FEDERAL REPUBLIC OF NIGERIA

DEBT MANAGEMENT OFFICE
NIGERIA

NATIONAL DEBT MANAGEMENT FRAMEWORK

(2008-2012)

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Glossary

AfDF	African Development Fund
BPE	Bureau of Public Enterprises
CBN	Central Bank of Nigeria
CPIA	Country Policy and Institutional Assessment
DMO	Debt Management Office
DMDs	Debt Management Departments
DSA	Debt Sustainability Analysis
DRI	Debt Relief International
EIB	European Investment Bank
EU	European Union
FDI	Foreign Direct Investment
FEC	Federal Executive Council
FGN	Federal Government of Nigeria
FRL	Fiscal Responsibility Law
FRN	Federal Republic of Nigeria
GDP	Gross Domestic Product
IBRD	International Bank for Reconstruction and Development
ICM	International Capital Market
IDA	International Development Association
ISA	Investments and Securities Act
ISPO	Irrevocable Standing Payment Order
JDCC	Joint Domestic Debt Committee
MFPCC	Monetary and Fiscal Policy Coordinating Committee
LCDs	Local Contractors' Debts
LEEDS	Local Government Economic Empowerment and Development Strategy
LGAs	Local Government Areas
MDAs	Ministries, Department and Agencies
MDGs	Millennium Development Goals
MFPCC	Monetary and Fiscal Policy Coordinating Committee
MoF	Ministry of Finance
NASS	National Assembly
NBS	National Bureau of Statistics
NEEDS	National Economic Empowerment and Development Strategy
NIPC	Nigerian Investment Promotion Commission
NPC	National Planning Commission
NSE	Nigerian Stock Exchange
NTBs	Nigerian Treasury Bills
OAGF	Office of the Accountant General of the Federation
OPEC	Organisation of Petroleum Exporting Countries
OSSAP-MDGs	Office of the Senior Special Assistant to the President on Millennium Development Goals
PAs	Pension Arrears
PDMMs	Primary Dealer Market Makers
PPPs	Public-Private Partnerships
PRSP	Poverty Reduction Strategy Paper
PSI	Policy Support Instrument
SDRs	Special Drawing Rights
SEC	Securities and Exchange Commission
SEEDS	State Economic Empowerment and Development Strategy
SPV	Special Purpose Vehicle

EXECUTIVE SUMMARY

Until 2000, the management of Nigeria's public debt was defective, resulting in a debt crisis. The strategies adopted and the institutional arrangements in place were inadequate to achieve a sustainable debt regime for Nigeria. Public debt management responsibilities were diffused across several agencies and operators, leading to ineffective and poor coordination of debt functions. This resulted in rapid growth in the country's debt portfolio from less than US$1 billion in 1970 to about US$28.27 billion in 2000 and to about US$35.94 billion by end 2004.

Following the successful Paris Club debt deal and the exit from the London Club debts, the external debt stock dropped to US$3,544.49 million in 2006 from US$35.94 billion in 2004 and stood at $3,654.21 as at December 31, 2007. On the other hand, domestic debt rose from US$10.314 billion as at December 31 2004 to US$18,575.67 billion by end of December 2007 representing 83.56 percent of the total public debt stock. It is pertinent to underscore the reasons for the upward trend in the domestic debt stock over the years. While the US$18.575.67 billion domestic debt stocks may seem a fairly large amount, its size largely reflects the cumulative effects of financing Nigeria's budget deficits in the past, including public sector capital expenditure needs. The increases are accounted for by different sets of factors, reflecting a shift towards market-based funding of government deficits, borrowing for developmental purposes and on-lending to institutions such as Nigerian Agricultural and Rural Development Bank, Bank of Industry and the Federal Mortgage Bank. The increase in the domestic debt stock was also as a result of the issuing of Special Bonds by the Federal Government to resolve the lingering crises of pension arrears and local contractors' debt.

Until recently, Nigeria's effort in tackling its debt problems was often not underpinned by proper analysis. No Debt Sustainability Analysis (DSA) was ever carried out throughout the period of debt overhang. As an IDA-only country, Nigeria is to undertake a DSA yearly. In a bid to independently ascertain the sustainability of Nigeria's debt portfolio and monitor the effects of Paris Club debt relief and future new borrowings, the government decided to conduct National Debt Strategy Workshops in both 2006 and 2007. The outcome of the DSA, therefore, feeds into this "National Debt Management Framework", which sets the policy guidelines for debt management in the country. Working towards stronger policy coordination with other government agencies, it is expected that this document will also influence and guide policy analysis and decisions in the agencies such as the Ministry of Finance, Budget Office, and the Central Bank of Nigeria.

The National Debt Management Framework will also seek to assist Nigeria in maintaining the current sustainable debt portfolio consistent with economic growth and development, and in line with the development agenda of the present administration.

Accordingly, the Framework will focus more broadly on guidelines for sustainable External, Domestic and Sub-National debt management.

The framework includes a risk management section, designed to ensure prudent risk management and sound debt practices. Sound debt practices entail proactively managing debt such that debt servicing costs are minimized subject to an acceptable level of risk. In this respect, some risks inherent in the Nigerian debt structure have been identified, with the view to conducting regular risk analysis and stress tests of the debt portfolio.

In line with international best practices in debt management, broad based policy direction in a form of Medium-Term Public Debt Strategies (2008-2012) have been articulated, aimed at giving DMO a new strategic focus in external, domestic and sub-national debt management with the aim of maintaining the current debt sustainability. The Medium-Term Public Debt Strategies are informed by President Yar'Adua's vision of transforming Nigeria into one of the top twenty economies in the world by the year 2020. Inspired by this vision, the new strategic focus is committed to ensuring that National and Sub-national Governments subscribe to the principles of prudent and sustainable borrowing, and effective utilization of resources. The Strategic Focus also seeks to create a robust domestic debt market supportive of private sector development.

On external debt management, the new policy direction under the Medium-Term Public Debt Strategies will be on mobilizing additional financing such as grants and concessional loans targeted at accelerating growth and poverty reduction, as well as meeting the MDG related targets. Borrowing externally will be done subject to the provisions contained in the External Debt Borrowing Guidelines (2007-2009) and new Fiscal Responsibility Act.

The new domestic debt strategy will focus attention on the development and deepening of the domestic bond market through the additional use of derivative instruments, index-linked bonds, as well as the introduction of foreign currency denominated FGN bonds with the objective of providing low cost funding for the Government. The new strategic focus will also integrate cash management with domestic debt management operations and deepen the bond market so that the private sector can play a crucial role in its development by accessing long-term funds.

The new strategic direction for the sub-national debt management will be to develop appropriate sub-national borrowing guidelines and facilitate access to, and ensure cost-effectiveness of funding for States by structuring appropriate capital market instruments for on-lending to the State governments. The new direction also includes establishing Debt Management Departments (DMDs) and building capacity for debt management in all the thirty-six States of the federation as well as developing a sub-national debt market.

This New Strategic Focus and corresponding National Debt Management Framework were articulated as a response to numerous challenges facing debt management and in response to the changes in the country's debt structure.

1. INTRODUCTION

1. 1 Background

During the 1990s, the Nigerian economy recorded low growth rates averaging less than 3 percent per annum, low domestic investment, high unemployment and wide balance of payments deficits. Nigeria was in a situation of debt overhang, i.e. its debt stock exceeded its future repayment capacity. This resulted in low incentives to invest and the difficulty to access funds on the international capital market.

The past administration of President Obasanjo, which was elected in 1999, launched a home-grown development strategy, namely the National Economic Empowerment and Development Strategy (NEEDS). This was complemented by State (SEEDS) and Local Government (LEEDS) strategies. NEEDS aimed at value reorientation, poverty reduction, wealth creation and employment generation.

The economy responded positively to these policy reforms. The average annual real GDP growth rate was 6.5 percent between 2003 and 2007, reflecting the strong annual growth of the non-oil sector. The regime of fiscal prudence, tighter monetary policy and low deficit/GDP rates during this period resulted in single digit inflation.

Although the above achievements did not directly impact on the country’s external debt sustainability, the reforms enabled Nigeria to resume dialogue with creditors on debt relief. Through high level diplomatic initiatives, the government garnered the support of the international community and was eventually able to get the Paris Club, Nigeria’s leading creditor, to agree to a historic debt relief deal that allowed the country exit from all its Paris Club debt obligations in April 2006. This was followed by the exit from its London Club debt obligations.

Following its success with external debt, the government began the restructuring of the domestic debt portfolio, which was dominated by short term instruments. Furthermore, it started working on recognising and settling contingent liabilities that emerged from unfunded pension arrears, local contractors’ debts and privatized enterprises, through the issuance of sovereign bonds.

1. 2 Macroeconomic Framework

The medium-term macroeconomic assumptions underpinning the analysis in this document are based on the expectation that the reform efforts started by the administration of former President Obasanjo, as outlined in the NEEDS-1 document and the Millennium Development Goals (MDGs), will be sustained by the current administration. These assumptions were used as a basis for the 2006 Debt Sustainability Analysis (DSA) and are presented in Table 1.1. below.

Table 1.1 Key Macroeconomic Assumptions	
Real GDP Growth Rate:	-to target an average of 7 percent per annum, because of high growth rates in the non-oil sector as well as positive and strong response to economic reforms.
Balance of Payments:	-in surplus, provided current reform efforts are adhered to; -oil and gas exports to grow over the next few years, due to higher world energy needs and higher production capacity, given increased investment in joint-venture projects in the oil and gas sector; -non-oil exports to rise to 7 percent per annum; -imports to grow at 10 percent annually, due to the need for raw materials, capital and intermediate goods for the rehabilitation of the industrial sector.
Foreign Reserves:	-to remain at current high levels of over US$40 billion, given fairly high oil prices and the adherence to prudent fiscal management, despite the cut in Nigeria's OPEC quota.
Foreign Direct Investment:	-to grow at an annual average rate of 17 percent, particularly in the energy sub-sector, supported by a boost in international investors' confidence given by the sustenance of current reforms, particularly the privatization of State owned enterprises.
Budget Deficit:	-at 3 percent of GDP; -gross revenue/GDP to average 32.6 percent; -federal government expenditure/GDP to average 15 percent; -capital expenditure/total expenditure to average 39 percent, due to high infrastructure investment, expected decline in recurrent expenditure following civil service reform and fiscal prudence.
Inflation Rate:	-to remain on stable single digit level, as a result of stable exchange rates and food supply availability.
Exchange Rate:	-on an appreciating trend of 4.8 percent per annum.
Interest Rate:	-to be administered as in the current regime.

On assumption of office, the present administration of President Yar'Adua committed to sustaining the aforementioned reform efforts and drew a new vision of the economy aimed at Nigeria being among the top twenty world economies by the year 2020 ("Vision 2020"). In order to achieve this goal, a 10-13 percent annual average growth target has been set and the debt strategy will be renewed in the light of this.

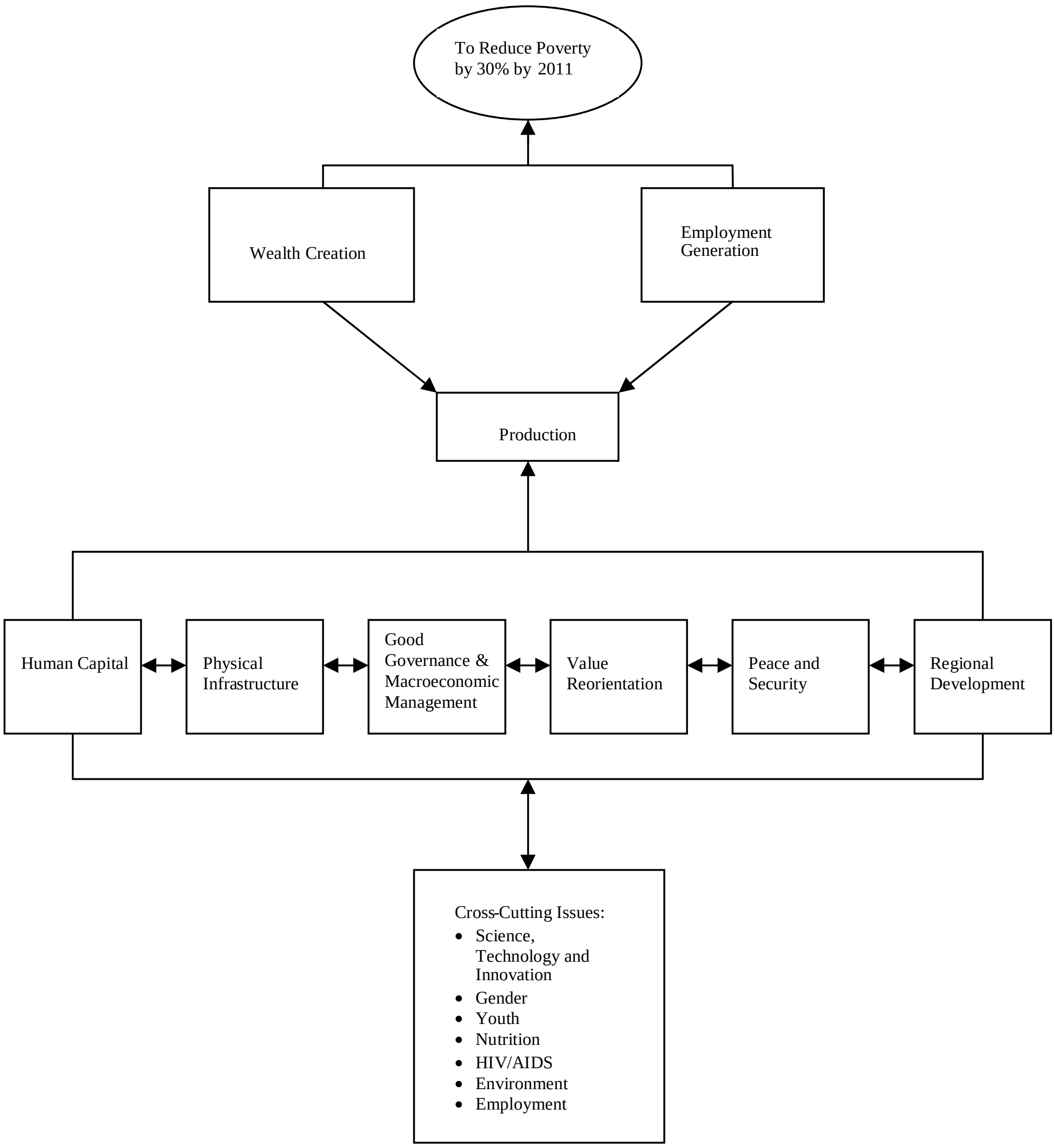
Table 1.2 Seven Point Agenda

1. Food Security & Agriculture
2. Wealth Creation & Employment
3. Mass Transportation
4. Land and Housing Reform
5. Security
6. Power & Energy
7. Qualitative and Functional Education

More precisely, this vision is to be achieved by focusing on areas laid out in Mr President's "Seven-Point Agenda", as well as the draft NEEDS-2 document. The Seven-Point Agenda focuses on sustained growth of the real sectors of the economy; the development of physical infrastructure and human capital; food security and agriculture, land reform and housing reforms; security and resolving the Niger Delta crisis (Table 1.2).

