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7. HOUSING FINANCE

A. OVERVIEW AND INSTITUTIONAL BACKGROUND

7.1. Mortgage lending in Nigeria, prior to 1976, was largely restricted to a single public-owned housing bank, the Nigerian Building Society (NBS), supported by some mandatory and state contributions. The NBS was created in 1956 and converted in 1976 into the Federal Mortgage Bank of Nigeria (FMBN). The FMBN mobilized some limited deposits and granted a few mortgage loans mostly to higher-income borrowers.¹

7.2. Commercial banks also granted some housing loans, mostly to their own staff as part of benefit packages. Until 1991, banks were mandated to lend 7.5% of their loans in real estate, or to alternatively fund the FMBN². Thereafter, mortgage lending virtually ceased, until some very recent initiatives. Insurance companies also held a small mortgage portfolio, totaling N37 million in 1994. Disappointing overall housing finance flows led the Government to embark on reforms in the early nineties.

7.3. Decree No. 53 of 1989 authorized the licensing of Primary Mortgage Institutions (PMIs)³ as specialized institutions to collect households’ savings and originate mortgage loans. PMIs were based on the British model of building societies and were expected to support the development of a more vibrant and competitive housing finance sector. The Ministry of Works and Housing (MWH) and the FMBN were appointed as regulators and supervisors for PMIs. However, FMBN’s regulatory and supervisory responsibilities were transferred to the CBN in 1997.

7.4. By 1991, housing shortages were estimated at 5 million units, the result of a state policy favoring the government as a direct producer and financer of housing. A National Housing Policy was developed to “ensure that all Nigerians own or have access to decent housing accommodation at affordable costs by the year 2000.” For example, in 1994 the National Housing Program was assigned the goal of producing 121,000 housing units. The Housing Policy Council and the Implementation Committee of Housing Policy were created to measure progress, identify issues, and recommend changes. Ministries of Work and Housing (at both federal and state levels), public housing corporations, property development agencies (including the Federal Housing Authority, FHA) were to develop partnerships with the private sector, in order to develop land and produce affordable housing units, supported by cheap land and subsidized infrastructure. Sites and services projects were encouraged,⁴ as well as cheaper housing solutions and new technologies. In addition, the Urban Development Bank was expected to fund infrastructure projects. The overall housing policy was not designed in a sustainable way and has not been monitored efficiently, creating current problems including difficult

¹ N0.44 billion between 1977 and 1991 for 8,874 borrowers, e.g., a yearly average of 142 borrowers per year.
² Since 1997, real estate investments are prohibited for banks, except those resulting from an executed loan guarantee.
³ Also known in Nigeria as savings & loans, mortgage banks, or building societies.
⁴ Including a World Bank project (“Imo”) closed in 1993. It fulfilled most of its planned physical outputs, but proved unsatisfactory about cost recovery, delays, and as a housing policy tool.
access to titled land, shortage of domestic building materials, and the lack of professional developers.

7.5. In 1993, the former FMBN was split into two separate federal financial institutions: i) the FMBN which was modified to become a second-tier apex and regulatory institution for PMIs, acting as an executing agency for the MWH and to be supervised by the CBN; and ii) the Federal Mortgage Finance Limited (FMFL), a public-owned retail PMI, which inherited most of the former FMBN’s loan portfolio and was expected to become a role model for the primary mortgage industry.

7.6. A National Housing Fund (NHF) was created by Decree No. 3 of 1992 to subsidize “affordable” mortgage loans and catalyze long term funding for PMIs and is managed by the FMBN. Collections began in 1994. It is funded by mandatory contributions from all employees of 2.5% of basic wages with the employees earning 4% per annum on this money and becoming eligible for NHF financed loans. By decree, banks were also expected to fund the NHF in amounts equal to 10% of overall loans and advances, to be remunerated at current account interest rate plus 1% (i.e. about 5%). Life and non-life insurance companies were also to respectively invest 20% and 10% of their premiums in the NHF, remunerated at a low fixed rate of 4%. Given inflationary conditions, CBN has never applied this requirement to banks, nor have insurance companies complied with these requirements. Such rules would have contradicted the liberalization of the financial system, undermined the interest rate structure, and jeopardized the development of contractual savings institutions. However, the enacted decree has not been amended and the resulting ambiguity still affects relations between FMBN (manager of the NHF), banks and insurance companies.

7.7. The NHF was expected to refinance affordable mortgages originated by PMIs to eligible contributors at “slightly below commercial rates.” Under this plan, PMIs assume all credit risks and the FMBN refines 80% of PMI mortgage credit balances at 5% interest with PMI lending rates capped at 9% (with terms up to 25 years). The maximum loan amount was N500,000, before being increased to N1.5 million in 1998. There is no relation between the accrued savings of contributors and the amount of loans they are eligible to receive. NHF was to subsidize “affordable” mortgage loans and catalyze long-term funding for PMIs.

7.8. But these initiatives have largely failed. PMIs have proven largely non-viable and few survived the 1990s for reasons including: i) improper status and regulatory status as specialized institutions; ii) high inflation; iii) mistrust of PMIs by households due to various malpractices; and iv) a persistent lack of appropriate funding. PMIs made very few mortgage loans. Meanwhile, the NHF (operated as a housing tax fund) also financed an insignificant volume of housing loans utilizing the collected savings to pay for FMBN’s administrative structure and expansion costs. NHF funds not spent by FMBN are largely converted from long-term capital (which is in short supply and has a high

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5 Loans can be granted only once in the borrower’s life, and existing mortgage loans cannot be refinanced.

6 There is no ceiling on housing values (just a minimum 90% loan-to-value ratio) or on borrower’s incomes. Yearly inflation rates were relatively high in the last decade and culminated to 53% before standing now at about 12%-13% (housing prices are reported to grow faster than the official CPI).
opportunity cost) into short-term bank deposits. Commercial banks have just begun to enter the mortgage industry and are not supported by the NHF. Long-term contractual saving from institutional investors have not found their way into mortgages.

7.9. Given the lack of growth, the housing sector has not contributed as it should have to broader economic growth, through its associated anticipated catalytic effects on construction, labor market, savings mobilization, creation of wealth, and the development of financial markets. In 1994, if national statistics are reasonably accurate, housing investment in the formal sector represented only 1.7% of GDP, which is low when compared to other emerging countries, and in particular to African countries (where housing investment is estimated to represent between 3% and 8% of GDP formation), and it may have even worsened since. Recent data on residential mortgage debt stock is not available but the team’s estimation is a relatively low 0.2% of GDP. At this juncture, there are increasing shortages of affordable units in a rapidly urbanizing Nigeria.

7.10. Homeownership ratios in urban areas are low (between 20% and 40% of total population live in their own homes), mainly because of unaffordable prices of housing (often representing on average, nine years of households’ incomes). The lack of long-term affordable mortgage finance also contributes to low homeownership ratios. The dominant rental sector has also been hit by recession, as net rental yields, despite the absence of rent controls, are lower than inflation rates on the non-prime market. Most new projects are developed by private individuals for leasing purposes on a small scale. A significant part of the population in Lagos cannot gather the two years of rent advances required by landlords because of the current shortages, high inflation risks, and deteriorating assets. Such high rental advances approach the levels of the down-payment usually required for mortgage loans (usually about 25%) and represent an unaffordable barrier for many households who are then pushed into slums.

7.11. The following sections describe the overall disappointing performance of the housing finance industry players, i.e. PMIs, FMBN, NHF, banks, and investors and offer policy recommendations to address the weaknesses. A discussion of housing policy is contained in Appendix 7.1. It must be emphasized that housing finance reforms alone cannot create an instant improvement with respect to affordable housing conditions in Nigeria without concurrent reforms of housing policy and housing market infrastructure.

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7 Usually standing at over 7%. However, a lot of self-construction may also not be reported.
8 Ratios between 1% and 5% can be found in repressed mortgage markets, while ratios between 5% and 15% are found in emerging economies that have achieved some success in reforming their mortgage markets and housing policy.
9 The average urbanization ratio was 41.3% in the 1992-97 period, versus 23.4% in 1970-75. 50% is soon expected.
10 Maintenance costs are high because of the severely under-developed infrastructure. An exception would come from 8% pre-tax USD yields, reported by one large investor on the niche of prime rental markets for the expatriates detached by foreign companies. This non-Nigerian market would return much higher yields in naira equivalent than average rental markets, but it required an active involvement in the real estate development and management phases.
B. PRIMARY MORTGAGE INSTITUTIONS (PMIS)

7.12. PMIs play an insignificant role in housing finance despite the licensing of PMIs between 1991 and 1994\(^{11}\). Currently, 195 PMIs remain licensed, of which only 74 regularly send returns to the CBN. It is believed that most of the 120 PMIs that do not report are dormant, insolvent or no longer in existence. 54 PMIs are accredited by the FMBN for NHF-funded refinancing and 50 PMIs are members of the Mortgage Banking Association of Nigeria. However, knowledgeable observers estimate that less than 20 PMIs are now actively operating.

7.13. Many PMIs were founded by individual shareholders who invested the minimum N5 million in paid-up capital \(^{12}\), often without any knowledge of the housing finance industry. Some PMIs were founded as a second-best alternative to banks (that required larger initial capital). Shareholders were mostly private individuals, state governments, and real estate developers. The FMFL, the only government-owned PMI, while continuing to operate faces serious financial problems.

7.14. The PMI industry is concentrated in the hands of 5 dominant PMIs: The largest privately-owned PMI is *Union Homes Savings & Loans*, part of the Union Bank Group, which has net-worth of N486 million. Others include Abbey Building Society, Finacorp Building Society, Safe Trust Savings & Loans, and Aso Savings & Loans. Geographically, PMIs are not diversified as most of those that are active operate from Lagos. \(^{13}\)

7.15. PMIs, in aggregate have a very small market share with 1997 aggregate assets amounting to N6 billion, representing less than 2% of total banking assets. By 1999, PMI assets had grown to roughly N15 billion, including N12 billion attributed to Union Homes Savings & Loans. PMIs are poorly positioned to play a significant role in housing finance while their volatile, costly and short-term deposit base is not well suited to support long-term lending. Current accounts and fixed, short-term deposits constituted 75% of their total resources in 1997, while the proportion of cheaper and more stable savings is small. This has resulted in high costs of funds (now above 25%) and lending constraints as the corresponding transformation risks were too high for substantial mortgage lending to occur. On the other hand, commercial banks’ deposits are better suited to substantially increased lending. While 96% of their loans have tenors of less than 12 months, their cost of funds is much lower and somewhat less volatile with transformation risks on such a short term volatile base significantly reduced because of the stability of core demand and saving deposits.

7.16. Not surprisingly, most PMI investments are short-term, principally bank deposits and treasury bills, with some investments in stocks and estate development through subsidiaries. They have granted very few short-term discretionary variable-rate-

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\(^{11}\) 184 approvals by April 1993, 290 at the peak in 1995.

\(^{12}\) This threshold has later been raised by FMBN to N20 million.

\(^{13}\) Out of 50 PMIs accredited by the NHF in 1998, 30 had their headquarters in Lagos (most have no branches).
mortgages (14% of their total assets in 1997\textsuperscript{14}). Most of the loans are very short term (usually at best 3-5 maximum years, with interest rates above 30%) for housing bridge loans and consumer loans, collateralized by mortgaged properties. Loan rates were also capped until 1996, which was also a major constraint in the face of high cost of funds.

7.17. PMIs are largely mistrusted by the Nigerian population due to: i) a large number of unprofessional institutions, operating under inadequate regulatory and supervisory oversight; ii) absence of deposit insurance coverage\textsuperscript{15}; and iii) a lack of confidence in the low interest rate savings and loans system which has been undermined by inflation as well as economic and political uncertainties. In retrospect, the building society model proved unsuited to the unstable macroeconomic and political environment in Nigeria.

7.18. Moreover, the government-owned FMFL has failed in its objective of being a model for other PMIs. It is now essentially illiquid and insolvent (see Annex 5A). Its negative actual net worth is very large (probably about N0.8 billion), if the required additional provisions are taken. Its request for further state re-capitalization stands between N1.1 and N1.3 billion. It inherited negative net worth from FMBN’s de-consolidated retail structure and some deposits placed in banks were lost in the wake of the recent banking crisis. Moreover, the FMFL has recently had to reject multiple requests for deposit withdrawals due to severe liquidity constraints. Inflows are used to pay administrative expenses leaving little available funding for new loans. Most recent loans have gone to short-term speculative developers rather than to fund single-family mortgages. FMFL has few performing mortgage loans, which could serve as collateral for fresh refinancing from NHF. Its negative actual net worth is very large (probably about N0.8 billion) given the need for additional provisions. FMFL has already started a process of downsizing (reductions from 1200 to 600 staff and from 62 to 53 branches) in an effort to reduce costs and stabilize its accumulated deficit.

7.19. The PMI regulatory and supervisory framework is ambiguous as described below:

\textquote[???]{}There has been little cooperation between CBN and FMBN since the shift of responsibility from FMBN to CBN in 1997. These institutions have not conducted any joint inspections, and CBN has not been using FMBN inspectors despite the inadequate number of inspectors available to examine PMIs. CBN only started to actively supervise PMIs in 1999, due to limited resources and pre-occupation with other financial institutions.

\textsuperscript{14} Finacorp Building Society has recorded in 1998 a unique 40% ratio of loan to assets, but most of these loans were very short term (less than a month) and funded consumer or small business, collateralized by mortgaged properties.

\textsuperscript{15} Finacorp Building Society took a positive initiative through offering some deposit insurance to its depositors, through a private insurance company at the same 0.75% fee as for NDIC-insured depositors (for banks).
So far most PMIs have not been inspected by on-site inspection teams or subjected to off-site analysis. CBN only started to send off-site inspectors in 1999, first to the reporting PMIs, which are more likely to represent significant financial volumes. Dormant PMIs have not been identified and de-licensed. Inspection staff is also limited given the large number of PMIs to cover and of other financial institutions (5-6 staff are assigned to PMIs out of the 21 NBFI off-site supervision officers, and a limited part of the 64 on-site inspectors).

FMBN has protested against CBN’s “singular action of robbery” and asks for the return of the supervisory powers it possessed prior to 1997. Returning supervisory functions to FMBN is however not desirable, given the likely evolution of the PMI sector to be regulated more along the lines of the banking industry and CBN’s comparative advantages over FMBN in carrying out any supervisory functions with a more proper mandate and better means.

The legal shift of supervisory responsibility from FMBN to CBN is still ambiguous as the PMI Decree is still in force and empowers MWH and FMBN with functions relating to licensing, de-licensing, reserves, supervision, and sanctions, whereas the amended BOFID extends CBN’s regulatory and supervisory responsibilities to all specialized financial institutions, including PMIs and FMBN. Also, the latest BOFI Decree remains vague about the exact nature of CBN’s regulatory powers over PMIs. Its Article 59 mentions that: i) CBN shall have power to supervise and regulate the activities of specialized institutions; and ii) CBN shall prescribe the minimum paid-in capital requirements for specialized institutions. The Decree does not mention other banking requirements (e.g. loan-loss provisions, reserves, liquidity, concentration limits, capital adequacy ratios, eligible activities, etc.). According to article 32 (a), specialized institutions are required to keep accounting books like banks, but the reporting from PMIs to the CBN may be requested “from time to time”, not necessarily on a monthly basis and fiscal year-ends vary among PMIs, resulting in inability to consolidate industry financial position. According to article 32 (a), the “findings and recommendations made by CBN are sent in specific cases to the appropriate Ministry for necessary actions” (MWH in the case of PMI and FMBN). This seemingly limits CBN’s capacity to impose sanctions and corrective actions (notably the de-licensing).

FMBN’s prior regulatory framework for PMIs is still formally valid, and FMBN still keeps 5% of PMI deposits on which it pays 4% interest in statutory reserves. According to its right specified by article 59 (2), in October 1999, CBN raised minimum PMI paid-in equity requirements to N100 million, but with a two-year compliance grace period. The grace period seems excessive given the urgent need to move rapidly to consolidate the PMI industry and eliminate insolvent PMIs.

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16 For example, FMFL still applies loose loan-loss provisioning rules (5% after 1 year of arrears for mortgage loans versus 100% for any bank, 10% between 3 and 5 years of arrears, 15% after 5 years) due to its insolvent position.

17 Some PMI have not met the restricted nature of their assets (acquired untitled lands; direct construction).
CBN’s NBFI off-site supervision department has prepared a new regulatory and supervisory framework for PMIs, inspired by banking regulations but taking into account “PMI specific aspects.” The mission was unable to review this draft and therefore has no comment at this juncture.

**Recommendations**

7.20. **PMIs.** The 1989 Decree on PMIs should be revised to make it fully congruent with CBN’s taking full control of the regulatory and supervisory framework, which should be transformed to largely parallel the existing framework applied to banks.

7.21. The list of authorized PMI activities should be extended at least in the housing sector, to include (non-exhaustive list):

- refinancing of existing mortgage loans
- residential second mortgages (provided that loan-to-value ratios limits are met)
- loans and equity funding for housing developers, with tight credit risk and concentration limits
- loans to housing cooperatives and housing rental investors (with prudential underwriting criteria)

7.22. However, a request from the Mortgage Banking Association to allow PMIs to make commercial property loans needs further analysis given the high potential credit risk. This request is probably premature and if such lending is to be allowed, it should be very limited during a testing phase. The mission also recommends that CBN not impose any minimum proportion of mortgage residential loans to total loans, assets or deposits. However, the extension of eligible loans or equity investment to other sectors than housing for diversification purposes is not recommended given PMIs’ status as non-banks as well as their low capitalization, and lack of experience in other lending sectors (notably corporate).

7.23. The Mortgage Bank Association is also requesting that PMIs have the right to mobilize foreign exchange resources, obtain direct access to treasury bills market (currently through banks), and open check accounts. The mission does not have sufficient access to financial data to analyze these requests, but would note that foreign exchange mismatches may become a dangerous substitute to current term mismatches in naira. The mission does recommend that PMIs be required to measure their exposure to interest rate risks, given the extent of such risks in a term transformation business of this type.

7.24. The statutory reserves made by PMI to FMBN (currently 5% of their total savings remunerated at 8% since 1999) should be transferred to the CBN. If PMIs are then effectively supervised in accord with an improved prudential regulatory framework in line with that of commercial banks, the NDIC may consider extending deposit insurance to sound PMIs. While this would enable PMIs to better compete with banks in attracting savings, PMIs may always remain weak because of inadequate diversification and unattractive deposits. In the long run, PMIs will require this insurance (like in the US or UK) if they are to survive, because these specialized financial institutions always need
some funding from deposits (even if their main funding source may then come from secondary mortgage markets).

7.25. A move to rapidly de-license dormant PMIs as well as those not meeting the requirements of reporting, provisioning, concentration limits, and the N20 million minimum capital requirement is a high priority. This action is required to restore the reputation of and ensure the stability of the overall PMI industry. Off-site and on-site supervision should be accelerated. The participation of ex-FMBN inspectors in this regard is recommended. CBN should make audit and inspection reports available to FMBN to support its NHF-refinancing activities. The accreditation of mortgage lenders for NHF refinancing should remain the responsibility of FMBN.

7.26. **FMFL** adds little value as either a role model or a supplier of mortgage funding and it should be closed. It has no business legitimacy to be further re-capitalized and should be closed. Responsibly servicing its current portfolio could be taken over by another bank/PMI or receiver. Deposits could be sold to another financial institution (preferably a well rated bank covered by deposit insurance).

7.27. Even if these recommendations are implemented, it is unlikely that more than a handful of PMIs will survive and become active mortgage lenders. Their origination skills may be more usefully exploited in association with some commercial banks support (then acting practically as mortgage brokers) or by using secondary mortgage markets (so as not to keep on balance sheet long-term mortgage portfolios).

### C. FMBN AND THE NATIONAL HOUSING FUND

7.28. In practice, the NHF is not legally different and its accounts are not separated from those of FMBN. FMBN has become dependent on NHF revenues and its primary activity at present is collecting NHF contributions as a fiscal public agency. FMBN’s financial performance has been disappointing, as summarized in Annex 5B and NHF’s impact as a housing finance policy instrument has been very poor.

7.29. FMBN’s administrative expense, adding to 10% of total assets (inclusive of NHF funds), is excessive for a second tier lending institution. NHF’s funding represents the bulk of FMBN assets and liabilities. Most of the savings is placed in short-term financial instruments at very attractive spreads. Yet subsequent large interest spreads have not been sufficient to cover FMBN’s mounting operating costs, and FMBN’s operating deficit worsened until 1998 despite N700 million in accrued budgetary grants. N500 million of the grant was provided to fund a costly network computerization which is still under implementation. FMBN did not invest NHF savings very well in 1997 and 1998, with average rates of return of 6.8% and 8.5% respectively, i.e. far lower than prevailing market rates. Reasons for this poor performance have not been identified.

7.30. By September 30, 1999, NHF had collected about N4 billion from 1.7 million contributors, a small fraction of the targeted 12 million contributors from an estimated 50

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18 This trend may be reversed in 1999, given the larger amount of collected savings and higher financial returns.
million labor force. 60% of contributors in 1997 were civil servants who have difficulty avoiding this mandatory requirement, while the self-employed easily escaped this requirement. Many private companies, labor unions, and even public institutions (two states as well as CBN staff) flatly reject NHF contributions, which are perceived as another wage tax. The poor performance of collections is due to the unattractive 4% saving rates, not compensated by a reasonable opportunity to obtain a subsidized mortgage loan. Nonetheless, FMBN recently embarked on an aggressive national marketing campaign, which includes tour visits, conferences and more recently some TV-broadcast spots to persuade more employees to contribute their savings to the NHF. For this purpose, FMBN conveys the illusory message of an easy access to homeownership through affordable loans.

7.31. The NHF began disbursing loans in 1997, three years after initiating collections. The performance of the NHF is summarized in Annex 5C. As at end-September 1999, NHF had disbursed only a disappointing N75 million for only 141 individual loans. It has approved an additional N86 million (164 loans), and was reviewing the equivalent of N224 million corresponding to 261 other applied mortgage loans. This situation now looks somewhat better, but there are few signs of a real acceleration of the program. Moreover, 15% of applications under current review\footnote{Often requiring some additional documentation from PMIs to FMBN.} are more than one year old and 61% more than 6 months old, suggesting a considerable portion may not be approved or disbursed.

7.32. By December 31 1998, although all NHF contributors are supposedly eligible, NHF refinanced only 1 borrower per 4000 contributors (i.e. 141 loans). Even if the Fund could disburse at its maximum capacity (which would require amendments to NHF mechanisms), this ratio would not reach more than 1 borrower per 500 contributors. Therefore, the NHF functions essentially as an unsustainable “lottery”. It finances few borrowers (often insiders) who receive large subsidies (net present value over 70%) funded by a much larger number of taxed contributors. The system is neither financially sustainable, nor socially progressive. Although virtually all employees are now eligible contributors, given the low qualifying minimum wage - N3,000 per year - unchanged despite inflation since NHF’s establishment, most NHF borrowers are high-income staff from financial institutions and high-ranked civil servants. Maximum loan ceilings have been raised from N0.5 to N1.5 million, thus in some cases contributing only as a minor funding source to expensive housing investments. Lower-income workers are therefore indirectly taxed to subsidize higher-income brackets.

7.33. Despite their financial attractiveness for borrowers, NHF loans are slow to disburse for several reasons:

i) These loans are not profitable for PMIs. Gross margins for the refinanced amounts are capped at 4% while PMIs must co-finance 20% of these 9% loans from their own funds, which currently cost more than 20%. PMIs are unlikely to significantly expand NHF loans under such conditions and largely limit them to very important clients or their own staff.
ii) Beyond its legal mandate to manage the NHF, FMBN has little practical incentive to utilize much NHF money for refinancing mortgages, given the far better spread in financial market products. In 1999, spreads from such investments was 17%.

iii) These spreads finance part of FMBN’s excessive administrative costs from directly collecting NHF contributions at each employer’s place. FMBN staff grew from 933 in 1997 to 1,200 in 1999, while delivering only 141 mortgage loans through a 20-staff credit department.

iv) PMIs are actually net lenders to NHF/FMBN, via required capital deposits and statutory reserves which are 14 times greater than the balance of all loans approved or under review by FMBN.

v) While FMBN’s guidelines do meet NHF Decree standards, several rules are cumbersome and costly for PMIs, and/or create unnecessary duplication of PMI underwriting work by FMBN. Rules of collateralization also appear to be rigid and excessive. Thus, FMBN, despite not taking credit risk on individual loans, acts more like an influential co-financier than a true wholesale funding agent.

