trades unions have long objected to the scheme and asked workers to stop contributing. This duly happened in all but three states, although the situation has now changed and contributions are being made in 27 states. The government and financial institutions also have never made the contributions that they were required by law to make.

Primary Mortgage Institutions (PMIs)

345. Primary mortgage institutions, which were established through Decree No 53 of 1989, as their name suggests, were intended to be specialists in mortgage lending, like savings and loan associations in the USA and building societies in Britain. Their role is to collect retail deposits and to make mortgage loans, both on the open market and as the only institutions through which loans from the NHTF are distributed. However, they have low capitalization and poor governance. They are distrusted by the public, which has meant that they have been unable to raise deposits.

346. Until 1999 PMIs were regulated by the FMBN. In that year regulation was moved to the Central Bank of Nigeria, recognizing that they were banking institutions. Most PMIs are very small, have made no loans at all and engage in various real estate activities to keep themselves going. Some are owned by the states. Most of the larger PMIs are either subsidiaries of banks or are connected with banks. One of the largest – Union Homes, is listed on the Nigeria Stock Exchange, and another, Spring Mortgages, in which Spring Bank has a 51 per cent shareholding, will be listing shortly.

347. When the CBN took over regulation there were 199 PMIs, of which 115 were described as “terminally distressed”. 97 of these were closed down. In December 2005 only 43 had the prescribed capital of ₦100 million (\$850,000) and of the 70 that made returns in 2005 only 15 complied with the minimum ratio of mortgage loans to assets of 30 per cent. The poor quality of PMIs is usefully illustrated by the fact that FMBN checks individually each application for a loan, introducing further delay and cost into the system. It does not feel able to rely on the procedures of the PMIs through a service level agreement. The PMIs currently serve little useful purpose. Their position was usefully summarized in a speech in 2007 by Dr Obadiah Mailafia, the Deputy Governor of the CBN who said, *“PMIs globally do not fulfill their mission and their contribution to housing finance supply is limited. Ratios of mortgages to assets and mortgages to loanable funds (defined as deposits collected) are well below the 30 per cent and 60 per cent thresholds set by the regulators and document that the PMIs failed to perform their function as mortgage originators. With commercial banks putting increasing resources into developing their mortgage market, PMIs are bound to lose further market share, with the exception of those that are operating as mortgage finance subsidiaries of the commercial banks. Weak capacity has been an additional cause of the lack of success of PMIs in the mortgage market and the outright failure of several.”*

Table 15: PMIs, Consolidated Balance Sheet, 2006

	₦ million	\$ million	per cent
Assets			
Cash	1,302	11	1.1
Bank balances	64,576	550	56.5
Loans and advances	30,012	250	26.2
Other assets	11,654	100	10.2
Fixed assets	6,848	60	6.0
Total	114,393	980	100.0
Paid up capital	12,566	107	11.0
Reserves	2,941	25	2.6
Current year profit	45	-	-
Deposits	74,215	630	64.9
Placements from banks	3,096	25	2.7
Long terms loans NHTF	7,462	65	6.6
Other liabilities	13,968	120	12.2
Total	114,393	980	100.0

The table shows the very small size of PMIs, the fact that their assets are largely held with banks, negligible profitability and also a high proportion of fixed assets.

Issues to be addressed

There are a number of issues that need to be addressed:

- FMBN has a wide range of functions but no clear direction or strategy.
- FMBN is in a financially weak position which makes it difficult for it to be effective.
- The NHTF is not viable or sustainable in its present structure.
- The PMIs have a privileged position but make no significant contribution towards the development of mortgage finance.

Funding

348. Some analysts have suggested that the inability to raise long term funds is a significant constraint on the development of the mortgage market. This is based on the argument that mortgage loans are long term and therefore need to be financed by long term investments. In fact many countries, notably Britain, have largely funded mortgage loans through short term deposits, the adjustable rate mortgage being used to mitigate the effects of the maturity mismatch. While long term funding would be desirable, in the short term the availability of funds is not a constraint on the development of mortgage lending in Nigeria. This section examines both the immediate prospects and how long terms funds can be accessed in due course.

Banks

349. As already noted banks are very liquid, and are seeking to expand their mortgage lending, using the adjustable rate mortgage. It is probable that over the next few years the volume of bank mortgage lending will grow rapidly and that bank lending will account for well over 90 per cent of total mortgage lending. This will usefully serve to diversify the balance sheet of the banks. Normally, one would expect such an expansion of mortgage lending to lead to a decline in margins. However, in Nigeria bank margins are already low by sub Saharan Africa standards and even low by world standards, and there is probably not much scope for margins to fall further, at least in the short term.

350. The adjustable rate mortgage largely, but not wholly, transfers interest risk from lender to borrower. If the general level of interest rates falls then mortgage rates can be expected to fall similarly. However, inflation looks set to remain at around the 8 per cent level and it may be that there is little scope for a fall in market rates. A significant increase cannot be ruled out, and this is where the use of the adjustable rate mortgage would be tested. Borrowers need to be aware of the nature of their mortgage product, that is that the interest rate can go up.

Securing longer term funding

351. It is desirable that longer term funds are available to help finance mortgage loans. This would have a number of advantages including diversifying the sources of funding, facilitating the matching of assets and liabilities and enabling borrowers to have a choice between fixed rate and adjustable rate loans.

352. The banks themselves can raise long term funds through bond issues or simply by seeking long term deposits. However, there has to be a supply of funds as well as a demand. At least in the short term the institutions best placed to supply longer terms funds are the Pension Fund Administrators, both because they hold significant funds – ₦500 billion (\$4.3 billion) and because they have long term and predictable liabilities. It is understood that the PFAs are interested in holding mortgages in their portfolios, although obviously these would need to be at a higher return than equivalent government securities. They may well also be interested in making long term loans to banks which in turn might be lent on mortgage.

Priorities and Action Plan

353. It is always tempting for such an analysis to conclude with recommendations for new legislation and institutional reform. The analysis of the current market suggests that this is not the immediate priority in Nigeria in order to stimulate housing finance. Rather, the legal and institutional framework is not the main problem; what is needed is a concerted effort to make the present arrangements work efficiently.

Phase 1: Priorities

Phase 1 should be implemented within two years. It deals with the priorities that are capable of being “quick wins” – essential to put momentum into the reform process. Five recommendations are put forward for Phase 1, all of which can be implemented without legislative changes:

1. Substantially improve the transaction process by reducing the time taken to achieve the necessary consents and reducing the costs from the current level of 20-30 per cent of the value of the transaction to nearer 5 per cent. This is by far the most important single measure; if action is not taken on this the other measures will not succeed.
2. Either abolish the NHTF or significantly reform it so as to redress the balance between contributors and borrowers.
3. Substantially increase the capital requirement for PMIs, and make loans through the NHTF, if it is to continue, only to those that meet this and other standards.
4. Put the FMBN on a stable financial footing and develop its role as the source of knowledge, statistics and expertise on the mortgage market, and facilitator of market improvements.
5. Implement through the FMBN a simple mortgage liquidity facility which would help pave the way for the use of covered bonds and mortgage backed securities in the longer term.

Phase 2: Measures

The phase 2 measures are those that are not essential to stimulate the market and which will take longer to put in place, in some cases because of the need for new legislation. They should be implemented over a five year period. They are:

1. Put in place arrangements through the FMBN which would allow covered bonds and mortgage backed securities to be issued. This may require some legislative changes.
2. Reform the arrangements for foreclosure by one or both of improving current processes within the current legal framework and by providing for extra-judicial procedures.
3. Develop a mortgage insurance program in conjunction with a commercial insurance company.
4. Linked with 1 and 3, facilitate some common standards for underwriting and for documentation.
5. Remove the need for Governor’s consent for land transactions, which will entail changing the Constitution.
6. Introduce large scale land registration programs and facilitate the acquisition of title by existing occupiers of property.

7. Introduce a comprehensive suite of training programs.
8. Regulate the activities of real estate agents.
9. Introduce comprehensive building codes and provide protection for buyers of houses during the course of construction.

SECTION V. THE ENABLING ENVIRONMENT

Ensuring Good Corporate Governance

An overview of corporate governance

354. Corporate governance refers to the set of rules and incentives by which the management of a company is directed and controlled. It concerns the relationships among the management, board of directors, controlling shareholders, minority shareholders, and other stakeholders. International good practice revolves around four key elements: strong shareholder rights, high levels of transparency and disclosure, and strong and professional boards of directors – all supported by a strong legal and enforcement framework. Good corporate governance can enhance investor trust, attract outside investment, and demonstrate a country's commitment to observe international standards. Ultimately, good corporate governance contributes to sustainable economic development by enhancing the performance of companies and increasing their access to outside capital.

355. Corporate governance is particularly important for emerging markets like Nigeria that want to join the club of the “next 11”, and upgrade its financial system as part of the FSS2020 program. Sound corporate governance principles and practices are particularly significant to financial institutions: they are considered riskier than many other types of companies; the character of assets and liabilities are more opaque, leading to an asymmetry of information, less transparency and a greater ability to obscure existing and developing problems. Good governance also complements effective financial supervision, and allows supervisors to better allocate their scarce resources and concentrate on troubled institutions with weak governance, where supervision is most needed. In its full implementation, good governance protects the interests of depositors and other bank stakeholders, builds and maintains public confidence, and ultimately contributes to the integrity and stability of the financial sector.

Recent events

356. **Corporate governance is an important policy concern in Nigeria.** A number of events have raised the profile of corporate governance reform in Nigeria, including the recent growth (and decline) in the equity market, corporate scandals, and the Financial Sector Strategy 2020 program (FSS2020).

357. **Corporate governance reformers have been galvanized by recent scandals.** Perhaps the most important was the discovery of financial fraud at Cadbury Nigeria Plc in 2006/2007. The regulators have taken action against the company, and suits have been filed against the board. But the Cadbury story is also a cautionary tale, as the fraud took place even though there was a foreign parent, and was only discovered after the foreign parent took control of the local subsidiary.

358. **The equity market has grown rapidly in size and importance.** The consolidation of the banking sector has resulted in significant capital increases by the banks, and big increases in the number of shareholders. As in other emerging markets, the five years leading up to 2008 saw a boom in market prices and activity. Nigeria has the second largest equity market in sub-Saharan Africa after South Africa. At the end of September 2008, 218 companies were listed on the Nigerian Stock Exchange (NSE) with a market capitalization of N9.8 trillion (US\$ 83.6 billion). Big international names, such as J.P. Morgan and Morgan Stanley, have begun to establish themselves locally. International portfolio investment is increasing. The recent market declines have been painful, but also represent an opportunity for reform.

359. **Corporate governance reform is a key component of the FSS2020 program.** FSS2020 is an integrated program launched by the Central Bank and the government with the goal of upgrading the financial sector in Nigeria, by the year 2020. The program aims to transform Nigeria's financial system into a catalyst for growth by strengthening domestic financial markets, enhancing external integration, and developing an international financial centre.

360. **The most important large companies are locally owned financial institutions.** This is the reason why corporate governance is so important in the financial sector in general and in the banking sector in particular. There are in general four types of large companies in Nigeria: locally owned financial institutions, other locally controlled companies, subsidiaries of foreign multinationals listed on the exchange, and state-owned enterprises. Ownership patterns are not transparent. Anecdotal evidence suggests that control of locally-owned companies can be established with a relatively small proportion of shares (less than 50 percent). Almost all companies reportedly have controlling shareholders⁷², but most operate in the background and out of the public eye. International investment remains modest. The recent revelations of massive losses in Nigerian banks portfolios and the intervention of the CBN indicate the size and importance of the issue.