This feeds into the NEEDS-2 goals of aspiring to reduce poverty via employment generation, wealth creation and value reorientation (Figure 1.1). The new government also reiterated its commitment to achieving the Millennium Development Goals by 2015.

Figure 1.1 NEEDS-2



2. INSTITUTIONAL STRUCTURE AND REGULATORY ARRANGEMENTS FOR DEBT MANAGEMENT

2.1 Introduction

Prior to the establishment of the Debt Management Office (DMO) in 2000, the institutional framework for managing the country's debt was very weak. Debt management was characterized by:

(a) The lack of coordination among the various agencies involved in contracting and managing public debt;
(b) A weak and unreliable database;
(c) The lack of skilled debt managers;
(d) Weak institutional arrangements for managing domestic and sub-national debt; and,
(e) A loose legal framework.

This section summarises the legal and institutional arrangements for public debt management in Nigeria which served to overcome the weakness above.

2.2 Legal Framework for Debt Management

The extant legal framework for managing debt includes, among others, the following:

a) The Constitution of the Federal Republic of Nigeria: This vests exclusively in the National Assembly (NASS) the power to make laws to regulate both external and domestic borrowing for the federation - Federal, State and Local Governments. The Second Schedule, Exclusive Legislative list, items 7 and 50 confer this authority on the NASS. Pursuant to its constitutional authority and mandate, the National Assembly enacted the Debt Management Office (Establishment) Act, 2003, Act no. 18 and Fiscal Responsibility Act to regulate external and domestic debt at the Federal, State and Local Government Levels.

b) The Debt Management Office (Establishment) Act, 2003, Act no 18: This establishes the DMO as an autonomous body charged with the responsibility of managing the country's debt. Among other things, it empowers the DMO to:

i. advise government on how to fund its financing gap;
ii. issue guidelines on public borrowing by Federal and Sub-national governments, their agencies and public enterprises; and,
iii. determine the level of Federal Government's contingent liabilities that may result in extra-budgetary spending and recommend appropriate action for dealing with them.

c) The Local Loans (Registered Stock and Securities Act): This act provides for the creation and issue of registered stock, Government Promissory Notes and bearer bonds for the purposes of raising loans in Nigeria.

d) The Treasury Bills Act: This empowers the Minister of Finance to issue Treasury Bills, through the Central Bank of Nigeria (CBN) as his agent, to the limit of 150 percent of the estimated revenue of the Federal Government and gross revenues of the State for the current year. The Consolidated Revenue Fund is to be credited with the proceeds of this issuance from which the Minister is allowed to pay out any charges and expenses arising thereof.

e) The Treasury Certificate Act: By this Act the FGN can raise short term loans of not more than two (2) years tenor by issuance of Treasury Certificates, whose proceeds may be on-lent to States.

f) The Government Promissory Notes Act, CAP 164: A Government Promissory Note is a promissory note issued under Section 3 of the Government Promissory Act. Given the definition under Section 3, Government Promissory Notes are securities issued whenever authority is given to raise any sum of money by loan or repay any loan raised by the Federal Government.

g) Investment and Securities Act No 29 2007 (ISA): This empowers the Securities and Exchange Commission (SEC) to regulate borrowing from the domestic capital market by Federal, States, local governments and other government agencies. This Act makes provisions for borrowing from the Nigerian Capital Market.

h) Central Bank of Nigeria (CBN) Act 2007: This Act enables the CBN among other things to discount or rediscount project-tied bonds issued by State Governments, Local Governments and corporations owned by the FGN or State Governments, being bonds which have been publicly offered for sale and with maturity not exceeding three years, and grant advances to the Federal Government.

i) Fiscal Responsibility Act 2007: This imposes fiscal discipline on the Federal and to some extent the State Governments, and their agencies and particularly for the States in respect of borrowing, debt management and oil-based fiscal rule within a medium-term expenditure framework. Also, the States have committed to adopting similar legislation.

2.3 Institutional Arrangements for Debt Management

2.3.1 The Debt Management Office

The government established a Debt Management Office in 2000 with the mandate of managing the country's external and domestic debt. Part III, Section 6 of the Debt Management (Establishment) Act 2003, specifies that the DMO shall:

a. Maintain a reliable database of all loans taken or guaranteed by the Federal or State Governments or any of their agencies;

b. Prepare and submit to the Federal Government a forecast of loan service obligations for each financial year;

c. Prepare and implement a plan for the efficient management of Nigeria's external and domestic debt obligations at sustainable levels compatible with desired economic activities for growth and development and participate in negotiations aimed at realising these objectives;

d. Set guidelines for managing Federal Government financial risks and currency exposure with respect to all loans;

e. Advise the Minister on the terms and conditions on which monies, whether in the currency of Nigeria or in any other currency, are to be borrowed;

f. Submit to the Federal Government for consideration in the annual budget, a forecast of borrowing capacity in local and foreign currencies; and,

g. Prepare a schedule of any other Federal Government obligations such as trade debts and other contingent liabilities, both explicit and implicit and provide advice on policies and procedures for their management.

Moreover, the Act empowers the Debt Management Office to issue periodic guidelines to regulate the conduct of external and domestic borrowing as approved by the Federal Executive Council (FEC) and the National Assembly.

2.3.2 Debt Management Related Committees

In addition to the establishment of the DMO, the government has constituted multi-agency advisory committees, namely:

a) **Monetary and Fiscal Policy Coordinating Committee (MFPCC)**: to clarify and harmonise the objectives of public debt strategies, fiscal and monetary policies, among other things. Members of the Committee are drawn from DMO, MoF, CBN, Budget Office, OAGF and NPC.
b) **Bond Market Steering Committee**: to get the buy-in of all relevant stakeholders and to speedily resolve any conflicting policy issues that may hinder the orderly development of the Nigerian bond market. Members of the Committee are drawn from DMO, SEC, NSE, CBN, PENCOM, and the organised private sector.
c) **Sub-national Steering Committee**: to streamline the management of Nigeria's domestic debts, make fiscal federalism effective, and ensure full involvement of States in the

management of sub-national debt, the maintenance of a reliable database and the design of borrowing guidelines. Members of the Committee are drawn from the six geopolitical zones, OAGF, FMF, CBN and DMO. A representative of the World Bank serves on the Committee on an advisory basis.

2.3.3 Inter-Agency Relations

a) In matters of policy, strategies and procedures for its operations, the DMO must obtain the approval of the Board, whilst the approval of the National Assembly (NASS) must be obtained for the negotiation and acceptance of external loans and the issuance of guarantees. DMO must also obtain the approval of the Federal Executive Council (FEC) with respect to guidelines drafted for its procedures and strategies.

b) National Planning Commission (NPC) by mandate is responsible for managing grants from development partners. To enable the government have a holistic view of capital flows, DMO liaises closely with the NPC to obtain grant data.

c) The DMO collaborates with other government agencies for various activities, including the conduct of Debt Sustainability Analyses (DSAs), debt servicing and settlement and, as mentioned above, macro, fiscal and monetary policy coordination. Such government agencies are the following: Federal Ministry of Finance (MoF), National Planning Commission (NPC), National Bureau of Statistics (NBS), Central Bank of Nigeria (CBN), Office of the Accountant General of the Federation (OAGF), Bureau of Public Enterprises (BPE), Office of the Senior Special Assistant to the President on Millennium Development Goals (OSSAP-MDGs) and the Budget Office of the Federation.

d) The CBN currently issues Nigerian Treasury Bills (NTBs) via an auction system in which prices are market-determined. Joint efforts are being made to involve DMO in the process, because of the implications that the issuance of NTBs has for the overall supply of government securities in the market. CBN raises instruments for monetary purposes while DMO raises debt instruments for government financial needs, including cash management needs. To ensure coordination in market intervention, close relationship is achieved through the Monetary and Fiscal Policy Coordinating Committee.

3. DEBT MANAGEMENT ORGANIZATION

3.1 Board and Management Structure of DMO

Following the establishment of the DMO in 2000, debt management functions have been concentrated in this autonomous government agency located under the Presidency. The DMO Act provides for a Seven-member Supervisory Board, where the Vice President of the Federation is the Chairman, the Minister of Finance is the Vice-chairman and other members include the Attorney-General of the Federation, the Chief Economic Adviser to the President, the Governor of the Central Bank of Nigeria, the Accountant-General of the Federation and the Director-General of DMO. The Director-General of DMO is also the Secretary to the Board. The Board was inaugurated on Thursday, 23rd August, 2007.

3.2 Departments and Operational Responsibilities

The DMO is structured in a front, a middle and a back office configuration in line with international best practice in debt management. It consists of four core departments and one support department (Figure 3.1), namely:

Portfolio Management Department (Front Office) - negotiates loans and is responsible for the issuance of sovereign bonds.

Strategic Programmes Department (Front Office) - responsible for facilitating the development of Debt Management Departments (DMDs) in the 36 States of the Federation; nationwide public debt education; the establishment of the Debt Management Institute; and the management of associated issues and externalities affecting public debt.

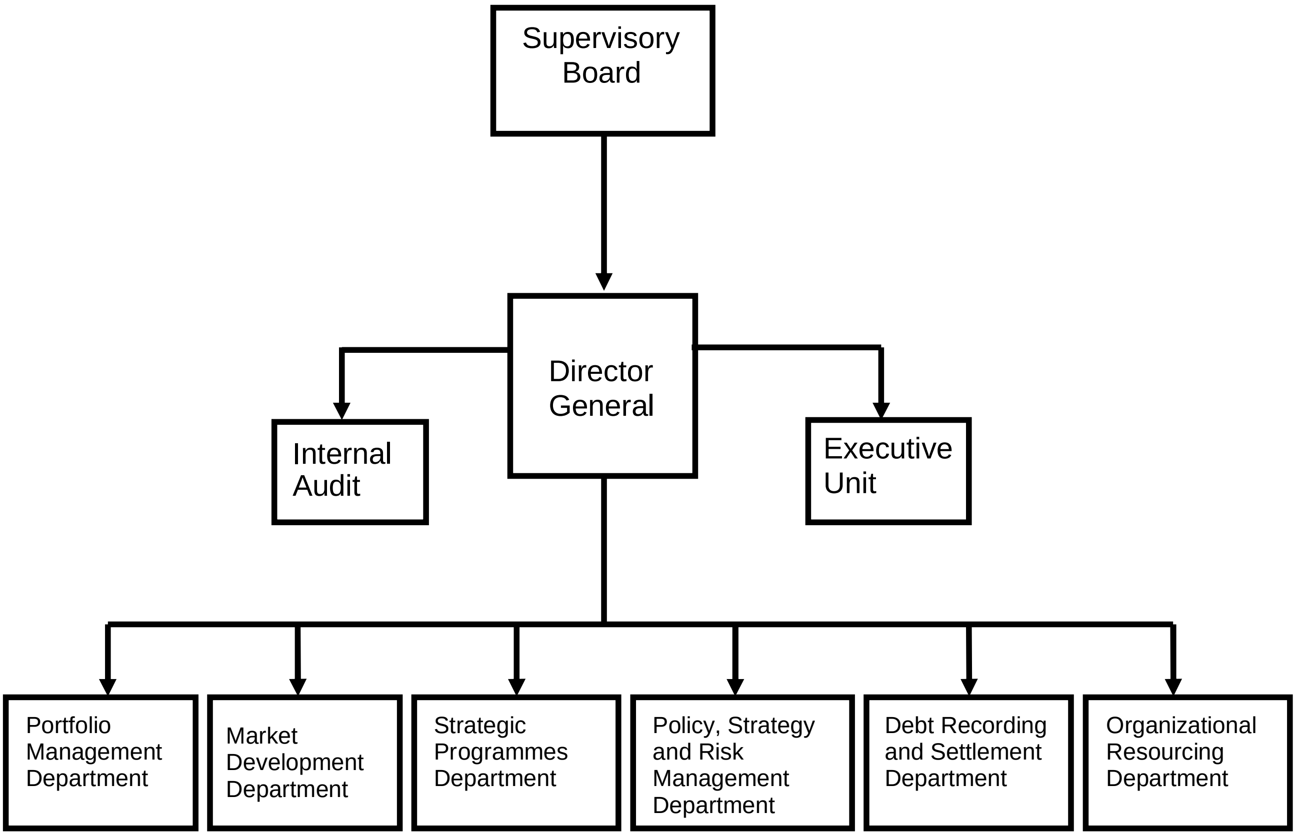
Market Development Department (Front Office) - responsible for the development of the Federal Government of Nigeria debt securities market.

Policy, Strategy and Risk Management Department (Middle Office) - responsible for, among others, the formulation of policies and strategies; performing debt sustainability analyses and risk evaluations on the portfolio.

Debt Recording and Settlement Department (Back Office) - responsible for the recording of public debt data and the servicing of debt.

Organisational Resourcing Department (Support Office) - responsible for human resources and administrative issues, IT, accounts, outreach and communications.