**Recommendations**

Reforms are needed to amend the National Housing Fund to accelerate disbursements and make it a more effective housing finance policy instrument. Any future contributions to the NHF by employees - both existing members and new ones - should become voluntary, in the form of deposits recorded through individual saving books by selected eligible banks and PMIs (preferably not by FMBN itself in order to reduce its own cost and keep a light second-tier structure). Saving withdrawals should not be permitted during a minimum period (e.g. 5 years), without a corresponding penalty. Interest rates on savings should be established and periodically adjusted to be at a level slightly discounted from a reference market rate (either average term deposit rates of the largest banks, or short-term treasury bills), to better protect savings from inflation and make the system more appealing. This policy would be applied to remunerate existing savings, without any retro-active additional interest corresponding to past periods. Mortgage rates would then be adjusted accordingly (also slightly below market rates for term loans). The NHF would then be more attractive for contributors and the voluntary feature should reduce FMBN’s high collecting costs.

FMBN and NHF should maintain separate accounts and financial statements given their different mandate. FMBN should charge the NHF a fixed administrative fee for administrative support services and these services should be specifically defined.

The savings collected through the NHF by FMBN should be the object of an explicit prudential investment policy, approved by a duly constituted FMBN Board. Investment results and operating costs should be reviewed periodically, including an examination of FMBN management and other fees imposed on NHF.
Within a voluntary system, the present N3000 mandatory threshold should be eliminated, or at least raised to more realistic levels to include only potential home-ownership candidates.

NHF loan amounts should be more directly correlated to the level of a given contributor’s prior savings. The multiplier between savings (including accrued interests) and the loan amount granted should be limited (say to 1.5 times) to limit NHF liquidity risk if a large proportion of NHF contributors become long-term borrowers. A limited multiplier of this type is socially better than long waiting lists to obtain a loan, and/or restricting accessibility to NHF refinancing to a small minority of NHF contributors. NHF loans would then represent a smaller proportion of each housing investment with other main funding sources to include built-up prior savings, and market-oriented mortgage loans from banks which could be facilitated by contributors demonstrated prior savings discipline.

Alternatively, and preferable to the presently highly subsidized interest rates, NHF could provide small, up-front grants to contributors based on prior savings, social housing needs and contributor ability to obtain complementary commercial mortgage credit. This option would clearly separate market finance from subsidies, which is desirable, but may reduce the chances for some contributors to leverage at least a small loan with NHF funding.

7.34. Also, FMBN should amend its NHF-loan policy in the following ways:

- Financially sound commercial and merchant banks should be eligible to disburse NHF loans on the same basis as PMIs. However, the accreditation process to become an NHF qualified lender should remain the main responsibility of the FMBN, with CBN providing FMBN with its own inspection reports to support the process.

- The current 4% cap on lending margins should be eliminated or raised substantially. Minimum levels of over-collateralization through some co-financing of primary lenders is desirable to strengthen prospects of developing secondary mortgage markets. The current 0.5% ceiling applied to up-front fees should be raised to cover a larger part of actual underwriting costs and assist in making origination of NHF financed loans a profitable business, thus enabling it to expand.

- FMBN should change its current apex procedures such that it becomes a true wholesale institution:

  - Eligibility rules for collateral assets should be amended. PMIs are currently required to not only assign the mortgage deeds of the newly-funded NHF loans through their Sale and Administrative Agreement, but also assign “a block of mortgage loans previously granted by the PMIs.” This duplication adds little value, and prevents PMIs from raising potential refinancing from other mortgage lenders. A block of prior mortgages could be viewed as alternative eligible collateral, for example as an interim collateral solution until the mortgage deeds for newly refinanced loans are registered. Other guarantees should be made eligible including treasury bills, central bank papers, short-
term papers of highly rated banks, transferable and reliable third-party guarantee (from the borrower’s employer), etc.

- FMBN imposes excessive underwriting document requirements relating to the borrower and his investment and scrutinizes each individual case as if FMBN were taking direct credit risk without recourse guarantee from the primary lender. While justified on the first one or two NHF refinanced loans made by an individual PMI to facilitate training, this approach is costly, cumbersome and not sustainable on a larger scale. A strategic and technical re-positioning of FMBN is required so it can play a true wholesale funding role (e.g. making some ex-post sample inspections of the portfolio rather than carefully reviewing each individual loan in advance).

- FMBN should revise its yearly maximum lending limits to any primary lender - 50% of its shareholder’s value - and replace it with a potentially larger limit, depending on the rating and financial strength of the refinanced financial institution (varying according to its equity, size, capital adequacy ratio, liquidity ratio, etc).

7.35. **FMBN.** FMBN acts more like a retail bank, through reinvesting its cheap NHF deposits, than a mandated second-tier apex. It has become overly-dependent on a non-disbursing NHF. Its network (38 branches) and high operating costs are not conducive to a wholesale role in raising capital market funding for the mortgage industry and should be cut drastically. In addition, CBN should apply normal banking regulatory and supervisory guidelines to FMBN to ascertain its true net worth (excluding NHF) and capital adequacy ratio. Then two different strategic orientations may be considered:

i) The FBMN should restrict itself to a second-tier role, with a much downsized administrative structure to operate a revised NHF and develop secondary mortgage markets with other partners (catalyzing capital market funding for the mortgage industry was an explicit part of its mandate). This role would require only a few regional branches. FMBN management should then be held responsible for operating profitably. FMBN’s Board of Directors should be re-activated (absent since 1994), and according to its enacted founding decree, include representatives of the MWH, CBN, and the Mortgage Banking Association.

ii) Alternatively, FMBN could be completely dissociated from the management of NHF and abandon its second-tier functions and become an ordinary retail lender using NHF refinancing. Under this scenario, FMBN could become a normal competing PMI or commercial bank specializing in housing finance because of its initial expertise. It might be assigned some public missions by its shareholder (MWH) for social housing programs (loans and subsidies) under a revised housing policy (FMBN has started to fund a federal developer for higher-income housing projects in Abuja). FMBN should meet all banking requirements and be supervised by CBN as a bank rather than as a specialized financial institution. Under this scenario, its 1993 founding decree would have to be amended.
7.36. The mission does not support FMBN’s proposed expansion of the present strategy and its associated budgetary support (notably to fund the building of headquarters and local offices). The level of required down-sizing may depend on the selected orientation.

D. DEVELOPMENT OF PRIMARY MORTGAGE MARKETS WITH COMMERCIAL BANKS

7.37. Broadened mortgage lending by commercial banks is the primary potential source for financing a successful housing finance program in Nigeria as banks have most of the money, a more appropriate funding base and much of the country’s relevant lending skills in this arena. By contrast, re-structuring the PMI sector is an important and difficult challenge, but is unlikely to produce a comparable impact on the growth of the mortgage industry. Banks have natural comparative advantages over smaller and fragile PMIs to make housing loans, given their much bigger size, cheaper funding through core deposits, a large distribution network, their servicing and marketing departments and tools, and capacities to cross-sell retail products.

7.38. Two of the three largest commercial banks (First Bank of Nigeria and Union Bank) have recently started to offer market variable-rate mortgage housing loans to their non-staff clients. As an example, FBN is offering housing loans through its specialized central department in Lagos (the product is closely associated with consumer finance) and is now reporting a significant albeit still small N336 million mortgage portfolio mostly lent to high income business managers. The Union Bank has entered this market by re-capitalizing the largest active PMI (Union Homes Savings and Loans) to develop the mortgage business through this specialized subsidiary. New products are targeting an upper-income retail market segment of professional executives.

7.39. These initial moves are significant given the past preferences of conservative banks for short term loans. The mission believes they presage slowly increasing and broadening commercial bank lending in this market. Development of housing finance in Nigeria depends heavily on the will and capacities of other banks to enter this sector, given the expected risks and creditworthy demand. Banks have natural comparative advantages over smaller and fragile PMIs in making housing loans, given their much bigger size, cheaper and more stable funding through core deposits, a large distribution network, their servicing and marketing departments and tools and capacity to cross-sell retail products.

7.40. Banks’ current loan conditions are unattractive for middle-income mortgage borrowers given a combination of high loan rates (variable rates, currently above 30%, based on high margins) and modest tenors of the loans (3 to 5 years, sometimes up to 8 years). The minimum required equity is usually a substantial 25%. Given the high interest rates, longer terms may not contribute much to greater loan affordability. A key issue will be how to reduce their transformation risks, costs of funds and margins, while extending the terms of their loans.

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20 These are “discretionary” variable rates loans: the bank can change rates at its sole decision, to reflect its new costs of funds.
7.41. Banks - as well as PMIs – have a great need for mortgage loan training e.g. in underwriting, servicing and funding mortgages, and in assets/liabilities management. There are also needs for an education campaign directed at potential borrowing households.

7.42. Improvements in the mortgage market infrastructure are necessary with regard to mortgage registration (fee waivers and reduced delays in obtaining mortgage consents are needed), transfer of mortgage portfolios (same remarks), and risk-weighting of mortgage residential loans for capital adequacy in line with Basle’s core principles (50% risk-weighted instead of 100% as applied by CBN). However, mortgage collateral effectiveness must first be improved for lenders. Some interviewed bankers report that mortgage foreclosure functions relatively smoothly through the Courts, except for practical eviction which is difficult, while others reported cases of inefficiencies and corruption with Courts.

7.43. Other large banks may choose to take over some of the remaining active PMIs (as the Union Bank did), or to directly develop mortgage products as an essential part of their retail strategy. The experience of the First Bank of Nigeria may become an interesting model for other banks. A significant increase in commercial bank involvement in mortgage lending however requires access to external funding solutions, notably NHF funds and some form of secondary mortgage market (see below). Commercial banks should become eligible to collect NHF savings and disburse loans.

7.44. The Mortgage Bank Association has requested that NSITF contributors be authorized to make early withdrawals of 75% of their accrued savings to make down-payments on housing investments. Such a measure might be justified given NSITF’s inefficiency as a pension fund, and the valuable retirement shelter characteristics of a housing investment. However, the expected advantages of such authorization may be of little consequence as sums of money are insignificant relative to housing prices (monthly deposits to NSITF were limited to N300, i.e. N72,000 after 20 years) and such withdrawals would worsen the financial position of the troubled NSITF. As an aside, pension funds should not make mortgage loans to their members, but should be encouraged to purchase long term mortgage bonds.

7.45. The mission recommends the development of a new generation of more inflation-resistant mortgage loan instruments, in particular Price-Level-Adjustable Mortgages (PLAMs). Official inflation rates now stand at a moderate 11%-12%, but actual inflation (as expressed through a different basket of consumer goods) is reported by many observers as closer to 18%. Inflation levels of 12%-18% (and past inflation levels have been higher) adversely affect borrowers’ ability to purchase a home. A mortgage origination process should avoid large contingent credit risks, generated by potentially large changes in interest rates. PLAM instruments index nominal rates, nominal repayments, and outstanding balances with the same inflation index. Borrowers start repaying only the affordable real fixed part of nominal interest rates (maybe only half of current credit rates). The proportion of their incomes dedicated to repaying mortgage installments also remains stable as long as their real purchasing power does not decline.
significantly. Significant affordability gains may be achieved even if lending margins do not change. PLAMs also better protect consumers in case of rising rates, when compared to current discretionary variable-rate mortgages. Consequently, the potentially creditworthy mortgage market could expand. This process would also require some preparatory work relating to the accounting and fiscal treatment of capitalized interests, as well as educational efforts directed at both lenders and borrowers.

E. INSTITUTIONAL INVESTORS AND SECONDARY MORTGAGE MARKETS

7.46. Life insurance and pension funds remain under-developed in Nigeria (see Chapter 8 for details). But their relatively greater size, over the nearly absent mortgage markets and the important diversification needs of such investors offer an interesting starting point for the creation of rudimentary forms of secondary mortgage markets.

7.47. Life insurance and pension funds currently invest an excessive portion of their collected long-term liabilities in short-term placements (mostly Treasury Bills, deposits in banks, commercial papers) largely due to economic uncertainties and the lack of alternative investment vehicles. Their long-term assets are composed mostly of stocks and real estate assets with little going into debt instruments. Interviewed investors record a proportion of stocks in a range between 10% and 50% of long term investments. Stocks have been performing poorly in the last two and a half years and buy and sell transactions are quite slow and expensive, given the registration process, brokers’ fees, and the lack of a liquid secondary market (see Chapter 9). Most interviewed institutional investors placed between 20-25% of their assets in rental real estate (20%-22% for general and life insurance companies in 1996), estimated at book value -often well below market values- so as to meet the maximum levels allowed by law. In 1999, the NSITF recorded 61% of its assets in real estate.

7.48. Most investors are over-exposed in direct real estate (mostly commercial property to lease but also some residential assets) perceived as illiquid and returning unsatisfactory net yields, given the past depression period (through non-appreciated rents and high maintenance costs). Reported recent nominal yields ranged between 6% and 15%, compared with an official 12.5% and market perceived 18% inflation rate. Some of these yields also reflect returns from book value, and represent a worse return on market values. Higher market yields (23% before taxes) are quoted only for top rental segments (mostly with expatriates or foreign companies as tenants).

7.49. Different contractual savings institutions face somewhat differing situations but there is clearly a lack of diversification possibilities in alternative securities, especially fixed-income-securities, including secured bonds. In this regard, mortgage-related securities and mortgage portfolios represent an attractive concept. Some interviewed investors expressed interest in purchasing 5-year floating-rate mortgage bonds, if priced at least 200 basis points above short-term treasury bills, a seemingly reasonable premium

21 Banks and PMI currently adjust their credit rates when their costs of funds change (at their own discretion), with some possible harmful impacts on the required repayments and credit risks for borrowers.
under current economic conditions. Unfortunately, a lack of long-term treasury benchmarks does not facilitate the pricing of such mortgage bonds.

7.50. Institutional investors’ interest in residential mortgage debt and related securities depends on regulatory rules that limit investment in real estate to 25% of assets and require that at least 50% of assets are held in the form of government securities\textsuperscript{22}. One large insurance company directly grants mortgage residential loans to the best employees and managers of some corporate clients (current portfolio is about N150 million).

**Recommendations to Develop Secondary Mortgage Markets**

7.51. Given the existing funding mismatch problems of mortgage lenders (banks and PMIs) and the constraints faced by the NHF, some simple and robust forms of secondary mortgage markets should be developed as rapidly as possible.

7.52. The simplest variant would consist of encouraging sales of mortgage portfolios across banks, PMIs, and insurance companies. PMIs may then become primarily loan originators (a function encouraged by their small capitalizations and specialized structure), while transferring a large share of funding and its associated risks to banks, insurance companies and/or a newly created secondary mortgage facility (conduit type). Such investors would thus acquire a larger scale mortgage portfolio at lower underwriting costs. This would require an easy, cheap and irrevocable transfer of loans and deeds, with related administrative reforms and waivers of stamp duties. Yet this diversification effort may not be sufficient to mobilize adequate long-term liquidity for growing mortgage markets.

7.53. While contractual savings mobilized by life insurance companies and pension funds may represent a limited percentage of total national financial assets and GDP, they represent a very important market for fixed-income security issues. As explained before, such institutions are in need of alternatives to diversify beyond very short-term investments, real estate and stock market exposure.

7.54. The mission recommends the creation of a Secondary Mortgage Facility (SMF). Its capital would be owned by FMBN, banks and PMIs as mortgage lenders, and perhaps also by institutional investors. The FMBN has been initially mandated to play a catalyst function for developing secondary mortgage markets, and should therefore retain an equity position in the new structure (assuming FMBN continues to operate as a second-tier specialized financial institution). But given its past poor performance and inexperience regarding capital markets, the mission also recommends inviting other institutions to subscribe to the SMF’s capital base.

7.55. The SMF would issue market-oriented mortgage bonds with the proceeds used solely to refinance primary mortgage lenders, who would have to over-collateralize their

\textsuperscript{22} These ratios are met on a temporary basis for the last day of the year. They are sometimes by-passed or simply ignored (see Chapter 8).
refinancing utilizing eligible mortgage portfolios. Primary mortgage lenders would continue to assume credit risks during the first phase of the SMF’s development. Amortized, prepaid, or ineligible loans should be replaced as needed by collateral in the form of other mortgage loans or other high-quality assets (like treasury bonds, SMF bonds, etc.).

7.56. A SMF could help to: i) standardize mortgage loans; ii) diversify the best risks among mortgage lenders and loans;\(^{23}\) iii) issue larger and cheaper long-term bonds (maybe 5 years to start; then subject to refinancing renewals) as a specialized interface between capital markets and mortgage markets; iv) develop an efficient and sustainable source of funding; and v) re-channel scarce public resources to better target subsidies programs. SMF’s margin could remain limited (say, less than 1%).

7.57. The funding could take the form of refinancing lines, or full-recourse purchases of mortgage pools. In case of refinancing lines – like master purchase and administration sale contracts and deed assignment contracts established by FMBN– the SMF should have a senior privilege to become the sole owner of mortgage pools in case of bankruptcy of the primary lender.\(^{24}\)

7.58. Bond characteristics (size, coupon, term) would be targeted to the needs of institutional investors like banks, life insurance and pension funds rather than to retail investors. It would probably be best to start with single-bullet non-callable bonds, although the lack of liquidity associated with this characteristic would make them more suitable as investments by pension funds and insurance companies than by banks (except if the latter are able to hold the bonds for CBN reserve purposes). The current lack of benchmarks and yield curves complicates the pricing of such bonds, even if they could to some extent represent a good substitute for treasury bills. Multilateral institutions may also provide the SMF with some start-up financial assistance, for example as a complementary bridge support to the main bond liabilities, or to provide some minimum back-stop liquidity to the issuance and trading of such bonds. Creditworthy banks able to over-collateralize their bonds with mortgages, as well as the SMF, should be allowed to issue bonds of this type.

7.59. Indexed bonds (matching cash-flows of PLAM loans) should also be considered as investments by pension funds and life insurance companies, in order to protect their cash-flows from inflationary erosion and to match the expected growth of payments against long term liabilities.

7.60. The cost of bond funding and therefore the price of mortgage loans should be based on market-determined pricing but could be somewhat reduced by the following positive features, given the particularly secure aspects of these fixed-income securities (most of the following measures are found in OECD countries and compatible with Basle core principles):

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\(^ {23}\) First-ranked mortgage, loan-to-value ceiling, criteria of past performance, sufficient loan terms and interest rates, etc.

\(^ {24}\) FMBN contracts look well grounded in this respect. Yet, the 1989 Decree on PMIs stresses that PMI depositors are the first creditors in case of bankruptcy. A possible conflict between depositors and FMBN has not been tested yet.
bonds benefiting from a temporary (sunset) state guarantee (based on FMBN’s decree)
bonds eligible for rediscounting at the CBN by banks and PMIs.
bonds risk-weighted at 10% or 20% (compatible with Basle’s requirements, as demonstrated in similar institutions operating in US, France, Austria, Switzerland, Malaysia, Jordan, Trinidad & Tobago)
bonds treated as liquid assets for liquidity ratio calculation requirements for both banks and PMI
bonds as eligible placement assets for the NHF (its current surpluses could be used in part to purchase long term mortgage bonds)
bonds preferably payable to bearer for easier trading;
bonds benefiting from a facilitated issuance and trading framework of securities: lower fees SEC and Stock Exchange fees, lower trading fees, faster approval of SEC, simpler prospectus form; and
SMF-refinancing to be deducted by the primary lender from the base on which statutory reserves are calculated.

7.61. Some amendments would be required to the 1999 Investments and Securities Decree. For example, the section on bonds issued by public entities does not appear conducive to the regular smooth issuance of mortgage backed securities. Also, there is no possible trading within 21 days of the scheduled payment of quarterly or semestrial interest coupons. Also, the advantages provided to FMBN under the Decree with regard to secondary mortgage markets (securities backed by the state and eligible for CBN discount facility) should be transferred to the newly-created SMF institution.
APPENDIX 7.1: REFORMING HOUSING POLICY IN NIGERIA

1. Prior to 1991, housing policy mainly consisted of state governments directly delivering new housing. This policy failed on every front: i) volumes were low with only 15%-20% of planned targets actually completed; ii) housing quality was poor and there was an inadequate response to the expressed demand; and (iii) in terms of a regressive social allocation. A revised National Housing Policy was then released in 1991 to “ensure that all Nigerian own or have access to decent housing accommodation at affordable costs by the year 2000.”

2. The mission could not find any updated and reliable data about the housing sector and housing finance aggregates more recent than 1995, which could have helped to monitor the effectiveness of the housing policy. Decision makers lack adequate data about total newly-built units, contribution of the public sector, evolution of the total housing stock, evolution of land and housing prices, homeownership ratios, shortages and living conditions, growth of the informal housing sector, contribution of the housing sector to GDP formation, etc. No major policy re-orientation appears to have been decided in the last five years, despite evidence of policy failure. Each state follows its own policy within its means, leading to heterogeneous results.

3. The Federal Ministry of Works and Housing (FMWH) does not estimate housing investments funded at the national level by the public sector in a consolidated way. Other ministries run their own housing programs, mostly for their own staff. Budgetary decisions are made for specific projects, without a coordinated policy framework. The FMWH is now requesting (for the year 2000), some budgetary funding in order to start a four-year program equivalent to N10 billion, targeted to build 20,000 social housing units (5,000 units every year). No decision has been made yet about their planned allocation (proportions for FMWH staff versus other employees), status (for sale or to lease), and level of development in partnership with the private sector. This policy initiative does not look sufficiently prepared and may therefore run against the objectives of a more sustainable national policy.

4. The Housing Policy Council has played a modest reporting function which has virtually stopped in the last four years. Its latest report about housing indicators was published in 1995 from uncompleted survey replies. The Council had no significant influence on housing policy. From its own comments, the Council would currently prepare a housing databank project in coordination with the Office of Statistics. That initiative would be valuable to monitor a housing policy but the project has not been funded yet.

5. Land and property titling remains a complex and costly process. There are many reported cases of ownership conflicts, even between various public bodies, including federal and state governments. Red-tape and corruption worsen complex administrative and technical requirements. The approval of the State Governor is required for the final Certificate of Occupancy, and adds uncertainties and delays. Inadequate zoning and building authorizations are also quoted as key problems in some states. A survey conducted by the National Housing Council in 1995 identified as a worst-case scenario 3-year delays in a given state in order to obtain construction permits. A major cause lies in
the provisions of the Land Use Act of 1979, which is now outdated and needs to be revised.

6. Housing developers are insufficiently developed and do not meet professional standards. The mission was informed of various malpractices, including:

?? non-refund of deposits made by clients (for example by FHA), or non-payment of interest on interest-bearing deposits;

?? improper final allocation of units and major pricing changes through the construction process;

?? development projects not taking into account the actual expectations of household demand;

?? despite facilitated access to land and infrastructure for public development agencies (including FHA), they would produce less than 10% of total new units, and do not develop partnerships with the private sector, for example through limiting their role to land infrastructure. Private developers are perceived as competitors or only interested in high-income markets. Mixed programs are rarely developed; yet promising exceptions were noticed in Lagos.

?? uncontrolled risky development process, which sometimes begins before closing the titling and without any realist funding plan 25;

?? lack of reasonably sized private developers with sufficient financial capacities, combined with a lack of short-term finance from banks (including the Urban Development Bank) or PMIs, which both have to fund equity development through subsidiaries.