361. The corporate governance framework is based on UK legislation Nigeria is a common law country, and much of its corporate legal framework is based on UK legislation. Key laws include the 1990 Companies and Allied Matter Act (CAMA) (currently under review) and the 2007 Investment and Securities Act (ISA). The Securities and Exchange Commission (SEC) is the principal supervisor of securities markets and public companies.

Nigeria is making progress on Corporate Governance

362. **A variety of corporate governance initiatives have already taken place in Nigeria.** Listed companies are required to "state their level of compliance" with the Code of Corporate Governance issued by the SEC in 2003. The SEC Code primarily

⁷² This report adopts the term 'shareholder' to identify the owners of a company, recognizing that the legal framework and common terminology in Nigeria frequently uses 'member'.

focuses on the board of directors, shareholders, and the audit committee, and does not require any explanation of non-compliance. Some provisions of the Code were introduced into the 2007 ISA to make them mandatory. The SEC oversees compliance; to assist with this process, in 2008 the SEC launched a Half Yearly Report process, in which companies must report their compliance via a detailed corporate governance questionnaire. The SEC Code is currently under review by a committee led by the SEC.

363. Financial sector regulators have also recognized the importance of good corporate governance. In August 2009, the CBN announced the creation of a financial surveillance and stability unit within the CBN that would be led by a newly appointed Deputy Governor. This builds on past efforts to improve banking supervision and regulation. The Central Bank of Nigeria (CBN) issued a separate and mandatory regulation (the CBN Code) for banks in 2006. The Pension Commission (PenCom) issued a mandatory Code for pension funds in 2008 and NAICOM, the regulator of insurance companies, issued its own Code for insurance companies in 2009. CBN has also developed a Code of Conduct for bank directors.

364. A number of private sector institutions play key corporate governance roles. These include the Institute of Chartered Accountants of Nigeria (ICAN), the Institute of Directors of Nigeria (IODN), the Institute of Chartered Secretaries and Administrators of Nigeria (ICSAN), and the Financial Institutions Training Center (FITC). The IODN has created (in partnership with the SEC and the CAC), a Center for Corporate Governance to facilitate and promote the establishment of effective and sustainable corporate governance.

365. Nigeria is unique because of its powerful shareholder associations. Nigeria has a large number of shareholder associations, which collectively play an important role in corporate governance. Seven regionally-based associations were formed in the early 1990s as part of the privatization program, and many more were formed in the late 1990s. The shareholder associations have played a positive role in monitoring companies and increasing awareness of shareholder rights. However, many observers have raised concerns about situations in which associations may not have acted in the public interest. The SEC published a Code of Conduct for Shareholders' Associations in 2007.

Key Findings

366. The following sections highlight of the principle-by-principle assessment of Nigeria's compliance with the OECD Principles of Corporate Governance.

Investor Protection

367. Most basic shareholder rights are protected by the Companies Act. Shareholders have a right to participate in general meetings (AGM), either by proxy or in person, to elect and remove directors, to obtain most relevant information, and to attend

shareholder meetings. Changes to the company's articles, authorizing new capital, major transactions, and dividends all require shareholder approval.

368. **In practice, certain problems have emerged.** Market participants reported a number of problems with the execution of certain shareholder rights. Some companies reportedly select meeting locations that are difficult for shareholders to access, or do not send out meeting information on time. Companies can require that a minimum percentage of shares is required to attend the AGM. Shareholder recordkeeping is considered to be reasonably secure, although significant shareholder recordkeeping problems emerged during the peak of the IPO boom, as shareholders waited months to obtain final ownership. Shareholders do not have the benefit of mandatory pre-emptive rights in the event of a capital increase (although some companies include them in their Articles).

369. **Related party transaction protections could be strengthened.** Existing rules tend to focus on directors, who under CAMA need shareholder approval when they enter into a transaction with the company involving one or more non-cash asset representing at least 20 percent of the company's asset value. The rules apply to "shadow directors" and other persons connected to the director, but may not cover all indirect transactions between the company and its board members.

370. **The new rules governing the market for corporate control are confusing and appear to be inadequate.** The rules requiring tender offers are confusing to market participants, and are subject to different interpretations. Any person acquiring more than 30 percent of shares (or persons acting in concert holding between 30 to 50 percent of the voting rights wishing to acquire more shares) must make a tender offer. However, the tender offer does not need to be to all shareholders or for 100 percent of the shares, and the rules do not set any restrictions on the price. Directors duties during takeovers are well regulated – they must continue to comply with their duties, and make recommendations to shareholders without frustrating the offer.

371. **In practice takeovers are limited.** There appears to have been only one transaction under the new rules: Stanbic Africa Holdings Limited (a subsidiary of Standard Bank of South Africa) made a tender offer for 16.8 percent shares in IBTC Chartered Bank PLC, in addition to the 33.3 percent it acquired as a result of a previous merger. Following this transaction, the Central Bank at the time banned foreign takeovers of local banks and set a cap on foreign equity stakes in domestic banks at 10 percent of their total assets. Following the banking crisis in August, 2009, the CBN's policy on foreign purchases of equity in Nigerian banks was reversed, although as of now the process still remains to be tested.

372. **Insider trading is prohibited in theory.** Insider trading and the abuse of information obtained in official capacity are forbidden in Nigeria. The SEC has the power to invalidate such transaction. However, there have been no cases so far.

373. **Institutional investors are regulated with regard to corporate governance.** Pension funds have to disclose their investment policy (previously approved by PenCom) and their portfolio on their websites. However, they are not required to disclose their voting policy, or actual votes. Funds are not permitted to enter into related party transactions with their sponsor except with banks.

Disclosure

374. **Companies produce audited annual financial statements based on national standards.** Following a lengthy debate and as confirmed by a joint protocol agreed between the NASB, the SEC and the CBN in April 2009, Nigeria has decided to *adopt* rather than *adapt* International Financial Reporting Standards (IFRS). As of now the national standard setter has developed a set of local accounting standards (SAS), and all companies in Nigeria are required to prepare and present annual audited financial statements to shareholders. A survey of annual reports of 80 companies carried out jointly by the World Bank and IFC in April 2009 indicates that financial statements are generally available for listed companies. 75% of companies surveyed disclosed that they used SAS to prepare their accounts. 3% (or two companies) disclosed that they used IFRS. 20% of the companies surveyed reported using both NASB and IFRS (presumably filing two sets of statements).

375. **There are now strong pressures to move towards IFRS implementation.** In April 2009, the NSE advised all quoted companies to adopt IFRS by 2011. At the moment, at least two banks have indicated their intention to adopt the IFRS standards going forward and the CBN is also transitioning towards requiring banks to report according to IFRS and NASB is also party to the April 2009 protocol endorsing the move towards full adoption.

376. A bill is before Parliament (the Financial Reporting Council Bill) that would create a government body, the Financial Reporting Council, modeled on the UK's FRC. The new body would oversee the promulgation and enforcement of accounting and auditing standards.

377. **SAS accounting standards compromise the value of financial reporting,** especially in the financial sector. For example:

- There is insufficient disclosure of related party transactions -- IAS 24 (covering the disclosure of related party transactions) has not been adopted or adapted in Nigeria.
- The lack of consolidated accounting has resulting in bank brokerage subsidiaries lending to customers to buy shares. Consolidated supervision would result in such shares being deducted from the bank's regulatory capital.
- Banks record NPLs according to days past due (and not based on the prospective viability of their borrowers), and assets are valued at historic cost rather than market value.

378. **The NSE approves annual financial statements of the listed companies before publication.** The Nigerian Stock Exchange reviews submissions by companies for compliance with the listing requirements, which include accounting standards and disclosure required under CAMA. The audited financial statements of a listed company are only published after approval of the Stock Exchange, and de-listing is the only sanction for noncompliance.

379. **Nigerian companies use the Nigerian Auditing Standards issued by ICAN.** Auditors should have relevant degree, be members of ICAN or the Association of National Accountants of Nigeria (ANAN) and be independent. Auditors of banks are required to rotate every 10 years. Auditors are subject to civil liability for negligence even though in practice no auditors have been sued.

380. ICAN (with assistance from the World Bank) has updated its Code of Ethics in line with the IFAC Code of Ethics for Professional Accountants and is in the process of developing a quality assurance system to ensure compliance with auditing standards and code of ethics and strengthening the disciplinary process.

381. Companies are also required to disclose a variety of non-financial disclosures. Companies must attach a board report to the annual financial statements. This report must include a description of probable future developments and research and development activities, detail the recommended dividends, and the directors' interest in the company, their remuneration, and any transactions by directors. In general, the WB / IFC survey reported a high degree of compliance with these requirements.

382. **Companies should disclose their compliance with the Code of Corporate Governance.** All listed companies must include a corporate governance statement in the directors' report. It discloses the recommended dividends, the directors' interest in the company, their remuneration, and any transactions by directors. In addition, the annual report (and the prospectus) must state the level of compliance with the SEC Code of corporate governance. According to the WB / IFC survey, 61% of the surveyed companies disclosed their compliance with a corporate governance code.⁷³ 89% of companies disclosed at least some information about the structure and operation of the board. Surprisingly, only 1% of all the banks surveyed published a Corporate Governance Compliance report.

383. Of the 61% that reported that they were compliant with a corporate governance code, only 25% stated that they were fully compliant. 36% did not disclose their degree of compliance, and only 5% of these companies gave details of non-compliance.

⁷³ Of the 61% that disclosed compliance with a corporate governance code, 23% did not disclose which specific code was being adopted, 14% stated that they were compliant with CBN Code of Corporate Governance, 11% stated that they were compliant with the SEC Code of Corporate Governance, 5% stated that they were compliant with both SEC and CBN Codes, and 3% reported compliance other codes such as Company and Allied Matters Act (CAMA), OECD and Kings Code. 4% reported compliance with more than two codes (SEC, CBN and others).

384. Also, the SEC is now beginning to monitor compliance with the Code, through a special half-yearly reporting process launched in 2008, but this report will not be disclosed to the market.

385. **Significant ownership interests are to be disclosed, but the rules are inconsistent, and compliance appears to be low.** A variety of rules (in different parts of the legal framework) seek to require shareholders and companies to disclose significant ownership.

- Shareholders who, directly or indirectly, hold more than 10 percent of the company's share capital must notify the company. There does not appear to be a specific requirement for the company to immediately notify the market.
- Companies must disclose substantial shareholding, defined as five percent of the issued shares (in the annual report, the proxy statement, and the prospectus).
- Directors are also required to disclose any shareholding interests.
- The Listing Rules require that change in voting control or in beneficial ownership of the securities carrying voting control shall be notified to the Director-General of the NSE.

386. These rules are not consistent, and none appear to be particularly effective. In the end only 31% of surveyed companies disclosed information about the ultimate controlling entity. The recently appointed Governor of the Central Bank disclosed in the Financial Times that it is difficult to identify the shareholders of many banks.⁷⁴

387. **This lack of transparency is troubling in the listed sector, but it is particularly problematic for banks,** where recent dilution due to IPO activity has left relatively small shareholders with controlling stakes. Identifying the 'real' owners of banks and other listed companies can be extremely difficult due to the use of nominees. In financial institutions, it is particularly important that owners are 'fit and proper'.

388. Other aspects of the non-financial disclosure regime are in place:

- Companies are required to disclose aggregate board remuneration but not a remuneration policy, or any non-financial information about directors. The SEC Code recommends that disclosure should be "full and clear", and detailed disclosure of the remuneration of the chairman and highest-paid director. The WB/IFC Survey indicates that almost all the companies that were surveyed (97.5%) disclosed aggregate board remuneration, while only 51% disclosed aggregate remuneration for executives and none disclosed individual remuneration. 2.5% disclosed a remuneration policy. Most companies complied with the Code and disclosed the pay of the Chairman (71%) and the highest paid

⁷⁴ "Interview with Nigeria's new central bank governor", Financial Times, June 21 2009

director (50%).