Figure 3.1. Debt Management Office: Organizational Structure



4. DEBT STRUCTURE

4.1 Total Public Debt

As at 31st December 2007, Nigeria's total public debt stood at US$22,229.88 million (Figure 4.1) which indicates an increase from US$17,349.69 million in 2006 due to increase in the domestic debt stock, after declining from US$32,306.73 million in 2005. Following the Paris Club debt deal, the external debt stock which stood at US$35,944.65 in 2004, dropped to US$20,477.97 million in 2005 and a further reduction to US$3,544.49 million in 2006 but a slight increase to US$3,654.21 in 2007. As a result of the debt deal, in 2006 the external debt share of the portfolio declined to 20.4 percent, while from 2002 to 2004 it had averaged 77.3 percent. On the other hand, domestic debt accounted for an average of 22.6 percent for the period 2002-2004 but rose from 2005, accounting for 83.56 percent of the portfolio in 2007.

Figure 4.1: Total Public Debt, 2003 – 2007 (US$ million)

A study published in the 2003 World Economic Outlook derived a tentative threshold of 50 percent for the ratio of total public debt to GDP in emerging markets. As Table 4.1 shows, the ratios for Nigeria were well above that threshold before the Paris Club debt deal of 2005. As at end 2006, after the final exit from both Paris and London Club debt obligations, the total public debt/GDP ratio fell to 12.39 percent and total public debt stock declined to N2,239.11 billion (US$ 17, 349.69 million). This ratio further declined to 11.67 percent in 2007.

Table 4.1 Total Public Debt/GDP Ratio

	2001	2002	2003	2004	2005	2006	2007
GDP (Naira billion)	6,895.20	7,795.76	9,913.52	11,411.07	14,572.24	18,067.83	22,848.89
Total Public Debt (Naira billion)	4,210.96	5,155.72	5,588.46	6,147.88	4,167.57	2,239.11	2,596.44
TPD/GDP (%)	61.07	66.13	56.37	53.88	28.60	12.39	11.67

4.2 External Debt

Nigeria's external debt stock, comprising public and publicly guaranteed debt as at 31st December 2007 stood at US$3,654.21 million as against US$3,544.49 million in 2006. The debt stock increased by 26.8 percent between 2001 (US$28,347 million) and 2004 (US$ 35,944.65 million). However, a 43.0 percent fall to US$20,477.97 million was recorded in 2005, due to the implementation of Phase I and II of the Paris Club debt deal. A further 82.7 percent fall was registered between 2005 and 2006, when the external debt stock stood at US$3,544.49 million. Although Non-Paris Club debt stock decreased steadily from 2001 to 2004, it rose sharply from US$47.5 million to US$461.8 million in 2005, due to new disbursements of loans contracted from China. As at end - 2006 - Non-Paris Club debt stock stood at US$326.08 million, or 9.2 percent of the external debt portfolio.

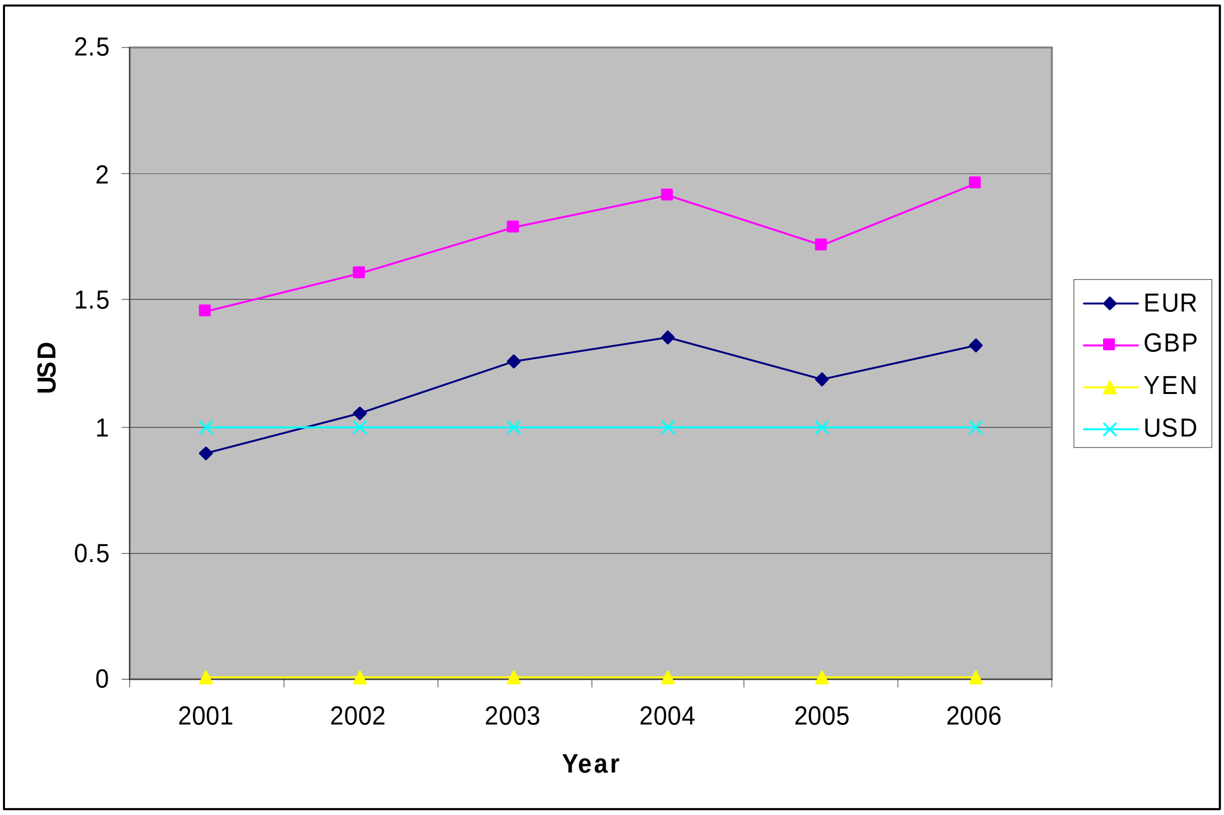
Increases in Nigeria's external debt stock (Table 4.2) since 2001 are largely attributable to the accumulation of arrears, foreign exchange exposure of the country's debt portfolio and the depreciation of Nigeria's external debt reporting currency, the US dollar, against the three major external debt portfolio currencies, namely the Euro, the British Pound Sterling and the Japanese Yen (Figure 4.2). In particular, the consolidation into Euro of Nigeria's external debt to EU countries in 2003 and the subsequent appreciation of the Euro against the US Dollar were largely responsible for the growth in the nation's debt stock. Over the period 2001-2004, this accounted for an external debt stock increase of US$12,628.31 million.

Table 4.2 External Debt Stock, 2001-2007

	2001	2002	2003	2004	2005	2006	2007
External Debt Stock (USD ml)	28,347.00	30,991.86	32,916.81	35,944.65	20,477.97	3,544.49	3,654.21
External Debt Stock (Naira ml)	3,188,754.03	3,934,416.63	4,258,118.54	4,778,841.22	2,641,658.13	457,239.21	426,811.70

Note: Exchange rate – Naira (₦) per US$: 2001 – ₦112.49, 2002 – ₦126.95, 2003 – ₦129.36, 2004 – ₦132.95, 2005 – ₦129.00, 2006 - ₦129.00, 2007 - ₦116.80

Figure 4.2: Exchange Rate Trend (US$ per Unit Currency)



Source: CBN

4.2.1 External Debt Stock by Creditor Category

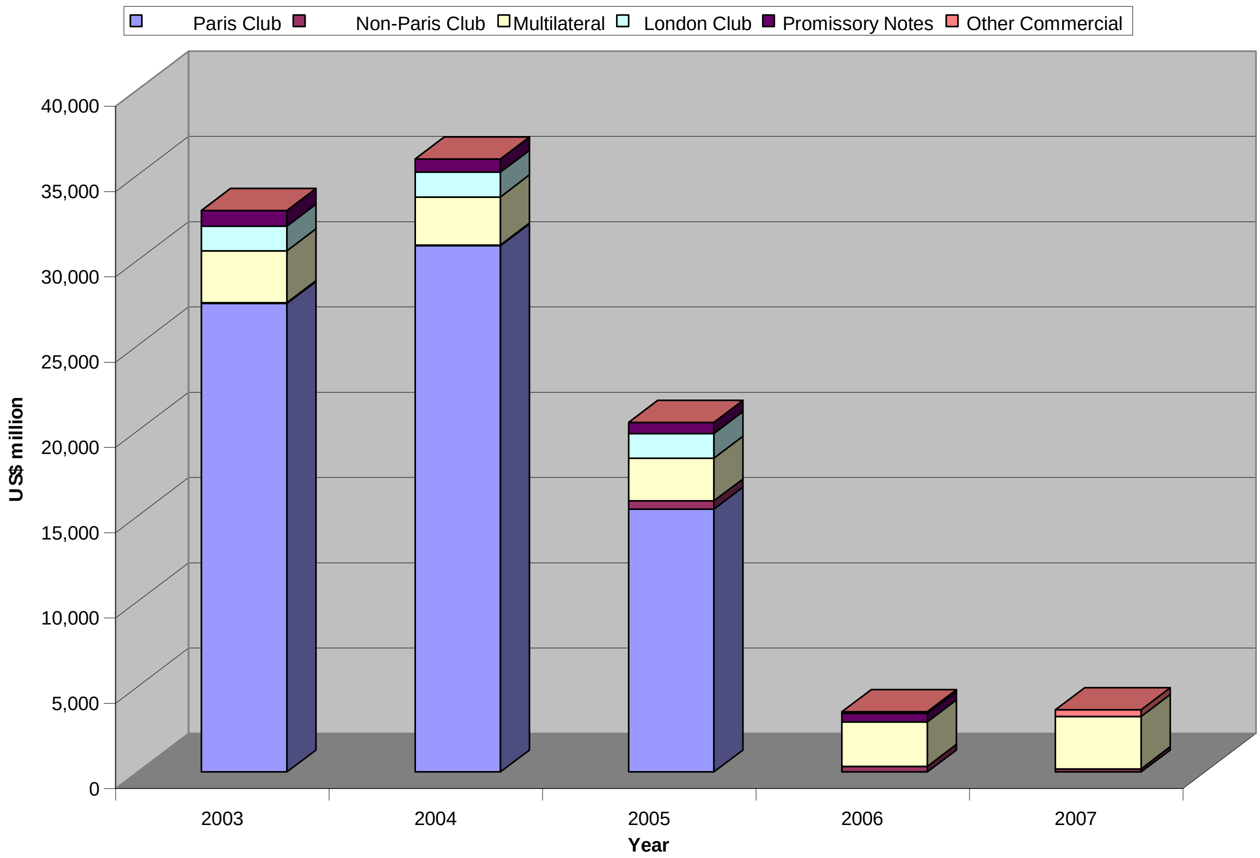
For the period 2001-2004, Paris Club debt continued to dominate the country's external debt portfolio, representing 85.8 percent of total external debt stock in 2004. It then declined to 75.3 percent of the total by the end of 2005, before the final exit in 2006 (Figure 4.3).

As at December 2005, London Club debt stock comprised US$1,441.79 million worth of Par Bonds and US$509.01 million of Promissory Notes. The Par Bonds were repaid in November 2006. In March 2007 the government reached an agreement with Promissory Notes Holders so that any payments due would be secured by a substitute obligor appointed by the Federal Government, selected through a competitive bidding process. This arrangement discharged the Government of Nigeria from its obligation to pay for the remaining installments due and allowed the final exit from all London Club debt obligations.

Although not formally part of the London Club debt stock, 1.76 million units of Oil Warrants, issued in association with the Par Bonds during the 1992 restructuring, also elicit service payments, subject to oil prices going above US$28 per barrel over a period of more than six consecutive months. In February 2007, the government launched a cash tender offer in the form of a modified Dutch Auction for US$220 per Right associated with the Warrants. Subsequently, 21 percent of the Warrants were redeemed.

Multilateral debt rose between 2001 and 2003 because of new disbursements on concessional terms by the International Development Association (IDA) and the African Development Fund (AfDF). It then declined from 2004 to 2005, as a result of repayments made on maturities due on IBRD, AfDB and EIB loans, only to increase slightly again to US$2,608.30 million and US$3,080.91 million in 2006 and 2007 respectively.

Figure 4.3: External Debt by Creditor Category 2003-2007 (US$ million)



4.2.2 New External Commitments

Total new external commitments amounted to US$3,801.85 million over the period 2001-2007 (Table 4.3). About 81 percent of these was from Multilateral creditors (mainly IDA), while the remaining 19 percent was from Non-Paris Club Bilateral creditors. China has emerged as a new creditor with a new commitment of US$509.7 million in 2002 and a further US$208.0 million in 2006 for the Telecommunication Support Project.

Table 4.3 New Commitments by Creditor Category, 2001-2007 (US$ million)

Creditor Type	2001	2002	2003	2004	2005	2006	2007	Total
Paris Club	-	-	-	-	-	-	-	-
Multilateral	414.88	45.63	673.99	268.69	674.79	301.26	704.91	3084.15
Bilateral Non-Paris Club	-	509.70	-	-	-	208.00	-	717.7
TOTAL	414.88	555.33	673.99	268.69	674.79	509.26	704.91	3801.85

4.2.3 Disbursements by Creditor Category

Over the 2001-2007 periods, there was a steady increase in disbursement flow, which witnessed a sharp rise from US$387.61 million in 2005 to US$512.57 million in 2006 before falling to US$424.55 million in 2007 (Table 4.4). Disbursements were mainly from multilateral creditors, although new disbursements from non Paris Club bilateral lenders, like China, swelled as well.

Table 4.4: Disbursements[1] by Creditor, 2001-2007 (US$ million)

	2001	2002	2003	2004	2005	2006	2007
Official							
Multilateral							
IDA	9.07	18.83	63.18	156.19	244.95	337.36	330.68
IFAD	0.30	-	5.17	2.43	2.46	5.20	6.52
ADB	16.73	32.60	21.45	26.26	10.42	5.53	2.34
ADF	2.75	0.40	16.43	0.35	6.98	10.11	47.08
Bilateral	-	-	-	3.67	122.80	130.93	37.94
Private	-	-	-	-	-	23.44	-
TOTAL	28.85	51.83	106.23	188.90	387.61	512.57	424.55

[1]Disbursements exclude grants.