7. An excessive proportion - quoted 60% ratio - of building materials is imported, thus increasing housing prices through the depreciation of the naira over the past five years. Only manpower, sand, granite and pipes are reported to be locally produced. Most equipment (windows, sanitary, etc.) and cement are still imported, while the raw materials exist in Nigeria (for example aluminum). But the related processing industry is under-developed.

Recommendations

?? Create an executive housing policy body at the highest possible level, with representatives of the Ministries of Finance, Works and Housing, Justice, as well as the CBN, FMBN, the Bankers Committee/Institute of Bankers, and the Mortgage

25 For example FHA, which is now running various programs representing about 21,000 units. FHA now faces a liquidity crisis due to many insolvent clients, who prove unable to repay the 80% left balance after their initial 20% deposits for reserving a social housing unit. In addition FHA faces its own funding constraints from tight federal budgetary assistance, but and large expenditures. The absence of property titles which could be mortgaged prevents banks or PMI from securing construction or acquisition finance. Its public status should not exempt FHA from holding any work until property titles are actually cleared (FHA estimates usual delays at 6 months, which would be reasonable given the fact that FHSA just have to pay delayed compensation for land, not high interest rates).
Banking Association. This body should propose comprehensive housing policy reforms.

?? Develop a legal and fiscal framework for real estate leasing contracts
?? Revise the Land Use Act, as well as land zoning and building standards;
?? Develop a Housing Policy database with the Council of Housing Policy
?? Create Real Estate Development standards (insure deposits, clarify allocation, inspect work progress, etc.)
?? Develop partnerships between federal & state development agencies with private developers, who focus on land infrastructure and titling
?? Develop a building materials industry through tax exemptions and venture capital funding (development banks)
8. CONTRACTUAL SAVINGS: INSURANCE AND PENSIONS

I. INSURANCE INDUSTRY

A. INTRODUCTION

8.1. The Nigerian insurance sector is under-developed, with premiums received amounting to less than 1% of GDP. The ratio of insurance premiums to GDP is a common measure of insurance penetration in a market. Table 8.1. shows values for this important statistic over 1993-98. These figures are taken from an industry study. The sharp drop in the ratio during 1997 is an aberration, attributable to problems experienced by NICON, the state-owned insurance company, in connection with a special class of business it conducts with government agencies as clients. Although Nigeria is the most populous and one of the largest countries in Africa, it trails other countries in the size of its insurance market (see Table 8.2.). In 1980, gross premium for the industry was approximately N350 million, which translated at that time into US$500 million. It is likely that this volume represented a more significant contribution to GDP than do insurance activities in the current era.

Table 8.1: Insurance Penetration in Nigeria (Gross Premium Income/GDP)

<table>
<thead>
<tr>
<th>Year</th>
<th>GPI-GDP Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>0.93%</td>
</tr>
<tr>
<td>1994</td>
<td>0.92%</td>
</tr>
<tr>
<td>1995</td>
<td>0.86%</td>
</tr>
<tr>
<td>1996</td>
<td>0.88%</td>
</tr>
<tr>
<td>1997</td>
<td>0.68%</td>
</tr>
<tr>
<td>1998</td>
<td>0.86%</td>
</tr>
</tbody>
</table>
Table 8.2: Comparative Insurance Premiums (% GDP) (1998 Ratios)

<table>
<thead>
<tr>
<th></th>
<th>Total business</th>
<th>Non-Life</th>
<th>Life</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>%</td>
<td>%</td>
<td>%</td>
</tr>
<tr>
<td>South Africa</td>
<td>20.63</td>
<td>3.49</td>
<td>17.14</td>
</tr>
<tr>
<td>Mauritius</td>
<td>4.32</td>
<td>2.12</td>
<td>2.20</td>
</tr>
<tr>
<td>Zimbabwe</td>
<td>3.92</td>
<td>2.04</td>
<td>1.88</td>
</tr>
<tr>
<td>Kenya</td>
<td>3.48</td>
<td>2.71</td>
<td>0.78</td>
</tr>
<tr>
<td>Morocco</td>
<td>2.60</td>
<td>1.96</td>
<td>0.64</td>
</tr>
<tr>
<td>Tunisia</td>
<td>1.65</td>
<td>1.53</td>
<td>0.12</td>
</tr>
<tr>
<td>Ivory Coast</td>
<td>1.53</td>
<td>1.08</td>
<td>0.45</td>
</tr>
<tr>
<td>Nigeria (est.)</td>
<td>0.86</td>
<td>0.76</td>
<td>0.10</td>
</tr>
<tr>
<td>Egypt</td>
<td>0.65</td>
<td>0.49</td>
<td>0.16</td>
</tr>
<tr>
<td>Algeria</td>
<td>0.54</td>
<td>0.51</td>
<td>0.03</td>
</tr>
</tbody>
</table>

Source: Sigma No 7/ 1999. Published by Swiss Reinsurance Co.

8.2. As the figures indicate, life insurance penetration in Nigeria is very limited. It has been estimated that not more than 5% of the population is covered by any form of life insurance policy. Arguments for the low penetration include: i) the low level of disposable income for the majority of the population; ii) lack of public confidence in local financial institutions which undermines willingness to enter into contractual savings arrangements with an insurance company; iii) lack of interest in traditional fixed premium, fixed benefit forms of life insurance in a market exposed to the potential erosive effect of currency devaluation and inflation. It is possible that there would be more interest in life insurance if contracts were to be denominated in hard currencies and offered as linked products. The values of such products would not then be eroded by the changing macro-economic situation. To date, such products are not readily available in Nigeria. However it is likely the lack of disposable income on the part of the majority of the population is the over-riding factor.

8.3. Insurance business has been carried on in the country since the 1920’s. Initial efforts involved UK companies. For many years the market developed in an orderly manner. However, in the 1970’s and 1980’s, a process of indigenization occurred, during which most of the foreign insurance companies withdrew from the market and a large number of new local entrepreneurs launched insurance companies. The rules for entry were not stringent, especially with respect to capital requirements, and the result was a proliferation of small companies, with inadequate resources and virtually no expertise in the insurance business.

8.4. The situation has deteriorated since that time. The last decade has been particularly hard on the insurance industry, especially in light of the significant devaluation of the currency. While the amount of premiums collected, expressed in naira, has grown significantly over the period, there has been a real contraction in the market during the period. The US-dollar equivalent of premium income for the industry during calendar year 1980 was approximately $500 million, whereas the corresponding equivalent for
1998 is an estimated $240 million. We thus have a considerably smaller total market, being served by a much larger number of companies.

8.5. The following list was prepared by a local insurance expert when asked to explain the reasons for the decline in volume and quality in the insurance business in Nigeria: i) destructive competition and rate-cutting; ii) prevailing level of insecurity and crime resulting in theft of vehicles and property; iii) alarming increase in costs of production for insurance companies; iv) the adverse effects of the so-called “Nigerian factor” on such matters as insurance claims management resulting in fraudulent and grossly exaggerated claims; and v) low public awareness of insurance and a general misunderstanding of the insurance concept.

B. MARKET PROFILE

8.6. The reality today is that the major block of business that is written in Nigeria is motor vehicle third-party liability insurance. This insurance is obligatory although we have seen statistics suggesting that as many as 40% of drivers may be traveling on the country’s roads without the necessary insurance coverage. There is intense competition for the business and this has led to rate-cutting and a practice that has been described as “premium purchase” – bribing people to place insurance with a particular broker or company. Premium rates for this insurance are to follow a tariff system established by the government authorities. However, this tariff system appears to be ignored by the industry and there does not seem to be a serious effort at enforcement.

Table 8.3: Gross Premium Income – Proportions by Line of Business

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Life</td>
<td>10</td>
<td>6</td>
<td>12</td>
</tr>
<tr>
<td>Non-Life:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Motor</td>
<td>20</td>
<td>18</td>
<td>28</td>
</tr>
<tr>
<td>Fire</td>
<td>10</td>
<td>10</td>
<td>12</td>
</tr>
<tr>
<td>Marine</td>
<td>16</td>
<td>17</td>
<td>15</td>
</tr>
<tr>
<td>Accident</td>
<td>6</td>
<td>5</td>
<td>7</td>
</tr>
<tr>
<td>All other</td>
<td>38</td>
<td>44</td>
<td>27</td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

8.7. Other lines of insurance are seriously under-developed in Nigeria. One estimate suggests that property insurance is in place on less than 10% of the cases where it should be applied. It can be said that this is due to a lack of awareness of the potential role of insurance and risk management for business enterprises, but it is also likely that the industry operates in an atmosphere of mistrust and it will take some time to change the attitude of business people and of the individual consumer.
8.8. Information obtained from the industry association reveals that claims paid by the industry consume approximately 30% of its premium revenues. A loss ratio in excess of 60% would be more likely in a market like Nigeria. Administration expenses, commissions and other costs of operation are consuming over 50%, or the lion’s share of premium revenue. This would not be possible in a mature insurance market where costs should not exceed 20% or perhaps 30% of premiums. Thus, while in aggregate, the industry appears to enjoy a modest level of profitability, this derives from the low claims ratio and not from any operating efficiency.

8.9. An analysis of the high operating costs indicates that the costs of production include commissions, overriding commissions, wages, business procurement expenses as well as gifts to staff in the offices of both the insured and some brokerage firms, along with other hidden “commissions” collected by the insurance company’s own staff. These “extras” produce a situation where it costs proportionately more to generate premium revenue in Nigeria than it would in other countries. It can also be said that the volumes of business obtained in Nigeria are so low that they cannot support the administrative costs of the large number of authorized companies. The solution to this problem may require tough measures, involving both the office of the supervisor and the management of the most responsible companies. The requirements for entry should be toughened and there could be a limit placed on the maximum amount that a company may pay in commissions. Such a provision operates in the State of New York, USA and it is an effective control. However it will take a major effort to implement such this provision in face of the prevailing situation.

8.10. Income from investments is an important part of total revenue for insurance companies in Nigeria. Although the companies complained about the restrictions imposed on their investment activities by regulation, they have developed quite sophisticated portfolios. The following summary of total investments was derived from the statistical report of the National Insurance Commission:

<table>
<thead>
<tr>
<th>Table 8.4: Investment Portfolio (General Business)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Govt. Securities</td>
</tr>
<tr>
<td>Stocks &amp; Bonds</td>
</tr>
<tr>
<td>Real Estate/Mortgages</td>
</tr>
<tr>
<td>Policy &amp; Other Loans</td>
</tr>
<tr>
<td>Cash Deposits</td>
</tr>
<tr>
<td>Bills of Exchange</td>
</tr>
</tbody>
</table>
Table 8.5: Investment Portfolio (Life Business)**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>%</td>
<td>%</td>
<td>%</td>
</tr>
<tr>
<td>Govt. Securities</td>
<td>14</td>
<td>10</td>
<td>18</td>
</tr>
<tr>
<td>Stocks &amp; Bonds</td>
<td>42</td>
<td>37</td>
<td>35</td>
</tr>
<tr>
<td>Real Estate/Mortgages</td>
<td>22</td>
<td>29</td>
<td>23</td>
</tr>
<tr>
<td>Policy &amp; Other Loans</td>
<td>10</td>
<td>8</td>
<td>7</td>
</tr>
<tr>
<td>Cash Deposits</td>
<td>12</td>
<td>11</td>
<td>15</td>
</tr>
<tr>
<td>Bills of Exchange</td>
<td>0</td>
<td>5</td>
<td>2</td>
</tr>
</tbody>
</table>

**As noted below, these figures may represent only a year-end snapshot of the investment portfolios of companies. Their portfolios may look quite different at other times during the year. One life insurer informed the team that it had 60 – 70% of its assets invested in real estate.

8.11. An examination of industry data for the past few years indicates that the assets appearing in the aggregate balance sheet for the insurance industry as a whole displayed the following profile:

Table 8.6: Asset Profile of the Insurance Industry

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash and other current assets</td>
<td>15%</td>
</tr>
<tr>
<td>Premiums Receivable</td>
<td>20%</td>
</tr>
<tr>
<td>Investments and Loans</td>
<td>33%</td>
</tr>
<tr>
<td>Fixed Assets</td>
<td>27%</td>
</tr>
<tr>
<td>Other</td>
<td>3%</td>
</tr>
</tbody>
</table>

8.12. According to figures prepared by the Central Bank of Nigeria, the bulk of industry investments is placed in securities of private issuers. The following table provides estimates of the percentage distribution of loans and investments (other than real estate) for the insurance industry over the past few years:

Table 8.7: Distribution of Insurance Loans and Investments

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans of all kinds</td>
<td>12%</td>
<td>9%</td>
<td>6%</td>
</tr>
<tr>
<td>Government Securities</td>
<td>10%</td>
<td>11%</td>
<td>7%</td>
</tr>
<tr>
<td>Private Securities:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><em>Debentures</em></td>
<td>12%</td>
<td>7%</td>
<td>8%</td>
</tr>
<tr>
<td><em>Equities</em></td>
<td>28%</td>
<td>48%</td>
<td>58%</td>
</tr>
<tr>
<td><em>Other</em></td>
<td>39%</td>
<td>25%</td>
<td>21%</td>
</tr>
</tbody>
</table>
8.13. This table indicates that lending activity, including mortgage lending, is not a major area of investment for insurance companies. It is also interesting to note the increasing emphasis on investments in corporate equities.

C. PLAYERS IN THE INDUSTRY

8.14. There are several publicly-owned companies in Nigeria as well as a large number of privately-owned companies. Only the federally-owned companies are of substantial size, although there are a number of companies that are at least partially-owned by governments of the various states of Nigeria.

Federally-owned:

??NICON Insurance Corporation. Owned 100% by the Federal government and during 1996 controlled over 50% of the non-life business in Nigeria. Most of this was Government business that it receives on a mandatory basis (see further information below).

??Nigerian Agricultural Insurance Corporation (100% Federally owned)

??Nigeria Export-Import Bank – provides export credit facilities and funding.

Largest Insurance Companies:

Largest companies in non-life insurance on basis of gross written premiums were (1996 figures estimates in millions of USD):

Table 8.8. Largest Non-Life Insurance Companies (Gross Written Premiums, US$)

<table>
<thead>
<tr>
<th>Company</th>
<th>Premium (US$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>NICON Ins Corp</td>
<td>119.2</td>
</tr>
<tr>
<td>UNIC Insurance</td>
<td>11.0</td>
</tr>
<tr>
<td>Leadway Assurance</td>
<td>8.6</td>
</tr>
<tr>
<td>Industrial and General</td>
<td>8.4</td>
</tr>
<tr>
<td>Alliance</td>
<td></td>
</tr>
<tr>
<td>Aiico Insurance</td>
<td>6.2</td>
</tr>
<tr>
<td>Lion of Africa</td>
<td>5.5</td>
</tr>
<tr>
<td>Law, Union &amp; Rock</td>
<td>4.5</td>
</tr>
<tr>
<td>Royal Exchange</td>
<td>4.5</td>
</tr>
<tr>
<td>Prestige</td>
<td>3.5</td>
</tr>
</tbody>
</table>

Foreign Ownership:

8.15. The insurance laws do not prohibit foreign investors from owning significant shares (even 100%) of an insurance enterprise. However the Companies Act limit such foreign ownership to 40%. There are at present 2 companies in the market that are 40% owned by foreign investors – one investor is American and the other British. It would be a good idea to remove this restriction on foreign ownership and thus to allow participation by
foreign insurance groups that could bring badly-needed insurance expertise to Nigeria. As mentioned earlier there is little foreign presence in the insurance market. This situation is not likely to change until foreign investors gain a great deal more confidence in the business environment in Nigeria. There is hope that the new democratic government will change these perceptions.

D. INSURANCE REGULATION AND SUPERVISION

8.16. Not all of the problems facing the insurance industry in Nigeria can be solved through stronger regulation and supervision, but there are measures in these two areas that could be adopted in order to promote the development of an open, competitive and financially-sound insurance market.

Regulation

8.17. The first genuine attempt at local insurance regulation was the Insurance Act of 1976. This was enhanced by other decrees issued in 1991 and 1997. The system of regulation currently in place is that established with the decrees issued in 1997. By virtue of the 1997 decrees, the effective administration, supervision, regulation and control of insurance business in Nigeria is the responsibility of the National Insurance Commission. The system calls for the Commission to (among other things):

??Approve rates of premium to be paid in respect of all classes of business
??Approve rates of commission
??Regulate transactions between insurers and re-insurers in Nigeria and those outside Nigeria
??Approve standards, conditions and warranties applicable to all classes of insurance business
??Protect insurance policyholders and beneficiaries and third parties to insurance contracts

8.18. The list of powers, duties and responsibilities of the Commission is extensive. Unfortunately, the Commission has not been provided with all the resources that would be required to carry out such a broad mandate. The control aspects of the system are so extensive that it is doubtful that any supervisory office could deal with them effectively no matter how many employees it had. Much more effective use can be made of scarce supervisory resources if the emphasis is placed on the financial condition of companies rather than on minute verification of compliance with a lot of detailed regulations.

8.19. The Commission also suffers from the fact that its governing Board has not been appointed. The decree calls for the establishment of a governing Board with an impressive list of representatives from various elements of the public and private financial community in Nigeria. This Board could be quite helpful to the Commissioner in the discharge of his duties, but for some reason the necessary nominations to the Board were never made.
**Minimum Capital**

8.20. The 1997 decrees raised the minimum capital requirements for insurance companies as follows:

- ?N20 million for Life Insurance
- ?N20 million for General Insurance
- ?N50 million if General Insurance is to include certain specific classes such as credit insurance; oil and gas; contractors’ risk and marine/aviation insurance
- ?N150 million for Reinsurance

This level of capital is not large by world standards but represents a considerable improvement in Nigeria. The new minimum is to apply to new companies coming into the market. However it is quite reasonable that existing companies also be expected to possess at least this much capital.

8.21. Unfortunately, the application of the new rules has presented a problem. The rules require that the total initial capital of a company must be deposited with the CBN, likely a security consideration. Once a company is licensed, 50% and later 85% of this deposit is returned to the management to invest as it sees fit. The authorities decided that this practice should be applied to existing companies as well. They thus requested existing companies to turn over to the CBN an amount of money equal to their base capital. Since the funds deposited with the Central Bank would earn interest at a very low rate (set by the CBN) and certainly less than what the funds could earn in other investments, the companies were very reluctant to make these transfers. Measures such as this are very destructive to the relationship between the supervisor and the industry. Perhaps this could have been avoided if the Commissioner had access to the advice of the governing Board.

8.22. The 1997 decree also provides for a regime for identifying “fit and proper” candidates for chief executives and managers of insurance companies. This is also an excellent suggestion. However such a measure can only be applied with retroactive effect with extreme care. The supervisor has apparently threatened to remove executives from companies they have managed for many years because they lack certain professional credentials that are now judged to be valuable qualifications for an insurance executive. This could also jeopardize the relationship between supervisor and industry.

**Investment Rules**

8.23. Companies have also protested about the investment rules prescribed by various decrees. The Act prescribe that the companies must have not less than 25% of their funds invested in government securities which are low-yielding. Officially, investments in real estate may not exceed 25% for non-life companies and 35% for life insurance companies. While these appear to be very prudent limits on real estate investments, company managers are opposed to such restraints because they consider real estate investments to be the ideal opportunity for them.
8.24. In addition to the requirements specified in the decree, investments by insurance companies must also respect the requirements of the National Housing Fund decree of 1992. By virtue of this decree, every life company must invest 40% of its life funds and 20% of its non-life funds in real property, 50% of which should be paid into the National Housing Fund at an interest rate not exceeding 4%. We understand that non-compliance with this requirement is widespread.

8.25. These constraints on investments are very unwelcome to the insurance company managers who can earn much higher rates on return on other types of investment, including even bank deposits. It appears that companies have adopted the philosophy that the rules need only be observed on the date when annual statement filings are due. Thus, window-dressing techniques, such as borrowing of securities, are followed, such that, on December 31, the companies can report a balance sheet that appears to comply with the rules.

**Solvency Margin**

8.26. The decree does specify a solvency margin to be maintained by insurance companies. Companies must maintain capital and free surplus that amount to at least 15% of one year’s premium income. The rules are somewhat ambiguous and are not uniformly applied by the companies. The European Union has adopted a formula for solvency monitoring that requires a somewhat larger amount of capital. What is more important is that the rules must make very clear the way in which the various items of assets and liabilities are to be evaluated for purpose of the test. This work has not all been done for Nigeria. The team learnt that overdue premiums are not admitted as assets for purposes of the test. This is commendable.

8.27. The solvency formula adopted for measuring the solvency of insurance companies operating in the European Union measures the net assets of the companies against a “required amount” that is determined by a formula. This formula includes parameters that are a function of the premium volume of the company, the extent to which its business is reinsured, and the volume of claims that the company has been experiencing.

8.28. The required amount is the greatest of the following three values:

- the minimum absolute amount of capital that is required to obtain a license to do business
- a percentage (varies between 18 to 22%) of the net annual premium income of the company. This net amount is determined by taking the gross premium income of the company and reducing it by the amount of premiums ceded to reinsurers. However, the reduction for reinsurance is limited to 50% of premiums.
- a percentage (range of 22 – 26%) of the average claims incurred by the company over the last three years. The claim figures are also to be net of reinsurance, but reinsurance may not reduce the claims factor by more than 50%.
Supervision

8.29. The office of the supervisor is in a state of transition. The incumbent Commissioner has been in his position for approximately two years. He appears to enjoy the respect of the insurance industry since he is a career insurance professional and an experienced insurance broker. The office does not have the human and financial resources to discharge all the control functions that appear to be imposed on them.

8.30. At the same time, the supervisor has come to realize that there is an important function for him to perform in monitoring the financial condition of the companies. This is clearly the most important duty for his office and he believes that he will need to develop new procedures and recruit a different class of professionals into the office. At present he has only 10 employees engaged in the process of inspection of companies. Many more staff members are engaged in the process of approval of forms and premium rate schedules.

8.31. The trend in insurance supervision around the world is to move away from prescribed tariffs and such control-oriented supervisory devices, and to favor supervision based on solvency monitoring. It is certainly not helpful to the relationship between supervisors and the industry to continue with an imposed tariff system that is not observed, except by the most scrupulous of industry players and that is scarcely enforced by the supervisor.

E. ROLE OF STATE COMPANIES

NICON Insurance Corporation

8.32. An important player in the local insurance market is NICON Insurance Corporation, a state-owned corporation. This company receives approximately one-third of all premiums collected by the insurance industry in Nigeria. The company is a composite, offering policies of life insurance as well as all lines of general insurance.

8.33. Since its establishment, the company has been the primary insurer of government property. As a result of decrees issued in 1997, the company has been awarded a virtual monopoly. No government property is to be insured with any other carrier except with the approval of the President of the country. This monopoly is an irritant to other companies doing business in Nigeria since the volume of government business is large.

8.34. NICON does not limit its operations to government business. It competes with other companies for all classes of insurance business. The mission was impressed with the apparent professionalism of the staff of NICON. However we did not perform a sufficiently thorough investigation to be able to provide an assessment of its efficiency and long-term profitability.

8.35. The mission was informed that the payment of premiums on government property is not very timely. In fact, NICON has built up a substantial “account receivable” for
premiums not paid to it by government departments and agencies. This poses a solvency and revenue problem for NICON today but will be a serious impediment to any attempts to privatize it in the future.

8.36. Life insurance policies sold by NICON in the past have been principally of the traditional endowment variety. Plans are now underway to introduce an investment-linked policy. This would be a state-of-the-art policy but it is not clear what appetite there will be for such policies among Nigerians. The ideal future for NICON would be a gradual removal of the right to insure government property. This should then be followed by privatization of the company.