- In practice, while some companies may disclose some director qualifications, the board nomination process is not disclosed.
- Companies must disclose information about employees and employment in the directors' report.

Banks are required to disclose material risks to the CBN; other (listed) companies do not have this requirement.

389. Whistleblowers are protected when they act in good faith. Whistleblowers — employees who informed about a company's illegal practice — can be a critical source of corporate information. In Nigeria, whistleblowers who disclose certain information in the public interest are protected as long as they act in good faith.

Company oversight and the board

390. **In general, boards play a central and strategic role in Nigeria.** Nigeria has a one-tier board system. Listed companies have at least two directors which do not need to hold any shares of the company. The SEC Code recommends a minimum of five directors, and suggests that the board be composed of a mix of executive and non-executive directors. Boards are elected at the AGM by shareholders, based on a recommendation from the board. The non-executive directors should bring independent judgment and should not be dependent on the company for their income.

391. **Director's fiduciary duties are defined in the CAMA.** Fiduciary duties of directors are described in the CAMA. Directors must "act in the best interest of the company as a whole, promote the purposes for which the company was formed, and act in the interests of the company's employees and its members." They also shall act honestly, in good faith and with the degree of care, diligence and skill which reasonably prudent director would exercise in comparable circumstances. Although the law does not require companies to have a Code of Ethics, some companies do have one for their board of directors. In practice, very few cases have proceeded in Nigeria. In 2007, the shareholders of Cadbury Nigeria launched a class action against their directors for breach of duties.

392. **Both the board and management have responsibilities for overseeing financial reporting.** Under CAMA, it is the duty of the directors to prepare the financial statements of the company and ensure that the statements include the information required under the. According to ISA, the CEO and chief financial officer must also certify the financial statements. The Code and the CAMA require that the audit committee ascertains whether accounting and reporting policies are in accordance with legal requirements.

393. **A number of (conflicting) requirements govern board objectivity and independence.** The SEC Code recommends that a board should have a mix of executive

and non-executive directors, and provides some basic independence requirements for non-executive directors (NEDs). The CBN Code prescribes that the board should be composed of more non-executive directors than executive directors and at least 2 executive directors must be independent, appointed by the bank on merit. In practice, a recent IFC survey indicated that banks do not adopt the same definition of “independent director” and 40 percent of boards do not include an independent director. In contrast, the SEC Code does not explicitly recommend the presence of “independent director” but mentions that the non-executive directors should bring independent judgment and be independent on the company for their income (except for their directors’ allowance and fee).

394. The SEC Code also recommends that the roles of Chairman and CEO be “ideally” separated, while the CBN Code mandates it for banks. In addition, two members of the same extended family should not occupy the position of chairman and that of CEO or executive director of a bank at the same time.

395. **The audit committee requirements in the law are non-standard and its value is unclear.** The CAMA mandates an audit committee, but it is not a true committee of the board – the audit committee consists of both directors and representatives of shareholders. This committee has significant responsibilities under the law and the codes. However, because of a reported lack of trust between the board and the appointed shareholder representatives, it is unclear if boards delegate responsibility to such a body, and its value is unclear. The process of appointing shareholder representatives is also unclear.

396. Some director training is being carried out. The Codes recommend / mandate training of board members. The FITC provides training for bank directors. The IOD provides a 2-day company direction course.

397. Some other board responsibilities are not fully in line with the requirements of the OECD Principles. A number of board responsibilities are not included in current law or good practice recommendations for listed companies (although they are sometimes included in the CBN Code):

- *Board self-evaluation.* The CBN and NAICOM Codes (but not the SEC Code) require that a performance appraisal or review should be carried out. This appraisal is not a self-evaluation but should be performed by an outside consultant (CBN §5.4). In the 2009 WB/IFC Survey of listed companies, 22.5% of the surveyed companies disclosed the company’s board evaluation procedure.
- *Board nomination.* Neither the law nor the SEC Code suggests the creation of a nomination committee for the selection of the board members, and companies are not required to disclose their nomination process.
- *Setting remuneration.* The law provides that the board fix the remuneration of the managing director only (although in practice, remuneration committees tend to fix the remuneration of all the executive directors). There do not appear to be any

recommendations to create a formal and transparent procedure for developing policy on executive remuneration, or for fixing the remuneration packages of individual directors, and there do not appear to be any provisions requiring that the level of remuneration should be sufficient to attract, retain and motivate directors.

- *Related party transactions.* There are no requirements to monitor related party transactions by the audit committee or the full board.

Enforcement

398. The SEC has placed significant emphasis on corporate governance reform. The SEC regulates the capital market. It registers securities and market intermediaries, oversees the exchange and trading system, investigates of alleged breaches of market laws and regulations and enforces sanctions. The SEC is now beginning to monitor compliance with the SEC Code, through a special half-yearly reporting process launched in 2008, but this report will not be disclosed to the market. The SEC is seen as relatively fair and balanced by market participants, although transparency could be improved – for example, there is no annual report or similar publication available on its website.

399. The SEC has significant enforcement power and authority, although enforcement actions remain relatively limited. The Administrative Proceedings Committee (APC) of the SEC adjudicates disputes. Findings of the APC are appealed to the Investment and Securities Tribunal (IST), set up for this purpose under the ISA. The appeal process is frequently used and decisions of the regulator have been reversed. Decisions taken by the APC have to be approved by the board of the SEC.

Some sample cases:

- The SEC compelled a shareholder in AP PLC to sell down and reduce its shareholding below the threshold for mandatory takeover bids;
- SEC issued a trading halt of the shares of Big Treat plc, AP plc and Capital Oil plc for unusual trading activity and share price movements;
- SEC suspended trading in the shares of Cadbury Nigeria plc for misstatement of its accounts.
- The SEC dissolved the board of Afroil Plc, and placed a five-year ban on its Managing Director, over the sale of the company's illegally warehoused shares.

400. Although the enforcement powers of the SEC are strong, its enforcement impact is difficult to measure because of a decline in the number of cases taken on by the APC. Based on data obtained from the SEC, over the period 2001 to 2005, there were 159 cases in the APC. This number has decreased to 3 cases over in 2006 – 2008.

401. **The CAC is responsible for the enforcement of company law.** The Registrar of Companies at the Corporate Affairs Commission (CAC) is responsible for enforcement of the CAMA and its reporting requirements. However, in practice the CAC does not have the capacity to fulfill this function. Although evidence tends to be anecdotal, reports indicate that many companies do not file their financial statements with the CAC, and that sanctions are not applied⁷⁵. The CAC is currently completing the task of scrubbing the registry of inactive companies, which will enable it to better enforce the rules in the future.

402. **The governance of the NSE has raised significant concerns.** The NSE is a self-regulatory body, and it monitors the compliance of listed companies with the listing requirements, including the financial reporting requirements. It is also responsible for policing the activities of its member/brokers. The NSE is owned by its member/brokers. As in all such structures, its incentives to enforce listing and membership rules are limited by the exchange's own interest in increasing the level of market activity and fees. Demutualization is planned for the near future.

403. The World Bank's review and informal discussions with market participants suggest that:

- The exchange is not very transparent – it is difficult, for example, to understand the governance structure of the exchange from publically available information.
- The exchange appears to have adopted conflicts of interest policies and procedures that leave it open to charges that it is not acting in the public interest. Examples include (a) the requirement that companies have their financial statements pre-vetted by the exchange, and (b) exchange management sitting on boards of listed companies.
- It is not always clear how the NSE and the SEC are sharing their regulatory responsibilities.

404. The enforcement of auditing and accounting standards is in its early stages. The NASB and ICAN are also self-regulatory bodies with the power to enforce standards. However, they appear to lack human and financial resources to do so.

Recommendations

405. Nigeria has undertaken a series of important reforms in recent years. However, the objectives of building a world-class financial system, increasing the capital market's international reputation, and meeting the goals of FSS2020 will all be furthered by additional aggressive corporate governance reform. The following section details policy recommendations that can address weaknesses in Nigeria's corporate governance and investor protection framework.

⁷⁵ ROSC Accounting and Auditing in Nigeria, 2004; Elewechi N. M. Okike, *Corporate Governance in Nigeria, the Status Quo*, March 2007.

High Impact Targeted Reforms

406. The following five recommendations are key steps that should be taken to correct significant weaknesses and send a message to international investors about the intent of Nigeria to push forward with the adoption of international standards and practices.

I Implement international accounting and auditing standards: NASB should work to immediately adopt international accounting and auditing standards for public interest entities (listed companies and financial institutions). Adoption would both send a strong signal to foreign investors, and would improve reporting for local stakeholders (particularly financial sector regulators).

II Improve the disclosure of ownership: The SEC and CBN should immediately focus on improving the disclosure of ownership. Ownership disclosure is a basic requirement for a strong governance framework. If ownership is not transparent, it is difficult to identify related parties, and (in the case of financial institutions) impossible to apply “fit and proper” tests. Addressing this problem will involve (a) reviewing annual reports and regulatory filings for compliance with disclosure regulations, (b) ensuring that regulators have adequate powers to require nominees to disclose beneficial owners, and (c) consider the implementation of a rule that would give the CBN and the SEC the power to cancel the voting rights of “anonymous” shares until the ownership of those shares is clarified.

III Improve the effectiveness of the SEC Code of Corporate Governance: The report recommends a number of enhancements to the SEC Code. But perhaps the most important step is to focus the attention of companies by moving towards a full implementation of “comply or explain”; companies should be required to explain any non-compliance. The reporting process developed by the SEC to track compliance should be used to track fraudulent responses.

IV Fix the audit committee: The law mandates an audit committee, but it is not a true committee of the board – the audit committee consists of both directors and representatives of shareholders. This committee has significant responsibilities under the law and the codes. However, because of a reported lack of trust between the board and the appointed shareholder representatives, boards may not delegate responsibility to the committee, and its value is unclear. The Companies Act should be amended in order to make all of the audit committee board representatives.

V Improve the governance of the key regulatory bodies: Governance reform of the NSE is a key step in building additional trust in the marketplace. As part of its ongoing governance reforms as it prepares for demutualization, the NSE should undertake a thoroughgoing review of its own governance policies. Demutualization will raise new governance challenges; overcoming them will require strong oversight from the SEC. As

in all companies, and institutions, governance reform should proceed along a number of basic steps:

- *Benchmark governance against the competition.* The NSE working with the SEC should carry out a detailed independent review of the governance of the NSE, including an evaluation of the functioning of the National Council. This review should include comparisons with governance structures and policies of exchanges in peer group countries (India, China, Brazil, South Africa, etc.), and make recommendations for improvements.
- *Update policies and procedures.* The exchange should update several key policies including (a) the conflicts of interest policy for its board and senior staff, (b) board nomination and appointment policies that include the appointment of representatives of stakeholders, and (c) disclosure policies.
- *Eventually: be a corporate governance leader in its own right.* Longer term, the exchange's new governance policy should include the adoption of the provisions of the SEC Code, full publication of audited financial accounts and annual reports, and independent board members.

407. The government should also consider reforming the governance of the SEC. The Presidential appointment system that has been established for Pencom and the DMO has resulted in strong and effective institutions.

Medium Term: Reforms to the legal and regulatory framework

408. The key laws and regulations governing corporate governance should be systematically updated and harmonized. The government should assemble a working group to review and assess the entire corporate governance legal framework. The framework should be finalized as part of a broad consultative process that serves both to incorporate relevant experience and to raise the awareness of Nigeria's investors on the new law and the importance of good corporate governance. A detailed set of recommended legal and regulatory reforms is discussed below.