4.2.4 External Debt Service Payments

DEBT SERVICE PAYMENTS

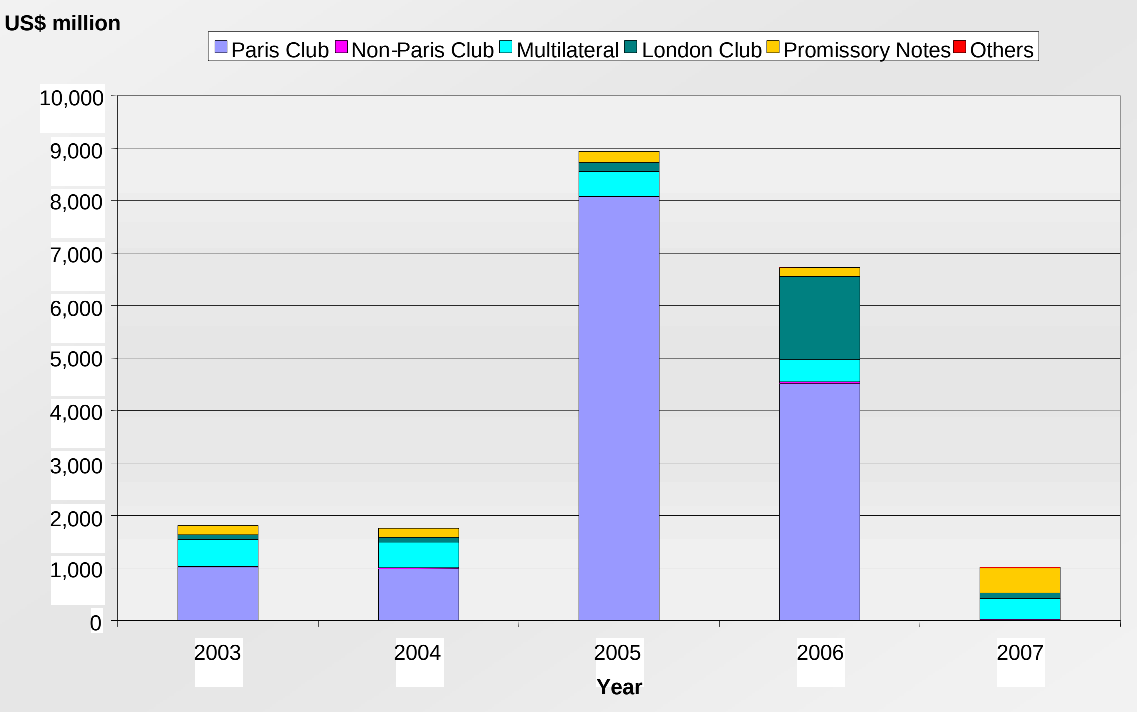
Debt service payments were on an alternating trend throughout the period 2003-2006 (Figure 4.4, table 4.5). Total external debt service payments for the year 2007 was US$1,022.04 million, compared to US$6,729.20 million in 2006, reflecting a decrease of US$5,707.16 million, or 558.40 percent. This substantial decrease was due to large payments made for the Paris Club and London Club debt exit, which constituted the bulk of debt service payment obligations in 2006.

The highest payment of US$8,940.93 was made in 2005.This was mainly in respect of settlement of London Club debts. In addition it shows that the largest debt service payment of US$476.60 million, or 46.63 percent, was made to the Promissory Notes holders. The second largest payment amounting to US$392.77 million, or 38.43 percent, was made to Multilateral creditors. Payments to London Club creditors amounted to US$102.59 million, or 10.04 percent of the total. US$27.48 million, or 2.69 percent, was paid to non-Paris Club bilateral creditors and US$22.60 million, or 2.21 percent, to Other Creditors.

Table 4.5 External Debt Service Payments, 2003-2007 (US$ Million)

Creditor Category	2003	2004	2005	2006	2007
A. Official					
1. Bilateral					
Paris Club	1,020.18	994.45	8,070.79	4,519.87	0.00
Non-Paris Club	13.26	11.65	11.39	25.56	27.48
2. Multilateral	509.23	487.28	471.67	426.62	392.77
Sub-Total	**1,542.66**	**1,493.38**	**8,553.85**	**4,972.05**	**420.25**
B. Private:					
1. London Club (par bonds/oil warrants)	90.21	90.15	169.86	1,584.58	102.59
2. Promissory Notes	176.42	171.23	213.55	170.84	476.60
3. Other Commercial	0.00	0.00	3.67	1.60	22.60
Sub-Total	266.62	261.38	387.08	1,757.14	601.79
Grand Total	**1,809.28**	**1,754.76**	**8,940.93**	**6,729.20**	**1,022.04**

Figure 4.4: External Debt Service Payments, 2003 - 2007

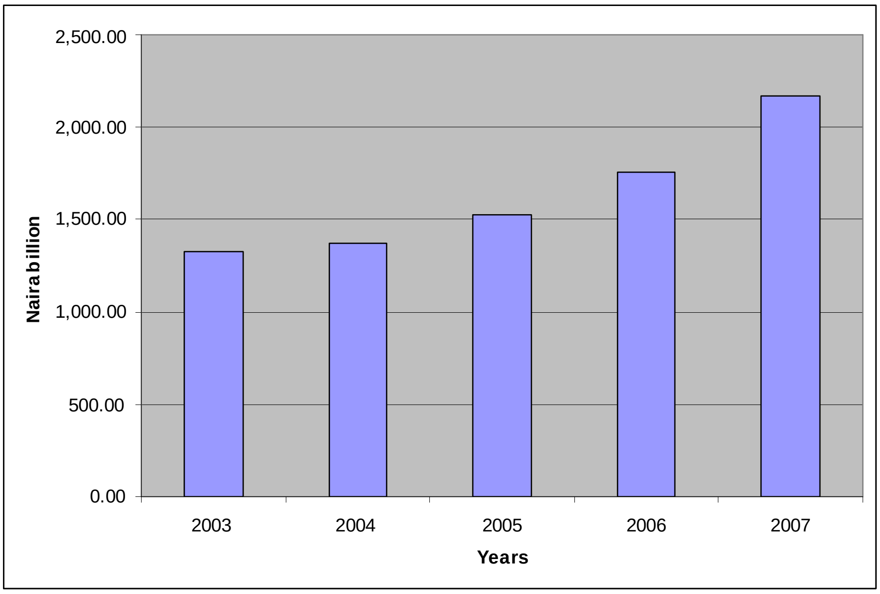


4.3 Domestic Debt

4.3.1 Total Domestic Debt Stock

Over the period 2003–2007, Nigeria's domestic debt stock rose from N1,329.72 billion to N2,169.63 billion, i.e. by 23.75 percent. Between 2005 and 2006 alone, it increased by 14.89 percent, representing an increase of N227.35 billion (Figure 4.5). The observed increases in the stock of domestic debt are accounted for by new issues of Nigerian Treasury Bills (NTBs) and FGN Bonds to finance budget deficits, lengthen the maturity structure of the debt portfolio and develop the domestic debt market.

Figure 4.5: Trend of Total Domestic Debt Stock, 2001-2007 (₦ billion)



4.3.2 Domestic Debt Composition and Structure

As at end-Sept 2007, the structure of the nation's domestic debt is made up of the following:

1. Nigerian Treasury Bills:
   i. 91-day
   ii. 182-day
   iii. 365-day
2. FGN Bonds:
   i. 2-year
   ii. 3-year
   iii. 5-year
   iv. 7-year
   v. 10-year

3. Treasury Bonds; and

4. Federal Republic of Nigeria (FRN) Development Stocks.

Figure 4.6 and Table 4.6 shows the holdings of domestic debt by instruments as at 31st December, 2007. The banking sector remained the major holder, accounting for ₦1,394.75 billion, or 64.28 percent, followed by the non-bank public, which accounted for ₦484.29 billion, or 22.32 percent, while the Central Bank of Nigeria (CBN) had a share of ₦290.59 billion, or 13.39 percent of the total holdings. The holdings of both the banking sector and the non-bank public have been on the increase since 2001 due to: insufficient alternative classes of assets to invest, recent growing efficiency of the secondary market, and growing activity in the pension sector.

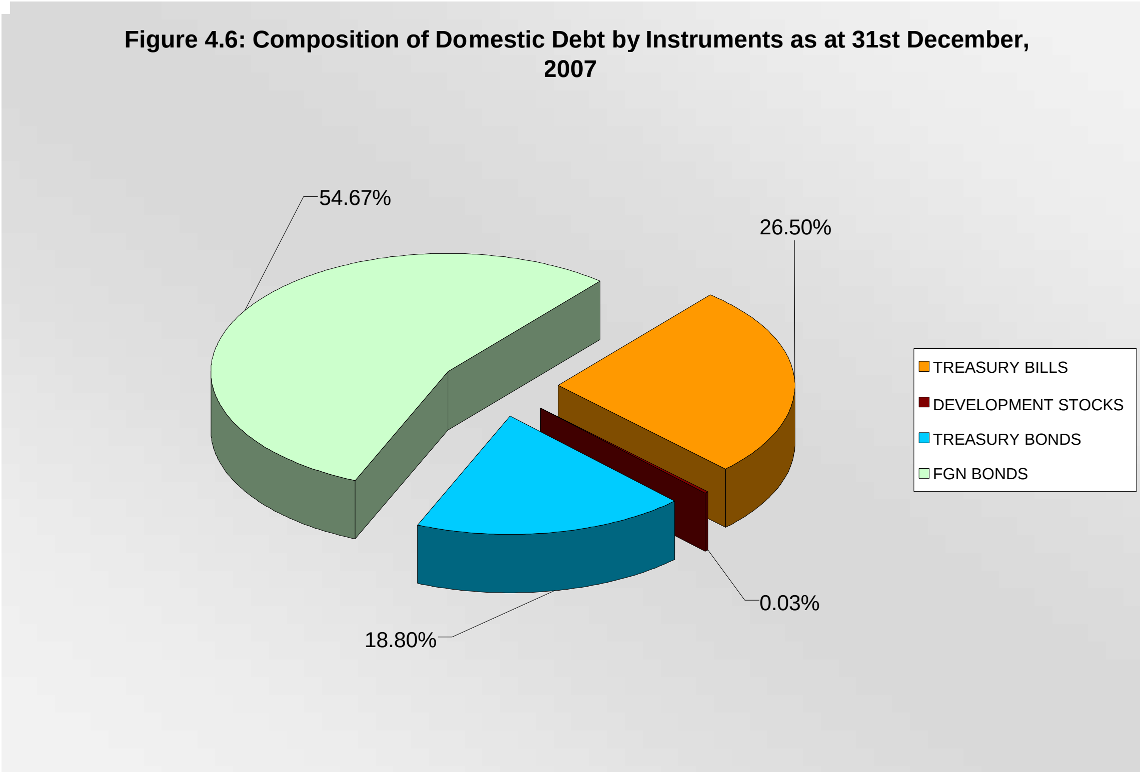
Table 4.6: Holdings of Domestic Public Debt Instruments as at 31st December, 2007

INSTRUMENT	NON-BANK PUBLIC	CENTRAL BANK	BANKS AND DISCOUNT HOUSES	TOTAL AMOUNT OUTSTANDING
FGN Bonds	342.82	N/A	843.34	1,186.16
NTBs	17.57	5.94	551.41	574.92
Treasury Bonds	0	407.93	0	407.93
Development Stocks	0.62	N/A	N/A	0.62
TOTAL	**484.29**	**290.59**	**1,394.75**	**2,169.64**

Source: CBN

COMPOSITION OF DOMESTIC DEBT BY INSTRUMENTS

Figure 4.6 illustrates the composition of domestic debt by instrument as at end-2007. FGN Bonds of ₦1,186.16 billion, accounted for 54.67 percent, while Treasury Bills of ₦574.93 billion accounted for 26.50 percent of the total domestic debt stock. The decrease of NTBs from 56 percent of the total debt stock in 2005 to the present level of 26.50 percent is attributable to the refinancing of this class of obligations with longer tenored instruments. Treasury Bonds amounted to ₦407.93 billion, or 18.80 percent, while FRN Development Stocks comprised ₦0.62 billion or 0.03 percent of the total domestic debt stock.



4.3.3 Holding Structure of Domestic Debt

There are three key holders of government debt instruments (Table 4.7), namely banks and discount houses, non-bank public and the Central Bank of Nigeria (CBN).

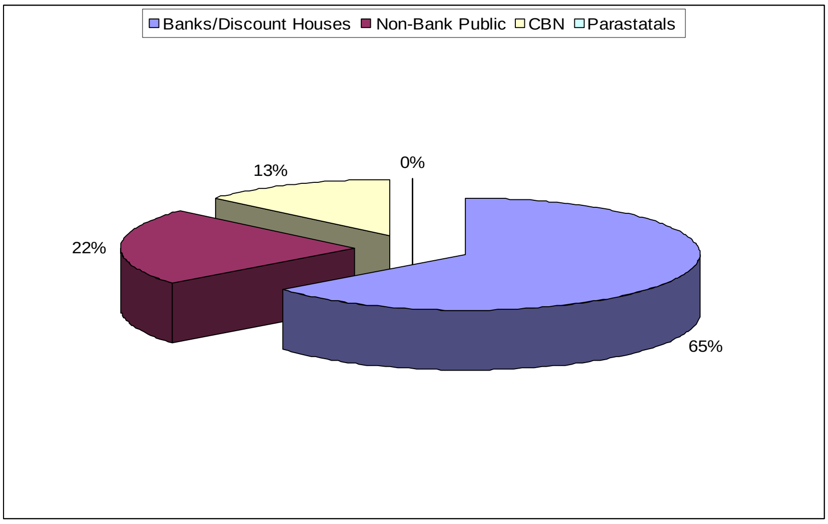
CBN accounted for the bulk of holdings of domestic debt for the period 2001–2003, with an average of 49 percent. However, from 2004, banks and discount houses have emerged as the major holders of government debt instruments and have remained so as at end-2006, accounting for 56 percent of total holdings. CBN held, instead, 21 percent of the total (Figure 4.7).