**Nigerian Reinsurance Corporation (Nigeria Re)**

8.37. *Nigeria Re* was created in 1977 to meet several concerns of the government. At that time, there was a general withdrawal from the local insurance market on the part of the experienced foreign operators. Following a pattern seen in a number of other African countries, a state-owned reinsurance company was created and all companies are obliged to cede 20% of the premiums that they receive to this company. This initiative was taken with the encouragement of advisors from UNCTAD. The objectives were as follows:

i) Companies are obliged to reinsure some of their business as part of their risk management efforts. A mandatory local cession would ensure that at least some of this reinsurance, along with the related cash and capital flows, remained in the country.

ii) Re-insurers are in a position to monitor the performance of all companies in the industry. Management of *Nigeria Re* sees the corporation as a sort of Central Bank for the local insurance industry

iii) There was a shortage of capable insurance executives in Nigeria (still the case). A reinsurance company that is staffed with capable professionals can make up for some of the deficiencies in technical competence among the companies

iv) The reinsurance company could provide training to the staff of their client companies. This is certainly the case on a global scale and companies such as Swiss Re and Munich Re devote considerable effort to such training.

8.38. A very successful example of the execution of these roles occurs in Zimbabwe. In that country the local re-insurer was essentially the spawning ground for an entire cadre of capable managers that has been spread among the various local companies. The reality in Nigeria however is that *Nigerian Re* has outlived its usefulness. There is little practical need for this compulsory reinsurance. In fact it is likely that through the operation of this compulsory reinsurance, companies are ceding away premiums, and consequently profits, that they could otherwise have safely retained for their own accounts.

8.39. It is interesting to note that UNCTAD, as early as 1993, withdrew its support for the creation of these state-owned monopoly re-insurers. We have recently learned that *Zimbabwe Re* has been successfully privatized (with removal of the right to a mandatory cession) and that the company continues to operate successfully in a competitive market.
meeting the competition of the international re-insurers. It is difficult to say whether Nigerian Re would fare as well following privatization. However, we think that the optimal situation would be to terminate the mandatory cession of 20% of all premiums written. The government should also give serious consideration to the privatization of the company.

F. MISCELLANEOUS PROBLEMS

Overdue Premiums

8.40. We learned that premium receivables are very large – amounting to 38% of annual premiums. Some of these premiums are years in arrears. In the past, companies have adopted a tolerant attitude. If a client is not in a position to pay the premium when it is due, they provide a “grace” period for its payment. However the preferred method of accounting is to report the premium as received and set up an asset for premiums receivable. Like any other such asset, a reserve should be established for doubtful collection. This has not been common practice in Nigeria.

8.41. In other countries, the value of the asset for premiums receivable is adjusted to eliminate those long overdue. This can be done very neatly through the solvency margin test. For example, in some countries when premiums are more than 90 days overdue, then these amounts are to be removed from the assets used in measuring the adequacy of capital. Such an approach should be adopted by Nigeria.

8.42. In an effort to address this problem, we have seen the development of a new approach for insurance in some African countries. The concept of “cash for cover” has become popular. The implication of the concept is that insurance coverage does not start until a premium is paid. For newly issued policies this is quite appropriate. However most observers consider it too draconian for policies already in force. For example, if a client has been insured with a company continuously for several years, most insurers would be reluctant to terminate the coverage because of a slight delay in remittance of a renewal premium.

8.43. The consequence of the attitude just expressed is that local companies are ignoring the Commissioner’s campaign for “cash with cover”. There is no question that steps must be taken to reduce the extent of delays in payment of premiums. The adjustment to the solvency test approach described above would be of some assistance in that direction. Other measures could also be considered.

8.44. It should be noted that the Nigerian government itself accounts for most of the overdue premiums. It thus becomes a case of determining whether such a receivable from a government agency or parastatal is a better class of assets than a receivable from a member of the general public. However there is also some doubt that government agencies will ever feel compelled to pay those premiums.
G. RECOMMENDATIONS

Regulatory/Supervisory Framework

(a) Board for Insurance Commission

8.45. The Board for the Insurance Commission should be constituted as soon as possible. The work of the supervisory team will be enhanced if a proper representative Board is constituted. Some of the powers of supervision under the legislation rest with the Board. Of greater importance is that the Board can establish supervisory policy and can serve as a medium for communication between the industry and the government, leaving the supervisor greater independence to concentrate on monitoring and applying sanctions to the companies as necessary.

(b) New investment rules

8.46. The investment rules under which insurance companies operate should be changed to reflect the reality of the Nigerian situation. The rules should serve to protect the policyholders of the insurance companies and also to provide the maximum rate of return that is consistent with the safety of principal. The present rules require that a substantial portion of assets be essentially loaned to governments or government institutions, without regard to the best interests of the policyholders.

8.47. Of equal importance is the enforcement of the investment rules. The rules should be applied on a 365-day per year basis and the practice of window-dressing should be stopped. New reporting and inspection rules should be established by the supervisor such that compliance with the investment rules will be properly monitored.

8.48. The Board of Directors of each company should be obliged to establish an investment policy that governs the investment activities of management. This policy should be in writing and should be updated each year. Both the Board and the supervisor will monitor investment activity against this statement of policy.

(c) Clarify solvency standard

8.49. Adequacy of capital should be monitored on a continuous basis. The supervisor should collect monthly reports that will permit such monitoring. The legislation and regulations that prescribe the minimum capital and surplus requirements to be maintained should be revised to clarify the provisions. We would recommend that the formula for minimum solvency that has been adopted by the countries of the European Union should be introduced. If necessary, companies could be given a reasonable period of time to comply with the formula.
However the description of the formula should make clear all the necessary details, such as:

??How assets are to be valued
??What assets are to be admitted for purposes of the test, especially regarding the treatment of outstanding premiums
??What steps will be taken and what sanctions applied by the supervisor when a company fails to satisfy the requirements? There should be varying degrees of severity for remedial action

*(d) Deregulation of Premium Rates*

8.50. The legislation and regulations should be amended so as to permit the gradual removal of supervisory controls over pricing of insurance products. This can be accomplished by granting discretionary power to the supervisor to determine those classes of business for which there will be controls over premium rates. There can be a “sunset” clause such that all premiums will be free of controls after a period of time, such as 5 years.

8.51. In applying this authority, the supervisor would be expected to allow freedom of pricing for the various classes of policy as he becomes convinced that the technical expertise available to the companies and the statistics being collected are such that they will permit prudent setting of prices by the companies. There are two sides to the test. Prices should not be so low as to imperil the financial strength of companies and they should also not be too high as to be unfair for policyholders.

8.52. The supervisor could adopt a “file and use” approach to all price fixing by companies. That is to say, companies would ultimately be free to set their own prices for policies, with the caveat that the supervisor could at any time determine that a particular company is following a dangerous or unfair practice and could order that company to desist from the practice and to change its pricing on the product in question.

*(e) Foreign Investors*

8.53. The rules should be changed to ensure that foreign investors have authority to establish subsidiaries in Nigeria.

*Activities of Supervisor*

*(a) Minimum Capital*

8.54. The request of the supervisor to have new companies place their initial capital into a deposit with the Central Bank is appropriate and prudent. However we do not think there is any need for existing companies to shift assets to the Central Bank.
(b) Solvency monitoring

8.55. The focus of the work of the supervisor should shift to solvency monitoring. In order to achieve this, a clear standard for minimum solvency must be prescribed, as indicated above. The work of the supervisory staff should shift away from control of prices in favor of a system of analysis that is dedicated to formation of an accurate assessment of the financial condition of the company and its future prospects. This will require the development of new tools of analysis and perhaps new reporting requirements.

(c) On-site inspection procedures

8.56. The work of supervision should be re-oriented so as to focus on the identification of the risks that each institution faces, speaking particularly of those risks to its financial soundness. This will imply changes to the on-site inspection work. Inspections in such an environment are no longer exercises in verification of compliance with rules and standards, but are rather attempts to identify the unique risks that each company faces in light of its portfolio of business, investments, business practices, etc. The inspectors then work with company managers, once they have agreed on the risk assessment, to forecast the potential impact of these risks on the company’s financial position and to establish programs for remedial action to mitigate these risk effects.

(d) Desk Analysis Procedures

8.57. Develop desk analysis procedures that focus on early identification of financial problems. This should support on-site inspection

II. THE PENSION SYSTEM

A. INTRODUCTION

8.58. Nigeria’s Pension System is composed of the Nigerian Social Insurance Trust Fund (NSITF), public service pension schemes, occupational (Company Sponsored) pension plans and, personal pension plans. The system is very much fragmented, lacks an adequate overall policy, a legal and regulatory framework and an empowered coordinating body to supervise it. Existing programs cover only a small share of the labor force leaving most Nigerians to rely on family support for old age income.

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26 A study of the old in Nigeria stated that 97% of the urban and 93% of the rural old reported receiving financial and material assistance from the family or kin (Ekpeyong S., O.Y. Oyeneye and M. Piel, “Reports on the Study of Elderly Nigerians”. University of Birmingham, Birmingham 1986.)
B. ELEMENTS OF THE PENSION SYSTEM

The National Provident Fund (NPF).
8.59. NPF was established in 1961 as a compulsory savings scheme for private sector employees. NPF collected mandated contributions of N8 per month from employers and employees (N4 each) and provided a lump sum payment based on total contributions paid plus interests earned at retirement (minimum 55 years of age), invalidity, death, emigration and/or withdrawal after a long period of unemployment. Over time, the NPF failed to provide reasonable pensions, due to the low contribution rate which was kept constant at N8 per month despite increases in wages and inflation, inadequate investment returns and chronic administrative problems (poor record keeping, fraud, high overhead costs, etc).

The Nigeria Social Insurance Trust Fund (NSITF).
8.60. In 1993, the Federal Military Government, based on the advice and recommendations of the International Labor Organization, enacted Decree No. 73 of 1993, creating NSITF as a government-run social insurance fund for private sector employees and the self-employed in substitution of NPF.

8.61. Starting operations in 1994, the NSITF inherited a large and costly administrative structure from the defunct National Provident Fund as well as the responsibility to collect contributions and provide various benefits (retirement benefits and grants, survivor benefits, death grants, invalidity benefits/grants). NSITF collects mandatory contributions from salaried workers and voluntary contributions from independent workers equivalent to 7.5% per annum (workers contribute 2.5% and employers 5%) based on the registered workers basic salary and subject to a maximum salary base of N48,000 (approximately US$480) per annum. An average worker has to contribute for a minimum of 10 years and reach the age of 60 to be eligible for a pension calculated on the average salary of the best three out of the last 5 years of work. The basic pension replacement rate is 30% of the basic salary, plus 1.5% accrual for every additional year over 10 years, with a maximum replacement rate of 65%. Appendix 8.1 (a) presents a detailed summary of eligibility requirements and benefits under NSITF’s pension scheme.

8.62. Providing benefits on a defined benefit basis puts the program to significant financial risk and greater financial management challenges. While NSITF is currently able to meet the present payment of liability benefits under the defunct National Provident Fund (N4 million paid to approximately 656 claimants), its ability to do so in the future, is likely to be in doubt as the number of claimants and pension benefits increase. Moreover, the NSITF faces a number of serious problems in administration, management system, soundness of financial planning, and policy that raise questions as to its ability to perform its designated role without significant reforms.

27 Salaries in Nigeria include a basic salary (or taxable income) plus allowances. The sum of both is called Total Emoluments.
Main Weaknesses of NSITF

8.63. Mismatch between the level of contributions and benefits. Nigeria is in the lowest tier of payroll taxes for mandatory pensions schemes in Africa (Table 8.9). With mandatory contributions at 7.5% of basic salary subject to a maximum salary base of N48,000 per annum, the maximum annual contribution per worker amounts to only N3,600 (US$36).

Table 8.9. Payroll Tax Rates for Pensions (%)

<table>
<thead>
<tr>
<th>Africa</th>
<th>Employee</th>
<th>Employer</th>
<th>Combined</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nigeria</td>
<td>2.5</td>
<td>5</td>
<td>7.5</td>
</tr>
<tr>
<td>Kenya</td>
<td>5</td>
<td>5</td>
<td>10</td>
</tr>
<tr>
<td>Zambia</td>
<td>5</td>
<td>5</td>
<td>10</td>
</tr>
<tr>
<td>Gambia</td>
<td>5</td>
<td>10</td>
<td>15</td>
</tr>
<tr>
<td>Uganda</td>
<td>5</td>
<td>10</td>
<td>15</td>
</tr>
<tr>
<td>Ghana</td>
<td>5</td>
<td>12.5</td>
<td>17.5</td>
</tr>
<tr>
<td>Tanzania</td>
<td>10</td>
<td>10</td>
<td>20</td>
</tr>
</tbody>
</table>

Source World Bank (1994) and author's personal research

8.64. Not surprisingly, benefits are also insignificant and while they are on average less than 16% of the total take-home pay, they still surpass what is actuarially and financially sustainable.

8.65. Uncertain Financial Sustainability: As a consequence of the mismatch between contributions and benefits, the system may face some shortfalls in 5 years if the current level of contributions is not raised. In this respect, the latest actuarial valuation (December 31, 1998)\(^{28}\) shows that, in order to add 10 to 15 years of financial equilibrium and maintain the current level of benefits, contributions will have to be raised to 13 and 15 percent, respectively, with many more adjustments thereafter\(^{29}\).

8.66. As inadequate as they are today, contributions are still NSITF’s main source of income, followed by investment returns. Contributions of N820 million\(^{30}\) (US$ 820 thousand) were collected from January to June 1999, investments increased by N330 million (US$ 33 thousand) to N3.9 billion (US$39 million), and returns of N131 million (US$131 million) was earned during the same period. While contributions collected have


\(^{29}\) Decree No. 73 of 1993 establishes the possibility of increasing contributions as required by the actuarial reports of NSITF. Just after 5 years of operations, the Actuarial Report is already calling for an increase in contributions. While this may be needed to balance the future finances of NSITF, it is a very difficult political decision that most governments avoid, even when they have the right to do it.

\(^{30}\) Annual contributions for 1997 and 1998 were in the order of N1.1 billion per year (approximately US$1.1 million).
increased considerably over the last five years, investments have not grown in the same proportion (See Figure 8.1), due, among other factors, to the high administrative expenses and low investment returns.

**Figure 8.1. Growth of NSITF’s Contributions and Investment**

![Graph showing contributions and investments from 1993 to 1998.](image)

8.67. The increase in the level of contributions in the last 5 years is due, in part, to the increased number of contributors to the system. From 1994 to 1999, NSITF registered over 500,000 new workers and collected over N4.9 billion in contributions, equivalent to 84% of the total contributions collected by NPF from 1962 to 1993 and by NSITF from 1994 to 1999. The increase in the value of contributions, apart form the increased number of contributors, is due to the increase in the contribution rate from N96 per year to N3,600 (maximum) per year.

8.68. *Administrative Expenses.* With 55 offices in 8 zones and over 1900 employees (25% of which are active in collections), the incidence of decentralization and staff salaries on NSITF’s administrative expenses has reached unreasonable levels. Figure 8.2, shows the high percentage of contributions used by NSITF to meet its administrative expense. At this time, this amounts to over 61% of total contributions.

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31 The increase in the level of contributions in the last 5 years is due, in part, to the increased number of contributors to the system.
8.69. This amount surpasses the 25% level recommended by the 1992 actuarial valuation based on forecast contributions of about N1.5 billion and rising to about N4 billion annually in the following four years. Due to the economic depression of the past three years and the unstable political environment, which hindered meaningful growth, annual contributions have only grown to N1.2 billion. Conversely, as a result of spiraling inflation, the energy crisis of 1997/1998 and the official rise in public sector salaries and wages, administrative expenses increased in the last five years at rates much higher than the contribution levels. While future administrative expenses as a percentage of contributions could be reduced by increasing collections (through aggressively expanding labor force coverage and compliance), past expenses have meant lower than required investment growth, thus jeopardizing NSITF’s long term financial sustainability.

8.70. Investments. The slow growth of investments as a percentage of total contributions (see Figure 8.3 and Table 8.10 for a detailed description of NSITF Investments) together with the low rates of return, inadequate investment policies and the restriction imposed by the Trustee Investment Act, are affecting the long term financial sustainability of the NSITF system (e.g. a minimum of 50% of total investments have to be in government securities).

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32Investment growth during 1997 is relatively high compared to the other years shown. This can be explained by the increased in the value of projects in progress during 1997 that are part of real estate investments. The value of projects in progress increased from N556 million in 1996 to 1,368 million naira. Overall, the value of real estate investments increased from N889 million to N1,707 million.
8.71. In spite of the slow growth in investments, NSITF’s investment portfolio has increased considerably from N1.4 billion in 1994 to over N3.5 billion in 1998. While the increase is considerable, NSITF has concentrated its investments in a few assets (particularly real estate and equity) that are not producing the required rates of returns to keep NSITF in financial equilibrium in the future.

8.72. NSITF’s general investment guidelines derive from the Investment Trustee Act and the Management investment policies. The Board is required to approve the allocation of assets and ratify any alteration made from time to time. With no Board appointed since 1994, the Ministry of Labor approves NSITF’s investment allocation on an annual basis but is not required to ratify any alterations made. Thus, NSITF does not follow the approved percentages as its management considers that asset allocation should not be rigid and can vary as long as it follows strict elements of security, liquidity, yield and diversification (in that order of priority).

8.73. As Table 8.10 shows, there is a wide discrepancy between the approved percentages and the current distribution of investments. Of particular concern are: i) the concentration of assets, with 61% invested in real estate (property) and over 31% invested in equities (mainly oil, gas and manufacturing); and ii) the low percentages in fixed income investments (particularly the absence of Treasury Bills) despite the mandate of the Investment Trustees Act to maintain at least 50% of their allocation in government securities).

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33 Real Estate is registered at book value to avoid showing any losses, as NSITF believes part of their properties (particularly their commercial properties in Lagos) have depreciated considerably over the last few years.
8.74. The concentration of the portfolio in a small number of risky assets and industries, and the absence of fixed income securities are clear signs that NSITF is not following the elements of security, liquidity, yield and diversification they claim to be the priority of their investment policy. Moreover, the rates of return obtained are so low (11% for 1995, 15% and 16% for 1996 and 1997 respectively) that they do not justify the deviations in the approved percentages and non-compliance with the mandated investments in government securities.

Table 8.10 NSITF: Investment Portfolio Asset Allocation (%)

<table>
<thead>
<tr>
<th>Investments</th>
<th>Approved Percentage</th>
<th>Current Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Quoted Securities</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equities</td>
<td>45</td>
<td>34.5</td>
</tr>
<tr>
<td>Loan Stocks</td>
<td>25</td>
<td>31.75</td>
</tr>
<tr>
<td>Development Stocks</td>
<td>10</td>
<td>1.85</td>
</tr>
<tr>
<td>Treasury Bills</td>
<td>5</td>
<td>0.94</td>
</tr>
<tr>
<td><strong>Unquoted Securities</strong></td>
<td></td>
<td><strong>65.50</strong></td>
</tr>
<tr>
<td>Equities</td>
<td>15</td>
<td>2.95</td>
</tr>
<tr>
<td>Loan Stocks</td>
<td>5</td>
<td>0.23</td>
</tr>
<tr>
<td>Real Estate</td>
<td>20</td>
<td>61.65</td>
</tr>
<tr>
<td>Bank Deposits</td>
<td>10</td>
<td>0.59</td>
</tr>
<tr>
<td>Others</td>
<td>5</td>
<td>0.08</td>
</tr>
</tbody>
</table>

Source: NSITF

8.75. Evasion (Past due Contributions). It is generally believed that high rates of evasion and low coverage are the consequences of the poorly designed NSITF scheme where contributions are perceived as a tax, collection and inspection systems are inadequate, record keeping and information systems are outdated, non-payment and delayed payment of obligations are common, and clear and enforceable penalties for non-compliance are lacking.

8.76. Employers are required to make monthly payments of contributions and provide the necessary information that identifies each worker for whom contributions are being paid. In more than 50% of the cases, employers do not send records, thus making it difficult to determine the number of covered employees and detect fraud (e.g. under-reporting or missing contributions. When an account is past due, the local office staff in charge of compliance initiate a procedure to carry out on-site inspections to verify the correct calculation, deduction and payment of contributions. Remedial actions include sanctions of up to 5% of the past due contributions, warning letters, civil litigation and criminal prosecution. From 1994 to June 1999, an average of 20% of all accounts have been past due. Complaints have been fielded for non-compliance in 2,872 cases. Some only required a warning letter, 1,464 were brought to civil litigation and 17 followed a criminal procedure. A total of N101.7 million have been recovered but at a very high cost.
(NSITF has 450 employees in 54 offices dedicated to collection and compliance functions alone). To curb evasion and increase collections, NSITF will require more than manpower. It will require a better reporting and collection system.

8.77. **Coverage.** Given the economic stagnation and hyperinflation of the recent past together with a lack of accurate information, poor record keeping and poor NSITF’s enforcement capacity, it is not surprising that coverage remains low at only 12% of the economically active population (EAP). Low coverage means NSITF’s revenue flows will continue to be negatively affected and administrative expenses as a percentage of contributions will remain high. Remedial actions to increase coverage should be to include other sectors of the economy such as the agricultural sector that counts for 70% of the population and currently represent only 1% of total contributors.

8.78. **Other problems: the reference salary, the averaging period, and the effect of inflation.** The reference salary for the calculation of a pension is equal to the claimant’s best 3 years average salary paid in the 5 years immediately preceding retirement (based on a minimum of 10 years of contributions). Basing the pension on salary towards the end of a worker’s career is inequitable because it redistributes income to workers with rising age-earning profiles. An end-valued benefit formula encourages fraud in the form of under-reporting earnings in early years and over-reporting earnings during the last few years of work, thereby adding to the financial imbalance of the system. These problems could be mitigated if the pension depended on average salary over some longer period of time (e.g. 5 to 7 years). For Nigeria, however, the possibility of extending the averaging period should be carefully reviewed because contributions and pensions will have to be revalued for inflation and, most likely, include monetary and other general allowances. Otherwise, the system will penalize those who retire when inflation is high or whose basic salary is small compared to their allowances.

**Public Service Pension Schemes.**

8.79. The Pension Decree (Decree 102 of 1979) makes the provision of pension schemes compulsory for all employees in the public service in Nigeria, including the federal, state and local governments, parastatals and quasi-government organizations (e.g. CBN, the railway corporation, utility companies, universities, port authority). To date, approximately 650,000 active members and 130,000 pensioners are registered in the Public Service Scheme. The benefits payable (gratuities and pensions) are defined according to a scale of benefits which are identical for all arms of the Public Service and in line with the length of service (see Appendix 8.1b). The lack of a systematic and coherent pension policy in the public sector (e.g. the increase, in January 1999, of the minimum pension from N7,900 to N21,000 and the maximum pension up to N54,000) results in the frequent inability of many government agencies, state and local government pension funds to meet their pension obligations estimated at N14.5 billion for 1999 and N15.4 billion for 2000. Since most of these plans operate on a non-contributory basis and are still charged on and paid out of the Consolidated Revenue Fund of the Federation, funding will continue to be insufficient.

34 Except the Armed Forces and Special Civilian Categories that operate on a different structure.
Weaknesses of Public Service Pension Schemes

8.80. High frequency of benefit reviews, inadequate funding of the schemes and lack of current actuarial valuations. The Pension Act No.102 of 1979 makes the provision of pension schemes compulsory for all public servants. This act regulates the pension and gratuity benefits payable to all employees in the public service in Nigeria. Since its enactment, a series of reviews have taken place, some of which have resulted in an increased pension liability for the government that remain largely unfunded. The absence of periodic actuarial valuations in most schemes, on which to base the financial implication of such reviews, makes it even more difficult to accurately determine the past and future liabilities of the 189 public service pension schemes.

8.81. Poor coordination and problems with pension portability. Having multiple pension schemes and multiple parties involved in the management of public service pension schemes is inefficient and costly. In fact, according to the Report on the state of the public service schemes (prepared by the National Insurance Commission), the retirees and the entire civil service could not pin down a particular organization responsible for the overall process of pension management and, the several organizations handling various aspects of the schemes keep shifting blames when there is a fault. The lack of coordination between entities makes the recognition of past service (for the purpose of determining acquired rights and pension portability under the public service pension schemes) very difficult. Although the Office of the Establishment is in charge of ensuring portability of pensions within the public service schemes, it does not function as a clearing house. Pension payments are the responsibility of the last employer, which in most cases is unable to collect resources from previous employers.

