Debt Management Office Technical Report
Sovereign Domestic Debt Technical Advisory Assistance Program To
The Federal Republic of Nigeria
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Close-Out Report – August, 2004

INTRODUCTION

In line with the Office of Technical Assistance (OTA's) overall government debt issuance and management assistance mission statement, the Nigerian sovereign domestic debt management program's central focus has been to develop, within the host country, market-based issuance practices and trading mechanisms for domestic government securities that support macroeconomic stabilization. Specific targets within the overall mission include: providing a non-inflationary means of public finance to the Nigerian federal ministry of finance, assisting the Central Bank of Nigeria with the development of instruments and markets in its implementation of monetary policy and providing support to the development of broadly based financial markets.

BACKGROUND

Following Nigeria's transition to a civilian democracy in 1999, an assessment of the Government of Nigeria's budget and debt management technical assistance needs was conducted by a Treasury team led by Jim Fall. The assessment culminated in a "forceful" and specific set of requests from then Acting Minister of Finance, Jubril Martins-Kuye, for technical assistance in budget, debt management, tax policy and administration, and financial crimes law enforcement[1]. This was followed-upon by other OTA/GDIM officials and resulted in the commencement of the GDIM technical advisory program, in July, 2001.

COUNTRY FINANCIAL AND ECONOMIC BACKGROUND

Nigeria has a large, Naira-denominated debt, concentrated in the central bank and the banking system. In recent times, the country spent more on debt service than on health, agriculture and education combined. Recently, debt service has hovered around 15% of

[1] Initial trip report.

total budget expenditures. This is a very high figure, even in comparison to other developing economies, and one that imposes significant constraints on the nation's budget and resources.

Approximately 55% of the total securitized debt is held in the form of 91-day Treasury Bills, which are continuously rolled-over. In addition, it had been the case that every year, for at least the last fifteen years, an additional amount representing that particular year's total deficit—initially reflected as an overdraft from the central bank—is securitized and added to the pre-existing stock. In addition to Treasury bills, the balance of the nation's public domestic debt has, on average over the review period, consisted of approximately ₦500 billion in longer-term debt instruments; i.e., Treasury Bonds and "Development Stocks". Historically, development stocks were issued to finance various capital projects over the years. Treasury bonds were introduced in 1989, mainly as a means of avoiding paying market rates, which had risen significantly in the wake of interest rate de-regulation, following adoption of the then-called, Structural Adjustment Program ("SAP"). Interest on those bonds was set at 5% across the board. The central bank absorbed almost the entire issue. In subsequent years during the military era, treasury bonds were issued whenever the government wanted to raise money at artificially low (non-market referenced) rates.

Close to 60% of the outstanding securitized public domestic debt is held by the Central Bank. An additional 34% is held within the financial sector, mainly by banks, and approximately 6% is held by non-bank investors.

BACKGROUND ASSESSMENT

At the onset of the program, Advisor conducted a comprehensive assessment of the Nigerian government's debt management and issuance functions and activities as well as the general financial and economic environment, to identify and analyze the main factors that had a direct bearing on the debt. The assessment included extensive meetings and detailed deliberations with all major stakeholders, including banks, discount houses (i.e., primary dealers and market-makers in treasury bills), other securities market operators, regional financial institutions, and regulatory organizations. The assessment also included a detailed review of the government of Nigeria's budget development and implementation processes, government's financial and accounting processes and record-keeping frameworks, legal and regulatory frameworks, the technological environment within which debt issuance and management functions and activities were being conducted, controls around debt issuance and management processes, debt management related organizational structures and capacity within the various governmental agencies and private sector outfits where debt issuance and management activities were conducted.