Table 4.7
Holding of Domestic Debt (₦ billion)

	2001	2002	2003	2004	2005	2006	2007
Banks/Discount Houses	386.45	460.20	506.78	669.07	759.61	882.85	1,394.75
Non-Bank Public	61.02	173.35	215.46	297.80	71.88	366.22	484.29
CBN	569.51	532.45	607.44	403.46	501.97	335.53	290.59
Parastatals	n/a	n/a	n/a	n/a	192.45	168.65	n/a
TOTAL	1,016.98	1,166.00	1,329.68	1,370.33	1,525.91	1,753.26	2,169.63

Source: CBN
Na: not available

Figure 4.7: Holding of Domestic Debt in 2007



Source: CBN

4.3.4 Maturity Structure of Domestic Debt

In 2001-2005, the domestic debt portfolio was characterized by the dominance of short-term instruments (i.e. NTBs), which comprised maturities of 91, 182 and 365 days and accounted for a yearly average of 60 percent of total domestic debt stock. Until 2004, the amount of short–term instruments was on an increasing trend. However, with the new issuance of FGN Bonds in 2005, the stock of long-term debt instruments which are mostly FGN Bonds, increased to 44 percent of the total. In 2006, there was a phenomenal shift in the maturity structure of the domestic debt stock as the share of long-term instruments actually surpassed that of short-term ones. The former became 60% of the entire domestic debt portfolio, while the latter reduced to being 40% of it (Table 4.8, Figure 4.8). This change in maturity profile was due to the successful restructuring programme initiated by the Federal Government.

Table 4.8
Maturity Structure of Domestic Debt (₦ billion)

	2001	2002	2003	2004	2005	2006	2007
Short Term[1]	584.54	733.76	825.05	871.57	854.83	695.00	709.77
Long[2] Term	432.44	432.24	504.63	498.75	671.08	1,058.26	1,459.86
Total	**1,016.98**	**1,166.00**	**1,329.68**	**1,370.32**	**1,525.91**	**1,753.26**	**2,169.64**

[1]Short term instruments are instruments whose maturity is a year or less, i.e. Treasury Bills.
[2]Long term instruments are instruments whose maturity is longer than one year, i.e. FGN Bonds, Treasury Bonds and Development Stocks.
Source: CBN and DMO

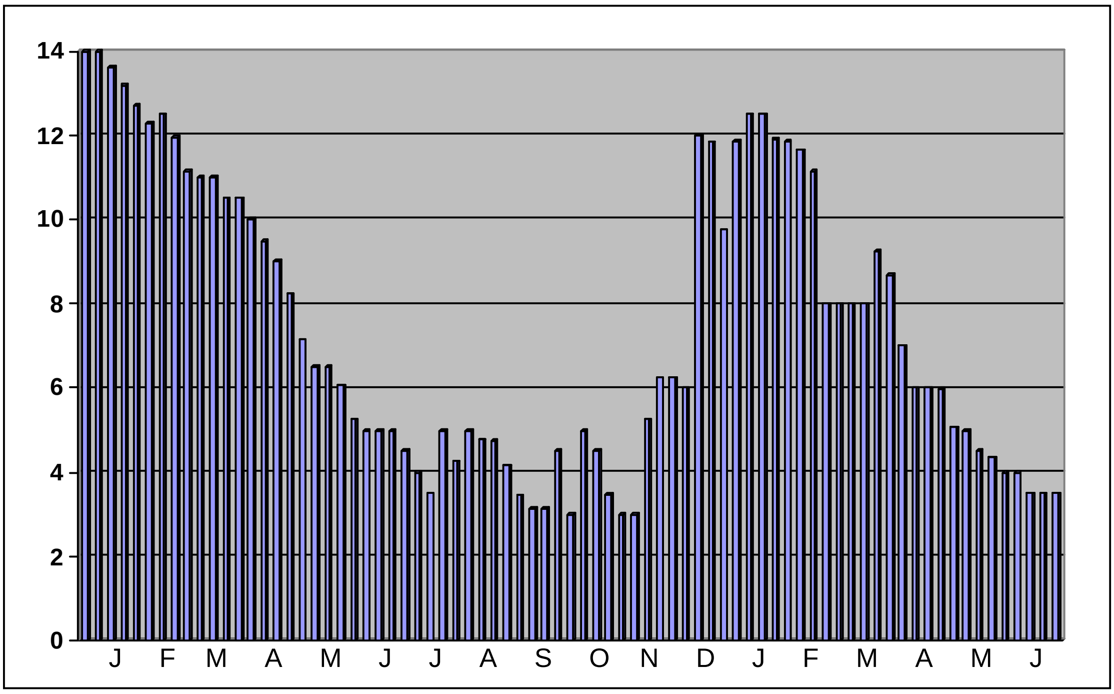
Figure 4.8: Trend of Maturity Structure of Domestic Debt Stock, 2001-2007

Source: CBN

4.3.5 Interest Rate Structure for FGN Securities

Interest rates on government securities have showed high volatility during the past two years. This could be attributed to a number of factors, such as the banking consolidation exercise, increased monthly allocations to the three tiers of government and the tight monetary policy stance of the CBN. For instance, the issue rate for the 91-day NTBs (Figure 4.9) ranged between 3.02 percent and 14.50 percent during the period January 2005-June 2006. As Figure 4.9 shows, in the first half of 2006, interest rates continued to be volatile as authorities accelerated their efforts to reduce the issuance of short-term papers with the objective of moving the market beyond one year instruments.

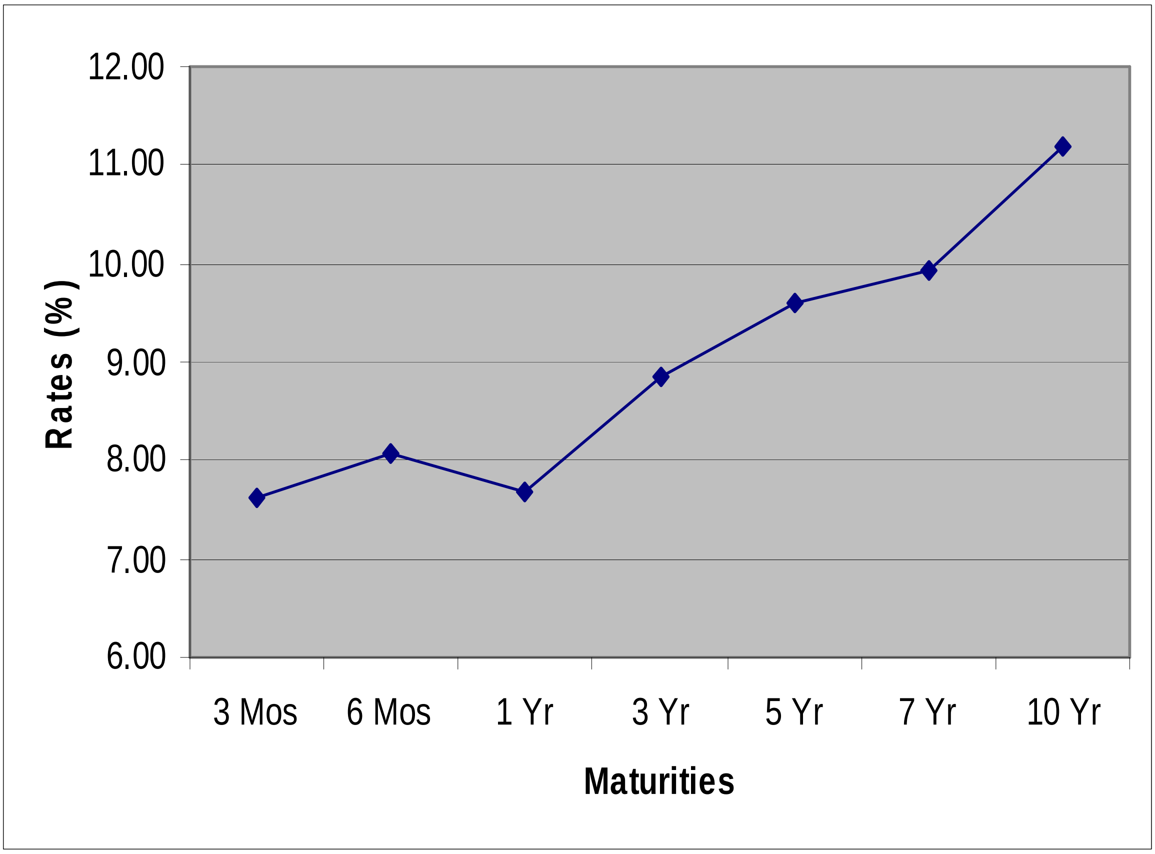
Figure 4.9: 91-day NTBs Issue Rate between January 2005 and June 2006



Source: CBN

At the end of 2006, the yield curve for the FGN Bonds was upward sloping for a maturity range of up to seven years, despite a blip for five-year maturity securities.

Figure 4.10: Yield Curve for the FGN Bonds (Indicative – 31 December 2007)



4.3.6 Amortisation Schedule of FGN Bonds

Table 4.9 displays the amortisation schedule for FGN Bonds issued to date. DMO issued more of the 3-year tenored bonds, amounting to ₦223.8 billion, representing 37.8 percent of the entire issuance for the year. The least was the 7-year bond, with a value of ₦117.2 billion, representing 19.8 percent of the total volume issued. The maturity distribution reflected investors' preferences. In order to minimise the risk exposure of the domestic debt portfolio, it would be advisable to continue current efforts to lengthen the maturity profile of the portfolio to tenors of seven and ten years. The 2007 Bond Issuance Programme envisages the issuance of such longer-tenured bonds and as at December 2007, a total of ₦592 billion was raised from the market using instruments of various tenors as detailed in the table below.

Table 4.9: FGN Bonds Issued in 2007 (By Maturities)

S/N	Tenor	Amount (N' billion)	Percentage
1	3-yr	223.8	37.8
2	5-yr	131.0	22.1
3	7-yr	117.2	19.8
4	10-yr	120.0	20.3
	Total	**592.0**	**100**

Source: Debt Management Office

5. RISKS ASSOCIATED WITH THE DEBT STRUCTURE

5.1 Introduction

Risk management is the process of identifying the level of risk that an entity wants to incur, measuring the level of risk that an entity currently faces, taking actions that bring the actual level of risk to the desired level and monitoring the new actual level of risk so that it continues to be aligned with the desired level. The process is continuous and may require alterations in any of these activities to reflect new policies, preferences and information.

Sound debt management practices stress the importance of analysing and monitoring the risks inherent in the structure of public debt as well as mitigating them, while taking into account the costs of doing so. In the trade-off between expected costs and risks, very often cost-minimisation is given priority over risk-mitigation in public debt management. However, an excessive focus on cost savings at the expense of risk reduction can have serious consequences for an economy and potentially lead to a crisis.

Risk management should be conducted regularly at both the national and sub-national level. In meeting the Sub-national Government's financing needs and its payments obligations, DMDs should ensure prudent risk management to avoid dangerous debt structures and strategies. DMDs should try to minimize expected debt servicing costs subject to an acceptable level of risk, by managing the trade-offs between expected cost and risk in the government debt portfolio. The cost of government debt includes the financial cost, which typically is considered to be the cost of servicing the debt over the medium to long run, and the impact on the State Government's fiscal position. DMDs should ensure that the cost of borrowing is not such that Sub-national Governments will be overexposed to risks inherent in their debt portfolio, especially market and liquidity risks. Minimizing costs, while ignoring risks, should not be an objective. This is because transactions that appear to lower debt servicing costs may embody significant risks for the government and can limit its capacity to repay lenders.

Taking the above issues into consideration, Nigeria has started some preliminary risk analysis in an attempt to develop the basis for carrying out in the future regular stress tests of the debt portfolio to assess the economic and financial shocks the latter may be exposed to and ensure the maintenance of debt sustainability. In this section, Nigeria's debt sustainability ratios are presented and discussed against internationally accepted benchmarks. This is followed by the identification of the specific risks faced by the portfolio and the measures that can be adopted to mitigate them.

5.2 Debt Sustainability Ratios

5.2.1 External Public Debt Ratios

While external public debt continued to dominate total public debt over the period 2001-2005, the Paris Club exit in 2006 changed the picture - external debt changed from 63.39 percent to 20.68 percent of total public debt while domestic debt changed from 36.61 percent to 79.32 percent. This change is clearly reflected in Nigeria's external debt solvency ratios (Table 5.2) over this period. Both solvency ratios (i.e. the ratio of external debt stock to GDP and export) remain above their thresholds over the period 2001-2004. From 2005, these ratios show sustainability, following the Paris Club debt exit deal.

The position is reversed when debt service ratios are considered. Both the external debt service/export ratio and the external debt service/government revenues ratio show sustainability until 2004. This is because Nigeria was not servicing the full amount due over that period. With the first two payments made under the Paris Club debt deal, the ratios indicate an unsustainable situation for 2005. However, the situation stabilised in 2006, with the final exit payment made to the Paris Club and the Par Bonds portion of the London Club debt. Although the latter were also considerable amounts, debt service payments remained at sustainable levels in 2006.

Table 5.1 External Debt Ratios, 2001-2006 (%)

	2001	2002	2003	2004	2005	2006	Threshold
External Debt Stock/Total Public Debt	75.70	76.28	76.19	77.70	63.39	20.43	N.A
External Debt Stock/GDP	46.24	50.45	42.95	41.86	18.08	3.7	30
External Debt Stock/Export	159.33	220.01	152.36	103.41	41.86	6.32	100
External Debt Service/Export	11.96	8.29	8.37	5.05	18.28	12.00	15
External Debt Service/Government Revenues	16.77	9.23	11.63	8.78	38.02	15.89	20

Note: There is no generally acceptable threshold for external debt stock as % of total public debt.
N.A: Not available

5.2.2 Domestic Debt Ratios

Although the share of domestic debt to total public debt has been on an increasing trend throughout the period under review, it was only a minor component of total public debt until 2006. With the final exit from Paris Club debt, domestic debt became the larger share of total public debt, at around 80 percent.

Table 5.2 shows that the domestic debt stock/GDP ratio was on a decreasing trend and at sustainable levels throughout the period 2001-2006. In spite of the increase in the domestic debt stock, the ratio was on a decreasing trend as a result of GDP growing at a higher rate than the domestic debt stock. The domestic debt service/government revenues ratio is also at sustainable levels and on a decreasing trend throughout the period under review. This is due to the restructuring exercise, which has lengthened the maturity profile of the portfolio, improved efficiency and increased competition, thereby pushing the coupon rate down and the bulk of servicing costs to the future. It is also due to higher government revenues over the period.