Occupational (company sponsored) Pension Plans

8.82. Occupational pension plans have been in existence for many years, originally on a provident fund basis often linked to life benefits. Defined contribution and benefit schemes started in 1962 but later remained largely the province of international employees. Over time, given the minuscule benefits paid by the NPF and the tax incentives provided by the government through the Joint Tax Board (JTB), many more companies established their own pension schemes to supplement employee retirement income. To date, according to the head of the JTB, there are about 2,000 approved schemes.

35 Parastatals and quasi-government organizations are partially funded while federal, state and local civil service schemes are unfunded.
36 In the case of those parastatals that will be privatized, clear rules have to be established to cover pension liabilities at the time of their sale either through price adjustments or previous funding by the government.
37 While Decree 102 of 1979 and its subsequent amendments give the general guidelines for pension provision for all public pension schemes, many parastatals and quasi-government organizations have created their own pension by-laws, resulting in different parameters (contributions, benefits, eligibility requirements, etc.) among them.
38 The Presidency/SGF office, The Federal Ministry of Finance, Office of the Establishment and Management Services, the National Insurance Commission, the Board of Trustees, the Joint Tax Board the different Ministries, Local and State Governments, and Parastatals; as well as, Insurance Companies, Fund Manager, Brokers, Auditors, Accountants, and, ultimately the Employees and Pensioners.
39 National Insurance Commission, Report on Assessment of the Public Service Pension Scheme (undated).
schemes in the country with about 90% of these being provident (defined contribution schemes) and 10% being pure pension schemes (defined benefit). Although coverage is difficult to estimate, it is believed that about 2.5 million people participate in such plans.

8.83. All schemes must have Trustees and a Trust Deed and Rules, which is the agreement between each company and its pension trust fund which establishes the eligibility and benefit structure of the plan. The majority of the plans are set up as provident funds where employer/employee contributions are limited to 25% of basic salary and benefits provided on a defined contribution basis (See Appendix 8.1c). Most plans undertake actuarial valuations on a regular basis (usually every three years) and, although companies are not obliged to cover any shortfalls, they usually do so, spreading them over a number of years.

**Weaknesses of Occupational Pension Schemes**

8.84. **Benefits.** Occupational plans are generally regarded to be well funded and provide a good level of pension benefits. However, benefits are not always extended to survivors and when extended, they are limited either to 5 years of payments (in defined benefit plans) or a lump sum equivalent to the remaining pension balance (in defined contribution plans). Also, in plans where lump sums are an alternative (e.g. Lever Brothers), most employees opt for this option despite the loss of other important benefits like health insurance. Thus, such schemes do not necessarily provide security for old age (in the form of regular income, health insurance or survivor benefits).

8.85. **Investment policies**  
Investment policies, in most cases, are established by special committees, principal officers, staff representatives and special advisors; and require Board approval. However, all investments, must be within Nigeria and are, therefore, generally restricted to real estate, mortgages, equities (both public and private), Treasury Bills, commercial paper and bank deposits (see Table 8.11 below).

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40 While most companies managed their own pension trust funds, there have been major moves, in the last ten years, towards deposit administration (Managed Funds) and the use of commercial banks, insurance companies, brokerage houses or special administrators or trustees by pension schemes.

41 Historically and culturally most Nigerians are happy to take cash benefits in a lump sum and to use the proceeds to build a house in their villages. This is encouraged by the difficulty in processing money away from the major cities and the reliance on family or community support for old age.
Table 8.11 Company Sponsored Plans - Investment Portfolio Asset Allocation

<table>
<thead>
<tr>
<th>Investments</th>
<th>Shell Trustees</th>
<th>Nigerian Breweries</th>
<th>Lever Brothers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property (Real Estate)</td>
<td>20(^{(2)})</td>
<td>10/15</td>
<td>N/A</td>
</tr>
<tr>
<td>Equity</td>
<td>20</td>
<td>40</td>
<td>12</td>
</tr>
<tr>
<td>Treasury Bills</td>
<td>60(^{(3)})</td>
<td>30/35(^{(4)})</td>
<td>50%</td>
</tr>
<tr>
<td>Money Management(^{(1)})</td>
<td>10/20</td>
<td></td>
<td>38</td>
</tr>
</tbody>
</table>

Notes:
1. Includes bank deposits, fixed income securities, commercial paper, debentures, etc.
3. Half are held in Nigeria’s Brady Bonds but authorization was received by JTB to count as 50% investment required in treasury bills for purposes of satisfying the Investment Trustee Act.
4. Pension Plans established prior to 1960 are only required to hold 1/3 of total assets in treasury bills.

Personal Pension Plans

8.86. Personal Pension Plans are mainly products offered by insurance companies as part of their life insurance business. The JTB does not need to approve Personal Plans, but has exempted premiums (of up to 25% of basic salary) and benefits from tax\(^{42}\). Individuals who subscribe to these plans adhere to certain rules and regulations including: (i) minimum initial premiums required to open an account, (ii) periodic deposits; (iii) management fees; and, (iv) penalties for early withdrawals. Appendix 8.1b presents the benefit rules of selected personal pension plans.

8.87. While considered by most to be a necessity to complement benefits provided by NSITF, public service and occupational schemes, personal pension plans are not common in Nigeria. The number of Nigerians on subsistence earnings (or not in any form of registered employment), make pension plans, as well as other life insurance products, unaffordable and/or superfluous.

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\(^{42}\) Early withdrawals (if permitted by the plan) may be subject to taxes; in which case the Insurance Company is obliged to withhold and pay them on behalf of the member.
Weaknesses of Personal Pension Plans

8.88. Early withdrawals. Some plans (e.g. AIICO Insurance) authorize members to make partial withdrawals without penalty after five years of membership and with a penalty before the five years. Allowing such withdrawals goes against the main purpose of a pension plan, which is to obtain income at retirement. Such practices should not be allowed.

8.89. Regulation and Supervision. The National Insurance Commission regulates and supervises the insurance industry as a whole but does not regulate or supervise the pension plans offered by individual insurance companies. Furthermore, as the review of the insurance industry indicates, regulation in several areas such as minimum capital requirements, clear separation of accounts between the company and the pension fund, audits, personnel qualifications, etc. should be improved to prevent the bankruptcy of insurance companies that could in turn lead to the failure of the pension plans they offer. This is particularly important in those plans where the funds are kept on the books of the insurance company (generally plans that offer a fixed interest rate).

C. REFORMING THE PENSION SYSTEM: A TWO-TIER APPROACH

8.90. With NSITF’s long-term financial sustainability in question, public pension schemes largely unfunded and, occupational (company sponsored) and individual schemes so diverse in nature, a single and coherent National Pension Strategy is required to overcome individual weaknesses and ensure old age income security. Such strategy should be built around a two tier approach where mandatory and optional savings are included and a minimum benefit is guaranteed.

8.91. The first tier could be a mandatory, publicly managed, defined benefit scheme. It would be re-distributive43 and provide a minimum benefit guaranteed by the government that could co-insure against long spells of low investment returns, recessions and inflation. The minimum benefit can take the form of an employment-related flat benefit or a minimum pension guarantee (See Box 8.1). The parameters of the new system (contributions, benefits, eligibility requirements, etc.) should be based on a detailed financial and actuarial analysis to ensure its long term sustainability.

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43 Re-distribution occurs when a minimum universal benefit financed with pooled contributions is on average worth more to those with lower lifetime income than those with higher lifetime income.
8.92. Funding for the first pillar should come from limited contributions by all employers and employees and/or from the Government’s General Revenue. This will require a formal commitment from the Government to make funding available on a regular basis (from other taxes/income) and, ideally the creation of a pension fund reserve (from privatization proceeds).

8.93. The second tier should be a voluntary system that incorporates all current voluntary and occupational schemes. All schemes would be regulated and supervised by a central regulatory agency (e.g. a National Pension Agency) that would ensure their financial sustainability and compliance with their own rules and regulations. This agency will also be in charge of promoting voluntary and occupational plans by providing the necessary incentives and establishing the minimum criteria they should follow to be granted tax exemption (e.g. annual audits, asset segregation and governance structure, safe custody of assets, guarantees, etc.).

**Implications for NSITF**

8.94. NSITF could become the government’s agency administering the first tier (mandatory defined benefit scheme). The current NSITF system would have to be redefined and expanded to include public service employees. An in-depth reorganization would have to be undertaken to make it more efficient and less costly. Such a reorganization should include, but not be limited to, improving/streamlining collections (particularly compliance), record keeping, information systems, investment strategies, and payments. Particular attention should be given to the investment strategy to make benchmarks/targets consistent with the actuarial projections and maintain the long-term financial viability of the first tier. This strategy, however, will be limited in scope until the Trustee Investment Act and other investment restrictions are lifted (e.g. investments abroad or in foreign securities) and new investment alternatives are created in the local markets.
8.95. If NSITF is not considered as an option to administer the first tier, the government could opt to contract out the administration of this tier (but keeping its guarantee). If so, a competitive bidding should take place and the most suitable financial institution(s) chosen based on costs and efficiency.

**Implications for the Public Service Pension Schemes**

8.96. Public Service Employees will participate in the first tier (mandatory defined benefit scheme) administered by either NSITF or the financial institutions chosen to administer his first tier. In addition, current pension schemes could become part of the second tier (voluntary and occupational plans) but under new parameters. The basis for the computation of contributions and benefits should be equal for all and the system should be funded to facilitate portability. Each government entity could administer its own system (more costly) or could do it through an insurance company (like many parastatals do today).

8.97. **Implications for the Voluntary and Occupational Schemes.** Voluntary and Occupational Schemes would be part of the second tier but subject to the supervision of a National Pension Agency.
**APPENDIX 8.1: PENSION SYSTEMS-SUMMARY OF BENEFITS**

*a: NSITF - Summary of Benefit(s) Rule contained in Decree 73 of 1993*

<table>
<thead>
<tr>
<th>Benefit Type</th>
<th>Eligibility Condition</th>
<th>Benefit (Replacement Rate)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retirement Pension</td>
<td>Age 60 (males &amp; females) 10 years of contributions Retired from regular employment</td>
<td>30% of final base salary + 1.5% for every additional year of contributions beyond 10 years. With a maximum replacement rate of 65% after 33 years of contributions. Payments are for life.</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retirement Grant</td>
<td>Up to Age 60(males &amp; females) Minimum of 12 months of contributions Retired from regular employment</td>
<td>Lump-sum payment equivalent to the final monthly contribution multiplied by the number of months of paid contributions.</td>
</tr>
<tr>
<td>Disability Pension</td>
<td>Disability certification for total or partial disability At least 36 months of contributions out of which 12 have been worked continuously.</td>
<td>30% of final base salary + 1.5% for every additional year of contributions in excess of the qualifying period, up until retirement age.</td>
</tr>
<tr>
<td>Disability Grant</td>
<td>Disability certification for total or partial disability At least 12 months of contributions.</td>
<td>Lump-sum payment equivalent to the final monthly contribution multiplied by the number of months of paid contributions.</td>
</tr>
<tr>
<td>Survivors Pension</td>
<td>Survivors of contributor, retiree or disabled who, at the time of his/her death was receiving or would have qualified for retirement/disability pension.</td>
<td>100% of the deceased’s retirement/disability pension.</td>
</tr>
<tr>
<td>Survivors Grant</td>
<td>Survivors of contributor, retiree or disabled who, at the time of his/her death was receiving or would have qualified for retirement/disability grant.</td>
<td>Lump-sum payment equivalent to the deceased’s retirement/disability grant.</td>
</tr>
<tr>
<td>Funeral Grant</td>
<td>A deceased member who prior to the time of death was receiving retirement/disability pension. A deceased member who has contributed to the Scheme for not less than 60 months</td>
<td>Lump-sum fixed at N2,000.00 (aprox. US$20.00)</td>
</tr>
<tr>
<td>Early Retirement</td>
<td>At 55 but below 60 years of age (males and females) 10 years of aggregate contributions</td>
<td>Pension is computed in the same way as the Retirement Pension but a penalty (reduced pension) is applied</td>
</tr>
</tbody>
</table>


---

<table>
<thead>
<tr>
<th>Age</th>
<th>55</th>
<th>56</th>
<th>57</th>
<th>58</th>
<th>59</th>
</tr>
</thead>
<tbody>
<tr>
<td>% of full pension</td>
<td>70</td>
<td>76</td>
<td>82</td>
<td>88</td>
<td>94</td>
</tr>
</tbody>
</table>
### Summary of Benefit(s) Rule contained in Decree 102 of 1979

<table>
<thead>
<tr>
<th>Benefit Type</th>
<th>Eligibility Condition</th>
<th>Benefit (Replacement Rate)</th>
</tr>
</thead>
</table>
| Retirement Pension | Age 60  
Minimum 10 years of service                                                                                      | 30% of final base salary + 2% for every additional year of contributions beyond 10 years. With a maximum replacement rate of 80% after 35 years of service. Payments are for life. |
| Pension Gratuity   | Minimum of 5 years of service                                                                                      | Lump-sum payment equivalent to 100% of the final base salary + 8% for each additional year up to 300% after 35 years of service.                            |
| Disability Pension | Disability occurs in the course of his official duties but has not completed the minimum qualifying service to be eligible for a pension  
subject to the following degrees of disability:  
?? No less than 70%  
?? Between 50% to 69%  
?? Between 30% and 49% | Pension equal to final base salary at date of injury subject to a maximum of:  
30%  
15%  
10% |
| Disability Gratuity| Disability occurs in the course of his official duties and has completed the minimum qualifying service to be eligible for a pension. | Lump-sum payment equivalent to 100% of the final base salary + 8% for each additional year up to the time of disability |
| Survivors Pension  | ?? If Officer dies while in service  
?? If an officer dies in the course of his official duty and without his own fault | ?? 100% of the deceased’s retirement pension (calculated based on accumulated replacement rate until time of death) payable for five years with the option of a one time Lump-sum payment.  
?? 1/3 of the deceased’s retirement pension (calculated based on accumulated replacement rate until time of death) payable for life |

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45 Application of this pension decree was retroactive to April 1, 1974. Although Public Service Schemes vary in nature (contributions, level of funding, etc.) they all follow the same benefit rules.

46 Provision shall not apply to any officer who by reason of injury is entitled to compensation under the Workmen’s Compensation Act.

47 Determined by a Medical Board.

48 Widow receives 1/3 of pension and, children receive 1/3 each until reaching 18 years of age.
(b) contd.

<table>
<thead>
<tr>
<th>Benefit Type</th>
<th>Eligibility Condition</th>
<th>Benefit (Replacement Rate)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Survivors Gratuity</td>
<td>?? If Officer dies while in service but has served for at minimum of 10 years</td>
<td>?? Lump-sum payment equivalent to accumulated gratuity benefits until time of death</td>
</tr>
<tr>
<td></td>
<td>?? If an officer dies while in service but has not served for a minimum of 10 years</td>
<td>?? Lump-sum payment equivalent to one year’s salary</td>
</tr>
<tr>
<td></td>
<td>?? If an officer dies in the course of his official duty and without his own fault</td>
<td>?? Lump-sum payment equivalent to accumulated gratuity benefits until time of death</td>
</tr>
<tr>
<td>Early Retirement</td>
<td>N/A</td>
<td>Pension is computed in the same way as the retirement pension but shall not exceed 70% of his salary.</td>
</tr>
<tr>
<td>Pension</td>
<td>N/A</td>
<td>Gratuity is computed in the same way as the retirement gratuity but shall not exceed 300% of his salary.</td>
</tr>
</tbody>
</table>


c: Occupational (Company Sponsored) Plans – Summary of Benefit(s) Rule

i: Shell Nigeria

<table>
<thead>
<tr>
<th>Type of Benefit</th>
<th>Eligibility Requirement</th>
<th>Benefit (Replacement Rate)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pension</td>
<td>Current employees: at age 55 optional at age 60</td>
<td>?? 2% per year of service up to 60% of last salary (plus leave allowance) payable as an annuity in monthly or bi-monthly arrears</td>
</tr>
<tr>
<td>Survivor</td>
<td>Death of member within 4 years of retirement</td>
<td>?? Lump sum equal life expectation less pension payments received up to time of death</td>
</tr>
<tr>
<td>Disability</td>
<td>At age 45 Ill-health certified by the company doctor</td>
<td>?? Same as pension benefit</td>
</tr>
<tr>
<td>Early Retirement</td>
<td>At age 45 Minimum 15 years of service</td>
<td>?? Same as pension benefit with a deduction of 3% per year.</td>
</tr>
</tbody>
</table>

49 For causes of reorganization and/or abolition of an office without possibility of transfer to another office
50 Shell Nigeria is a Non-contributory defined benefit pension plan.
51 Post-retirement adjustments of pensions are not done regularly but Human Resources is looking at this issue and its financial implications.
52 A lump sum payment of up to 25% can be obtained but will reduce the value of the annuity.
**ii: Lever Brother Plc**

<table>
<thead>
<tr>
<th>Type of Benefit</th>
<th>Eligibility Requirement</th>
<th>Benefit (Replacement Rate)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pension</td>
<td>At age 50</td>
<td>?? Lump sum equal to the accumulated balances in accounts “A” and “B”, or ?? Pension for life applying all accumulated balances in Accounts “A” and “B”</td>
</tr>
<tr>
<td>Survivor</td>
<td>?? Death of member while in service ?? Death of member while drawing his pension</td>
<td>?? Lump sum equal to the greater of the sum of the “A” and “B” accounts and 3 times the annual salary ?? Any pension due up to a maximum of 5 years</td>
</tr>
<tr>
<td>Disability</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Early Retirement</td>
<td>?? Minimum three years of service</td>
<td>?? Lump-sum equal to the accumulated balance in account “A”, plus a proportion of account “B”</td>
</tr>
</tbody>
</table>

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53 Lever Brothers is a Contributory defined contribution pension plan for those who retire before the minimum retirement age and is a defined benefit for those who retire at the minimum retirement age. The Employee mandatory contributions are 7.5% of basic salary with an additional contribution of up to 2.5% on a voluntary basis. The Employers contributions are 12.5%. The trustees shall keep “A” and “B” accounts in respect of each member. The member’s contributions shall be credited to the “A” account and the Employer’s contribution to the “B” account. The interest rate applicable to both accounts is fixed from year to year by the Trustees.

54 Subject to a minimum guarantee period of 5 years. Pension payments are regularly index to cushion the effects of inflation. Benefits like Health insurance and “Soap Package” are retained.

55 Proportion of B account equals to 30 percent for 3 years of service and 10 percent for each additional year up to 100%.
iii: Nigerian Breweries\textsuperscript{56}.

<table>
<thead>
<tr>
<th>Type of Benefit</th>
<th>Eligibility Requirement</th>
<th>Benefit (Replacement Rate)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pension</td>
<td>at age 55 or after age 50 at employers request, and minimum 20 years of service</td>
<td>?? Lump sum equal to the accumulated balances in accounts “A” and “B”, or ?? Pension for life with a minimum guaranteed replacement rate of 55% of final basic salary\textsuperscript{57}</td>
</tr>
<tr>
<td>Survivor</td>
<td>?? Death of member while in service</td>
<td>?? Lump sum equal to the accumulated balances in accounts “A” and “B” plus three times his contribution salary at the date of death</td>
</tr>
<tr>
<td></td>
<td>?? Death of member while drawing his pension</td>
<td>?? Lump sum equal to the accumulated balances in accounts “A” and “B” at the date of retirement less the total amount of pension paid to date of death plus three years pension at date of death.</td>
</tr>
<tr>
<td>Disability</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Voluntary Retirement</td>
<td>?? Between 50 and 55 years of age, and minimum 20 years of service</td>
<td>?? Lump sum equal to the accumulated balances in accounts “A” and “B”, or ?? Pension for life based on a guaranteed replacement rate of 55% of final basic salary less 5% for each year by which age is less than 55</td>
</tr>
<tr>
<td>Early Retirement/Termination of Service</td>
<td>?? Minimum 5 years of service (and no qualification for pension or voluntary retirement)</td>
<td>?? Lump-sum equal to the accumulated balance in account “A”, plus a proportion of account “B”\textsuperscript{58}.</td>
</tr>
</tbody>
</table>

\textsuperscript{56} Nigerian Breweries is a Contributory defined contribution pension plan. The Employee mandatory contributions are 7.5% of basic salary and the Employers contributions are 12.5%. The trustees shall keep “A” and “B” accounts in respect of each member. The member’s contributions shall be credited to the “A” account and the Employer’s contribution to the “B” account. The interest rate applicable to both accounts is fixed from year to year by the Trustees.

\textsuperscript{57} While the plan is considered a defined contribution scheme, given this minimum replacement guarantee, the plan transforms itself into a defined benefit plan. If the accumulated balances are not enough to pay the promised replacement rate, the employer agrees to supplement the pension to that level by payment of a special contribution to the Pension Reserve Account.

\textsuperscript{58} Proportion of B account equals to 50 percent for 5 years of service and 10 percent for each additional year up to 100%.
**Type of Benefit** | **Eligibility Requirement** | **Benefit (Replacement Rate)**
--- | --- | ---
Pension | At age 50 | ?? Lump sum equal to the whole accumulated units at the bid price, or ?? Life Annuity applying all accumulated units, or ?? A combination of both
Survivor | Death of member | ?? Lump sum equal to the whole accumulated units at the bid price
Disability | N/A | N/A
Early withdrawals | At any time before age 50 | ?? Lump sum equal to the withdrawn units at the bid price subject to a termination charge (reduced grade) in the first five years

---

59 Aiico’s Personal Pension plan is a defined benefit plan. A minimum contribution of N500,000 is required and additional amounts can be contributed in multiples of N50,000 annually. All Contributions are invested in units of “Aiico Managed Investment Fund” (AMIF) at the running unit price at the that time. The rate of return to contributors to the plan is therefore linked to the investment performance of AMIF. The accumulated value of a member’s contributions at any time is the value at which all his units may be sold. Aiico charges three fees: A custodial service fee equal to 2% p.a. of the net asset value of the Fund payable on each valuation date; a management fee equal to 1% p.a. of the net asset value of the Fund payable on each valuation date and a Success/Incentive fee. Once a certain specified annual rate of return is achieved, the balance of the earnings, after the payment of all expenses is shared by the fund (70%), Aiico (15%) and the Portfolio (15%).
### African Alliance Insurance Company

<table>
<thead>
<tr>
<th>Type of Benefit</th>
<th>Eligibility Requirement</th>
<th>Benefit (Replacement Rate)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pension</td>
<td>N/A</td>
<td>Life annuity</td>
</tr>
<tr>
<td>Survivor</td>
<td>Death of member</td>
<td>Full refund of contributions with interests</td>
</tr>
<tr>
<td>Disability</td>
<td>Partial or total disability</td>
<td>Life annuity equal to 50% of the pension for three years (^{61})</td>
</tr>
<tr>
<td>Early withdrawals</td>
<td>At any time before age 50 I</td>
<td>Lump sum equal to the withdrawn units at the bid price subject to a termination charge (reduced grade) in the first five years</td>
</tr>
</tbody>
</table>

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\(^{60}\) African Alliance Personal Pension plan is a defined contribution plan. Contribution are agreed on an individual basis depending the desired level of benefits and retirement age. There are three different level plans: The Essential, the Silver and the Gold Plan. And benefits can include pensions, survivor and disability. Medical Insurance and partial lump sum benefit at retirement are optional in all plans.

\(^{61}\) Gold plan only.
9. MONEY AND CAPITAL MARKETS

I. THE MONEY MARKET

A. INTRODUCTION

9.1. Nigeria’s money market is the framework for the buying and selling of short-term financial instruments, with terms to maturity of less than 12 months. The money market is often the starting point for the development of other financial markets because trading in short-term assets usually serves to prepare the ground for trading in longer-dated instruments.

9.2. The development of a deep and liquid money market in Nigeria is important in many respects: i) it helps banks and other financial intermediaries manage liquidity and interest rate risks; ii) a well-developed money market provides the central bank with a wider array of instruments for the conduct of monetary policy and also helps in the transmission of policy signals; iii) it provides businesses with access to short-term funds for working capital; iv) it enables the government to meet short-term financing requirements; v) it facilitates the transmission of changes in market conditions and helps the system to adjust for shocks; vi) a liquid money market promotes the liquidity of the foreign exchange market; and vii) a liquid money market raises confidence in the financial system and encourages financial saving.