REVIEW FINDINGS

The review, which took place during the first three months of the program, identified several pervasive factors which hampered the implementation of sound or effective debt policy. One of these was the overly fragmented nature of debt management, whereby debt management operations were conducted from up to five different agencies, including the Central Bank, Ministry of Finance, Office of the Accountant General, National Planning Commission, and the National Economic Intelligence Committee. The review indicated that there was little collaboration amongst these agencies. Not surprisingly, this lack of collaboration and dispersal of functions involved conflicting institutional roles. For example, the Central Bank's pervasive involvement in debt management along with its substantial holdings of government debt, conflicted with its monetary management responsibilities. Given the contemporaneous economic environment, characterized by macroeconomic instability and persistent inflation, the debt portfolio was overly subject to monetary policy pressures. And from a legal standpoint, a substantial amount of the bank's debt management related functions and activities appeared to lack the appropriate legal mandate.

RESEARCH ANALYSIS AND DATA GATHERING

Another finding was that there was a serious lack of an adequate, debt-related data-gathering or analytical process to guide debt policy and decision making. This absence of a sound, analytical basis for debt policy formulation, deliberation or decision-making was indicative of the way in which debt management was being conducted. Finally, the review also revealed a lack of a coordinated approach or mechanism for the dissemination of domestic debt-related information to stakeholders or the general public – which as subsequent events showed advisor, were crucial. This has been a hindrance to consensus building, particularly in building the institutional (including parliamentary) support often needed to achieve key debt related activities.

In terms of the portfolio, in addition to the large and increasingly expanding sovereign domestic debt, fostered by unbridled fiscal expansion, the nation's debt stock had been and continues to be characterized by excessive monetization of annual budgetary deficits, over-reliance on short-term debt and concentration of debt in the central bank and the banking system, the improper use of the CBN's statutorily-mandated overdraft "ways and means" account, and the lack of any appreciable secondary market activity in government bonds.

Given these and other background review findings, Advisor developed a comprehensive work program which aimed to enhance debt management practices within the respective agencies responsible for debt management as well as to develop the capacity of the Debt Management Office (DMO), the agency conferred with statutory responsibility for managing the nation's debt. The vision of the work plan was to develop a debt management organization capable of providing policy alternatives to the government of Nigeria. The key specific objectives were to improve the management of the debt portfolio, lengthen the maturity structure of the debt, inculcate a market-based government debt funding culture, and enhance secondary market-trading activity through increased liquidity and enhanced price discovery in the government securities market. The central mission was to devise and guide the implementation of a long-range debt issuance and management plan that is supportive of the ongoing economic reform efforts of the government of Nigeria and facilitates macroeconomic growth.

EXTERNAL DEBT RELATED ACTIVITIES

While the advisory program's mandate was to advise on the government of Nigeria's domestic debt issuance and management program, Advisor's attention and advice was periodically sought on matters pertaining to the nation's external debt. This included, for example, advisor being requested to review proposals and/or sit on presentations by major financial institutions offering proposals to restructure Nigeria's external debt (e.g., Citigroup and Deutsche Bank proposals to restructure Nigeria's Par bonds, through buy-backs and swaps.) Particularly worthy of note was when advisor was contacted urgently over a weekend in mid-2003, in the wake of a key Supreme Court ruling, which forbade the Nigerian government from further deducting 1% from federation revenues, for the purpose of servicing the aggregate debt owed by the federal government and the states. Given the financial and political implications of the decision, advisor's participation was sought on devising a program to comply with the decision. Another recent episode was when the minister of finance called for advisor to meet over a period of time, with a state governor and the state government's top economic officials and financial advisors, led by KPMG, to provide guidance on external currency financing options and the implications of providing a financial guarantee to the state government, looking to develop an export-free zone.

IMPLEMENTATION OF WORK PLAN

The debt advisory program was implemented in three phases. The first phase, which spanned the first year and a half of the program, included, in addition to the comprehensive background review, a broad review of the proposed debt management act, which legally conferred sovereign debt management responsibility on the debt management office and laid the basis for the new debt management structure. Advisor requested the assistance of GDIM Legal Advisor, Calvin, Ninomiya, who undertook a detailed review of the new bill and proffered key advice. This led to the re-draft of portions of the legislation as it related to the authority to borrow, helped clearly define the relationship with the central bank as fiscal agent, firmly granted authority to the Debt Management Office to act as the sole borrowing agent for the State and authorized the Debt Management Office to select instruments for borrowing and issue regulations to implement the Act as well as provided clear, legislative affirmation that existing debt continue to be a direct obligation of the sovereign as issuer.