409. Update the CAMA. A new CAMA should be drafted and passed into law. It should draw on experience from the recent updates of the UK and Australian companies acts. It should be fully harmonized with recent developments in the legal framework, improve shareholder rights, and raise the fines for non compliance.

410. As part of this process, the SEC should revise its corporate governance code, and work to harmonize the SEC Code with the CBN / NAICOM codes. A joint working group should be assembled to harmonize the provisions and requirements of the three codes. All the codes will be stronger (and better understood) if inconsistencies and conflicts were removed, and if they were strengthened to include additional elements of international good practice.

411. Update the ISA, SEC regulations, and the Listing Rules. The ISA, SEC regulations affecting corporate governance and the Listing Rules should also be updated, with three general goals:

- Implementing the full list of non-financial disclosures required by the OECD Principles.
- Moving disclosure regulations for listed companies from the listing rules to SEC regulation, in preparation for the demutualization of the exchange.
- Updating and clarifying the tender offer rules in the ISA.

Medium Term: Institutional reforms

412. **Adopt international accounting and audit standards.** The Financial Reporting Council Bill currently before the National Assembly should be enacted.

413. The NASB (or the new Financial Reporting Council) should move immediately towards full convergence of SAS with IAS/IFRS, full adoption of ISA without modifications, and mandatory observance of these standards by “public interest entities” (listed companies and regulated financial institutions). Separate, simpler standards for other (smaller) companies should also be promulgated. The audit of financial statements prepared by public interest entities should be carried out in accordance with ISA and other related IFAC-issued pronouncements, and ICAN’s Code of Ethics should be fully comparable with the IFAC Code of Ethics for Professional Accountants. FRC and ICAN should work to produce implementation guidelines and training programs to help the accounting and auditing profession to transition to IFRS.

414. The professional associations working with the FRC should prepare local implementation guidelines

415. **Training and capacity building for the SEC and its staff.** The SEC should provide training and capacity building for its staff, in the area of corporate governance. The SEC should also clarify and formalize its regulatory powers over the NSE. The SEC should assume responsibility for monitoring and enforcing disclosure requirements, and disclosure quality should become a primary focus. A short term priority should be the disclosure of information about ownership.

416. **Facilitate the on-going movement towards risk-based supervision.** The CBN and NAICOM should continue to build on their ability to monitor and evaluate the governance of Nigerian banks and insurance companies. Good corporate governance should be the first line of defense of financial sector supervisors. The on-going global financial crisis indicates the importance of focusing supervisory activities on those institutions with relatively weak boards and entrenched management.

417. **Strengthen the e-dividend process** The e-dividend procedure is a major step in the direction of shareholder interests, but recent reports of problems in IT security are troubling. The SEC and the CSCS should review procedures to minimize possibilities for fraud and identity theft.

418. **CSCS should continue its drive towards consolidation, dematerialization, and regulation of the registrar** The market will be well-served by the planned rationalization in the settlement and depository activities and a move to mandatory abandonment of paper based certificates (full mandatory dematerialization) for listed companies. The strategy should examine options for the integration of the registrars and the CSCS, including dividends and other corporate actions.

419. **Future revisions to the PenCom Code should address voting disclosure issues.** When the PenCom Code is revised, the working group should consider adding provisions on the disclosure of voting policies

Creditor Rights and Insolvency

An Overview of Nigeria's Current Practices

420. **Despite having a relatively well-developed legal and judicial system Nigeria's legal framework for the financial sector remains antiquated and unsophisticated.** The legal framework has not been updated for many years and does not providing adequate foundation for a modern financial system. It suffers from a number of weaknesses affecting many developing countries, such as antiquated concepts, absence of laws for new developments, non-consolidation of laws and overlap in laws. Furthermore, enforcement is a major issue.

421. **Financial institutions are overly reliant on real estate as collateral and recognize other security interests over movables to a much lesser degree.** Nigerian legislation provides for several security mechanisms and the Central Bank, through its regulations, prohibits unsecured lending practices by financial institutions. The mortgage over immovable assets is the security preferred by financial institutions. Such mortgages, however, are subject to delays in registration because of the need to obtain the Governor's Consent to the granting of a mortgage. It is unclear if this requirement serves any function other than to act as a means of taxation.

422. Mortgages are required to be registered at the Lands Registry of the state where the property of the collateralized immovable asset is registered and, in the case of a corporate borrower, also at the Companies Registry. The Land Registries are not interconnected with the Companies Registry and searching for details of security given is unreliable for many reasons. For example, the high costs involved in registering security are a major disincentive to accurate registration.

423. Many lenders, including major banks, rely on the so-called "equitable charge" whereby possession of the title deeds secures the lender, usually in connivance with the borrower to avoid the charges associated with the registration of the security. Where charges are registered, understating the sums involved is common-place with the lender relying on its ability to "up-stamp" the security before having rely on it in court.

424. **Efficient and effective legal mechanisms for debt resolution are urgently required.** The legal framework for creditor rights in Nigeria is considered deficient in a number of important areas, specifically with respect to the laws relating to insolvency and corporate reorganization. Improving this legal framework will foster commercial confidence and predictability by enabling markets to more accurately price, manage and resolve default risk. Financial institutions rely on effective creditor rights to reduce deterioration of asset values and generally promote credit access. In Nigeria, recognizable deficiencies in the legal framework supporting credit and creditor rights are marked by the antiquated and unsophisticated insolvency legislation, jurisdictional challenges and an inefficient judicial system, and a weak secured transactions regime.

425. For nations emerging into full market economies, such as Nigeria these systems are invaluable in attracting domestic and international investment. They also serve to establish a means for the efficient rehabilitation of potentially viable enterprises and the preservation of jobs. Where businesses are nonviable, enforcement and liquidation procedures offer a means to recycle assets in the local economy to more efficient market users. These systems are also essential to maintaining appropriate checks and balances in commercial relationships through incentives that encourage responsible corporate behavior and governance and through disincentives that penalize management and owners who lack financial discipline or behave irresponsibly.

426. **Nigeria lacks the insolvency and security enforcement systems that are required by a modern, credit-based economy.** The insolvency and security enforcement systems must be supported by a legal framework that provides for the creation of security interests in all types of property; movable and immovable, tangible and intangible, present and future, and on a global basis, by all types of borrowers in favor of all manner of lenders and providers of credit.

427. In turn, the effectiveness of such a framework is predicated upon straightforward, inexpensive security registration mechanisms, the predictable, swift and affordable enforcement of secured claims without the requirement for insolvency procedures; and a sound insolvency system that provides an orderly, efficient and equitable debt collection mechanism for failed or failing enterprises. When these elements are in place, borrowers are able to gain broad access to credit on more favorable terms, lenders and providers of credit are able to reach informed credit decisions based on more accurate assessments of the risk inherent in the underlying transaction, and financial discipline is generally instilled in market participants.

428. As pointed out, in Nigeria the insolvency and security enforcement systems are considered inefficient, time-consuming, expensive and discriminately favorable to the debtor. Furthermore, there is little effective law to prevent the dismemberment of the debtor's estate. The absence of effective provisions for reorganization proceedings in Nigeria is indicative of the deficiency of the legal framework.

429. Insolvency systems, like general systems for debt recovery and enforcement, stabilize commercial relationships by enabling market participants to more accurately price, manage and control risks of default and corporate failure. Insolvency procedures offer a means for collective resolutions when the threat of financial failure raises questions about that enterprise's viability and, therefore, its ability to continue into the future. Consequently, an insolvency system plays a vital role in maintaining commercial and market confidence and in stabilizing the financial system, serving as a disciplinary mechanism for both the financial and corporate sectors. Effective insolvency processes encourage prudent lending and a sound credit culture by:

- establishing mechanisms for the financial restructuring of firms whose going-concern value exceeds their liquidation value, thus preserving both value and employment;
- providing an orderly exit mechanism for failed enterprises;
- ending the unproductive use of potentially valuable business assets and transferring them through a liquidation process to more efficient market participants;
- providing a final and equitable debt collection mechanism for creditors;
- improving the enforcement of creditor rights to expand credit flows; and
- providing a transparent mechanism for the exercise of sanctions against those guilty of wrongful trading and other insolvency related offences.

430. **There is widespread disregard for the effectiveness of the insolvency system in Nigeria.** The legislation is so old and poorly written that it is almost ineffectual in terms of sanctions against the directors of failed companies. There are no provisions for the disqualification of directors for simple mismanagement or personal liability for wrongful trading. This results in directors of companies faced with the threat of insolvency proceedings being able to transfer such assets as remain to other entities contrary to the interests of creditors.

431. **The Table below provides statistics on how frequently insolvency procedures are used in Nigeria.** These statistics illustrate that the present procedures are rarely used when compared with the number of new companies being formed.

Table 16 Number of Insolvency Cases compared with Company Registrations

	2002	2003	2004	2005	2006	2007 (Jan -Apr)	Total
COMPANIES REGISTERED	30,608	31,656	23,198	29,045	34,718	N/A	149,225
CHARGES REGISTERED	998	1256	1150	928	890	N/A	5222
MEMBERS' LIQUIDATIONS	N/A	7	12	27	20	12	78
CREDITORS' LIQUIDATIONS (VOLUNTARY)	N/A	NIL	NIL	NIL	NIL	NIL	NIL
COMPULSORY LIQUIDATIONS	N/A	2	1	14	2	1	20
RECEIVERSHIPS	44	22	48	80	62	N/A	256

Source: Data provided by the Department for Public Affairs, Corporate Affairs Commission on 11th May 2007

432. **There is no system of credit referencing in Nigeria.** This is an obstacle to the development of Nigeria as a credit-based society. Most other societies that have emerged into fully functioning market economies have benefited from a growth in consumer credit which is only possible with systems that permit providers of credit to manage the risk involved. This will frequently involve systems of establishing national identity, such as passports and national identity cards.

Creditor Rights and Enforcement Procedures

433. **Financial institutions are required to rely on collateral for lending** as unsecured lending by Nigerian banks is not permitted by statute⁷⁶. Most financial institutions only make loans or overdrafts available to Nigerian borrowers against the security of real estate, notwithstanding the difficulties experienced in its realization (see below). With the exception of the register of companies' charges maintained by the Corporate Affairs Commission, there is neither omnibus law providing for the registry of immovable assets in Nigeria nor any dependable method of establishing what, if any, charges exist over such assets. While each state and the central government are expected to have their own land registries for the registration of all interests and charges in respect of land, the absence of a national land registry system is a serious deficiency.

434. The main criticism of this process has to do with the stamp duty and filing fees for registration of mortgages and the statutory requirement to obtain 'Governor's Consent' to any transaction including the taking of security with its attendant considerable costs and delays. As a result, there is widespread practice of taking but not registering security over land, especially where borrowing was intended to be relatively short term, in order to avoid the costs of registration. This results in land registries being inaccurate and of little use to lenders seeking to establish the credit-worthiness of potential borrowers.

435. **The enforcement of security and of pursuing unsecured claims in Nigeria is expensive, time-consuming and prone to delay tactics.** Foreclosure and receivership are typically met or even anticipated by litigation by the debtor aimed at preventing the exercise of the security. Practices that would almost certainly be deemed an abuse of process in similar jurisdictions are tolerated by the Nigerian courts. There have been a number of cases in which courts have shown what bankers feel is a disproportionate sympathy for the borrowers and a variety of delay tactics are adopted by the legal profession regardless of the merits of the defense. In the course of such delays, any equity in the assets securing the borrowing is depleted. As a result, both secured and unsecured creditors resort to enforcement mechanisms not requiring the supervision of administrative or judicial authorities. Undoubtedly the inefficiency in recovery of secured lending adds to the cost of lending across the market.