B. STRUCTURE OF THE MONEY MARKET

9.3. The Nigerian money market is comprised of the inter-bank market as well as the market for instruments such as treasury bills (TBs), treasury certificates (TCs), certificates of deposit (CDs), bankers’ acceptances (BAs), commercial papers (CPs) and short-dated eligible development stocks (EDS). The main market participants include commercial and merchant banks, discount houses, insurance and pension funds, corporations as well as individuals.

9.4. In 1998, the value of money market instruments outstanding stood at N247.3 billion, a 64.2% increase over the 1994 level of N150.6 billion (Annex 6A). This trend has been principally driven by increases in TBs which overwhelmingly dominate the market. TBs accounted for 90% of the total value of instruments outstanding in 1998, up from an 81% average over 1994-98. Treasury certificates were phased out in 1995. Commercial papers and Bankers’ Acceptances are the principal private sector instruments available and jointly accounted for 10% of the market in 1998. In terms of overall importance, the value of money market instruments outstanding averaged 35% of total bank credit between 1994-96. After increasing sharply to 74.5% in 1997 due to the
conversion of N103 billion worth of long-dated treasury bonds into treasury bills, they dropped back 48% of bank credit as at end-1998.

C. INSTRUMENTS OF THE MONEY MARKET: RECENT TRENDS

(a) Treasury Bills
9.5. These short-term government debt instruments have the dual purpose of raising short-term finance for the government and serving as the principal instruments for monetary policy. Treasury bills are traded through three different fora: i) a weekly primary auction which is open to all commercial and merchant banks, discount houses and some designated brokers; ii) Open Market Operation (OMO) auctions which admit only licensed discount houses, with other institutions submitting bids through discount houses; and iii) repurchase transactions through discount houses.

9.6. The value of new TB issues has grown from N34.9 billion in 1994 to N75.2 billion in 1998 (Annex 6B). The central bank is by far the biggest subscriber to TBs, accounting for 64% of subscriptions in 1998, down somewhat from its average share of 71.6% over 1993-98. This large subscription is due to banks’ relative unwillingness to purchase TBs because of the unattractive yields as a result of ceilings imposed until late-1998.

9.7. In 1998, total TBs outstanding amounted to N221.8 billion, a 114.6% increase over the 1993 level (Annex 6B) 62. The principal holder of outstanding TBs is the CBN. However, CBN holdings decreased from N40.5 billion in 1994 to N21.9 billion in 1996 as commercial bank holdings increased, following a slowdown in credit growth to the private sector. However, there was a sharp increase to N141.6 billion in 1997 and at the end of 1998, CBN holdings stood at N121.9 billion, a fall of 14% relative to 1997 levels.

9.8. The holdings of commercial banks have gone up and down over the years, increasing to N47.2 billion for 1998. Holdings of merchant banks have been comparatively small averaging N6.7 billion over the five year period. TBs held in the "others" category (including discount houses, government parastatals and non-bank financial institutions) have climbed by 70% from N25.7 billion in 1994 to stand at N43.7 billion in 1998. In terms of percentage shares, this rivals the holdings of CBN and commercial banks and is mainly driven by discount houses who are required to hold TBs amounting to 60% of their total deposit liabilities.

9.9. Since 1993, Open Market Operations (OMO) have been the primary tool of monetary control employed by the CBN and TBs have been used as the sole intervention security. In the operation of OMO, banks and other institutions bid for TBs through discount houses which are the only institutions allowed to deal in the weekly OMO auction sessions. Annex 6C shows transactions at OMO sessions between 1994 and 1998. Total bids rose sharply to N274.4 billion in 1996 due to a sudden lack of alternative money market instruments following the conversion of all TCs into low-yielding treasury

62 Outstanding TBs did not change from 1994 through 1996 because all new issues were made to refinance maturing bills
Since 1996, total bids have been on a slide, falling to N59.8 billion in 1998. This trend has been due largely to the directive requiring banks to provide 100% naira cover for their bids at the foreign exchange auctions. As a result, banks rediscussed a large proportion of their TB holdings and cut back sharply on bids at both the primary and OMO auctions. Low yields on TBs compared to returns on the resurgent inter-bank market also proved to be a major disincentive. However, there is hope that the deregulation of TB rates will increase demand for these securities at OMO sessions.

(b) Commercial Papers
9.10. Commercial Papers (CPs) are short-term debt instruments issued by private firms. Total CPs outstanding increased from N5.2 billion in 1994 to N12.9 billion in 1997 but fell back sharply to N7.2 billion in 1998, reflecting a downturn in economic activities (Annex 6D). Commercial banks are the dominant investors, holding an average of 77.4% of total CPs outstanding over the period. Merchant banks are also significant investors in CPs although the level of their holdings has fluctuated erratically in recent years.

(c) Certificates of Deposit
9.11. CDs were first introduced by CBN in 1975 as inter-bank debt instruments designed to channel surplus funds from commercial banks into merchant banks for the purpose of promoting medium to long-term lending of merchant banks. However, both commercial and merchant banks soon began issuing CDs. CDs are characterized by a maturity range of 3-36 months and wholesale unit issues of not less than N50,000. Those maturing within 18 months are classified as liquid assets and count towards satisfying banks' liquidity ratio requirements. Total CDs outstanding increased from N15.2 million in 1994 to N277.3 million in 1996, but the market has been inactive since then (Annex 6D). The market for CDs has been adversely affected by the recent distress in the banking system and no new issues have taken place in the past two years. All banks have eliminated CDs from their portfolios and as at end-1998, all CDs outstanding were held by the non-bank public.

(d) Bankers acceptances
9.12. These are credit instruments issued by private companies and guaranteed by banks. Total BAs outstanding increased by over 275% from N4.7 billion in 1994 to N17.5 billion in 1998 (Annex 6D). This rise in BAs has been steady over the five years under consideration, posting an average growth rate of 40.3%. Commercial banks dominate the market with their holdings standing at N12.6 billion in 1998, compared to N2 billion in 1994. However holdings by merchant banks and discount houses have also been substantial with merchant banks accounting for 16.1% of total holdings on average over 1994-97, while discount houses accounted for 20.9%.

(e) Treasury certificates and eligible development stocks
9.13. Activities in the market for treasury certificates and short-dated eligible development stocks have virtually ceased. In 1995, a substantial portion of the TC holdings of the CBN was converted into low-yield treasury bonds which were then

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63 This created a shortage of tradeable securities which was addressed in 1997 with the conversion of N103 billion worth of treasury bonds into treasury bills.
converted into treasury bills the following year. The market for Eligible Development Stocks was inactive from 1994 through 1997, but recorded N990.3 million in 1998 due to the securitization of some CBN direct advances outstanding to the federal government into EDS.

(f) The inter-bank market
9.14. This is the forum for trading funds between banks with surplus reserves and those in deficit. Overnight funds dominate the market, accounting for 95% of total transactions on average over 1994-98. Trades of 30-day, and 90-day tenors accounted for the remainder. Inter-bank placements hit an all-time low of N3.3 billion in 1994 due to widespread distress in the banking system (Annex 6D). As several distressed banks were liquidated (31 at last count) and confidence gradually returned to the financial system, placements increased sharply to N8.8 billion in 1996 and by 1998, stood at N62.4 billion, making this the second biggest money market component. Other factors accounting for this increase include the rise in the demand for overnight funds to back bids at the then Autonomous Foreign Exchange Market (AFEM)\(^\text{64}\).

D. THE ROLE OF DISCOUNT HOUSES
9.15. Discount Houses were created in 1993 to play a central role in the implementation of market-based monetary policy. In the operation of Open Market Operations (OMO), banks and other financial institutions bid for treasury bills through discount houses as they are the only institutions allowed into the OMO auction sessions. Aside from bidding through discount houses, banks can also rediscount TBs at discount houses. Discount houses therefore have a central role in developing the secondary market for treasury bills, which is the sole intervention security for OMO.

9.16. Only licensed financial intermediaries are allowed to form discount houses and there are five discount houses currently in operation\(^\text{65}\). In fulfillment of discount houses’ expected role as promoters of the money market, the treasury bill rediscount rate at the CBN discount window is 1% lower for discount houses than for commercial and merchant banks. This is designed to encourage banks to use discount houses as a first resort in meeting their liquidity needs. As part of their portfolio requirements, at least 60% of discount house liabilities must be in treasury bills.

9.17 Discount houses have played an important role in the money market in particular and the financial system in general. For instance, at the height of the banking distress, when the inter-bank market was virtually dead, discount houses did quite well in providing liquidity to cash-strapped banks. With imperfect information on the relative health of banks in the system, it was difficult to identify banks which posed significant credit risks and virtually all banks began placing surplus reserves with discount houses.

9.18. However, as distress resolution progressed and the system was rid of insolvent banks, confidence has gradually returned and the inter-bank market has been rejuvenated.

\(^{64}\) The AFEM requirement for 100% naira backing for foreign exchange bids substantially stimulated activity on the inter-bank market.

\(^{65}\) These are Kakawa, Consolidated, First Discount, Express and Associated Discount Houses
As a result, discount houses have suffered some adverse effects. Money-at-call from banks, which is their main source of investible funds has become volatile since the banking crisis peaked in 1994. It fell from N5517.6 million in 1994 to N707.9 million in 1995. A rise to N7653.1 million in 1996 was followed by a 78.8% fall to N1617.3 million in 1997. Further, between 1996 and 1997, discount houses experienced a 41% shrinkage in both cash balances and total assets (see Annex 6E) as banks looked more and more to the interbank market than to discount houses to fund their liquidity requirements.

9.19. As the Nigerian financial system continues to change rapidly, post-crisis, the continued survival of discount houses in the present form is questionable. At this juncture, they face several challenges to their traditional business base. For now, their use for OMO auctions continue but should disappear once the CBN becomes more adept at handling the logistics of conducting indirect monetary policy. There is therefore a need to clarify what the medium to long-term role of discount houses would be. As business volume in the traditional areas fall, one can envisage a reduction in the number of discount houses, possibly through mergers of the smaller ones with the bigger ones.

9.20. An alternative scenario is for discount houses to significantly broaden the scope of their activities, perhaps by converting to either merchant or commercial banks. The report team however learnt that discount houses are not inclined towards converting to banks and would rather see a widening of the range of financial services they can provide while maintaining the corporate status quo. They see the concentration of discount houses in money market activities as too risky in a fast-changing financial environment, especially with the expected commencement of “universal banking” (under which banks will be allowed to offer non-banking services), the business opportunities for banks are expected to increase considerably. In addition, the money market is shallow and saturated and offer relatively unattractive investment opportunities for discount houses. As such, there have been proposals to expand the scope of discount houses to activities such as leasing, foreign exchange and free investment in capital market instruments. Currently, discount houses can invest in capital market instruments on a selected basis and subject to the approval of CBN.

9.21. There is however a need to eliminate the regulatory distortions associated with the operation of discount houses. In particular, the authorities should consider relaxing portfolio restrictions requiring discount houses to hold 60% of their deposit liabilities in treasury bills. Although discount houses compete with banks for deposits, they are forced to invest most of their liabilities in treasury bills whose rates are not yet fully competitive with market rates. Relaxing these portfolio restrictions will therefore create a level playing field and provide incentives for discount houses to find a sustainable niche in the financial system.

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66 Associated Discount House however recently acquired majority interests in Gateway Bank of Nigeria PLC.
E. PROBLEMS AND CONSTRAINTS OF THE MONEY MARKET

9.22. Policy instability. Although the chronic instability in government policies has tended to push Nigerian investors towards short-term financial instruments, the money market has been adversely affected by several changes in government policies relating to the foreign exchange market which have often disrupted money market activities. For instance, in 1998, CBN issued a directive that banks should provide 100% domestic currency cover for their foreign exchange bids at the AFEM. This triggered a massive sell-off of treasury bills by banks. This directive was reversed in 1999, leading to an increase in banks’ demand for treasury bills. Other changes in foreign exchange policies have caused similar frequent adjustments in bank holdings of money market instruments. In addition, the arbitrary use of direct instruments of monetary control poses problems for the money market. It is not uncommon for the CBN to debit the accounts of commercial and merchant banks without notice (by amounts equivalent to its calculation of excess liquidity), precipitating substantial rediscounting of TBs. In response to frequent policy changes, banks often maintain "precautionary" excess reserves far beyond prudent levels.

9.23. Inadequacies of the Payments system: The Nigerian payments system is based predominantly on cash transactions and inadequacies in the system inhibit money market activities. Given the concentration of money market activities in Lagos, banks and other participants in the money market need to have funds available there in order to purchase treasury bills and other instruments. The automation of the payments system is grossly inadequate with little development of IT systems and satellite communications. In addition, there is no standardization of available IT systems. This makes the transfer of money cumbersome and considerably slows down all forms of economic activity, including money market transactions. For instance, it takes banks approximately 7 days to get the funds into Lagos should they wish to invest them in the money market.

9.24. Constraints on market liquidity: The transactional liquidity of the money market is constrained by three key factors which limit the quantity of bills available for trading on the secondary market viz.: i) the substantial amount of TBs in the hands of the CBN (64% in 1998); ii) portfolio regulations requiring discount houses to maintain 60% of their deposit liabilities in the form of TBs; and iii) high liquidity ratios imposed on commercial and merchant banks (currently 40% of deposit liabilities), which are usually satisfied by holding TBs. In addition to these factors, frequent changes in government policies force banks to hold excess cash balances to guard against the unpredictability of government financial policies. As earlier mentioned, CBN’s penchant to administratively debit accounts of banks in an attempt to control systemic liquidity means that banks tend to hold precautionary excess reserves far above prudential needs. Consequently, many banks are always in surplus with little incentive or need to trade bills.

9.25. Dominance of treasury bills: Government policies tend to favor treasury bills and serve to discourage the development of the inter-bank market and other private money market instruments as liquidity ratios are high (40%) and eligible securities counted
towards meeting the ratios are limited to TBs. Similarly, inter-bank placements are excluded from the calculation of the liquidity ratio, posing obstacles to the further development of the inter-bank market as a source of active liquidity management by banks. This situation has served to constrain the active diversification of the money market beyond government securities.

9.26. Auction failures: Despite the removal of caps on primary TB issue rates in late-1998, the primary market for TBs still often does not clear as TB offers are almost always substantially under-subscribed. Figure 9.1 presents total monthly TB offers and sales on the primary market between September 1998 and September 1999. It shows that auction failure has been a regular occurrence with sales consistently falling short of offers. The following factors contribute to auction failures: i) TB rates are to a large extent still administratively determined, usually below market rate levels, despite the deregulation of TB rates, with CBN in the habit of rejecting bids that it considers too high; ii) the primary market for TBs is limited in the variety of bills available as virtually all TBs are of 91 days maturity. This discourages participation of banks that desire other maturities; iii)

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67 CDs maturing within 18 months are also eligible but the market for CDs is virtually dead.

68 Call placements with discount houses and inter-bank placements secured with TBs count towards liquidity requirements.
CBN inability to reasonably gauge what the market is willing to absorb. For instance in July 1999, the CBN offered N359.8 billion in TBs but received bids amounting to only N48.5 billion, a shortfall of over N300 billion. This indicates that the CBN has problems with setting reasonable auction sizes; iv) the propensity of banks to hold excess reserves as a precaution against changes in government policies (usually direct debits of their accounts by CBN) limits the amount of bids at primary auctions; and v) inadequacies in telecommunications which make it difficult for authorized dealers to get through by phone to CBN dealing rooms.

F. RECOMMENDATIONS

9.27. Ensuring macroeconomic and policy stability: The money market can only thrive in an environment of macroeconomic and policy stability. Therefore, the government should ensure that both inflation and government deficits are kept low and policies should also be aimed at reducing volatility in other macro-variables. More importantly, the authorities need to ensure greater stability of financial and macroeconomic policies. Policy stability and predictability will reduce the level of uncertainties currently faced by market agents and increase the liquidity of the money market by reducing the need for banks to hold substantial amounts of excess reserves.

9.28. Addressing auction failures: An important step towards ending auction failures is to allow TB rates to be truly market determined. As mentioned earlier, there is anecdotal evidence that the primary issue rates are still subject to some administrative intervention. It is only when rates are market driven that the sustained interest of banks and other investors in TBs can be assured. Full deregulation of rates should be accompanied by other complementary policies to stimulate demand and competition including: i) diversification of the tenors of TBs available at primary auctions; and ii) injecting more competition into the primary market by allowing the direct participation of insurance companies and other interested investors.

9.29. Improving liquidity: If the degree of auction failure is successfully reduced, the CBN can substantially reduce its absorption of treasury bills and lower the total volume of bills in its possession. This will allow more bills onto the secondary market for trading. Similarly, more bills can be released onto the market by: i) relaxing existing portfolio requirements which mandate discount houses to hold substantial amounts of bills; ii) lowering liquidity ratios and widening the list of eligible instruments; and iii) injecting more stability and predictability into government policies to reduce the volume of precautionary excess reserves usually held by banks.

9.30. Diversifying the money market: There is a need to widen the money market further by encouraging more development of instruments other than treasury bills. For instance, the current upsurge of activity on the inter-bank market can be further enhanced by allowing inter-bank placements to count as part of liquidity requirements. Similarly, other private liquid instruments such as bankers’ acceptances could be made eligible in assessing liquidity ratios.

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69 The primary auctions are currently limited to commercial and merchant banks, discount houses and some designated brokers.
Improving the payments system: An efficient payments system is critical to the functioning of a market-based economy. Financial markets in particular require a well-functioning mechanism for payments and settlement. Upgrading payments technology and increasing the speed with which money is transferred from one part of the country to another will greatly enhance economic and financial transactions. The money market will particularly benefit since money market transactions take place only in Lagos and require the transfer of funds into Lagos by banks and other interested investors.

II. THE CAPITAL MARKET

A. INTRODUCTION

In spite of remarkable recent gains, the Nigerian capital market remains underdeveloped, accounting for only 0.5% of total financial assets as at end-1997. Market capitalization is low (9% of GDP) and the secondary market is relatively illiquid (turnover of 5.2%). There is little diversification of securities traded, as the market is overwhelmingly dominated by transactions in equities. The market currently plays an insignificant role in resource mobilization as new equity issues are small in number and the bond market is moribund.

Further development of the capital market in Nigeria is important for the purpose of mobilizing medium- and long-term funds for productive investment. The banks which dominate the financial system typically operate on the short-term end of the market. An active and effective capital market will therefore help mobilize long-term finance and widen the array of financial instruments available to savers and investors, increase diversity and competition, and facilitate the channeling of resources to the most productive ventures.

B. STRUCTURE OF THE CAPITAL MARKET

(a) Institutions

The key players on the Nigerian capital market include the Securities and Exchange Commission (SEC), which is the overall supervisory and regulatory body for the market, the Nigerian Stock Exchange (NSE), issuing houses, stock-brokers, unit trusts as well as company registrars. As the apex institution in the financial system, CBN closely monitors activities and developments in the capital market.

SEC was established in 1979 to replace the Capital Issues Commission (established 1973) with the overall objective of promoting an orderly, active and transparent capital market. Its major functions include: i) registering all security dealers and approving security issues; ii) maintaining surveillance over the securities market to prevent fraudulent and unfair trade practices; iii) ensuring adequate protection for the
investing public; and iv) regulating mergers and acquisitions and authorizing the establishment of unit trusts.

9.36. The Nigerian Stock Exchange (NSE) began operations in 1961 as the Lagos Stock Exchange (LSE) but was decentralized and transformed into the NSE in 1977 with additional trading floors in Kaduna and Port Harcourt. At this time, the NSE has a total of 7 trading floors (Lagos, Kaduna, Port Harcourt, Ibadan, Kano, Onitsha, and Abuja) offering facilities for trading in equities, corporate debentures as well as government development bonds. Most of the market activity however takes place on the Lagos floor of the exchange, which in 1997 accounted for 90% of total deals, 95% of total volume traded and 92% of total value traded.

9.37. In 1985, a second-tier securities market (SSM) was introduced in an attempt to encourage small and medium-scale indigenous companies to seek quotation on the stock market. Historically, small and medium scale enterprises willing to list shares have faced difficulties in selling shares to the public and listing requirements for the SSM were relaxed relative to what obtains on the main exchange, to assist them in gaining access to the resources necessary for modernization and expansion.

9.38. Other institutions active on the capital market include 14 unit trusts, several issuing houses, company registrars and over 150 stockbrokers.

(b) Instruments

9.39. Debt instruments available on the Nigerian capital market include government development bonds, some state government bonds, as well as corporate debentures. With respect to stocks, both ordinary and preference shares are available on the Nigerian capital market.

C. RECENT TRENDS ON THE CAPITAL MARKET

(a) Primary Market

9.40. Available data show that the Nigerian capital market does not play a significant role in the mobilization of fresh long-term capital. As Annex 6F reveals, the number of new issues on the market has been low and has shown a mixed trend over the 1994-98 period. 28 new issues were floated in 1994, and there was a sharp rise to 40 new issues in 1996 as the inflow of foreign portfolio investment increased and two new Unit Trust schemes were launched. Since 1996, the number of new issues has fallen sharply to stand at only 17 in 1998. It is notable that most recent new issues represent capital increases by

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For instance, First tier companies require a 5-year trading record for listing while second-tier firms require only a 3-year record. Also, a minimum of 100 shareholders are required for second-tier firms, compared to 500 for first-tier companies.

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firms already quoted on the exchange and there is relatively little activity in terms of Initial Public Offerings (IPOs).\footnote{Between 1994 and 1996, there were only 7 IPOs out of 89 new issues. Prior to this period, most of the IPOs came through the privatization exercise which brought a total of 28 new listings onto the NSE.}

9.41. Although the number of new issues has been small, the value of new issues has grown over the years, increasing five-fold from N2.2 billion in 1994 to N10.3 billion in 1997. There was a 6% fall to N11 billion in 1998. While there has been a recent increase in foreign portfolio investments, the sharp increase in value recorded in the past two years was due mainly to new issues from several banks and insurance companies trying to comply with higher minimum capital requirements.\footnote{The minimum capital requirement for banks was raised to a uniform N500 million from N50 million for commercial banks and N40 million for merchant banks.} In 1997 alone, 11 banks and 4 insurance companies accessed the capital market through direct sale of shares to the public.

9.42. In terms of the mode of issue, the Nigerian capital market lacks diversification as new issues have been dominated by direct sales of new equities to the public (offers for subscription). The value of new offers for subscription has grown from only N776 million in 1994 to N9.3 billion in 1998 (see Annex 6F), with direct sales representing 90% of new issues in 1998. Rights issues are next in popularity due perhaps to the low cost associated with this mode of issue.

9.43. The primary market for debt instruments has been dull and inactive compared to the market for equities. New debenture issues have been small in both number and value and are little used as sources of corporate finance. Debentures have averaged only 3.8% of the total value of new issues over the past four years. There have been no new issues of government development bonds since 1994 as the Federal government has tried to encourage state and local governments to access the primary market directly.\footnote{Development bonds or stocks were usually floated annually (with maturities ranging from 6 to 25 years) by the federal government to mobilize funds for on-lending to state and local governments.}

9.44. Only one private placement issue was recorded over the 1994-98 period; this was in 1997, worth only N3.6 million. The launching of new unit trusts accounted for new issues worth N50 million and N2050 million in 1994 and 1996 respectively.

\[b\] Secondary market

9.45. In recent years, the Nigerian capital market has shown a remarkable increase in market capitalization which increased seven-fold from only N41 billion in 1993 (representing 4.4% of GDP) to a still low N279 billion in 1996 (11.1% of GDP), falling somewhat to N257 billion in 1998 (9% of GDP) (Annex 6G).\footnote{In dollar terms, market capitalization increased over three-fold from $1 billion in 1993 to $3.5 billion in 1996, falling to $2.8 billion in 1998 (Annex 6G contains data on recent trends on the secondary market).} Comparative 1998 capitalization-GDP ratios in sub-Saharan Africa were 16% for Cote D’Ivoire, 18% in...
both Ghana and Kenya, 22% in Zimbabwe, 44% in Mauritius, and 146% in South Africa. This shows that despite the recent expansion, the Nigerian capital market still lags behind other African markets in terms of capitalization.