DATA GATHERING AND ANALYSIS

During the initial phase, advisor established a process within the debt office, for collating domestic debt related data and establishing the DMO as the repository for domestic debt related data. Advisor's research data gathering analytical initiatives also included providing lawmakers with information connecting improper debt management practices, including in specifically, persistent monetary financing of fiscal deficits, to wider macro-economic problems. This included co-authoring a research study that quantified the adverse effects of the persistent and excessive monetization of fiscal deficits on the economy. The research was published in a regional academic journal and used as leverage to gain attention and push for changes with policy-makers.

RATIONALIZATION OF INSTITUTIONAL RELATIONSHIPS

During the early stages of implementation of the work program, advisor initiated efforts and processes to rationalize roles and responsibilities among the various agencies handling debt management. This included reinstating a long-neglected process whereby, the ministry should formally, by instrument of warrant, instruct the Office of the Accountant-General of the federation to issue a mandate to the Central Bank, to conduct offerings of securities on behalf of the federal government and lay out terms and other features authorizing such offerings. Prior to this time and since the era of military governance, the Central Bank had been acting without legal authorization, mandate, or consultation and inappropriately taking on the role of debt policy-making and implementation. In order to adequately prepare and equip the appropriate agencies to take on their proper respective functions, a substantial portion of advisor's time was spent working with officials at the ministry and DMO, helping build the institutional competence needed to enable them to take a more appropriate and assertive role on debt matters. A key initiative that was conceptualized and implemented by the Advisor in this regard, was the establishment of an internal domestic debt management committee (within the debt office), to enhance debt policy formulation and deliberation. In addition, an inter-agency Joint Domestic Debt Committee, chaired by the Permanent Secretary of the Ministry of Finance and including representation from all the various agencies responsible for debt management, including the office of the president, was established to deliberate upon issues pertaining to debt policy. This afforded Advisor the opportunity to present often technical subject-matters in a manner that enabled positive debate and action.

ISSUANCE AND MARKET DEVELOPMENT

As previously laid out, the central thrust of the advisory program and focus of the advisor's work was on creating a long-range financing plan to facilitate debt reform, macro-economic stability and growth. This involved developing a game plan that addressed the nation's three key debt-funding related priorities:

- Limiting monetary financing of annual fiscal deficits and reducing central bank holdings of government debt.
- Properly aligning the debt portfolio (to achieve a more appropriate asset/liability match) and reducing the burden of debt service by lengthening the maturity profile of the debt.
- Promoting development of the domestic capital market.

In order to accomplish the preceding, a comprehensive, multi-year plan was developed to issue longer-dated instruments, in order to finance the annual fiscal deficits and address ancillary objectives. These included, for example, lengthening the maturity profile of existing debt; developing the secondary market to reduce reliance on CBN and set the stage for future restructuring. The issuance program was developed and is being implemented to accomplish the goals outlined for the attainment of domestic debt management objectives in general and for the financing of current and future Federal Government deficits in particular.

BOND ISSUANCE PROGRAM

The bond issuance and market development program, in the first phase, involved the issuance of bonds to finance the (annual) deficit and eliminate or at least reduce central bank financing of unsubscribed residuals from treasury offerings. In this regard, during

2003, the government of Nigeria issued its first bond in approximately fifteen years. This was also the first fixed rate bond issued by either a private or public entity in over a dozen years. The offering featured multiple maturities and fixed and floating rates. The program, which is expected to continue over the next five years, provides for the annual issuance of bonds to fund any new fiscal deficits (if any) or for the partial restructuring of outstanding treasury bills.