Table 5.2 Domestic Debt Ratios, 2001-2006 (%)							
	2001	**2002**	**2003**	**2004**	**2005**	**2006**	**Threshold**
Domestic Debt Stock/Total Public Debt	24.30	23.72	23.81	22.30	36.61	79.57	N.A
Domestic Debt Stock/GDP	14.75	14.96	13.41	12.01	10.44	9.70	20 -25
Domestic Debt Service/Government Revenues	10.89	10.62	9.94	7.66	4.96	3.05	28 – 63

Note: There is no generally acceptable threshold for domestic debt stock as a % of total public debt.
N.A: Not available

5.3 Risks Associated with Nigeria's Debt Portfolio

Based on the nature of Nigeria's public debt portfolio, the following key risks should be considered:

5.3.1 Solvency Risk

This is the risk associated with the country potentially becoming insolvent, when the volume of debt becomes so large as to threaten the country's ability to repay. This mainly applies to external debt.

The IMF and the World Bank (IDA) have introduced a new framework for assessing debt sustainability in low income countries. According to the Country Policy and Institutional Assessment (CPIA), Nigeria is ranked as a Poor Performer. As such, it is predicted to be able to sustain external debt levels within the thresholds displayed in Table 5.3. Following the Debt Sustainability Analysis (DSA) carried out by Nigeria in July 2007, the predicted values of Nigeria's external debt solvency indicators are those in Table 5.3.

Table 5.3 External Debt Solvency Indicators (%)				
Solvency Indicators	**2007**	**2010**	**2012**	**Thresholds**
External Debt/GDP	3.4	2.5	2.2	30
External Debt/Exports	8.1	8.1	8.3	100

Source: IMF/IDA/ Debt Management Office

Table 5.3 evidently shows that the country should not have any external debt sustainability problems at present as well as in the medium term. The final exit from Paris Club debt obligations is the main factor responsible for the change in Nigeria's external debt profile between 2005 and 2006 (final exit occurred in April 2006). Provided that Nigeria commits to obtaining largely concessional loans and sustaining economic reforms, external debt sustainability should be maintained in the medium term[1].

1 Although Nigeria as a Low Income Country may have an NPV of External Debt Stock to GDP ratio of 30%, it has been decided in the medium term to apply a more prudent country threshold of 20% in order to ensure continued debt sustainability.

Although to date, there are no internationally agreed thresholds for assessing the sustainability of domestic debt, Debt Relief International (DRI) has indicated a series of internationally accepted benchmarks to be used as a rule of thumb in domestic debt sustainability analysis. Some of them are shown in Table 5.4, together with the projections from Nigeria's 2007 DSA exercise[2].

Nigeria would seem not to have any domestic debt sustainability problems over the medium term. While the ratio of Domestic Debt Stock/GDP and Domestic Debt Service/Revenue are below the lower thresholds for the indicators, the other ratio, i.e. Interest Payments/Domestic Budget Revenue, is within the threshold boundaries in the medium term. The only exception is the Interest Payments/Domestic Budget Revenue ratio in the year 2010 – its value is higher than the upper boundary of the threshold.

Table 5.4
Domestic Debt Solvency/Liquidity Indicators (%)

Solvency Indicators	2007	2010	DRI Threshold Range
Domestic Debt Stock/GDP	9.7	8.6	20 – 25
Domestic Debt Service/Revenue	3.1	10.0	28 – 63
Interest Payments/Revenue	5.2	8.2	4.6 – 6.8

The rise above the threshold value of the Interest Payments/Domestic Budget Revenue indicator could be seen as a warning – since most values throughout the period under review are already in the middle range, it could be easily lapse into liquidity problem, if sound debt management practices are not maintained. The first lesson to learn from the above analysis is that domestic debt will feature in an increasingly prominent way in Nigeria's debt management issues in the coming years. All ratios are on an increasing trend between 2006 and 2010. Indeed, increasing attention to the development of the domestic debt market is presently being paid by DMO. Secondly, because of its renewed importance and its early development status, drawing a sound domestic debt management strategy must be prioritised to prevent the drift into an unsustainable debt position in the longer-run.

This risk is part of the trade-off faced in developing the domestic capital market. Its mitigation could be achieved by enhancing policy coordination between the DMO and CBN. The DMO should draw up an issuance calendar, which ensures an appropriate ratio of short and long-term instruments. The CBN, on its part, should support DMO's efforts by adopting a strong monetary policy stance and maintaining single digit inflation. The latter would drive down market interest rates on securities, decreasing the cost of government borrowing in the medium to long term. The Fiscal and Monetary Coordinating Committee and the Liquidity Management Committee could be used as platforms for coordination between CBN and DMO.

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2. Given Nigeria's economic conditions, the need to avoid a relapse into debt unsustainability, as well as the country's increasing emphasis on domestic borrowing and the development of the domestic debt market, an external debt stock GDP ratio of 20 percent is recommended. It should be noted that according to DRI recommendation, the domestic debt stock – GDP ratio for Nigeria would range between 20 – 25 percent and the upper limit of 25 percent is considered appropriate for Nigeria given the emphasis on domestic borrowing. Accordingly, the recommended total public debt/GDP ratio for the medium term, i.e. 3 – 5 years is 45 percent.

5.3.2 Market Risk

This is the risk associated with changes in market prices and their impact on the cost of government debt servicing. Three main sub-categories of this risk can be identified. These are interest rate risk, exchange rate risk and commodity price risk. All three are relevant for Nigeria's case. At the Sub-national level, these market risks are all relevant depending on the structure of debt portfolios. If the Sub-national government's debt portfolio consists only of domestic debt fully denominated in local currency, then the interest rate risk should be a major concern.

Interest rate risk

This is the risk associated with movements of the interest rate on domestic and international capital markets. Changes in interest rates could affect debt service payments. Costs increase when interest rates rise and debt has to be refinanced. This is true for both fixed and floating-rate debt, when new fixed-rate issues are financed at higher interest rates or when rates go up at the rate reset dates for floating-rate debt. This is why short-term and floating-rate debt is considered more risky than long-term, fixed-rate debt.

In considering interest rate risk, it should be noted that Nigeria's current external commitments are all at fixed interest rates. Domestic debt is also at fixed interest rates. Nigeria's efforts have lately focused on lengthening the maturity profile of its domestic debt portfolio. The latter exercise has implications for the interest rate risk that the portfolio could be subject to. The restructuring exercise started by initially lengthening the maturity of NTBs from 91 to 182 and to 364 days and then moved on to an FGN Bonds Issuance Programme. Lengthening the maturity profile of the domestic debt portfolio involves paying higher interest rates on longer-tenured instruments. As shown in Table 5.4, although the value of the interest payment/debt service ratio is not too high above its threshold, interest rate risk could become a concern in the medium-term. As mentioned in section 5.3.1, to mitigate such risk enhanced policy coordination between DMO and CBN will be needed.

Exchange rate risk

This is the risk associated with exchange rate movements. Since Nigeria's domestic debt has always been issued in domestic currency, exchange rate risk has been applicable only to the external portion of public debt.

Movements in exchange rates can increase debt servicing costs. Indeed, this is what Nigeria suffered in the early 2000s, when it was still tied to debt obligations to the Paris Club of creditors. Over the period 2001-2004, there was a 27 percent increase in external debt stock, largely attributable to the depreciation of the US Dollar against other portfolio currencies (as well as due to the accumulation of arrears). The increasing trend in the external debt stock became particularly strong from 2003 with the consolidation into Euro of Nigeria's external debt to EU countries and the subsequent appreciation of that currency vis-à-vis the US Dollar.

At present, after the Paris Club debt deal, approximately 42 percent of the external debt stock is in US Dollars, while 44 percent is in Special Drawing Rights (SDRs). Since Nigeria's revenues accrue predominantly from crude oil, hence are in US Dollars, the exchange rate risk associated with the US Dollar external liabilities is minimal, despite the US Dollar being on a depreciating trend. Moreover, the share of external debt to total public debt has been declining over the last two years, reaching approximately 20 percent in 2006, hence becoming a minor part of the public debt portfolio.

Commodity price risk
This consists of the risk associated with commodity price swings. Since Nigeria's is an oil-dependent economy, changes in crude oil prices can have major repercussions on government's revenues and lead to real economic shocks. A sudden or persistent drop in crude oil prices would curtail government's revenues and foreign exchange inflows. This would translate into the depletion of foreign exchange reserves to pay, inter-alia, debt obligations as well as into the accumulation of new debt to offset the lack of resources. Sub-national governments are not immune from the effect of volatility in crude oil prices since they depend mostly on monthly allocation from the Federation Accounts.

To mitigate commodity price risk as well as prevent wide government expenditure swings and the accumulation of huge deficits, the government has put in place an oil price-based fiscal rule to de-link expenditure from oil revenues. Since 2003, these budget price benchmarks have been below average international crude oil prices. For the 2007 budget, the price benchmark was set at US$40 per barrel. Since 2004, this has helped Nigeria to accumulate substantial foreign exchange reserves (currently over US$40 billion).

5.3.3 Rollover Risk

This is the risk associated with the government's inability to roll over debt or to do so only at much higher costs. Hence, the degree of rollover risk is a function of both the volume and the time distribution of debt payments.

With the final exits from Paris and London Club debts, this risk is more relevant to the domestic debt portfolio. Until recently, rollover risk was quite high in Nigeria because of the absence of a market for long term debt instruments, like many other developing and emerging markets.

DMO has responded by embarking on a serious effort to develop the domestic market by undertaking a series of activities. This includes putting together an Issuance Programme for FGN Bonds, aimed at restructuring the domestic debt portfolio by lengthening its maturity structure. Moreover, it seeks to deepen market activities by establishing resilient primary and secondary markets for government securities, a broad investor base and a yield curve in line with international best practices. In the recent past, the proportion of short-term instruments in the domestic debt portfolio was greater than that of long-term instruments, but by the end of 2006 the situation was reversed. Short-term instruments constituted approximately 40 percent of the domestic debt stock, indicating a change in the maturity structure of the portfolio. This implies a reduction in the roll-over risk associated with the portfolio.

DMO will continue the restructuring of short term debt instruments to long term until the ratio of 25:75 short/long term debt ratio is achieved. Issuance of longer tenored debt instruments will be increased to 20 year papers.

5.3.4 Refinancing Risk

This is closely related to rollover risk. Generally refinancing risk occurs when a borrower is not able to refinance or rollover an existing debt at a future date under favourable terms mostly due to rising interest rates. Typically, refinancing risk is associated with short-term debt. As DMO progresses with lengthening the maturity profile of the domestic debt portfolio the refinancing risk for the Government is expected to decline.

5.3.5 Credit Risk

Credit risk, sometimes called default risk, relates to loss due to non-payment by counterparty. This risk is particularly relevant at the Sub-national level, because there is high bank exposure. Most State Governments are highly indebted to banks to the extent that a large proportion of their monthly Federation Account allocation is used in servicing debt. In order to hedge themselves against this type of risk, the lending banks enter into the Irrevocable Standing Payment Orders (ISPOs) agreements with these governments. This is a major source of concern at both the Federal and Sub-national levels.

5.3.6 Liquidity Risk

The main type of liquidity risk refers to a situation in which the borrower's volume of liquid assets diminish quickly in the face of unanticipated obligations or when a borrower finds it difficult to raise cash through borrowing in a short period of time. This type of risk can have both an external and a domestic dimension. The DSA exercise has forecasted Nigeria's external debt liquidity ratios for the medium term. Comparing the figures obtained with the thresholds in Table 5.5, the ratios seem to be below the thresholds. Nigeria's liquidity ratios, therefore, appear sustainable in the medium term.

Table 5.5 Liquidity Indicators (%)			
	2007	**2010**	**Thresholds**
External Debt Service/Exports	1.1	0.76	15
Total Public Debt Service / Revenue	17.0	11.6	25

On the domestic debt front, the strong appetite showed by the market for NTBs and FGN Bonds, the lengthening of the maturity structure of the portfolio, as well as, the high volume of accumulated reserves of foreign exchange should be mitigating potential liquidity risks by ensuring that the government has the ability to raise funds quickly in case of need.

5.3.7 Contingent Liability Risk

There are two major types of contingent liabilities in Nigeria's recent debt management environment: those that occasionally arise from government fiscal operations and those that come from explicit guarantees on sub-national borrowings. Examples of the former are Local Contractors' Debts (LCDs) and Pension Arrears (PAs). LCDs represent a large volume of unpaid debts to local contractors that were accumulated over the years mainly due to the growth of the public sector, the lack of a due process and irregularities and overvaluations of government contracts. PAs on their part accumulated because the pension scheme, in the past, used to be funded neither by the employer (government) nor by the employee (the civil servant). In the last few years, a large volume of both LCDs and PAs have crystallized into explicit government liabilities and have been taken over by the DMO. In 2004, LCDs were put at ₦300 billion, about ₦150 billion were paid via direct budgetary provisions in 2005. The remainder of ₦150 billion was billed for securitization. In September and December 2006, ₦91.65 billion worth of special FGN Bonds were issued to pay LCDs. The outstanding ₦58.35 billion has been built into the 2007 calendar. Similarly, a total of ₦75 billion worth of special FGN Bonds was issued in July 2006 to pay PAs.

Measures to mitigate risks arising in the future from contingent liabilities have been put in place. More specifically, the Federal Government introduced a new contributory scheme to properly cover and fund pensions. The introduction of the Due Process mechanism shall also prevent the emergence of future local contractors' liabilities. Lastly, the current policy of securitising any outstanding government contingent liabilities will continue in the medium-term.

With regard to contingent liabilities arising from government guarantees on Sub-national and government agency debts, the guidelines in Chapter Six will reduce the risk of default by borrowers and thus minimize the crystallization of contingent liabilities.

5.3.8 Operational Risk

In Nigeria, the DMO is in charge of debt management and therefore put in place the necessary mechanisms to check different types of risks, which include errors in executing/recording transactions; failures in internal controls, systems or services; legal risks, etc.

Internal controls and operational procedures have been put in place and have been documented. DMO continually upgrades internal control and procedures to meet international standards.

6. MEDIUM-TERM PUBLIC DEBT STRATEGIES (2008-2012)

International best practice posits that the objective of public debt management is to ensure that the government financing needs and obligations are met at the lowest possible cost, consistent with a prudent level of risk.