9.46. The observed fall in market capitalization between 1996-98 stemmed from: i) declining stock prices (see para. 9.54 below); ii) the recent de-listing of many quoted firms including several distressed financial institutions; and iii) maturing government bonds that were not renewed. Equities represent the bulk of market capitalization and in 1997 accounted for 98% of total market capitalization with corporate and government bonds jointly accounting for the remainder.

9.47. The number of listed firms increased modestly from 174 in 1993 to 186 in 1998 but the potential impact of new listings on capitalization has been neutralized by the decline in the prices of securities and recent de-listings of distressed banks and maturing government bonds. The stock market is highly concentrated with market capitalization skewed towards a small number of listed firms. In 1997, the top 10 quoted companies accounted for 49% of market capitalization and the top 20 companies represented 71% of market capitalization. The top 20 companies in 1997 comprised 6 firms from the oil sector, 4 banks, 2 conglomerates, 4 from food and beverages, 2 breweries and 2 from building materials.75

9.48. As at end-1998, the total number of securities listed on the capital market stood at 264 as against the peak of 276 attained in 1994. Equities account for over 70% of the number of securities listed and is the only component that has been increasing over the years. In comparison, government bonds listed have decreased from 32 in 1993 to only 19 by 1998. Corporate bonds have also decreased from the peak of 70 attained in 1994 to stand at 59 as at end-1998.

9.49. The total number of shares outstanding on the NSE increased by 70% from 21 billion units in 1995 to 34 billion units in 1997. The privatization exercise which divested government holdings in 35 companies between 1991 and 1993 created over half a million new shares.76 New listings from state privatizations and private sector listings have also increased the number of available shares.

9.50. A breakdown of shareholders reveals that the general public (individual Nigerians) dominates shareholding, consistently accounting for over 40% of holdings since 1995 (Annex 6H). The share of foreigners has also been substantial, representing 24% on average over 1995-98.77 Also notable is the growing interest of institutional investors, whose share in total holdings has increased substantially from 23% in 1995 to 31% by 1997.78

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75 These numbers were obtained from the Securities and Exchange Commission.
76 28 of the 35 companies involved new listings on the stock exchange.
77 The liberalization of investment rules in 1995 sparked foreign interest in the capital market.
78 The mission could not obtain data on the breakdown into domestic and foreign institutional investors.
9.51. The Nigerian stock market has become much more active over the past five years. Between 1993 and 1998, the number of transactions (deals) doubled to over 84,000 per annum. Similarly, the value of transactions increased by over 1000% from only N804.4 million in 1993 to N13.5 billion in 1998. In 1998, 2 billion securities changed hands, compared to 449.5 million in 1993. This sharp rise in transactions is traceable to several factors including: i) greater awareness and increased interest in share ownership created by the privatization exercise of 1991-93; ii) recent liberalization of foreign investment rules and the subsequent increased inflows of foreign portfolio investment; iii) increased efficiency of the market due to the introduction of the Central Securities Clearing and Settlement System (CSCS) and of the Automated Trading System (ATS)\(^{79}\); and iv) improved flow of information about the capital market.

9.52. One striking feature of trading is the relative dormancy of the bond market (both industrials and government) as transactions are overwhelmingly dominated by equities. Since 1995, equities have accounted for over 90% of the total value of transactions and over 80% of the total volume. In 1998, virtually all the trading on the stock exchange was in equities and the market for both government and industrial bonds remained inactive\(^{80}\).

9.53. The upswing in trading activity has translated into an increase in market liquidity as measured by the turnover ratio\(^{81}\). This ratio rose sharply from a mere 0.8% in 1993 to 5.2% in 1998, indicating an improvement in the ease with which shares are bought and sold. The value of trading is still small relative to the size of the market but South Africa aside, this is a common feature of stock markets in sub-Saharan Africa. Comparative 1998 turnover ratios in sub-Saharan stock markets were 10.6% in Botswana, 2.6% in Cote D'Ivoire, 4.8% in Ghana, 5.9% in Mauritius, 4% in Kenya, 30.4% in South Africa and 9.2% in Zimbabwe.

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\(^{79}\) Trades are now cleared and settled on a T+ 5 basis compared to T+ 14 prior to the CSCS.

\(^{80}\) There were only 3 deals done in industrial bonds in 1998, worth only N200,000 and 1 deal in government bonds worth N15.6 million.

\(^{81}\) This is the ratio of traded value to market capitalization.
Box 9.1: Recent Developments in the Nigerian Capital Market

In recent years, conscious efforts have been made by the authorities to reform and promote the Nigerian capital market. The most significant recent reform was the repeal in 1995 of the Nigerian Enterprises Promotions Decree, which restricted foreign participation in domestic firms.

With the Nigerian Investment Promotion Commission Decree (NIPC) of 1995, the investment climate was liberalized, allowing unrestricted foreign interest in Nigerian quoted companies. It created the Nigerian Investment Promotion Commission to monitor the implementation of the decree in the areas of domestic and foreign investment promotion. Henceforth, both residents and foreigners have identical investment rights and opportunities.

The Exchange Control Act of 1962 was repealed and the Foreign Exchange (Monitoring and Miscellaneous Provisions) Decree was promulgated with the objective of easing the inflow of foreign investment. The new decree provides for the unimpeded repatriation of both principal and dividends from investments.

As part of its efforts to modernize market infrastructure, the NSE introduced the Central Securities Clearing System (CSCS) in 1997. This is an automated clearing, settlement and delivery system aimed at easing transactions and fostering investors' confidence in the capital market. In addition, performance information on the NSE is now linked directly to Reuters International Information System in order to disseminate relevant market information to subscribers. In 1998, the NSE completed the installation of the Automated Trading System (ATS). As a result, trades are now cleared and settled on a T+5 basis compared to T+14 prior to the CSCS/ATS.

In 1996, the government set up the Odife Panel to review the structure, conduct and performance of the capital market and to make appropriate recommendations. The panel identified outdated laws and regulations as major impediments to capital market development and recommended the establishment of a new National Stock Exchange in Abuja.

In 1999, all the myriad laws relating to the capital market were codified into a single document called the Investments and Securities Decree (ISD) 1999. The ISD repealed that part of the Companies and Allied Matters Decree which related to the SEC, and expanded the statutory functions of the SEC. Further, following the trend established by the NIPC Decree of 1995, the ISD placed emphasis on investment promotion and the internationalization of the Nigerian securities market.

Other notable recent developments in the capital market include: i) abrogation of the capital gains tax; ii) reduction in withholding tax from 15% to 10%; iii) elimination of double taxation on unit trust investments; iv) introduction of a graduated scale of brokerage commissions; v) introduction of trading in rights; and vi) continuing efforts to establish a viable over-the-counter market to trade in unquoted securities.

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82 This recommendation was rejected and the proposed Abuja exchange is now another trading floor of the NSE.
9.54. Between 1993-96, the stock market was buoyant with the *NSE All-Share Index* increasing by over five thousand points from 1544 in 1993 to 6992.1 in 1996. However, the index has been on a slide since then, with share prices declining by 7.4% in 1997 and by 12.3% in 1998. Out of the 182 equities listed in 1998, 113 were on offer, 28 on technical suspension and only 41 on bid. This recent downturn is attributable to the poor earnings performance of many quoted companies against the background of the generally poor performance of the Nigerian economy. In addition, the sharp increase in real money market interest rates (due to a steep fall in inflation) has made short-term investment options more attractive. The perennial instability and inconsistency of government financial and economic policies have also served to discourage longer-term investment strategies.

D. PROBLEMS AND CONSTRAINTS

9.55. **High cost of transactions:** Transaction costs on the Nigerian stock exchange are high and pose obstacles to the development of a more active secondary market. Minimum transaction costs amount to 3.2% on the buying side and 3.7% on the selling side, meaning that about 7% of an investor's investment capital goes into transaction fees and charges, on a “round trip”, in-and-out basis. This serves as a major disincentive to trading and partly explains why there is relatively little trading relative to market capitalization.

9.56. Charges for *sellers*, expressed as a percentage of total value of the transaction, include: i) stamp duty of 0.0075%; ii) Central Securities Clearing System (CSCS) charges amounting to 0.25%; iii) NSE charges amounting to 0.25%; and iv) brokerage commission of 2.75%. For *buyers*, transaction charges include: i) stamp duty of 0.0075%\(^{83}\); ii) SEC fee of 1%; and iii) brokerage commission of 2.75%. In addition, stock-brokers who are registered with the Federal Inland Revenue Service (FIRS) have to pay Value Added Tax (VAT) amounting to 5% of total commission earned on transactions\(^{84}\) although this tax is not collected from all such brokers.

9.57. **Market illiquidity:** High transaction costs constrain market liquidity and erode the gains derived from the Automated Trading System and the Central Securities Clearing System. Aside from high transaction costs, other factors hampering liquidity include: i) the “buy-and-hold” culture of Nigerian investors; ii) the use of share certificates as collateral for bank loans; and iii) the concentration of stock market activity in Lagos in the absence of electronic linkages between the Lagos floor and other floors of the NSE\(^{85}\). The relative illiquidity of the secondary market also hampers the development of the primary market; investors will be reluctant to subscribe to new security issues if they are going to find it difficult or costly to dispose of them when the need arises.

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\(^{83}\) In a *cross-deal*, both the buyer and the seller of a security are expected to pay the stamp duty separately.

\(^{84}\) Although the NSE has successfully appealed against the imposition of VAT on brokerage fees, the mission learnt that the Revenue Service still collects the tax from brokers who were registered under the VAT scheme before the requirement was abolished.

\(^{85}\) The new Abuja trading floor is the only floor electronically linked with Lagos.
9.58. **Policy instability:** The perennial instability of government financial and economic policies, as well as high inflation and political uncertainties in the recent past, have served to discourage investment on the Nigerian capital market. Given this instability and the associated lack of confidence in the economic and policy environment, the horizon of the average Nigerian investor is typically short-term. As a consequence, the money market has proved more attractive to investors who are averse to committing funds for a long time in an environment characterized by frequent policy reversals. The steady increase in short-term interest rates in the face of falling inflation rates has served to further enhance the relative attraction of short-term investments.

9.59. **Dormancy of the bond market:** The Nigerian capital market is relatively narrow and underdeveloped in part because of the continued underdevelopment of the bond market. Unlike equities which are available only to public companies, bonds are versatile and available to a wider variety of corporate and government entities as a means of raising term finance. The inactive bond market hampers productive activity as many enterprises find it difficult to issue bonds to mobilize much-needed medium- to long-term funds.

9.60. This inactivity can be traced to several factors. First, there is a general atmosphere of mistrust in the Nigerian economy and the absence of a bond rating agency means that potential investors have no means of assessing the quality of bonds. Many bond issues therefore fail due to low subscription rates. Second, the rigid and uncompetitive way in which many bonds are priced has made them much less attractive than money market instruments. Returns on government bonds currently average less than 6% and returns on industrial bonds typically average 10%. These rates cannot compete with rates in excess of 20% available on the money market, especially in an unstable policy environment. Third, money market instruments generally enjoy better tax treatment than capital market securities (see para. 9.64) and this has served to further enhance their attraction to investors.

9.61. **Poor performance of quoted companies:** Another deterrent to investor participation on the capital market is the poor state of the real sector. In recent years, the real sector has had to confront several problems including: i) a country-wide energy crisis which lasted for more than two years; ii) erratic power supply which has forced many manufacturers to resort to costly private generation of power; iii) the virtual collapse of physical infrastructure; iv) stiff competition from cheaper, used consumer items imported from Europe and North America; v) continued depreciation of the *naira* and the attendant increase in the cost of imported spare parts and raw materials; vi) increases in custom duties paid on raw materials; and vii) sharp reduction in the purchasing power of Nigerians which has curtailed demand and led to the unplanned accumulation of inventories by many firms. All these coupled with political and policy uncertainties served to hamstring industrial and commercial activities, leading to a slide in share prices and discouraging potential investors.  

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86 The impact on the stock market has been significant because the manufacturing sector account for over 50% of stock market capitalization.
9.62. **Limited Supply of securities:** Although the capital market has made significant progress in recent years, there is still a shortage of new securities coming onto the market. As previously discussed, the number of new issues has been small because of: i) the strong aversion of Nigerian entrepreneurs to dilution of ownership; and ii) reluctance to undergo the strict procedures governing the issue of new securities, especially the requirements for full disclosure of financial information as well as the frequency of submitting financial reports. In addition, the issuing process is full of processing delays and frustrations. There are several cases of poor documentation of issues by issuing houses due to the poor state of skills in the sub-sector. On the debt side, the absence of a bond rating agency limits the number of companies that can raise funds by issuing bonds. Further, the virtual lack of activity on the secondary market for bonds makes them quite illiquid and poses a key obstacle to the use of bonds as sources of finance.

9.63. **Low Institutional Demand for Securities:** Official portfolio restrictions partly explain why individuals dominate shareholding in Nigeria and why there is a relatively low demand for capital market instruments by institutional investors such as pension funds and insurance companies. The Investment Trustees Act of 1965 prescribes that at least 50% of pension fund assets and not less than 25% of insurance funds should be deployed into government securities. In addition, the National Housing Fund decree of 1992 mandates every life insurance company to invest 40% of its life funds and 20% of its non-life funds on real property, 50% of which should be paid into the National Housing Fund at an interest rate not exceeding 4%. The portfolios of pension funds and insurance companies indicate a worrying bias for real estate which accounts for about a quarter of their investments on average. There is also a significant holding of short-term bank deposits. This reverse transformation is unfortunate as contractual savings institutions offer a natural source of funding for the capital market by virtue of their long-term stable liabilities.

9.64. **Tax treatment of securities:** Money market instruments and bank deposits still enjoy better tax treatment and hold an unfair advantage over capital market securities. In particular, investment income from treasury bills is exempt from withholding tax (as are savings deposits under N50,000), in contrast to the 10% tax imposed on dividend income. This coupled with the higher risks that Nigerians usually associate with the capital market make capital market investments relatively unattractive. In addition, as previously mentioned, recent increases in real short-term interest rates have made money market instruments much more attractive to investors.

9.65. **Level of Skills:** The Nigerian financial system as a whole suffers from a chronic shortage of qualified personnel and the securities sub-sector is no exception. This shortage of skilled professionals poses an obstacle to capital market development. There is evidence of low professionalism, for instance, in relation to the quality of issue applications submitted to the SEC. Without competent, well-trained professionals to carry out capital market activities, the level of confidence in the capital market remains low and the development of the market is curtailed.

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87 It should be mentioned however that many of the portfolio regulations are ignored for most of the financial year.
E. RECOMMENDATIONS

9.66. The capital market has the potential to play a leading role in the rejuvenation of the Nigerian economy and the generation of sustained economic growth. To enable the capital market to effectively play its role in mobilizing and allocating long term funds, there is a need to address current obstacles to its effective functioning. The recommendations in the following paragraphs pertain to policy steps required to create a viable capital market.

9.67. Lowering transaction costs: There is an urgent need to review the various fees and charges applicable to transactions on the NSE. In the first instance, a situation where some brokers pay the VAT while others do not creates confusion and it should be ensured that the non-payment of VAT on brokerage commissions is uniformly applied to all stock-brokers. In addition, there is room for the downward review of other fees and charges. The stamp duty serves no obvious useful purpose and the mission recommends that it should be abolished. The imposition of a SEC fee of 1% of transaction value on the buyer’s side does not make much sense as the SEC (unlike the NSE) does not have any direct connection with day-to-day transactions. Bringing total transaction costs down to reasonable levels (1-2% of investment capital) is crucial to encouraging trading, improving liquidity and encouraging share ownership.

9.68. Increasing the supply of securities: The supply of securities available on the capital market can be increased through: i) the resumption of the suspended privatizations of state-owned enterprises88. This should increase listings on the capital market and bring into the public domain a large number of securities. The last phase of the privatization exercise was responsible for 28 new listings and the creation of half a million new units of shares; ii) making the listing requirements less onerous by reducing the red-tape involved; iii) moving faster on the establishment of an over-the-counter market, which has the potential to widen the market further by allowing unquoted companies to raise capital on the capital market and facilitate the trading of these securities; and iv) an awareness campaign to inform companies about the benefits of listing as many firms, especially domestic SMEs, still do not understand the relevance of the capital market to their operations (e.g. the current SEC campaign to educate entrepreneurs through local Chambers of Commerce). It is important to intensify such initiatives and ensure their sustainability.

9.69. Increasing the demand for securities: Increasing the supply of securities coming onto the market will only be beneficial if there are buyers willing to absorb them. Increasing the demand for securities could be achieved by expanding the participation of institutional investors in share ownership. This will involve reducing portfolio restrictions currently imposed on insurance companies and pension funds. In particular, consideration should be given to reducing the Investment Trustees Act requirements that 50% of pension fund investments should be in government securities. In addition, fund managers

88 The privatization program resumed after the mission’s visit with the sale of government shares in the West African Portland Cement Company (WAPCO) in December 1999.
in these institutions should be encouraged to take up more capital market securities in their portfolios.

9.70. **Reinvigorating the bond market:** There is a pressing need to end the current inactivity on the bond market. With interest rates liberalized and the era of cheap bank loans over, raising finance by means of bonds should be made more attractive to both the government and the private sector. One obvious way of doing this is to make bond yields more competitive with interest-bearing securities on the money market. The government should issue competitively-priced, medium-term bonds on the market to serve as a benchmark and kick-start activity on this segment of the capital market. The development of an active market for government bonds will encourage private firms to raise funds by means of bonds. Other possible issuers of bonds are the privatized parastatals which can float bonds to finance modernization and other relevant projects. However, in the early stages it is likely that only big, blue-chip firms will be able to successfully market bond issues. To widen the relevance of the bond market to firms, the mission recommends faster progress on the planned establishment of a credit rating agency in Nigeria. Such an agency will assess the creditworthiness of bond issuers and provide an independent opinion of the risk of default. This will serve to generate greater investor confidence in the bond market and enhance the marketability of bond issues.

9.71. **Improving liquidity:** As mentioned above, reducing the level of transaction costs is crucial to improving liquidity on the secondary market. In addition, there is a need to link other trading floors electronically to the Lagos floor which is the nerve center of the Nigerian capital market. This move will permit trading from different parts of the country.

9.72. **Improving the legal and regulatory framework:** Transactions on the capital market are inherently risky and require the support of a detailed legal, institutional and regulatory framework. The recent Investment and Securities Decree is a step in the right direction but there is a need to complement securities laws by strengthening the capacity of the SEC to maintain effective surveillance and enforcement. Increasing staff strength and automating surveillance procedures could significantly increase SEC efficiency and effectiveness in this regard. The Nigerian legal environment in general exhibits a number of shortcomings especially in the protection of property rights and the resolution of disputes. Inadequacies of the judicial system means that court cases drag on for an unconscionably long time. Judicial reforms are therefore necessary to ensure that investors have substantial confidence in the law enforcement machinery.

9.73. **Stabilizing government policies:** Government policies need to exhibit greater consistency and predictability. An atmosphere of frequent policy reversals creates uncertainty and financial markets cannot thrive in an environment of uncertainty and low confidence. In such circumstances, risk-averse investors shun the capital market and favor short-term investments. Authorities should give careful consideration to policy moves before making them public. Consultations with relevant parties are important and will help to identify potential problems early on. There is hope that with a democratic

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89 The observed inverted yield curve in Nigeria has been a major disincentive to investment in bonds.
regime in place, due consultations on economic and financial policies will become a more regular occurrence. With a more stable policy environment, the confidence of investors will increase and their horizon will lengthen, and the increased demand for capital market securities becomes more likely.

9.74. Other policy measures required to create a well-functioning capital market include: i) encouraging the automation of the operations of intermediaries operating on the market to improve efficiency and liquidity; ii) strengthening transparency of transactions to encourage wider participation by local and foreign investors; iii) upgrading the skills of capital market professionals through training at both the firm and industry levels and embracing global best practices in conduct and competence\(^\text{90}\); and v) encouraging innovation and the introduction of new instruments (such as futures and options) to provide opportunities for hedging and provide a wider array of instruments for potential investors.

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\(^{90}\) This could be achieved through affiliations with foreign partners or by allowing the entry of foreign security trading firms.
Box 9.2: Elements of the Regulatory Framework for the Nigerian Capital Market

The Securities and Exchange Commission (SEC) is the apex regulatory agency for the Nigerian capital market. The functions of the SEC are both regulatory and developmental. In addition to registering securities and security dealers, maintaining surveillance over the capital market, enforcing securities laws, and investigating complaints, the SEC is also specifically charged with promoting capital market growth through public enlightenment programs, workshops and symposia as well as publications. Nigeria employs a two-layer regulation of the capital market. In addition to the statutory regulation of the market administered by the SEC, the Nigerian Stock Exchange (NSE) also functions as a Self-Regulating Organization (SRO), with rules that are aimed at promoting stock market fairness, transparency and efficiency. The NSE, which falls under SEC regulatory oversight, licenses its members, sets trading and listing rules and monitors trading on a day-to-day basis. The NSE also investigates any violation of its rules and has the power to impose sanctions on erring members.

Before 1993, capital market regulation in Nigeria was merit-based, implying that the SEC shouldered the responsibility for deciding whether the offering of securities was fair and just and approved or disapproved issues based on its judgment of the quality of the issue and issuer. Today, capital market regulation is based on full disclosure, whereby issuers are required to disclose and widely disseminate full information about their companies and the securities being issued. Investors subsequently make their decisions based on all material information provided by the issuer.


Consequently, the promulgation of the Investments and Securities Decree (ISD) of 1999 was an attempt to replace most of these laws/regulations with a single document. The ISD repealed parts of the Companies and Allied Matters Decree relating to the SEC, and expanded the statutory functions of the SEC. Further, following the trend established by the NIPC Decree of 1995, the ISD placed emphasis on investment promotion and the internationalization of the Nigerian security market.

Much emphasis is placed on investor protection, with a focus on full disclosure of information. The ISD also stresses capital market development, which is explicitly mentioned in the statutes as a key objective of the regulatory framework.
10. TERM FINANCE AND LEASING

I. TERM FINANCE

A. INTRODUCTION

10.1. In Nigeria, there is a chronic shortage of long-term debt capital. This issue has become more pressing given the need to revitalize the economy after years of economic mismanagement and stagnation. The current policy framework has identified the private sector as the fulcrum of economic regeneration. As such, term finance becomes important in order to revive the currently prostrate industrial sector and restore sustainable growth. The industrial sector is badly in need of capital to replace outmoded equipment and expand productive capacity.

10.2. The availability of medium to long-term financing is very important in a developing country like Nigeria for the following reasons:
?? Access to term finance encourages innovation and risk-taking by entrepreneurs. Most investment projects with high returns have long gestation periods which require long-term finance. If entrepreneurs finance such long-term investments with short-term debt, project risk increases sharply and failure rates are likely to increase substantially.
?? With access to long-term finance, firms are able to engage in strategic, long-term planning since they have to worry less about the liquidity risks associated with failing to renew short-term credit.
?? Further, firms cannot easily undertake modernization of plant/equipment, adoption of more productive technologies and expansion of productive capacity without long-term finance.
?? For the government, long-term finance allows the financing of vital social and physical infrastructure such as roads, schools, and both commercial and residential buildings.
?? Finally, long-term finance provides avenues for pension funds and life insurance companies to invest in long-term assets to enhance matching with their long-term liabilities.