TREASURY BILL RESTRUCTURING

Another important feature of the issuance program has been the phased restructuring of a substantial portion of the existing treasury bills. This entailed in the first phase, a "smoothening exercise", whereby, the weekly maturing 91 day T-bills were restructured in such a manner that, instead of widely divergent weekly maturing amounts, the maturing stock was smoothed out so that an even N60/65 billion was structured to become due weekly. This de-bunching exercise, in addition to making the subsequent partial restructuring easier without increasing the potential for future bunching, is also intended to reduce volatility in the money-market and the potential "volatility premium" that markets tend to place on such instruments.

In the other phase of the T-bill restructuring exercise, a certain percentage of 91 day treasury bills are being rolled into (initially) 6 month bills and (eventually) 12 month bills, in such a manner as to attain at least a conversion of 40% of the existing 91 day bills over the next five years.

MARKET DEVELOPMENT

With regard to the market development aspects of the work plan, Advisor devised a program for the implementation of a system of market-makers to facilitate the secondary market trading of government debt. This proposal also includes a horizontal as well as a vertical Repo program, anchored by the major banks and with access to the Central Bank's Repo window. This was negotiated by advisor. A cautious, phased implementation of the program has commenced.

With regards to the advisory program's market-development efforts, counterparts were advised extensively on re-structuring debt and developing new debt product proposals that should continue to gain acceptability in the domestic market without crowding out other borrowers.

Developing the domestic capital market in general and the sovereign debt market in particular was a key focus of advisory activities. This was to provide a firm platform for the issuance and aftermarket trading of government debt, in order to engender the liquidity craved by investors, and without which investors will not remain committed to investing in government bonds, as well as to provide a vehicle for the effective transmission of fiscal and monetary policy implementation.

OTHER NEW INSTRUMENT PROPOSALS

In addition to the bond issuance and market development program that was developed and is being implemented in a phased manner, Advisor also developed proposals to broaden the government securities market and satisfy the diverse appetites and requirements of investors, through the development of proposals for new instruments. This included proposals for the issuance of: (a) a dollar-linked bond and (b) an index-linked floater. Both proposals have been positioned for implementation at a future date, consistent with the broad, long-range plan proposed by the Advisor.

SUB-NATIONAL DEBT PROGRAM

A key aspect of the advisory program was the sub-national debt management program. The Nigerian federal republic comprises 36 states. Each one of those states had been, to varying extents, involved in prior borrowing activity – which under the previous centralized political governance structure, were considered to be de-facto guaranteed by the sovereign. A substantial number of these states are under severe financial strain. Notwithstanding, most have continued to seek access to both the private as well as, increasingly, the public debt market. Neither the borrowing states nor the private bank creditors or public investors' appear to have are fully come to terms with the economic realities of borrowing/lending under the new "de-centralized" legal/constitutional borrowing environment. The challenges presented by this state of affairs were ripe for advisory support. Advisor recognized that this was a serious issue, given the aggregate size of the outstanding debt and efforts being made by sub-sovereigns to continue to access the market. Counterparts recognized Advisor's concerns and accorded the issue the proper priority and attention. Subsequently, the World Bank Country program, and the UK's DFID, and more recently, the Canadian Forum of Federations and the EU, recognized how pressing an issue the subject matter was and provided funding support to the program, which was being managed under the auspices of the advisory program. (The WB was comfortable supporting the Nigerians on this matter because it was being managed under the auspices of our advisory program.) The program has subsequently gained very high visibility and is used as a platform for consensus-building on other fiscal federalism related issues between the federal government and the states. Among other things, the program has produced a draft fiscal responsibility bill, to guide borrowing by states. The program also involves states in contributing to and adhering to a uniform debt policy that promotes overall debt sustainability.

CASH MANAGEMENT

At various stages over the course of implementing the advisory program, Advisor raised the issue of effective cash management and its impact on effective debt management; in particular, how the absence of effective cash forecasting had increased the tendency toward sub-optimal debt management and borrowing practices. For example, at various times, the government, through its various agencies, has had a substantial average credit balance at the central bank. Such balances, even though substantial and maintained for considerable lengths of time on an average basis, do not attract interest income. At about the same time however, the government has issued treasury bills or maintained "ways and means" overdraft debit balances, up to the same amount as its existing aggregate credit balance.