6.1 Broad Policy Objectives

In addition to the standard debt management objective outlined above, DMO has identified a number of objectives, which more closely apply to the Nigerian case and are encompassed in its "new strategic plan", to be achieved in the 2008-2012 period. These aim to tackle the problems that have become evident from the review of the debt portfolio and the current institutional and legal structure in place for debt management, as outlined in the preceding sections of this document.

The broad policy objectives that DMO shall work towards achieving over the period 2008-2012 are the following:

a) Making public debt become a viable instrument for growth, development and poverty reduction;
b) Maintaining debt sustainability;
c) Strengthening existing legal, institutional and policy frameworks for efficient debt management;
d) Adopting a holistic view of debt as composed of both public and private debt to keep track of the evolution of both components, as well as identifying and managing contingent liabilities;
e) Institutionalising debt management best practices at both the national and sub-national levels of government;
f) Maintaining a comprehensive, reliable and efficient national and sub-national debt database, and to ensure prompt and accurate settlement of debt service obligations;
g) Integrating cash management with debt management to reduce the cost of funding to government;
h) Mobilising additional financing such as grants and concessional loans to accelerate growth and poverty reduction and meeting other MDG-related targets;
i) Borrowing from concessional sources in the short to medium term, while working towards establishing a viable and competitive presence in the international capital market (ICM) in the medium to long term, in order to finance key infrastructure projects;
j) Developing a multi-instrument domestic debt market with deepened participation to support private sector-led growth through enhanced access to credit;
k) Widening the scope of the financial and capital markets in line with the Financial System Strategy 2020 through the use of derivatives and other instruments;
l) Developing Debt Management Departments in all the States of the federation and building capacity in debt management through, among other approaches, attachment programmes at the DMO;
m) Developing a debt market for State Governments that will allow them to have access to borrowing through the issuance of State bonds;
n) Creatively using FGN guarantees to support the financing of projects under public-private-partnership initiatives (PPPs), Joint Venture Schemes and on-lending to sub-national entities;

o) Increase public awareness of debt issues and engage in public debt education via the establishment of a Public Debt Management Institute and the enhancement of communication of debt issues to the wider public;
p) Making Nigeria an exporter of debt management skills and major destination for out-sourced debt management services; and,
q) Modelling and implementing effective risk management strategies.

6.2 Public Debt Management Framework

In compliance with the DMO Act of 2003, this framework shall guide borrowing by all tiers of government for the period 2008-2012. While maintaining a holistic view of debt, to achieve effective public debt management, Nigeria's debt strategy for this period is categorized into external, domestic and sub-national debt.

To ensure this strategy is internalised and complied with, DMO will continue to engage in wide stakeholder consultations.

6.2.1 External Debt Strategy

6.2.1.1 Introduction

With an external debt stock of around US$3 billion as at 31 Dec 2007, composed predominantly of 85 percent multilateral loans on concessional terms, Nigeria's external debt portfolio is sustainable. The strategic analysis conducted by DMO, complemented with the experience and lessons learnt in managing external debt over the past few years, has allowed DMO to put together the following strategies and objectives which now form the basis for effective external debt management in Nigeria.

External Debt Management Strategy:
To prudently access concessionary financing needed to fund growth and development within a sustainable debt profile, while facilitating private sector participation in the funding of critical infrastructure, in particular, and the real sector in general.

6.2.1.2 Objectives

Following the Paris and London Clubs debt exit, three main objectives inform Nigeria's external debt strategy, namely:

a) The need to avoid a relapse into an unsustainable debt position by instilling fiscal discipline at all tiers of government, particularly by extending the Fiscal Responsibility Act at the Sub-national level;
b) The need for new financing to be on concessional terms in order to minimize the cost of foreign currency funding of the government's financing gap, while providing additional

resources to accelerate growth, development and poverty reduction, as well as meeting other MDG-related targets; and,

c) The need to facilitate private sector participation in the funding of critical infrastructure, in particular, and the real sector in general, using various methods including Public Private Partnership (PPP) models.

6.2.1.3 Guidelines for External Borrowing

International best practice for overall debt sustainability in low income countries (LIC), recommends external debt stock to GDP ratio of not more than 30 percent. Given Nigeria's economic conditions, the need to avoid a relapse into debt unsustainability, as well as the country's increasing emphasis on domestic borrowing and the development of the domestic debt market, an external debt stock GDP ratio of 20 percent is recommended. (It should be noted that according to DRI recommendation, the domestic debt stock – GDP ratio for Nigeria would range between 20 – 25 percent and the upper limit of 25 percent is considered appropriate for Nigeria given the emphasis on domestic borrowing. Therefore, the recommended total public debt/GDP ratio for the medium term, i.e. 3 – 5 years is 45 percent). Accordingly, the following general guidelines will apply with regard to external borrowing by the Federal Government, State Governments or their agencies, for the fiscal years 2008 up to 2012, subject to modifications from time to time.

a) Purpose of External Borrowing:

i. Any Government in the Federation or its agencies and parastatals desirous of borrowing shall specify the purpose for which the borrowing is intended, demonstrate how this purpose is linked to the developmental objectives embodied in NEEDS II and the Seven-Point Agenda and undertake a cost-benefit analysis, detailing the economic and social benefits of the purpose to which the intended borrowing is to be applied; and,

ii. Sectors considered under NEEDS II and the Seven-Point Agenda include health, education, rural development, environment, housing development, employment and youth development, gender balance, infrastructure, public sector reforms, privatization, governance, transparency, anti-corruption, service delivery and expenditure reforms, amongst others.

iii. Government will express preference towards creditors that provide programme support, on-budget support, un-tied and multi-year predictable financing, and encourages creditors to maintain a constant policy dialogue with the Federal Government, including the Debt Management Office.

b) Approval/Approval-in-Principle:

i. Any Government in the Federation, or its agencies and parastatals can only obtain external loans through the Federal Government. The Federal Government negotiates and signs any external loans and then on-lends the funds.

ii. Federal and, State Governments and their agencies and parastatals wishing to obtain external loans shall obtain Federal Government's approval-in-principle from the Federal Ministry Finance, prior to full scale negotiations for such loans;

iii. To receive approval-in-principle, the applicant governments or agencies must provide evidence that they have not over-borrowed externally. In this regard, State Governments must demonstrate that the ratio of their projected external debt service plus all other deduction obligations for the next twelve months (inclusive of the new loan under consideration) to their total Federation Accounts Allocation over the preceding twelve months will not exceed 40%. This rule will be applied on a case-by-case basis and may take into account other sources of revenue, as appropriate. Agencies will be required to provide cash flow statements that will enable the appropriate authority to determine the viability and sustainability of their external borrowing;

iv. Every State shall execute a Subsidiary Loan Agreement with the Federal Government which may include an Irrevocable Standing Payment Order (ISPO) that allows the Office of the Accountant General of the Federation (OAGF) to deduct monthly, money from the State's gross allocation to pay back the loan contracted to the lending institution;

v. No external loan will be approved without evidence that appropriate cost-benefit analysis and feasibility studies have been carried out and prioritisation as well as due process procedures have been followed;

vi. All external borrowing proposals of the Federal Government and its agencies and parastatals, State Governments, their agencies and parastatals and Local Governments for the next fiscal year should be submitted not later than 180 days preceding that year to the Minister of Finance for incorporation into the public sector external borrowing programme for the coming year; and,

vii. All external loans must be supported by Federal Government guarantee before final approval. In the case of a State Government wishing to contract external borrowing, the State Executive Council must approve the loan proposal, and this will be followed by a resolution of the State House of Assembly. Thereafter all (Federal and State Governments and their agencies) proposals should be submitted to the Federal Ministry of Finance and the Debt Management Office for consideration, before being passed to the Ministry of Justice for clearance and to the Federal Executive Council for approval (subject to being contained within the Annual Budget approved by the National Assembly).

c) Terms of New External Borrowing:

In line with the government's commitment to maintain debt sustainability, new borrowing will only be considered on concessional terms as evaluated by the DMO. New loans must have a grant element of at least 35 percent when calculated with an appropriate discount rate.

Analysis conducted on total expected disbursements of concessional external funds for 2008 indicates a figure of US$193.6 million. The 2008 budget deficit is to be financed by a mixture of signature bonuses, sales of government properties, privatisation proceeds and domestic borrowing. The latter will finance the bulk of it with around N200 billion of FGN Bonds issuance. However, none of this is earmarked to fund the massive infrastructure investment needed to achieve the new growth target of the government.

d) Non-Concessional Borrowing:

i. Where a commercially-oriented project with self-repaying capacity must be undertaken by any government or any government agency (perhaps because such a project also has compelling public interest) and where such a project requires an external loan, funding and project development options that do not commit the

Federal Government in terms of guarantee or counterpart funding should be pursued. Such options include PPPs, the "Build, Operate, Recover and Transfer" arrangement, conceding to the external financier a lien on the products and other assets of the project under a hands-on management, which would subsist until the external loan is fully recovered from the profits of such a project. The acceptance of these options by the project promoters and the external financier/technical partner, would serve as an implicit test of the level of confidence to be attached to the claim of the two parties (promoter and financier/technical partner) that the project is commercially viable.

6.2.2 Domestic Debt Strategy

6.2.2.1 Introduction

In line with the practice of many governments, funding the financing gap may be from the domestic market. In order to maintain a viable domestic market and keep borrowing costs low, the DMO focuses on the key aspects of transparency, liquidity and regularity. For this reason, DMO issues bonds on a regular, pre-announced basis in order to build benchmarks for fixed-income securities.

Domestic Debt Management Strategy:

To further broaden and deepen the domestic bond market through: the introduction of a variety of government securities; the use of appropriate technology to aid effective and efficient issuance and trading; the improvement of the regulatory framework; and, the facilitation of the issuance of corporate bonds by the private sector for the development of the real sector of the economy.

The DMO Act empowers the DMO in collaboration with the CBN and OAGF to determine, among others, the floatation of Federal Government long-term securities to raise funds in the Capital Market; the type of securities that may be created, issued or floated to achieve the domestic debt management objectives of the Federal Government; the payment of interest; the maintenance of a register of holders; the redemption of securities at maturity; and the creation and management of sinking funds to provide for redemption of securities at maturity.

The Minister of Finance shall specify by directions published in the Federal Gazette, the mode of raising the loans, the sum of money to be raised by that loan and other particulars. Sovereign public issues usually contain the following information:

a) Issuer; ii) The Issue; iii) Units of Sale; iv) Purpose; v) Tenor; vi) Sinking Fund; vii) Coupon; viii) Status; ix) Security; x) Payment terms; xi) Opening date; xii) Closing date.

Sub-national Governments and their agencies may from time to time source for funds in the capital market to finance a specific project in the course of governance. Sections 222 to 273 of Part XV of ISA 2007 govern such borrowing. Section 223 of ISA enables any such borrower to do so either:

i. By the issue of securities in the form of Registered Bonds; or

ii. By the issue of securities in the form of Promissory Notes.

However as a check on possible excesses, a limit on amount of loans outstanding at any particular time including the proposed loans shall not exceed 50% of the actual revenue of the body concerned for the preceding 12 months.

Sub-national Governments and their agencies that want to issue bonds in the capital market are required by SEC to do so by way of prospectus inviting the general public to treat. The prospectus is expected to contain, among others, 5 years audited accounts of the State or the Local Government. The funds to be raised are to be tied to a specific project. The latest account may be such that accounts for operations over the past 1 year may not be available already audited to assist informed judgment. Such a situation might conceal the actual latest performance of the issuer. Accounts, though audited, but which are more than nine months old are regarded as stale for the purpose of a public issue. In such cases, a compulsory preparation and auditing of accounts within 9 months of an issue to guide the investing public on the latest operational status of the issuer is demanded. The Attorney General is also required to sign the offer documents stating that the statements contained therein are the true position of the affairs of the State.

As a measure of ensuring due repayment of the loan, an Irrevocable Letter of Authority to the Accountant General of the Federation to deduct the relevant sum at source from the statutory allocation due to the issuer, in the event of default by the issuer, must be sent by the issuer in order to meet its payment obligations arising from the loan. Section 251 ISA 2007 stipulates that a sinking fund be established to guarantee the liquidation of the loan as and when due. Installments due and not paid could therefore be deducted at source under the arrangement, and paid to the sinking fund.

6.2.2.2 Objectives

The main objectives of the domestic debt strategy include:

a) Raising finance in the domestic market to cover the government's borrowing needs;

b) Funding the nation's debt in a non-inflationary manner, without recourse to monetary financing;

c) Minimizing the cost of government's debt over the long term, while taking risk into account;d) Promoting the development of the domestic capital market;

d) Developing mechanisms for accessing the International Capital Market, including for Naira denominated debts;

e) Developing mechanisms for Sub-national and Agency Bond Markets;

f) Developing various innovative instruments such as derivatives and mortgage-backed securities to meet the various needs of the market; and,

h) Ensuring proper coordination between debt management and monetary policy.

6.2.2.3 Bond Market Development and Issuance in 2008-2012

The strategy for the development of Nigeria's bond market is organized on a medium term basis with an annual securities issuance work plan. In developing this work plan, the Federal Government conducts wide consultations with market participants through regular monthly meetings held with Primary Dealer Market Makers (PDMMs), usually before each FGN Bonds auctions. The PDMM system was established in 2006 to facilitate the emergence of a liquid and vibrant secondary market for government securities. Since its inception, there has been a steady rise in public subscription and strong foreign investor participation in FGN Bonds auctions.

Bond issuance in 2008-2012 will continue to aim at developing the bond market and creating a benchmark for the issuance of other instruments. This will be achieved through the issuance of longer-tenored instruments. Currently the FGN Bond Issuance Programme has been extended to include ten-year bonds and fifteen-year bonds are being planned for issuance in 2008.

The Bond Issuance Programme for 2008-2012 will aim at providing low cost funding for the FGN, subject to the control of risks within acceptable limits, and developing the market for long-term debt instruments, thereby creating a benchmark yield curve for other financial instruments in Nigeria.

The Work Plan for the bond issuance programme in 2008-2012 will include advertisement of Offer Circulars, conduct of auctions, post allotment activities and development of indicators for domestic debt sustainability.