B. THE SUPPLY OF TERM FINANCE

(a) Development Banks

10.3. Historically, the principal source of term finance in Nigeria have been the development banks, which were established with the specific aim of correcting the perceived lack of long term capital for declared priority sectors. As discussed in Chapter 5, Nigeria currently has six development banks, which focus respectively on providing long term credit to medium/large scale projects in industry and agriculture, small and medium-scale enterprises, export promotion and providing financing to support exporters, rural and agricultural development, education. In addition there is an apex agency aimed at providing credit to small and medium scale enterprises (SMEs).
10.4. As Chapter 5 reveals in detail, development banks in Nigeria are in a sorry financial state and are currently unable to provide meaningful long-term credit support in any of these targeted areas. The Nigerian government recently announced plans to merge the NACB and the Peoples Bank to form an Agricultural and Rural Development Bank.

(b) Commercial banks

10.5. Unfortunately, there is also virtually no medium to long-term credit available from commercial banks in Nigeria. As shown in Annex 7A, over 80% of commercial bank credit in Nigeria consist of loans of 12 months maturity or less. In 1996 (most recent data point), 52% of commercial banks’ credit consisted of loans on call. Next in importance are loans of 6 months maturity which accounted for 20% of total credit in 1996 and averaged 19.4% over the period under consideration. Loans with maturities between 6 months and 12 months accounted for 11% of total lending in 1996. Loans between 1 year and 3 years maturity accounted for a mere 7% of total credit (6.5% average over the period) and only 10% of loans outstanding had maturity greater than 3 years.

10.6. A partial explanation for this short-term bias of commercial bank credit is the maturity structure of deposits. Annex 7B presents data on the maturity structure of commercial bank deposits from 1993 through 1997 and indicates that in 1997, almost half of commercial bank deposits (49%) consisted of sight deposits, with shares averaging 46.7% over the entire period. Next in line are savings deposits, representing 29% of total deposits in 1997 (averaging 32.3% over 1993-97) and time deposits of 12 month tenor or less accounting for 21.4% of deposits in 1997 and 20% on average over 1993-97. Altogether, short term deposits (1 year or less) averaged 99% of commercial bank deposits over 1993-97. With gap management concerns in mind, especially in a macroeconomic environment that was unstable, it is prudent for commercial banks to have a bias towards short-term lending.

(c) Merchant banks

10.7. Merchant banks were set up with the expectation that they would take longer term deposits than commercial banks and correspondingly extend credit of longer maturity. Indeed, until 1996, merchant banks were directed to channel 20% of their loans and advances into medium and long-term lending. Available data however indicates that the reality is far from the expectations on both the deposit and lending sides. Annex 7C shows that time deposits of 12 months or less take up 65% of merchant bank deposits. Although merchant banks are prohibited from taking de jure demand deposits without special CBN permission, sight deposits took up 29% of total deposits in 1997. Notably, time deposits over 12 months have been relatively small, falling from 10% of deposits in 1993 to 0.5% in 1996 and standing at a mere 2% in 1997. Like commercial banks, merchant banks have not been able to mobilize significant amounts of medium to long-term deposits. Indeed as discussed in Chapter 3, merchant banks are in a weaker position than commercial banks to expand longer term lending, given their more volatile and de facto shorter term liability mix.

91 The stability of some types of deposits (e.g. savings deposits) appears to have no impact on the maturity of loans booked.
10.8. Correspondingly, merchant bank credit has been predominantly short term, although their performance has been better than that of commercial banks in this area (Annex 7D). In 1997, 63% of merchant bank credit had maturity of 12 months or less\textsuperscript{92}, while 37% consisted of 3-5 year loans. No loans were granted with maturity above 5 years.

(d) **Insurance companies and pension funds**

10.9. The contractual savings sub-sector (life insurance and pensions) has the potential to make significant contributions to the market for term finance by virtue of their stable and long-term liabilities. However, the Nigerian insurance sector is under-developed with total premiums received amounting to less than 1% of GDP, with life insurance actually representing a small fraction of that. Existing pension programs cover only a tiny proportion of the labor force and assessed contributions are grossly inadequate (see Chapter 8 for details). Both life insurance companies and pension funds currently invest their liabilities predominantly in short-term assets including treasury bills, bank deposits and commercial papers. Their long-term assets are principally in real estate which account for over 60% of the investment portfolios of many firms. In addition, both insurance and pension funds buy shares on the secondary market.

10.10. The investment profile of insurance and pensions is further complicated by government portfolio restrictions. The Investment Trustees Act of 1965 prescribes that at least 50% of pension fund assets and not less than 25% of insurance liabilities should be deployed in government securities.

10.11. In addition, the National Housing Fund Decree of 1992 mandates every life insurance company to invest 40% of its life funds and 20% of its non-life funds in real property, 50% of which should be paid into the National Housing Fund. Although many companies ignore these rules or simply engage in window-dressing to fulfil the requirements on a temporary basis for the last day of the year, they serve to discourage insurance and pension funds from diversifying the tenor and composition of their investment portfolios.

(f) **The capital market**

10.12. Although the capital market offers another opportunity for raising long-term debt capital, the Nigerian capital market has not been very effective to date. The primary market for capital market debt instruments is inactive with corporate debenture issues small in both number and value (see Chapter 9). Moreover, the federal government which issued yearly development bonds until 1994, no longer issue longer term debt instruments. Thus, there is a lack of benchmarks in the bond market. In sum, the capital market has also not performed satisfactorily as a source of long-term debt capital.

C. **THE DEMAND FOR TERM FINANCE**

10.13. It is useful to distinguish between the real sector’s *need* for term finance and the *effective demand* for it. There is no doubt that the real sector, particularly the industrial sector has a huge need for long-term debt capital. However, there is currently

\textsuperscript{92} This includes loans on call, of 6 months and those between 6 and 12 months.
little motivation for new investment by firms and there are significant credit risks associated with lending to the real sector.

10.14. Annex 7E presents some data illustrative of recent real sector performance in Nigeria. Overall, the growth of real GDP has been slow, averaging 2% over 1993-95. Slight accelerations of growth in 1996 and 1997 were soon reversed with a 2.4% growth rate recorded for 1998 in the wake of various shocks to oil production and the softening of international oil prices.

10.15. Due to a host of factors (see para. 10.16), manufacturing sector performance has been sluggish and disappointing. The sector recorded negative growth rates from 1993 through 1995, with the biggest slump (-14.2%) recorded in 1993. The decline in production averaged 6.8% over the three years. After growing marginally at 1% in 1996 and 0.3% in 1997, the manufacturing sector recorded a 4% fall in production in 1998. For over a decade, industrial capacity utilization in Nigeria has been less than 40% and latest numbers show capacity utilization at under 32.4%.

10.16. Sales and profits have also been low and declining as the manufacturing sector has faced various problems including: i) an energy crisis which lasted for more than two years; ii) erratic power supply which has forced many manufacturers to resort to high cost private generation of power; iii) the virtual collapse of physical infrastructure; iv) stiff competition from cheaper, used consumer items imported from Europe and North America; v) continued depreciation of the naira and the attendant increase in the cost of imported spare parts and raw materials; vi) increases in duties paid on raw materials; and vii) sharp reduction in the purchasing power of Nigerians leading to unplanned accumulation of inventories by many firms. As a result, there is little motivation for new investments as firms see no need to acquire new machinery or to upgrade production and distribution facilities. On the supply side, lenders are alert to the risks of lending to such a distressed real sector and many firms encounter difficulties in securing even working capital loans.

10.17. Not surprisingly, we have observed relatively low and falling levels of bank credit to the private sector. As a share of GDP, bank credit to the private sector has fallen from 12.5% in 1994 to stand at only 9.1% as at end-1998. Over 1993-98, the private sector credit averaged 9.4% of GDP.

D. PROBLEMS AND CONSTRAINTS

10.18. **Macroeconomic and policy instability:** In the recent past, the Nigerian economy was characterized by macroeconomic instabilities and uncertainties (see Chapter 2). Between 1993 and 1995, inflation ran at over 50% per annum, reaching a peak of 73% in 1995. Fiscal deficits amounted to over 15% of GDP in 1993 and between 1993 and 1995, the current account deficit averaged 6% of GDP. International reserves went as low as one month of imports in 1993 and the exchange rate depreciated rapidly.

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93 Credit to government fell from 27.3% of GDP in 1993 to 5.7% in 1998, indicating that this is not a crowding-out problem.
on the non-official market. Such circumstances make it very difficult to mobilize long-term funds and extend long-term credit.

10.19. Compounding the unstable macroeconomic environment was the instability in government financial and economic policies. Frequent policy changes and reversals have been the norm, making it impossible for firms to make any strategic investment plans. Lenders consequently favored short-term lending which they consider less risky as it affords them the opportunity to re-price in order to reflect new information which often comes in the form of changes in government policy or in the business environment.

10.20. **Legal environment:** Inadequacies in the legal environment including long delays in adjudicating cases of debtor delinquency and problems with contract enforcement in general also discourage term lending. In the absence of an adequate institutional framework for the enforcement of financial contracts coupled with the cost and difficulties of using the legal system to seek redress, lenders have favored short-term credit which makes it easier to control borrowers and minimize losses.

10.21. Other constraints on term finance include: i) real sector distress; ii) underdevelopment of contractual savings; and iii) underdevelopment of the capital market.

E. **RECOMMENDATIONS**

10.22. **Enabling environment:** The first step in improving the outlook for term finance is to provide a conducive environment by maintaining macroeconomic stability and ensuring the stability of government policies. High and variable inflation plus frequent reversals of government policy breed uncertainty and it is difficult to develop long-term financial contracts in an atmosphere characterized by such numerous uncertainties. In addition, the recent installation of democratic rule offers the opportunity for the formulation of more stable economic policies through a thoroughly consultative process.

10.23. **Revitalizing Contractual savings:** Given the nature of their liabilities, pension funds and insurance companies are natural sources of long-term resources and should be at the heart of a strategy to improve term finance. As outlined in detail in Chapter 8, there is a need to improve the policy environment within which pension funds and insurance companies operate. It is recommended that the restrictions on the portfolio of both pensions and insurance companies be adjusted and that they may be actively encouraged to make more long-term investments in the form of direct long term loans and advances, long-term deposits in commercial, merchant and specialized banks as well as active participation in new bond issues on the capital market. Increasing long-term bank deposits is particularly crucial as banks are still best placed to do term lending in Nigeria by virtue of their financial system dominance and reach.

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94 With short-term loans, it becomes more difficult for the borrower to conceal vital negative information from lenders
10.24. **Strengthening weak financial institutions** The rehabilitation and rationalization of NIDB and NACB directly engaged in long-term lending would be helpful. The banking system has largely recovered from its recent distress and has been substantially strengthened. However, development banks, primary mortgage institutions and finance companies are performing unsatisfactorily and present dismal financial pictures. At this juncture they are not in a position to grant term credit. As such, rehabilitating and revitalizing these development banks is an important input to improving the term finance situation in Nigeria. ⁹⁵

10.25. **Bond market** Improving the functioning and role of the bond market is another key element in improving the outlook for term finance (see Chapter 9 for details).

10.26. **Legal environment** Term lending will remain underdeveloped in Nigeria as long as it is costly and difficult to enforce financial contracts. There is an urgent need to strengthen the speed, transparency and integrity of the mechanisms for contract enforcement. This will involve far-reaching reforms of the judicial system and process but more importantly requires a change in attitudes to eliminate a prevailing culture of default and create an atmosphere of trust in financial transactions.

10.27. **Revitalizing the real sector** Finally, term finance cannot thrive unless there is a healthy demand for it. It is therefore imperative that steps be taken to bring the industrial sector back to life after years of neglect and near-collapse. Such a revitalization would require, *inter alia*: i) stable and appropriate macroeconomic policies to encourage investment; and ii) adequate supply of basic infrastructure to improve productivity.

### II. LEASING

#### A. INTRODUCTION

10.28. Leasing has tremendous potential for helping Nigeria to overcome the chronic shortage of medium to long-term finance in Nigeria, especially for small and medium scale enterprises (SMEs) which encounter the biggest obstacles in raising finance through conventional bank loans. Leasing is based on projected cash flows of the lessee, has certain advantages in respect to legal action in the event of default, and offers an alternative form of financing investment for SMEs who customarily find it difficult to obtain loans from banks due to the lack of collateral or their short credit history. In addition, as an alternative to conventional bank loans, leasing helps in diversifying the financial system, encouraging competition and better meeting the needs of business enterprises.

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⁹⁵ see Chapters 5 and 7 for details on DFIs and Housing Finance respectively. The report does not cover finance companies in detail but an earlier survey indicated substantial distress and marginalization of this sub-sector.
**Key participants**

10.29. In Nigeria, commercial and merchant banks are the main sources of lease financing. Historically, merchant banks have dominated the industry as commercial banks were only allowed to do leasing in 1990. Aside from commercial and merchant banks, there are also a few “stand-alone” commercial lessors. These independent outfits customarily finance their leases by borrowing from commercial and merchant banks. Only one independent leasing firm (C and I Leasing) is listed on the stock exchange. In addition, other leasing firms that are subsidiaries or divisions of major conglomerates regularly obtain funding from their parent companies.\(^{96}\) These commercial lessors are particularly active in leasing “low ticket” assets such as motor vehicles, office equipment and household appliances.

**Features of leasing transactions**

10.30. Leasing in Nigeria is concentrated on domestic leasing with few cross-border transactions. Two main types of leasing contracts are common: i) Finance or capital leases; and ii) operating leases.

10.31. **Finance lease:** This type of lease is the most common form of lease financing in Nigeria, especially among merchant banks. It is an arrangement whereby the lessee pays rentals over a specified primary period (during which the lease contract is normally non-cancellable) in sufficient amounts to amortize the capital outlay of the lessor as well as cover the lessor's cost of funds and desired profits by the end of the lease period. Usually, the lessor buys the equipment specified by the lessee and at the end of the lease period, ownership of the asset is transferred from the lessor to the lessee. The finance lease is therefore an alternative way for firms to finance the purchase of needed equipment. It is the responsibility of the lessee to maintain and insure the asset during the lease period\(^{97}\).

10.32. **Operating lease:** Under this type of leasing arrangement, leasing is for a short-term and the asset is not completely amortized during the primary period of the lease. The lessor can look forward to recovering his costs (plus profits) from a secondary lease or from the sale of the asset at the end of the lease period. Thus unlike in the case of the finance lease, operating leases are not to finance the purchase of equipment since they involve letting out equipment to several lessees in sequence and these lessees are not responsible for the maintenance and insurance of the equipment involved.

10.33. The range of assets handled by Nigerian lessors is quite extensive, including:

- **Communication and administration equipment:** Radio telephones, answering machines, computers, accounting and copying machines, air-conditioners
- **Industrial and manufacturing equipment:** construction equipment, machine tools, oil exploration and extraction equipment, printing presses, quarrying and mining equipment, water drilling rigs and textile machinery

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\(^{96}\) Examples include Holt Leasing (subsidiary of John Holt Ltd.), and Leventis Technical (AG Leventis).

\(^{97}\) In many cases, the lessor arranges for maintenance and insurance in return for a fee.
Transportation equipment: aircraft, motor vehicles, locomotives, ships, fishing trawlers and oil tankers

Miscellaneous: agricultural equipment, hotel equipment, medical and dental equipment, shop fittings and vending machines.

Growth of the Leasing Industry in Nigeria

10.34. Leasing started in Nigeria in the late 1960s with cross-border leasing of equipment from multi-national companies to their subsidiaries or affiliates in Nigeria, especially in the areas of mining and oil exploration. Most of these leases were operating leases. In the early 1970s, the massive post-civil war reconstruction effort coupled with the oil boom and the emergence of local merchant banks led to the development of domestic leasing. The leasing business became closely linked with the activities of merchant banks which were dominant in the market till the late-1980s.

10.35. Leasing received a boost in 1983 with the formation by six merchant banks of the Equipment Leasing Association of Nigeria (ELAN) to promote leasing in Nigeria but the bigger push came with the deregulation of the financial system starting in 1987. As the government softened entry conditions into banking, several new merchant banks promptly entered the leasing business. In 1990, commercial banks were allowed to engage in leasing, thus widening the market further.

10.36. The value of total assets on lease jumped by over 200% from N1.7 billion in 1993 to N5.2 billion in 1997 (Annex 7F), but the trend has been erratic. However, in 1997, the most recent year for which data are available, leasing registered a 24% increase over 1996 levels. However, leasing penetration grew marginally from 0.8% total domestic investment in 1993 to 1.5% in 1995 but fell back to 1% by 1997. This indicates that leasing is still a relatively insignificant option for investment finance in Nigeria.

10.38. As shown in Annex 7G, leasing has been predominantly for plant and machinery, reflecting the dominance of the manufacturing and oil/gas sectors. This is closely followed by the leasing of cars and commercial vehicles. Leasing of computers and office equipment (mainly to government) and of ships and aircraft are relatively insignificant. The manufacturing sector accounts for the lion’s share of leased equipment, with the value of assets leased to this sector standing at N1996.3 million in 1997, representing an increase of 300% over the 1993 level. The share of manufacturing in total leasing has risen steadily to stand at 38.7% in 1997. Next in importance is the oil and gas sector with total leased assets of N1.7 billion in 1997. The sector’s share in leasing almost doubled from only 18.3% in 1993 to 32.2% in 1997. Comparatively, the share of agriculture has fallen steadily from 16% in 1993 to only 3% in 1997 while the share of government has declined to 2% by 1997. Leasing to the transport sector has grown to N1 billion in 1997, an increase of over 400% over four years and raising its share in the leasing business to 19.1% by 1997.

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98 Annex 7F contains data from lessors who render returns regularly to the ELAN
99 Market penetration is defined as the ratio of leasing to total domestic investment.
B. PROBLEMS AND CONSTRAINTS

10.41. **Absence of a legal framework:** There is currently no enacted or codified law on leasing in Nigeria. This leaves a lot of uncertainties regarding many legal aspects of the leasing business. Aside from the *Bill of Sale Act* which is the only piece of legislation that has provisions directly relevant to leasing, other pieces of legislation applicable to leasing transactions include: i) the rules of Common Law; ii) provisions of Companies Income Tax Laws; iii) the 1965 Hire-Purchase Act (if the lease contract contains an option for the lessee to buy the equipment at the end of the lease period); iv) Finance (Miscellaneous Taxation Provisions amendment) Decree No. 3 of 1993; v) Sale of Goods Act of 1893 (if it is a finance lease); vi) the Banking and Other Financial Institutions Decree (BOFID) of 1991 (since leasing is dominated by banking institutions); vii) the Income Tax Act of 1979 which governs who claims capital tax allowances under different types of lease contracts; and viii) the Companies and Allied Matters Decree of 1990 which affects the establishment and running of companies. Dealing with this multitude of laws and regulations is confusing, reduces the flexibility of lease contracts and activities of lessors and increases the risks associated with leasing.

10.42. **Contract enforcement:** There is a general problem with contract enforcement in Nigeria but the absence of a single body of law to deal with leasing has created additional problems for the enforcement of leasing contracts. The poor state of the Nigerian economy has led to an increase in the number of lessees defaulting on their obligations. In many instances, rents are paid late or not paid at all and there have been cases of lessees absconding with assets on lease.

10.43. When a lessee defaults on his obligations, Section 12 of the Bill of Sales Act allows the lessor to enter the lessee’s premises and seize the assets in question. However, Section 13 of the same Act provides that all assets seized must remain in the premises from which they were so seized and shall not be removed for five days from the date of seizure. This is a major loophole which works in favor of defaulting lessees. Not surprisingly, many defaulting lessees move leased assets out of the reach of the lessor before the expiration of the mandatory five days. Further, no special provisions exist to assist the lessor in effecting seizure and serious breaches of the peace have occurred due to physical resistance from lessees.

10.44. An alternative legal option open to lessors is to obtain an *Order of Mandatory Injunction* against the lessee. However, this is only granted after all the facts of the case are determined and considered. Often, this process takes months to complete due to delays and inefficiencies in the judicial system. Some defaulting lessees actually favor litigation as it provides a way to stall and retain the use and possession of leased assets. In many cases, lessors have had to make concessions to defaulting lessees to facilitate a quick settlement.

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100 The five day moratorium is designed to give the lessee a chance to settle all outstanding payments or mount a legal response to the seizure if he so desires.
10.45. **Lack of domestic long-term funds**: Nigeria’s relative lack of long-term funds is a major constraint on the volume of leasing. Merchant and commercial banks who dominate the leasing business have to finance their leasing activities from short-term deposits. This imposes limits on the tenor and volume of leasing and substantially increases risk as they have to be mindful of the finance gap. For independent, stand-alone lessors who customarily obtain financing from banks, medium to long-term loans are typically not forthcoming. Moreover, independent lessors are reluctant to raise funds on the capital market either because of the costs involved or because of a reluctance to dilute share ownership.

10.46. **Accounting and taxation policies**: Accounting and taxation policies have largely militated against leasing in Nigeria. There is a particular problem with double taxation as the Value-Added Tax (VAT) is assessed when equipment is purchased and again when it goes out on lease. On top of VAT, there is a 10% withholding tax deducted from rentals. The combination of double VAT and the withholding tax significantly reduces the real value of rentals to leasing companies.

10.47. Further, the Nigerian Accounting Standards Board SAS II (the equivalent of International Accounting Standard 17) has removed the right of the lessor to claim capital allowances under finance leases. In line with IAS 17, the lessee is seen as the economic (though not legal) owner of the asset and thus allowed to include the leased asset on its balance sheet and claim the associated depreciation expense. The lessor is only allowed to list the lease receivable as an asset on its books. This has adversely affected the growth of the leasing industry since finance leases are the most common form of lease transactions in Nigeria.\(^{101}\)

10.48. **Rising Cost of equipment**: The continued depreciation of the naira has led to a sharp increase in the cost of imported equipment. This benefits lessors in that the value of assets they own can increase substantially in naira terms. On the other hand, as existing equipment becomes obsolete, the costs of replacing it has become prohibitive thus serving to dampen the leasing business.

10.49. **Poor skills and lack of awareness of leasing**: This is a key problem faced by the leasing industry in Nigeria. Leasing suffers from a substantial shortage of skilled professionals as well as a lack of awareness of the leasing business. The relatively low level of professionalism in the leasing industry (e.g. in supervision of clients) poses an obstacle to the expansion of leasing in the country.

C. **RECOMMENDATIONS**

10.50. **Sources of Leasing Finance** Pension funds and insurance companies should be tapped more vigorously as sources of funding for leasing companies. These financial institutions have predictable long-term liabilities and could become viable and sustainable sources of long-term lease funding. In addition, leasing firms should explore

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\(^{101}\) In IFC (1996), it is reported that this accounting practice has led to the virtual collapse of leasing in Kenya.
the opportunities available for raising equity or bond funding on the capital market. Seeking direct foreign investment (e.g. from the IFC) is another option. To date, the IFC has no investment in leasing in Nigeria despite the institution’s active direct investment in leasing around the developing world.

10.51. **Leasing law:** There is an urgent need for a comprehensive leasing legislation in Nigeria. Such legislation should: i) clearly indicate the rights, duties and obligations of both the lessee and the lessor within the framework of a leasing contract; ii) create a recognized body of law for leasing to make it easier to adjudicate cases involving breaches of contract; and iii) set out a quick and simple process for repossession of an asset if the terms of leasing contracts are violated. Once this is spelt out, the current confusion as to which laws to apply to which cases will disappear thus lowering the degree of risk associated with leasing.

10.52. However, the problem with contract enforcement goes far beyond the enactment of a leasing law. The inadequacies of the legal and judicial system as a whole creates problems for all forms of economic activity in Nigeria. The judicial process is lengthy, courts are inefficient and adjournments are frequent. Hence there is a bigger task of judicial reform and overhaul. With regards to leasing, there is a particular need to provide for physical police presence when the lessor is exercising his right to seize leased assets from delinquent lessees.

10.53. **Accounting and taxation:** It is unfortunate that SAS II contains a disincentive to the leasing business. While it would be ill-advised to promote leasing by abandoning international standards, the authorities might consider giving other forms of tax breaks to lessors, especially in the case of finance leases. One option is to compensate lessors for the loss of the capital allowance by completely eliminating the withholding tax on rentals or removing the VAT. This will serve to mitigate the adverse effects on finance leasing of bringing Nigeria accounting norms up to internationally acceptable standards.