436. **The laws relating to security over movables are antiquated, fragmented and fail to offer Nigerian businesses effective means of raising capital on the security of these assets.** The Bills of Sale Act is outdated legislation and therefore relatively

⁷⁶ The Banks and Other Financial Institutions Act LFN 2004.

inefficient. Apart from the antiquated registration procedure, the key weakness relates to the documentary requirements. As a result, the practice of asset-based lending utilizing movable business assets as security has not yet developed in Nigeria and there is a lack of evolution in more sophisticated financial transactions such as securitizations and derivative transactions to hedge interest rate and currency risk. While there is a workable system of registering floating charges over the assets of companies at the Corporate Affairs Commission, the practice of understating the value of such security for the purpose of avoiding or delaying the payment of the filing fees involved, renders such records of little value⁷⁷. Contrary to the legislation, late registration of such security is tolerated by the authorities.

437. Any protection that is offered by legislation such as the Dishonoured Cheques Act is negated by a failure of the courts to enforce it. It is suggested by many lenders that the failure to enforce the Dishonoured Cheques Act is a result of political interference, however, there is no doubt that this legislation is potentially beneficial.

438. Although the Companies and Allied Matters Act sets out the priority of claims, secured creditors prefer not to participate in the liquidation process but to enforce their security through out-of-court procedures. A creditor secured by a fixed legal charge generally has the right to foreclose on the secured asset or appoint a receiver to manage any interest in the secured property. Banks exercise these extra-judicial powers instead of exploring opportunities for rehabilitation or revival of viable businesses.

Legal Framework for Corporate Insolvency

439. In the area of corporate insolvency, the legislation is old and in need of urgent reform. The current companies winding up legislation in the Companies and Allied Matters Act (CAMA) is based on the United Kingdom's Companies Act 1948, but several reforms in the UK since then have not been implemented in Nigeria. The insolvency regime for individuals and partnerships is based on the Bankruptcy Act which dates back to the 1880s. Several aspects of companies insolvency legislation, such as the rules pertaining to fraudulent trading and the agreement of creditors' claims, are imputed to the companies legislation from the bankruptcy laws. The winding up procedure in CAMA can be in court (compulsory liquidation); under the supervision of the court; or out of court (Creditors' Voluntary Liquidation for insolvent companies and Members' Voluntary Liquidation for solvent companies). The relatively low experience of many bankers, lawyers and even judges in insolvency proceedings under CAMA is a reflection of the low regard that the Nigerian business and commercial community has for the usefulness of the present system.

⁷⁷ By any standards, these fees, which are based on the value of the security being registered, are considerable.

440. **From the point of view of a creditor, the law does not offer any credible threat to a recalcitrant debtor.** The delays that are possible through the court-driven procedures deter creditors from using them. It is commonplace for debtors to challenge the creditor's notice of demand or seek injunctive relief against the creditor on spurious grounds such as abuse of human rights. Also as an indicator of the attitude and usefulness of the insolvency process to creditors, it appears that the Nigerian Revenue rarely threaten insolvency proceedings against non-payers.

441. **The provisions for Schemes of Arrangement or compromise do not provide a workable method of corporate reorganization.** The present system does not incorporate any modern or efficient means by which a financially troubled debtor, individual, partnership or limited liability company can seek to rearrange their affairs and preserve a potentially profitable entity. The Scheme of Arrangement procedure in the case of companies is cumbersome, costly and was seldom used in the UK other than in connection with take-overs and mergers to modify shareholder positions. Its use in Nigeria is virtually unheard of.

442. **Insolvency proceedings, whether commenced by the debtor or by any one of its creditors, does not seek to maximize the value of the debtor's estate.** Because the law is so negative in its options, there is no procedure to prevent the premature dismemberment of the debtor's estate and creditors rarely derive any benefit from liquidation proceedings. Creditors are therefore reluctant to participate in creditors' committees or take any part in the insolvency process.

443. **Mortgagees and secured creditors are unable to enforce their security once insolvency proceedings have been commenced.** Despite the absence of any meaningful method of reorganizing a debtor's affairs, a creditor with a fixed charge over property is effectively prevented from taking any steps to enforce the security once insolvency proceedings have been commenced, leaving the secured property to be sold by the liquidator.

444. **In the absence of any workable procedure for the reorganization of debts between a financially troubled debtor and its creditors, the only procedure that has the effect of preserving a business is receivership.** Under the receivership provisions, a bank holding a debenture containing a floating charge may appoint a receiver with the power to sell all the assets of a business as a going concern. This can, at least in theory, have the effect of preserving businesses and thereby employment but it seldom serves the needs of unsecured creditors. In practice, largely because of the litigious approach of Nigerian debtors, banks appoint receivers only to recover debt when there is little prospect of the business being saved.

445. **The fraudulent trading provisions which should enable a liquidator to reconstitute the estate and set aside transactions against the interests of creditors are rarely, if ever, implemented.** Although there are provisions permitting a liquidator to set aside various transactions detrimental to the creditors, there is little evidence of

these provisions ever being used. As a result, asset stripping of financially troubled companies in Nigeria is common-place.

446. **The fraudulent trading provisions in the law carry too high a burden of proof to offer any credible threat to directors** who continue trading beyond the point then they knew or ought to have known that the company could not avoid insolvent liquidation. The insolvency laws contain no sufficient sanction against such directors which would impose financial liability on these directors to compensate the creditors affected by their decision to continue trading.

447. **There is insufficient incentive in the insolvency law for directors to commence reorganization proceedings.** Even if there was provision for a workable reorganization procedure, preferably capable of binding secured creditors subject to their protection against loss while the opportunity to reorganize the debtor's affairs was explored, there is little incentive for the debtor or its directors to use such a procedure. This does not encourage good corporate governance.

448. **There is no requirement for insolvency practitioners to be qualified, licensed, bonded or regulated.** This is unsatisfactory in a system which places a high reliance on the capability and integrity of practitioners and, while many major matters are handled by practitioners from the major accounting practices, some creditors appoint their own staff or use unqualified, unregulated practitioners.

Regulatory Framework for Creditor Rights and Insolvency

449. **There are frequently cases involving the same parties in different courts leading to further delays, expense and judicial inefficiency** – and despite the limited provisions for the transfer of cases from Federal to State courts and vice versa. Any judge of the Federal High Court can hear matters in bankruptcy or companies winding up. Although the Federal High Court has exclusive jurisdiction to hear matters dealing with banking and insolvency issues, the same court cannot adjudicate disputes between a bank and its customers. The latter falls squarely into the exclusive jurisdiction of the State High Courts.

450. **The Nigerian courts are under-resourced and overburdened and this affects their ability to adequately serve the financial community.** There are substantial delays in all litigation in Nigeria which does nothing to preserve what little asset value remains for creditors. This, and the inclination of the courts to tolerate extensive delay tactics, is a major deterrent to the use of the court system in Nigeria. Attempts to reduce the court backlog in Lagos by introducing a 'front-loaded' discovery procedure has had limited success but has not stopped the continued abusive practices of the local legal profession.

451. **Nigeria has developed firm rules to eliminate corruption in the judicial system.** While there are still occasional reports of minor corruption, substantial progress

has clearly been made. However, as yet there is no supervisory body responsible for regulating the conduct of Official Receivers and liquidators. There is limited continuing education for judges and few exchange visits are arranged with other judiciaries.

Credit Risk Management/Informal Workouts

452. **There has been no progress in establishing a credit reporting system in Nigeria.** Without access to reliable information on the financial condition of a debtor, a creditor is unable to properly assess the credit risk that it would assume in the context of the proposed debtor or transaction. In the absence of reliable financial information, a creditor is likely to limit the amount of credit by relying only on the value of security available.

453. **Despite the shortcomings of the formal insolvency system, the only informal procedures involve the rescheduling of bank debt.** With the exception of bilateral debt rescheduling between a banker and its customer, there is no practice of informal workouts to compensate for the lack of reorganization procedures in the insolvency law. There is no concept of a “pre-packaged plan” in Nigeria.

Developments

454. **While there is acceptance that the insolvency legislation is in need of complete overhaul and reform, there is no proposal to proceed with such reform with any urgency.** The greatest fear is that the existing system could be the subject of low level modification rather than a complete overhaul.

455. **The Corporate Affairs Commission has made considerable progress in developing the system of registering corporate entities.** This resource requires further development before it adequately serves the business community of Nigeria. It also requires enforcement of the existing legislation for its records to be reliable.

456. **The insolvency profession is developing its own professional body (BRIPAN) aimed at improving the skills, resources and reputation of the insolvency profession of Nigeria.** This will require considerable investment and support by the introduction of minimum standards of professional competence to act as an insolvency practitioner.

Summary of Findings and Conclusions

457. **The secured transactions regime is capable of improvement by centralizing the land registries and making that information available on-line. There are also considerable shortcomings in the manner of its operation and in matters of enforcement.** Priority should be placed on the following:

- **Registration of securities.** The requirement of Governor's Consent and the high registration fees and stamp duties are a disincentive to granting security and encourage reliance on unregistered security and 'upstamping'.
- **Charges over movables.** The Bills of Sale regime is antiquated and requires overhaul.
- **Enforcement procedures.** Enforcement proceedings are lengthy, costly and uncertain for all parties. Secured creditors do not feel that they will get swift, cost-efficient treatment in the courts or that they will be able to reliably enforce security in the event of default.

458. **The laws relating to insolvency and reorganization of businesses are antiquated and in need of complete overhaul and reform.** The principal considerations with respect to insolvency law are as follows:

- **Creditors' rights.** The provisions of the current law do not return value to creditors who, as a result, are reluctant to use it. It is telling that not even the Nigerian Revenue use the provisions of the insolvency law as a rule to enforce payment by recalcitrant debtors.
- **Debtors' relief from creditor pressure.** The overall objective of the Nigerian law is punitive and there is no incentive for a debtor to commence proceedings to escape undue creditor pressure.
- **Director and officer liability.** There is nothing in the insolvency legislation that imposes any financial penalty on a director for continuing to trade while insolvent.
- **Fraudulent trading.** The existing provisions do not deter asset-stripping from financially troubled companies and should be replaced with more modern, workable provisions.
- **Insolvency practitioners.** There is no requirement for insolvency practitioners appointed to act as Trustee or Liquidator to be qualified, licensed or regulated. This is inadequate in a system that places heavy reliance on the impartiality, competence and integrity of the insolvency practitioners. There is also no supervision of these practitioners.

459. **The institutional and regulatory framework for creditors' rights and insolvency matters is failing in its support for the financial community due to the unacceptable delays and subsequent cost consequences.**

- **Role of courts.** While, like most common law jurisdictions, Nigeria does not have a specialized bankruptcy court, the judges must deal with a complete

spectrum of matters and, as a consequence, do not have enough experience in insolvency matters.

- **Judicial resources.** The Courts do not have enough resources, but the tolerance of extensive delay tactics by recalcitrant debtors also adds to the delays from which the system suffers.
- **Credit risks.** Effective tools and techniques for credit risk management and credit information collecting, collating and sharing are not used.

Policy Recommendations

460. **Extensive and urgent measures are required to be taken to strengthen the creditor rights and insolvency regimes in Nigeria**, embracing both the legal and institutional frameworks.