Advisor proposed a cash management committee, which advisor initially chaired, until the function was taken over by the Minister of Finance, who specifically requested that the Advisor continue to serve on the committee. Following a recommendation on the same issue by the IMF, advisor was mandated to establish a technical sub-committee to collate and aggregate forecasts by the various agencies and line ministries.

STATUS OF WORKPLAN DELIVERABLES

- ✓ DMO adequately and legally prepared and empowered to assume the management of the nation's public domestic debt.
- ✓ Rationalized relationships between the MOF/OAGF, DMO and CBN
- ✓ Reduction of monetary financing of the nation's deficit. The new bonds are issued without recourse to central bank participation at primary offerings.
- ✓ Availability of debt instruments suited to market demand
- ✓ Longer tenors for government bonds. Proposal developed for the establishment of a ten-year yield curve over the next three years.
- ✓ Treasury bill restructuring program initiated
- ✓ Proper legal and regulatory framework for government securities primary and secondary markets.
- ✓ Developed and expanded naira-denominated, fixed debt investor base that is attractive to institutional investors.
- ✓ Guidelines for sub-national borrowing drafted and has been presented to parliament for approval
- ✓ Comprehensive and appropriate legal framework for the government securities market, including a rational tax policy for interest, dividends and capital gains from securities.
- ✓ Development and implementation of the Sub-Sovereign Debt Management Program

SELECTED MACROECONOMIC INDICATORS
(Figures in Naira Billion unless otherwise stated)

	2001	2002	2003[2]
Revenues	796.98	716.75	749.40
Expenditures	1,018.03	1,018.16	949.10
(Deficit)/Surplus	(221.05)	(301.40)	(199.70)
Domestic Debt Service	155.42	170.64	164.87
Domestic Debt stock	1,016.97	1,1666.00	1,329.72
Debt Market Capitalisation	14.20	15.60	33.60
Total Market Capitalisation	662.60	764.30	1,358.40
Exchange Rate (=N=/US$)	112.00	126.90	137.20
External Debt Service	238.12	140.74	246.96
" " (US$ billion)	2.13	1.17	1.80
External Debt Stock	3,176.29	3,780.21	3,988.61
External Reserves (US$ million)	10,415.60	7,986.70	8,785.37
External Reserves	1,166.55	1,013.51	1,205.35
Export (FOB)	2,001.23	1,874.87	1,967.17
External Reserves/Export	58.29	54.06	61.27
GDP (current Mkt Price)	5,702.65	5,901.97	6,138.09
GDP Per Capita	1,062.50	1,065.40	1,158.79
GDP Growth Rate	4.20	3.30	3.50
Domestic Debt/GDP (%)	17.83	19.76	21.66
Domestic Debt Service/GDP (%)	2.73	2.89	2.69
Domestic Debt Service/Expenditures (%)	15.27	16.76	17.37
Domestic Debt Service/Revenues (%)	19.50	23.81	22.00
Deficit/GDP (%)	3.88	5.11	3.25
External Debt/GDP (%)	179.54	64.05	64.98
External Debt Service/GDP (%)	4.18	2.38	4.02
External Debt Service/Expenditures (%)	23.39	13.82	26.02
External Debt Service/Revenues	29.88	19.64	32.95
Total Debt	4,193.26	4,946.21	5,318.33
Total Debt/GDP (%)	73.53	83.81	86.64
Total Debt Service	393.54	311.38	411.83
Total Debt Service/GDP (%)	6.90	5.28	6.71
Total Debt Service/Expenditures (%)	38.66	30.58	43.39
Total Debt Service/Revenues (%)	49.38	43.44	54.95
Gross National Savings	540.00	694.90	833.88
Savings/GDP (%)	9.47	11.77	13.59
Inflation[3]	18.90	13.20	14.00
Liquidity Ratio Requirements for Banks	40.00	40.00	40.00
Cash Reserve Ratio	12.50	12.50	12.50
Weighted Average Maturity of Outstanding Debt			

[2] Provisional

[3] Actual