The 2008-2012 Bond Issuance will include the following features:

- Following the continued sophistication of the appetite of the market, a variety of instruments such as floating rate and index-linked securities may be introduced;
- With growing sophistication and capacity in the market and also in order to optimally allocate government resources, the multiple pricing auction system may be introduced;
- The FGN Bonds auctions, which are presently conducted monthly, may be made more frequent as demand for the bonds continues to soar, particularly with limitations on re-openings; and
- The submission of bids will be done on the day and within a specified timeline or duration while settlement takes place on T+2.
- The restructuring of short-term debt instruments to long-term will continue until the ratio of 25:75 short-term to long-term debt ratio is achieved.

6.2.3 Sub-National Debt Strategy

6.2.3.1 Introduction

Until recently, there was no comprehensive sub-national debt strategy in place in Nigeria. The lack of coordination and regulation of sub-national borrowing has often resulted in excessive fiscal expansion, thereby creating problems for overall macroeconomic stability. This has been caused by the peculiar fiscal federalism of Nigeria, which often emphasizes fiscal autonomy at the expense of fiscal responsibility. Added to this, because of the lack of a reliable database for States' debts, as well as the lack of appreciation by certain stakeholders of key debt management issues, there was a pressing need to tackle the issue of sub-national debt management. The following guidelines have been produced to address the deficiencies.

Sub-National Debt Management Strategy:
To facilitate the development of capacity and competence for effective public debt management at the sub-national level, through the provision of support for the establishment and operation of Debt Management Departments in the States.

6.2.3.2 Objectives

The broad objective of sub-national debt management is to ensure that Sub-national Governments subscribe to the principle of prudent and sustainable borrowing and effective utilization of resources.

Other objectives include the following:

a) Strengthening existing legal, institutional and policy frameworks for efficient debt management;
b) Developing Debt Management Departments in all the States of the Federation and building capacity in debt management through, among other approaches, attachment programmes at the DMO;
c) Maintaining a comprehensive, reliable and efficient sub-national debt data base and to ensure prompt and accurate settlement of debt service obligations;
d) Building a viable sub-national bond market;
e) Maintaining debt sustainability;
f) Creatively using FGN guarantees to support the financing of projects under Public-Private-Partnership initiatives (PPPs), Joint Venture Schemes and on-lending to sub-national entities;
g) Adopting fiscal responsibility laws with regards to public finance management; and,
h) Establishment of a disciplined and well –focused public finance policy, and especially a well rationalized government borrowing policy.

These guidelines fit into the aforementioned objectives, by providing a strong structure for Sub-national Governments to rely on and follow, in order to increase sources of funding at affordable terms. This will enable Sub-nationals to pursue their economic development strategies, without compromising debt sustainability and macroeconomic stability. The guidelines touch on various aspects of sub-national domestic debt management, from on-lending and guarantees, to borrowing from the capital market and from commercial banks. The rationale for the guidelines is to avoid undue additional build-up of external debt which could cause debt servicing problems to Nigeria and to ensure that maximum benefits are derived from external borrowing. The guidelines are also to ensure that contingent liabilities emanating from sub-national fiscal operations do not crystallize into liabilities that impact on national debt sustainability.

6.2.3.3 Guidelines for Domestic Borrowing by States and for Federal Government On-Lending/Guarantees to States and their Agencies

6.2.3.3.1 Introduction

An important issue regarding guidelines for domestic borrowing (and also external borrowing) is what should be the appropriate ratio between the debt stock and the GDP. For domestic debt, there are no internationally established standard yet. But the DRI has recommended a domestic debt stock to GDP ratio of 20-25 percent. Given Nigeria's economic conditions, the need to avoid a relapse into debt unsustainability, as well as the emphasis on domestic borrowing and the development of the domestic debt market, a domestic debt stock to GDP ratio of 25 percent is recommended. (It should be noted that international best practice recommends a maximum of 30 percent ratio of external debt stock to GDP. However, Nigeria's emphasis on domestic rather than external debt puts external debt stock ratio to GDP at 20 percent, bringing it to a total of 45 percent ratio of total public debt stock to GDP). Accordingly, the following appropriate guidelines have been developed:

a) Domestic Borrowing:

The following general provisions will apply to all categories of loans to be contracted by the Sub-nationals:

- Any borrowing by a Sub-national shall be the obligation solely of that particular Sub-national unless explicitly guaranteed by the sovereign;
- The obligations of the Sub-national in any contractual loan shall be as stipulated in any agreement in respect of the loan;
- All Sub-national borrowings shall be subject to public disclosure and periodic updates to any original disclosure and the disclosure of material facts shall be the affirmative duty and specifically assigned function of appointed officials, lenders and lenders' representatives, issuing houses, underwriters and other market participants;
- Sub-nationals shall devise or put in place a collateral arrangement such as a sinking fund to hedge against potential default to protect investors; and,
- All Sub-nationals shall be subject to the rulings of a court of competent jurisdiction in the event of a violation or default in part or whole of the agreement governing any loan obligation of the sub-national.

The various categories of Sub-national domestic debt will include the following:

b) Domestic On-lending from the FGN:

The Treasury Bills Act, the Treasury Certificates Act and the Local Loans (Registered Stock and Securities) Act empower the Minister of Finance to raise money through the issuance of debt instruments and on-lend all or part to the States, subject to the satisfaction of conditions precedent prescribed by the Minister of Finance.

The following guidelines apply to on-lending by the Federal Government of Nigeria (FGN):

- The FGN, either from its internal sources or by borrowing from the market (either domestic or external) can on-lend funds to the Sub-nationals.
- On-lending is a direct responsibility of the Federal Government and all the projects and programs financed under this modality will be properly monitored by the Federal

Government through the DMO in collaboration with MoF, to avoid fiscal and other imbalances.

- DMO, in order to ensure an effective on- lending policy, will establish measures for the thorough assessment of projects and programs for which funds are requested, to ensure the rejection of all those projects that are judged non-viable.
- DMO would undertake a project assessment prior to processing the on-lending loan request and at regular intervals, thereafter. The main purpose of such assessment is to evaluate the prospects of the borrower (the Sub-national) to generate sufficient income to repay the loan. Should a project be considered critical for social development purposes, it shall be financed from concessional sources of funding and shall not need to be revenue generating.
- The following risks associated with the level and nature of on-lending must be evaluated by the DMO:
  - credit risk - the debtor may not have sufficient funds to meet its obligations.
  - legal risk - it may not be possible to enforce the right of recourse against the debtor.
  - market risk - changes in interest rates that will result in losses if loans have to be refinanced at higher rates in the future.
  - operational risk - due to inadequate internal control systems, human error, management failure or fraud.
- Research and information is needed regarding the extent, if any, of contingent liabilities of the States.

c) Guarantees by the FGN:

The government would normally extend guarantees to financially promote projects that are deemed to be in the public interest. This serves as an economic incentive for the capital markets and other lenders to finance the projects. Loans guaranteed by the government constitute contingent liabilities and are, therefore, a potential source of credit risk, if those obligations enter into default by the final recipients of the loans.

In the Nigerian context, there are two important factors that guide the management of guarantees at the Federal and Sub-national levels:

i. In the DMO Act, all external loans will either be contracted directly by the Federal Government or by Sub-Nationals through the Federal Government which must guarantee such loans. Therefore, the limit for guarantees is the total amount of foreign debt to be contracted, which is included in the budget approved by the National Assembly. Consequently, the legislation and Guidelines for External Borrowing are particularly relevant.

ii. All FGN guaranteed loans to public corporations (Parastatals, Agencies and Departments) would require them to issue Irrevocable Standing Payment Orders (ISPOs) tied to the allocations to their supervisory ministries, and in the case of Sub-national Governments to their Federation Account allocations. The ISPO will be for servicing both the principal amount and interest on the loans.

The following guidelines would therefore, apply to FGN Guarantees:

- The Federal Ministry of Finance would be responsible for issuing guarantees on behalf of the FGN;

- DMO will from time to time establish limits on borrowings with official guarantee, i.e. establish limits or benchmarks for external indebtedness and guaranteed domestic loans;
- DMO will from time to time set portfolio limits, single obligor limits, sector limits, etc, for guarantees to Sub-national Governments and public enterprises;
- DMO will compare costs and risks of issuing a guarantee vis-à-vis on-lending and advise on the preferred option;
- Guarantees would be treated as on-lending as they become instant credit upon crystallization;
- DMO would manage each guarantee from the time it is issued until it is extinguished and would advise and ensure that the beneficiary applies proper management, accounting and administration practices in managing the guarantee;
- A Sub-national requesting for guarantees will provide Approved Resolutions from its State House of Assembly and the State Executive Council;
- Beneficiaries will provide audited annual financial statements for the past five (5) years, financial forecasts for the tenor of the loan for which the guarantee is being sought and a feasibility study on the project to be funded with the loan for which the guarantee is being sought;
- Beneficiaries would provide relevant financial information on use of funds, disbursements, accounting, and degree of implementation of the project financed, and conduct regular consultations with DMO;
- The DMO will determine and charge a guarantee fee, as approved by the Board;
- The DMO would monitor the use of the loan to ensure that it serves the intended purpose and is repaid in accordance with the loan agreement; and,
- The DMO would ensure that the loan and guarantee documentation are clear and unambiguous.

Required agreements would have to be executed for government guarantees to be issued. They include:

- the loan agreement between the lender and the borrower;
- the guarantee agreement between the lender and the Federal Government; and,
- the agreement between the FGN and the borrower, which sets out the conditions under which the guarantee is issued.

d) Borrowings from the Capital Market:

The Investments and Securities Act No.29 2007 (ISA) provides for borrowing by raising of internal loans through issue of securities in the form of Registered Bonds or Promissory Notes by States, Local Governments and other Government Agencies.

Section 222 of ISA defines the bodies to which ISA provisions apply, to include:

- State Governments and the Federal Capital Territory, Abuja
- Local Governments
- Any statutory body established by the Law of a State or Local Government
- Any company which is wholly or partly owned by a State or Local Government

The provisions of the Act include the following:

- The total amount of loans outstanding at any particular time including the proposed loan shall not exceed 50% of the actual revenue of the body concerned for the preceding 12 months;
- Any internal loan to be raised from the Capital Market must conform to the requirements of ISA and as may from time to time be directed by the Securities and Exchange Commission (SEC);
- Before any application is made for contracting a loan from the Capital Market, such a body making the application must obtain the Approved Resolution of the State House of Assembly and the State Executive Council in the case of States and Local Governments; and,
- All applications to raise funds from the Capital Market shall, amongst other documents, be accompanied by an original copy of an Irrevocable Letter of Authority giving the Accountant General of the Federation the authority to deduct at source from the statutory allocation due to the body, in the event of default by the body in meeting its payment obligations under the terms of the loan and the relevant Trust Deed.

Other required documentations under the ISA include:

- Duly completed Form SEC 6;
- Copies of resolution of the State Legislative Assembly authorizing the Issue;
- A resolution on and gazette by the State Executive Council containing particulars of the proposed Issue;
- Audited accounts of the State for the preceding five (5) years;
- Draft prospectus, abridged particulars of the prospectus and the Trust Deed;
- Vending Agreement, i.e. mandate/engagement letter, appointing the Issuing House/Underwriter to the Issue;
- Underwriting Agreement between the State and the Issuing House;
- Reporting Accountant's report on the audited financial statements and the financial forecast;
- Schedule of claims and litigations involving the State;
- Bridging loan agreement (if any);
- Material contracts of the State;
- Letters of consent of all the professional parties to the Issue;
- Letter of confirmation from the Accountant General of the Federation of receipt of the Irrevocable Letter of Authority to deduct the principal and interest from the statutory allocation of the State;
- Feasibility report on the proposed project to be financed with the loan;
- Brief profile of key personnel of the issuer including members of the Executive arm of the issuer, Accountant-General, Auditor-General, Permanent Secretaries etc.;
- Any other document/information as may be required; and,
- The particulars of each loan to be raised pursuant to this Act shall be published in the Gazette or any other official document by the body raising the loan and shall include all the terms of the security.

e) Borrowing from Commercial Banks:

As part of their domestic capital raising options, the Sub-nationals may borrow from commercial banks. Such borrowing should be in line with the following:

- Without prejudice to the provisions of the Nigerian Constitution "All banks and financial institutions requiring to lend money to the Federal, State and Local Governments or any of their agencies, shall obtain the prior approval of the Minister of Finance" in accordance with Section 24 of the DMO Act, 2003, and the Fiscal Responsibility Act, and shall state the purpose of borrowing and the tenor. The monthly debt service ratio of a sub-national, which includes the commercial bank loan being contemplated, should not exceed 40% of its monthly Federation Allocation of the preceding 12 months .

- All commercial banks lending to a sub-national must make a provision (currently 50%) on all such loans in line with the Prudential Guidelines of the CBN.

- Sub-nationals should immediately, upon contracting of a commercial bank loan, furnish the DMO with details of the loan. The lending bank should furnish DMO and the borrowing Sub-national's DMD, where in existence, on a periodic basis with reports on various stages of drawdown on the facility and utilization of same by the borrower.

6.2.3.4 Other Sub-national Indebtedness

Despite the aforementioned borrowing options, the following are types of indebtedness Sub-national Governments could incur:

a) Local Contractors and Suppliers Debt

As part of their operations, Sub-nationals could contract debt in the form of local contractors and suppliers liabilities. To engender prudent, cost-effective and sustainable debt management at the sub-national level, local contractors and suppliers' credit must be properly contracted, documented, disclosed, serviced and redeemed. All such obligations must have the Approved Resolution of the State House of Assembly and Executive Council or any such bodies that serve the same function. All due process must also be strictly adhered to for such obligations to be contracted.

As soon as such obligations are contracted, the relevant department/unit of the sub-national responsible for debt management should be supplied with all the details on the obligations. Also, before such obligations are contracted, they must be included in the annual budget, to be submitted at least 180 days before the commencement of the budget year within which it will be operational. This is to ensure that such obligations are fully funded as and when due. The debt management department/unit must ensure that the annual budget put in place for such obligations is strictly followed and adhered to.

b) Pension Obligations

Pension obligations could also form a substantial part of a sub-national's debt portfolio if not properly managed. In order to avoid accumulated pension obligations, sub-nationals should adopt the Contributory and Fully Funded Pension Scheme as currently applies in the Federal Service and private sector for any organization with five (5) employees or more.

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