Creditor rights and enforcement

- Consistent with recommendations in other documents, including the Bank's own Micro, Small and Medium Enterprise Project for the Republic of Nigeria, methods of registering security over movables and immovables should be reviewed to simplify and accelerate processes. Registries must be made reliable and the entire system of taking, registering and enforcing security must be made dependable and cost-effective.
- The *Central Bank of Nigeria Act* (as amended, 2007) empowers the CBN to license and regulate credit bureaus. At present two credit bureaus have been licensed and a third has received approval-in-principle. More are expected to be licensed and come into the market in the future. Nonetheless, the present coverage of existing public credit information is severely limited and ignores vast sectors of the market, leaving these sectors with inadequate access to credit.
- The Dishonoured Cheques Act should be made workable, possibly by a revision with a new starting date and an implicit or actual 'amnesty' or acceptance that there were 'operational issues' with the prosecution of offences up to a date in the recent past. This will require support from the highest level if it is to have credibility and there must be an acceptance that it applies to all sectors of society.
- Methods of enforcing the rights of unsecured creditors and of security should be simplified with the court procedures made more accessible, timely and cost-efficient to encourage their use.

Insolvency legislation

- There is an urgent need for all-encompassing reform of the insolvency and corporate reorganization laws in Nigeria. The reform should be based on revisions to the laws of countries with similar legal traditions such as the United Kingdom and by the work of UNCITRAL⁷⁸.
- Workable reorganization procedures must be introduced in such a reformed law to offer an opportunity to directors of financially troubled companies to reorganize their affairs without the need for court involvement or the costs and delays encountered therein.
- Such provisions should allow for the ability, where it is in the interests of the creditors as a whole, to restrain a secured creditor from realizing on their security for an interim period on terms that provide adequate protection for the secured creditor.
- Insolvency procedures must offer a real threat to recalcitrant debtors to be of value to creditors. The fraudulent trading provisions should be replaced by the concept of wrongful trading as in force in the UK, including provision for directors and others to be made personally liable for losses suffered by creditors.
- The provisions of the UNCITRAL Model Law on Cross-Border Insolvency should be incorporated.

Regulatory framework

- The court system requires an overhaul to simplify the hearings of connected matters and to accelerate the delivery of judicial decisions.
- Comprehensive provisions should be introduced for the qualification, licensing and regulation of insolvency practitioners.

Informal corporate restructurings

- The reforms of the insolvency law should include methods by which a pre-packaged informal workout could be, if necessary, converted to a formal restructuring in order to bind dissenting minorities.

⁷⁸ United Nations Commission on International Trade Law Legislative Guide on Insolvency Law adopted 2004.

The Payments System

Aspirations towards reform

461. **The Nigerian authorities have defined a set of strategies to implement a long-term vision for the financial sector.** Towards this end, the Central Bank of Nigeria (CBN) has embarked on comprehensive reforms of the national payment system in line with international standards and best practices. CBN has recognized that certain payments system improvements will not take place without its leadership. Consequently, the reforms are being pursued in line with the framework of the FSS2020 strategy, a comprehensive long-term strategic plan for the development of the financial sector. The vision of the Nigerian authorities is to create an electronic payments infrastructure that is nationally utilized and internationally recognized as being world class.

462. The payment system strategy seeks to promote confidence in, and usage of, electronic payment instruments that are safe and encourages interoperability and straight-through-processing to minimize costs, errors and fraud on an end-to-end basis.

463. **Towards this end, the CBN has reconstituted the National Payments System Council (NPSC) and its technical sub-committees as a forum for high level representation of the key stakeholder groups.** The committees and working groups comprise persons who have full-time jobs in the private sector or in the CBN, and who are therefore unable to dedicate the time to the project. Work has proceeded more slowly than expected. The work is expected incorporate the following objectives:

- Achieving high quality, reliable, and affordable payment transfer
- Supporting increased confidence in the banking system.
- Achieving greater use of banking services in all geographic locations.
- Reducing Nigerians' dependency on cash and checks.
- Supporting a sound and well functioning interbank money market. Make mobile payment services available to promote the wider use of banking services and to increase access to microfinance services and stimulate economic development.

Overview of Payment and Securities Settlement Systems in Nigeria

435 **Relative to its peers, Nigeria's payments system is very paper-based.** The main payment instruments available in Nigeria include large-value credit transfers, checks, retail electronic debit and credit transfers, and payment card systems, among others. Electronic purses (a form of stored value cards), internet-based banking along with mobile payment services have recently been introduced. The CBN in 2006–07 commissioned a real-time gross settlement (RTGS) system which it owns and operates.

436 Nigeria relies heavily on cash for payments. Checks are used for wholesale and retail payments and currently account for over 90 percent of non-cash payments in

Nigeria. Less than 1 percent of non-cash payments are made using cards. In the area of payment cards, there are three private switch operators that are not interoperable. In this regard, the CBN is spearheading the implementation of a central switch to achieve interoperability for the card-based systems in Nigeria.

437 Currently, an estimated 7,000 point of sale (POS) terminals are deployed in the country, a ratio of 50 POS terminal per 1 million persons. This is extremely low compared to other countries in Africa: 130 POS terminals per 1 million inhabitants in Zimbabwe, 350 in Egypt, 500 in Morocco and close to 14,000 in South Africa.

438 **The private sector has provided much of the initiative for payment systems improvements, focusing mainly on the retail systems** with the implementation of an Automated Clearing House (ACH) for checks, direct debit and credit transfers. The ACH, which is owned and operated by Nigerian Inter Bank Settlement System (NIBSS), facilitates the electronic clearing and settlement of local checks on a multilateral net basis, with physical exchange of items occurring subsequently.

439 **Commercial banks record that international remittances through formal channels amounted to about US\$4.2 billion (7 percent of GDP) in 2006** – through 700,000 transactions, an increase of 30 percent over 2005. However, informal remittance flows into Nigeria are thought to be large, with much hand carrying of cash. Including informal transfers, total remittance inflows might be as large as US\$10 billion.

440 **In terms of geographical coverage, disbursement of remittances is restricted to bank branches.** This means that some recipients have to travel long distances to collect their money. About 35 percent of bank branches are in Lagos and Abuja.⁷⁹ The previous requirement that only banks serve as agents of remittance companies, coupled with the imposition of exclusivity contracts by international money transfer operators, resulted in a near monopolistic situation, with high commission rates. This provides an incentive for people to transfer cash using informal channels. Western Union charges approximately 7 percent of the principal sum to send money to Nigeria. This is significantly more than in other large markets where a competitive situation has developed. In the Mexico–US corridor, for example, where many players compete, the average cost is between 3 and 4 percent of sum transferred. It is expected that this percentage will fall dramatically as a result of a change in the CBN guidelines on money transfer operators which disallows exclusivity arrangements between money transfer operators and banks.

The Legal and Regulatory Framework

⁷⁹ Orozco, Manuel and Bryanna Millis, “Remittances, Competition and Fair Financial Access Opportunities in Nigeria.” USAID, October, 2007.

441 **The Nigerian authorities and stakeholders recognize the importance of establishing an appropriate legal framework that supports a sound and efficient payment and settlement system.** They have indicated their intention to adopt relevant payments system legislation. A new Act is to be drafted and will provide the legislative framework for the regulation and operation of the payments system. It will address issues such as insolvency and contractual relations between parties, custodial and consumer rights, laws and regulations on electronic signature, validation of netting and settlement finality. It will also vest statutory responsibility for oversight of the payment and securities settlement systems in the CBN and include provisions that satisfy the legal and regulatory requirements for electronic banking. Also, since the payments system includes participants incorporated in foreign jurisdictions and will ultimately operate with multiple currencies and across borders, it will be necessary for the law to address issues associated with foreign jurisdictions.

Large-Value Payment Systems

442 **Nigeria's RTGS system was implemented with the primary aim of reducing risk and enhancing efficiency in the payment systems.** Although a systemically important payment system, the RTGS system does not currently meet international standards relating to the provision and repayment of intraday liquidity on an automated basis. Currently, processes are manual and administratively burdensome. Intraday credit entries, once booked are not always reversed in a timely way thereby compromising monetary policy. In addition, the integration between the banks' internal banking systems and the RTGS system has not yet been implemented and straight-through-processing is therefore not achievable. Banks are unable to promote RTGS use for third party payments as, without the necessarily inconnectivity they lack the capacity to process large volumes through the RTGS system. The RTGS system is also not effectively linked to the CSCS's electronic depository for securities.

443 One of the consequences of the foregoing is that checks remain the primary payment means for large-value payments, including settling securities trades. Moreover, overall check usage continues to expand, despite the existence of the RTGS system. For the first 6 months of 2007, check usage increased by N2.6 trillion, compared with an increase of N13.4 billion for the RTGS system.

Retail Payment Systems

444 **Checks are used for wholesale as well as retail payments and currently account for over 90 percent of non-cash payments.** By comparison, checks account for 12 percent of non-cash payments in Brazil.

445 The ACH, which is owned and operated by NIBSS, facilitates the electronic clearing and settlement of local checks and direct debit and credit transfers. However,

the existing rules do not adequately delineate the rights, responsibilities, and obligations of participants, including customers, in the use of these instruments.

446 The use of payment cards in Nigeria and by Nigerians abroad is constrained by the perception of corruption and a generalized fear of fraud, misuse, or loss. It is reported that the international card issuers (Visa and MasterCard in particular) often block, or refuse to pay even genuine transactions as a precautionary measure against misuse. Both VISA and MasterCard operators in Nigeria are moving to more secure technologies, and, in particular, are replacing or combining magnetic stripe with CHIP technology in new cards. In this context it will be important to strike an appropriate balance between cost (of the cards) and risk.

447 There are three private switch operators in Nigeria that are not interoperable. Currently banks compete on the branding and deployment of ATMs. They acknowledge that the non-collaborative and competitive approach they now take to the deployment of ATMs results in a less than optimal distribution of machines and is not cost-effective.

448 In this regard, the CBN, jointly with the banks, is currently implementing a central switch, which will be operated by the NIBSS, to achieve interoperability among all the card-based systems in Nigeria. Such interoperability is a critical prerequisite for the effective distribution of ATMs and POS terminals throughout the country. Currently multiple ATMs are positioned side by side in some locations while many are not served at all. This initiative will also facilitate the harmonization of standards and protocols for card-based payment systems in Nigeria to address perceptions of fraud and misuse locally and abroad.

The Nigerian authorities embrace the transformational potential of mobile technology. Like most emerging economies, the Nigerian authorities' interest in mobile transactions is driven by widespread and growing access to mobile phones, lack of ready access to financial services and rapid growth in inflows of remittances from overseas. In this regard, challenges will come from devising an effective regulatory framework to address issues such as remote customer registration, fraud, and money laundering, and finding viable, scalable commercial models that work where disposable income is low.

Securities Settlement Systems

449 The secondary market for government securities has recorded significant growth over the past years and now averages an estimated N6 trillion annually. The CSCS reports average daily bond trades of N25 to N30 billion through the existing securities depository. Trades are done over-the-counter with cash settlement mainly by check. The Money Market Dealers Association and CSCS are jointly implementing a trading platform for government securities, even while the DMO is reported to be moving towards the implementation of a new trading platform.

450 **Securities settlement systems are an integral part of the national payment system and are critical to the effective functioning and development of the capital market.** If Nigeria is to develop an optimal payments infrastructure, it will be important that efforts are directed towards integrating the interbank payment system and the securities settlement system. Equally, integration with the interbank money market is critical in an environment in which large value payments are settled in a gross system as higher levels of liquidity are then needed. Currently, the CBN acts as registrar for government securities while the CSCS operates the central securities depository.

CBN Role in Payment and Settlement Systems

464. **Currently, the CBN oversight and operational role is not clear given the demands arising from financial sector developments.** There is no dedicated payment system department. The existing oversight activities are focused on ensuring that the systems are safe and efficient need strengthening. In addition, the elements for the establishment of the oversight function have not been fully articulated in the reform strategy.

465. The CBN has reconstituted the National Payments System Council (NPSC) and its technical sub-committees as a forum for high level representation of the key stakeholder groups. The committees and working groups comprise persons who have full-time jobs in the private sector or in the CBN, and who are therefore unable to dedicate the time to the project. Work has proceeded more slowly than expected.

Conclusions and Next Steps

Aspirations towards reform

- Emphasize access and payment system governance issues in the reform strategy and specify some of the main principles and requirements in these areas. The strategy should also specify the elements for the establishment of the oversight function
- Strengthen the mandate of the NPSC. Issue a clear mandate through the CBN to affirm the roles of the NPSC to enable it effectively engage in the relevant activities and effectively manage projects through to implementation
- Review and streamline the mandate, composition, organization and activities of the NPSC working groups. The establishment of separate working groups for each payment purpose creates redundancies and overlaps, and requires the use of greater resources. Some of the payment purposes could be made with the same electronic payment instrument – direct debit, credit transfer, check or card. Accordingly, the working groups could be streamlined according to payment instrument.
- Engage the services of a full-time project manager to coordinate project activities

and manage project implementation through to completion. Working group efforts should be focused on ensuring that suitable systems, rules and operating procedures be put in place for each instrument – direct debit, direct credit or credit transfers, checks and cards – through the establishment and documentation of a comprehensive set of ACH rules

- Expand the scope of the ACH rules beyond checks. The ACH rules are important in formalizing the relationships of all participants in a payment system. They define the specific functionality for the instrument and describe the operational procedures and processes to be observed by banks and other participants. Once these rules are developed and published, customers will know the requirements and standards to which banks must be held, for instance the timeframe within which certain action must be finalized.

Strengthening the legal and regulatory framework

- Update the law relating to payment systems and develop an appropriate regulatory framework for retail payment systems (such as mobile-based products and remittance services) that fosters market growth and encourages new entrants and innovation.
- Key aspects of the payments and settlement process that require legal support include: enforceability of transactions; protection of customer assets (particularly against insolvency of custodians); immobilization or dematerialization of securities; validity of netting arrangements; the holding, transfer, pledging, and lending of securities (including repurchase agreements and other economically equivalent transactions); finality of settlement; arrangements for achieving delivery versus payment; default rules; liquidation of assets pledged or transferred as collateral; and protection of the interests of beneficial owners

Large value payment systems

- Undertake a feasibility study and upgrade functionality of the RTGS system consistent with best practice and standard RTGS functionality.
- Key aspects of the upgrade that require technical feasibility assessment include:
 - Straight through processing connectivity with banks' systems that allow efficient processing of third party payments;
 - Automated processes at the CBN for intraday liquidity management and intraday lending;
 - Multi-currency functionality and interfaces with the regional payment system to be developed for the West Africa Monetary Zone for cross-border payments; and
 - Linkage with a central securities depository for the settlement of securities market transactions on a delivery versus payment basis.

Retail payment systems

- Develop a clear strategy to promote wide spread use of retail electronic payment instruments and reduce the importance of checks. In this way, encourage banks to continue to collaborate to improve the interoperability of switching platforms and rationalize the deployment of ATM and POS terminals throughout the country. Towards this end, the CBN should engage the services of a technical expert to provide advice regarding the appropriate standards and protocols required for card-based payment systems in Nigeria, consistent with the CBN's objective of safety, efficiency, access and interoperability in the payment systems.
- Promote development and use of mobile payment systems. Mobile payment services are a nascent industry in Nigeria. In other jurisdictions, mobile technology has demonstrated its potential to reach the rural unbanked with banking and payment services. The success of mobile payment services requires cross-industry cooperation and will depend on the wholesale arrangements between mobile operators and financial services providers and the retail distribution network which services the customers. The main issues that must be addressed include interoperability, security, convenience, pricing and the regulatory framework. These are the key factors in developing viable business models for mobile payment services and achieving critical mass across networks.
- Review the ACH rules with a view to developing comprehensive rules setting out the rights, responsibilities and obligations of all participants. In particular, this should include standardisation of the settlement cycle for local checks to achieve same-day interbank settlement, leveraging of the local check clearing infrastructure for foreign checks and imposing a limit on high-value checks in the ACH consistent with a strategy to promote use of electronic payment instruments. This will also strengthen the safety and efficiency of the payment systems because funds will be immediately available and transaction values and risk in the check clearing system will be significantly reduced. This exercise should be undertaken together with a public education program to discourage the use of checks for large value payments
- Develop an appropriate regulatory environment for retail payments that fosters market growth and encourages new entrants and innovation in development of payment instruments and services, while ensuring that risks are adequately mitigated. For mobile payments and remittances, in particular, it is important that the rules be balanced and appropriate, not so tight as to hinder innovation and adoption, or so lax as to open the door for fraud. Some of the regulatory concerns, particularly regarding risk mitigation, can be addressed by placing limits on transaction size, although in the longer run this may not be sustainable for mobile operators and could conceivably limit their operations to an inefficiently small scale.

Securities Settlement Systems

- It is desirable that the CBN takes a leadership role in the reform process of the securities settlement systems in Nigeria. In particular, CBN should explicitly incorporate issues related to the securities settlement system in the national payment system strategy and oversee and coordinate with the dealers and other stakeholders on the system upgrade and integration project for the securities trading, clearing and settlement system.
- As overseers of the upgrade project, the CBN will need to ensure that the project results in a system for clearing and settlement of capital and money market transactions that enables market participants to exchange securities and liquidity safely and promptly by merging the depository and registrar functions in an electronic securities depository. In addition, both the RTGS system and trading platform, when implemented, should be linked to the securities depository to support efficient trade initiation and the settlement of securities market transactions on a delivery-versus-payment basis.
- The foregoing notwithstanding, it will be necessary for the CBN to undertake an assessment of the CSCS depository's capability and determine whether the governance and operational arrangements are adequate and comply with the relevant international standards (the CPSS-IOSCO recommendations for securities settlement systems) and whether a new depository or other new arrangements are needed.

CBN role in payment systems

- CBN should undertake a review of its organisational capacity with a view to strengthening its ability to effectively carryout payment system oversight responsibilities consistent with international best practice and market developments.
- In this regard, an oversight policy needs to be developed and documented. It is important that discussions on the payments systems policy document occur both within the CBN and the National Payments System Council. This activity is aimed at validating the approach and communicating to market participants the Bank's specific objectives and approach.
- To support and facilitate the reforms and the needed system upgrades, it is desirable that the activities of the oversight function be organized along the major system types: large value payment systems, securities settlement systems, and retail payment systems. Oversight of remittances could be included within the last category, as this can appropriately be seen as a retail payment issue.
- Furthermore, the oversight function will require appropriate and adequate human and financial resources. At a minimum, there need for statistical and analytical skills of economists, legal, information technology, and risk management specialists. Appropriate training of personnel within the oversight unit will be necessary through regional and international forums and arranged visits to selected central banks and payment systems abroad. The unit will also need to

establish effective cooperation arrangements, including information sharing with other departments in the CBN and outside. Accordingly, it will be necessary for the CBN’s executive management to approve an appropriate restructuring, recruitment, and training to effectively carry out the oversight function.

- CBN should consider conducting educational campaigns to generally promote financial literacy and specifically raise awareness on the benefits of electronic payment services and enhance the understanding by the public in general of the market for electronic payment services, including use of formal channels to receive remittances. CBN will need to run such campaigns for some time to enable the public in general shift behavior

The Remittances Services Market

Overview

466. **Although estimates of the numbers of migrants are highly uncertain, Nigeria is one of the more mobile societies in Africa.** There is a large and vibrant diaspora in the United States and the UK, as well as in Europe and the rest of sub-Saharan Africa. According to the United Nations, there are 1.1 million Nigerians (0.84 percent of the population) living outside their home country.⁸⁰ The latest U.S. census estimated that 135,000 Nigerians live in the US. The 2001 U.K. census recorded 90,000 Nigerians living in Britain. However, these figures are likely to exclude undocumented migrants and U.K. or U.S. citizens of Nigerian descent. Nigerian migration is significant within West Africa; according to one estimate 500,000 Nigerians live in Ghana alone.⁸¹ Other estimates suggest much higher overall figures. An October 2007 U.S Agency for International Development (USAID) report suggested that 3.9 percent of the population, or 5.2 million Nigerians, may be living abroad.⁸²

467. **Likewise, estimates of sums remitted vary but are thought to be large and growing.** Official CBN remittance figures, as reported in the Remittances and Migration Factbook, are presented below:⁸³

Table 17: Remittances to and from Nigeria

	2000	2001	2002	2003	2004	2005	2006	2007e
Incoming Remittances (in million US\$)	1,362	1,167	1,209	1,063	2,273	3,329	3,329	3,329
Outflowing Remittances (in million US\$)	1	1	1	12	21	18	n/a	n/a

⁸⁰ Orozco, Manuel and Bryanna Millis, “Remittances, Competition and Fair Financial Access Opportunities in Nigeria.” USAID, October, 2007.

⁸¹ Ibid.

⁸² Ibid.

⁸³ World Bank Remittances and Migration Factbook.

<http://siteresources.worldbank.org/INTPROSPECTS/Resources/334934-1199807908806/Nigeria.pdf>

468. However, these amounts are likely understated. International remittances amounted to about US\$4.2 billion (7 percent of GDP) in 2006, through 700,000 transactions, an increase of 30 percent over 2005, according to commercial banks interviewed. Informal remittance flows into Nigeria are thought to be large, with much hand carrying of cash. Some estimates of total remittances including informal transfers range to US\$10 billion.⁸⁴ While the size of the flows is uncertain, the conclusions reached in this report are not affected by the precise size of remittances.

469. Whatever the exact numbers, the Nigerian diaspora is substantial and spread through many countries, and incoming remittance flows are large and growing. A 2007 USAID report suggested that the share of remittances coming to Nigeria from different regions may be split 36 percent North America, 37 percent Europe, 21 percent sub-Saharan Africa and 6 percent from the rest of the world.⁸⁵ With regard to outgoing remittances, there are significant but unknown numbers of nationals from other West African countries living in Nigeria. Many of them send money home to their friends and families.

470. **The regulation of foreign money transfers is based on the foreign exchange Act of 1995 and the banks and other financial institutions Decree of 1991, amended in 1999.** The Act authorizes banks to perform foreign currency payments under its narrow definition of “authorized dealers” in foreign currency. Effectively, all foreign exchange transactions have to go through banks, although exchange bureaus have delegated authority to sell foreign currency for specified purposes (for example, medical and school fees abroad) up to US\$5,000. There is no direct regulation by the CBN of money transfer operators. Their products are regulated by virtue of their agency arrangements with banks.

471. **In terms of geographical coverage, disbursement of remittances is restricted to bank branches. This means that some recipients have to travel long distances to collect their money.** About 35 percent of bank branches are in Lagos and Abuja.⁸⁶ Some 20 of the 24 commercial banks operating in Nigeria have agreements with Western Union or MoneyGram, and one has agreements with Coinstar and Vigo, a subsidiary of Western Union. In Nigeria, Western Union and MoneyGram have insisted on exclusive arrangements with banks. Thus a bank acting as an agent of Western Union is unable to work with any other money transfer operators. Of the 340,000 reported transactions per month, 270,000 (80 percent) are with Western Union, 60,000 with MoneyGram, and 5,000 to 10,000 with Vigo and Coinstar. It is thought that Nigerian banks retain 25 percent of the commission paid by remitters to the money transfer companies, making remittances a significant and stable source of revenue and profits.

⁸⁴ These estimates came from various members of the private sector with whom the team met.

⁸⁵ Ibid.

⁸⁶ Orozco, Manuel and Bryanna Millis, “Remittances, Competition and Fair Financial Access Opportunities in Nigeria.” USAID, October, 2007

472. **The requirement that only banks serve as agents of remittance companies restricts competitive market conditions that could contribute to lowering prices and improving service levels, particularly geographical coverage.** Western Union charges approximately 7 percent of the principal sum to send money to Nigeria. This is significantly more than in other large markets where a competitive situation has developed. In the Mexico/U.S. corridor, for example, where many players compete, the average cost is between 3 and 4 percent. Thus, the Nigerian market is plagued by high commission rates, leading to a strong incentive to use the informal market. It is expected that this situation will improve as a result of a change in the CBN guidelines which disallows exclusivity arrangements between money transfer operators and banks.

473. According to the USAID survey, the average amount of money sent home by Nigerians in the United States was US\$189 per transfer, with an average 13 transfers per year. The survey recorded that the average cost of each transaction was US\$12.70 or 7 percent. About 89 percent of transfers were reported to go through money transfer operators, with only 6 percent using account-to-account bank transfers and 5 percent using the internet.

Transparency and consumer protection

474. **Remittance pricing is somewhat more transparent in Nigeria than other similar countries because many remittance transactions do not include an exchange transaction.** An unusual feature of the Nigerian remittance market is that the recipient has the choice of receiving their funds in foreign currency or in Naira. This measure was introduced in 2003 to discourage the use of the informal exchange market. Most recipients now opt for U.S. dollars. For the nearly one-third of total remittances to Nigeria that come from the U.S., no currency conversion is required and there is no opportunity for remittance service providers to hide fees in exchange rate margins.

475. **In cases where conversion from the sending currency into U.S. dollars or Naira takes place, the exchange rate is not generally recorded on the receipt slip, and customers are not made aware of the conversion rates.** Remittances from places other than the U.S. are converted into U.S. dollars or Naira, though a few bank branches maintain stocks of pounds sterling and euros and could conceivably pay customers in these currencies. No commission is charged by banks to the recipient on incoming remittances.

476. **Exchange bureaus or informal exchangers offer slightly better exchange rates than the official bank rate.** Nigerians withdrawing dollars have the option of placing them in a U.S. dollar denominated “domiciliary” account at the bank. In practice, most people take the dollars in cash and then exchange them for Naira at exchange bureaus or informal exchangers which offer slightly better exchange rates than the official bank rate. The differential between the official rate used by banks and that of the parallel market has varied widely in recent months from just 1.5 percent to more than 30 percent.

477. **Customer dispute resolution mechanisms requires strengthening.** While an individual can take his or her complaint to the bank concerned and then to the Banker's Committee, there is little evidence that this process is effective—usage and awareness is low—and resort to the judicial system is clearly inappropriate for small claims.

Payment systems infrastructure

478. **Direct disbursement of remittances into a bank account is not possible.** Cash must be withdrawn and re-deposited by the customer, increasing the likelihood that it will be removed from the premises by the customer and converted at an exchange bureau. However, some banks have developed account-to-account services, including innovative mobile phone and card-based transfers. These operate within Nigeria and in some countries within the West African region.

479. **The CBN has embarked on a comprehensive reform of the national payments system that will significantly modernize payment transactions in line with international standards and best practices.** The reforms are being pursued in line with the framework of the FSS2020 strategy that will result in, among other things, interoperability of networks and greater automation that could contribute to reducing costs and improving the national/geographic coverage of services. Until now private sector efforts have focused mainly on the implementation of an Automated Clearing House (ACH) for checks and direct debit and credit transfers (see Section V on enabling infrastructure).

Legal and regulatory environment

480. **The remittance services market is not supported by an effective legal and regulatory framework.** Unlike in many other countries, global remittance service provider networks, such as Western Union and MoneyGram, are not required to be licensed or regulated in Nigeria. Remittance service providers are only regulated insofar as the products they offer are regulated through the CBN's oversight of the banks that act as their agents.

481. **Consequently, CBNs banking supervision does not regularly monitor the remittance services market, and has not yet become involved in the regulation of bank remittance service contracts, and other aspects such as market practice and consumer protection.** The banking supervision department grants bank licenses, supervises bank operations, monitors anti-money laundering/combating the financing of terrorism compliance. .

Market structure and competition

482. **The current regulatory framework discriminates exchange bureaus as they are not permitted to disburse remittances.** There is a network of about 600 exchange bureaus operating in Nigeria. Day-to-day regulation of exchange bureaus is carried out by the other financial institutions department (OFID) within the CBN, with policy-making handled by the trade and exchange department. OFID grants licenses, sets transaction limits and capital requirements (currently, 10 million Naira), receives monthly reports, and monitors anti-money laundering/know your customer compliance.

483. **The Nigerian Postal Service (Nipost) is potentially an important player in the remittance services market with good prospects of improving outreach particularly to rural areas.** However, its current regulatory status appears to be unclear. It operates its financial products under international postal regulations allowing for the provision of money order services. Nipost has four remittance services planned: (a) acting as agents of Western Union through an agreement with Union Bank, (b) use of the Postal Union system, (c) partnership with the Cash for Africa network, and (d) offering domestic money orders. It has 5,000 branches, 1,200 of which are Nipost-owned. All of them operate online, and have the ability to work offline if necessary. Nipost is also currently in the process of installing white-branded ATMs in their branches, with access to interoperable payment networks.

Governance and risk management

484. **The transfer and delivery of remittances seems to be reliable in the Nigerian market.** Currently, banks and international money transfer operators have internal risk control systems in place and conduct periodic audits of their agents. They ensure that customer funds are kept separate and are traceable.

485. In the area of anti-money laundering/combating of the financing of terrorism, international Financial Action Task Force regulations are followed largely due to the fact that the major participants on the remittance market are banks. The banks together with the large money transfer operators have created procedures to prevent their organizations being used for criminal purposes. The existing procedures appear to take into consideration many of the internationally recognized and used best practices.

Conclusions and next steps

Measures designed to strengthen transparency and consumer protection

486. The authorities are advise to consider adopting regulations to strengthen transparency by individual remittance service providers. Encourage provision of information in easily accessible and understandable forms on fees, foreign exchange rates including the margins applied on them. This will make it easier for customers to make an informed choice of service providers. The following steps are envisaged:

- Publish tables of comparative fees, foreign exchange rates including the margins applied on them.

- Consider undertaking educational campaigns to give senders and receivers sufficient background knowledge and enable them better understand the market for remittances.
- Strengthen consumer protection and enforcement. Consumer protection is important to encouraging customers to use formal remittance channels as well as to protect their economic rights. Accordingly, service providers must implement effective complaint and redress procedures that would increase public trust and confidence in the remittance market as a whole.
- Information on transparency and consumer protection could be made available through leaflets, newspapers and the internet both within Nigeria and, if possible, to the Nigerian Diaspora in remitting countries. A government sponsored website and a consumer friendly phone number could be considered.

Increasing efficiency in remittance transfer through reforms of the payment system infrastructure

487. Several of the reforms relating to the payments system will be of considerable benefit to reducing the cost of formal remittance transfers thereby encouraging use of safer transfer channels and use of banking services. Specifically relating to remittance the authorities should consider:

- Encouraging deposit taking institutions to link remittance disbursements to a broad range of financial services, including “domiciliary” accounts in foreign currencies. This will capture the unbanked segments of the market, improve the utility of remittance services, reduce the risk of robbery, diminish the attractiveness of exchange bureaus for currency conversion, and promote financial inclusion.
- Encouraging all remittance service providers, including non-banks, to cooperate on adoption of common and preferably internationally agreed standards for that allow interoperability among payment system networks and transaction processing automation. Forums such as the National Payments Systems Council and the FSS2020 Payment Systems Group can be used to discuss the specific ways to improve payment system infrastructure that have the potential to increase the efficiency of remittance services.

Strengthening the legal and regulatory environment

488. There is a need to strengthen the overall legal and regulatory environment to be applied to remittance services both as regards regulatory oversight and concerns related to anti-money laundering:

- Consistent with international AML/CFT requirements, CBN should consider instituting either a licensing or registration regime for remittance service providers. In this way remittance service providers will be recognized as specialized financial service providers in their own right distinct from taking deposits or banking and will enable non-banks (for example, exchange bureaus,

- merchants, etc) to effect remittance capture and disburse transactions and enter into agreements with international/domestic remittance networks.
- Strengthen oversight of remittance service providers as a prerequisite of liberalizing the market. This should include CBN undertaking a review of its organizational capacity and fostering cooperation. Key aspects of the regulatory and oversight framework should include CBN conducting background checks on owners, managers and agents, mandating clear and transparent organizational structures, ensuring satisfactory internal controls mechanisms including safeguarding requirements such as segregation of customer and operator funds, implemented on a risk-based basis taking into consideration transaction size/operator sophistication.
 - Strengthen ongoing cooperation among public authorities to ensure that policies are coherent. In Nigeria, as in many other countries, different aspects of the remittance industry fall under the jurisdiction of different public authorities, such as the central bank, the antitrust authority, the statistics office, the foreign exchange office, and others. Cooperation among these authorities is essential to ensure that policies are coherent.

Market structure and competition

489. A key objective of the CBN policy and regulatory environment should be to foster competitive market conditions by establishing a level playing field for all remittance service providers and guarantee access to new non-bank players, ensuring that new non-bank remittance agents have fair and equitable access to payments infrastructure and all relevant payment services. Banks and other institutions should not discriminate against non-bank remittance service providers when providing payment services, and ensure that new non-bank remittance agents have fair and equitable access to payments infrastructure and all relevant payment services. Liberalization and the entry of new players will generate significant benefits, including:

- A reduction in the cost of remittances. An un-ambitious short-term target would be to cut the commission rate by 1 percent, providing savings in truncation costs equivalent to at least US\$40 million per year. These savings will accrue to recipients, many of whom are poor, and to the Nigerian economy in terms of foreign currency earnings.
- The use of non-bank agents as distribution points will extend geographical coverage of payout points, especially in rural areas. At present, long journeys by public transport are frequently necessary to collect remitted funds from banks.
- A portion of the remittance flows currently moving through the informal market will switch to the formal market. This will increase the security of the transfers and enable improved data collection encouraging financial inclusion.

Governance and risk management

490. Ensure that any new regulations for remittance service providers in Nigeria are not overly restrictive and burdensome in their imposition of governance and risk

management standards. It should be emphasized that governance structures appropriate for some remittance service providers are likely to be quite different from those of large financial institutions.

491. Key aspects of any new regulations for remittance service providers will need to address the following:

- Ensure that remittance service providers participate in developing sound governance mechanisms. It is important that remittance industry stakeholders are consulted to help ensure that the regulations are proportionate and effective.
- Encourage remittance service providers to consider adopting harmonized industry minimum performance standards regarding disclosure. Some important aspects that should be covered include: (a) maximum time for holding remitted funds before releasing them to a recipient; (b) disclosure of longer transaction time for low-cost services; (c) information that will be included in receipts; (d), exchange rate and fees, and when the end user can expect to be informed about exchange rate and fees; (e) complaint procedures and resolution schemes, including the consequences of exceeding transfer times; (f) safety measures, including due separation of customer funds.
- Define mechanisms to strengthen consumer protection through effective customer complaints-handling procedures. In this way, encourage the industry to create a voluntary body to develop service standards and to help resolve conflicts between industry members, and between service providers and customers. Remittance service providers in Nigeria have expressed interest in establishing such procedures and should be encouraged to move forward.
- Ensure that practices foster market integrity by complying with all relevant anti-money laundering/combating financing of terrorism measures.

[END]