

**ASSESSING THE IMPORTANCE OF NIGERIA'S NATIONAL STOCK EXCHANGE FOR ECONOMIC
GROWTH AND CAPITAL MARKET DEVELOPMENT**

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Introduction

Distinguished conference participants, I am delighted to address this conference today to provide some context to the all-important topic of this conference. Lack of infrastructure is widely recognised as one of the major drawbacks to growth in Africa, and so the subject of debt financing on the continent is of critical importance.

According to NEPAD-OECD's Africa Investment Initiative, while well regulated financial systems are essential for macro-economic stability vibrant financial markets also play a critical role in channeling resources into productive investment and fostering growth. Some common obstacles to economic growth and capital market development in Africa include a lack of innovative financial instruments, notably those geared towards Small and Medium Enterprises, and underdeveloped capital markets that remain narrow and illiquid, thereby limiting access to long-term financing.

As Africa's financial markets evolve to a higher level of complexity, the importance of national stock exchanges cannot be overemphasized. Stock markets contribute to economic growth through functions such as: mobilization of savings for private sector and government use, creation of liquidity, risk diversification, and improved dissemination of information. An efficient and effective delivery of these services can indeed augment the rate of economic growth. In addition, the Stock Exchange should act as the barometer of the economy. Local and international investors follow an exchange's All-Share Index closely and take a cue on the economy from how the equity market behaves. The index affects the overall confidence in all sectors of the economy.

Africa is fast emerging as the new bride for investors following diminishing returns in emerging markets, financial crisis in developed markets and improved stability and governance standards in Africa. As increasing attention is directed at African economies it is important that our stock exchanges are

beacons of sound regulation, transparency and fairness, bringing investors together in vibrant and liquid trading environments.

Turning specifically to The Nigerian Stock Exchange, since the new leadership of The Exchange assumed office last year, much of our efforts have been geared towards transforming our market to meet these aspirations. With nearly two hundred listed companies in twelve diverse sectors, we service the second largest financial center in sub-Saharan Africa. We are also the third largest stock exchange in Africa by capitalization and the largest market in West Africa. As at March 9, 2012, there were 257 securities listed on The Exchange made up of 202 equities; 25 federal government bonds; 11 state government bonds; 16 corporate bonds; 2 preference shares; and one exchange traded fund.

Our goal is to make The Exchange the gateway to African markets, such that it is the first port of call for investors wishing to invest in Africa. Clearly, attracting the major players in our key economic drivers of growth, namely oil and gas, telecoms, power and ICT will be central to this effort, and we are making focused efforts to do so.

Having listened extensively to feedback from prospect companies, we have recently concluded a comprehensive review of our Listing standards, which have been duly approved by the Securities and Exchange Commission. We have introduced quantitative criteria and now offer greater flexibility, while positioning ourselves as a competitive listing destination. For example, our requirement that companies must have a five year financial and operating track record has led to the exclusion of some exploration and production and other natural resource companies which, due to the nature of their business, are unable to provide such records. We are also facilitating foreign listed companies to have access to a dual listing on our market.

We are leaving no stone unturned in ensuring that we lay the right foundation for restoring market integrity and meeting our promise to provide a first rate platform for listing and trading a wide range of securities. We are embarking on strategies to deepen the offerings in our market and plan to have five tradable instruments during the next five years to offer opportunities for investors to diversify their portfolios. In addition to equities, our aim is to promote active trading in Bonds, Exchange Traded Funds, Options and Financial Futures. Indeed, we are proud to announce that, in December 2011, The Exchange launched the first Exchange Traded Fund in West Africa, the ABSA Newgold ETF, which is backed by gold. These initiatives are a vital part of increasing the vibrancy, depth and competitiveness of The Exchange, so we can truly become the undisputed gateway to African markets. In 2012 we intend to revitalize bond trading on The Exchange, while 2013 is our target for introducing options. Financial futures will follow in 2015.

African Bond Markets

A conscious effort at steering the stock market towards debt management and yield curve development for both the public and private sector reduces volatility and insulates against liquidity shocks. If we successfully develop a full yield curve over at least a 5 year reference period then we will be able to even the flow of debt instruments, extend their maturities and build other credit products from them. Deep and well-functioning domestic debt markets play an important role in financing government budgets as well as facilitating the flow of long-term financing from investors to private enterprises. Long-term securities are important investment instruments for institutional investors such as pension funds and insurance companies that aim to match the long-term nature of their liabilities. The evolution of African stock exchanges into international bourses depends on their ability to create a stable transparent mechanism for the debt price discovery process. Investors are primarily attracted to:

- Liquidity
- Competitive trade pricing
- Efficient trading systems
- Free currency regimes
- Fungibility across stock exchanges
- Integrated settlement systems
- Stable and transparent macroeconomic and political structures
- Standardised trading rules

Sub-Saharan debt markets are mostly dominated by short-term government securities, with activity focused on the domestic primary market and limited activity in the secondary market. Corporate debt markets are largely non-existent in Africa, with the exception of South Africa and, to a limited extent, some North African markets. Although several countries have listed bonds, secondary market trading (both government and corporate) remains virtually nonexistent due to the “buy and hold” strategy of domestic banks who hold the bulk of the debt. This is due in part to the limited lending opportunities and also to some prudential requirements such as liquid asset ratios in some countries that require banks to hold a certain amount of their assets in government-issued paper.

The lack of government securities of longer maturity in most African markets limits the ability to establish a yield curve that would provide a benchmark for the pricing of corporate bonds. The essence

of developing our debt market becomes even more critical when we examine the opportunities inherent therein. These include:

- Lengthening the debt maturity profile of our various economies with the attendant impact of curbing effects of liquidity crises, reducing the cost of borrowing to the government and setting the cost of capital in the economy, specifically for financing long term projects
- Reducing interest rate volatility such that it improves the short and long term interest rate environment, especially where the banking system is strong.
- Perhaps an actual reduction in short-term interest rates resulting from increased liquidity and mid-term productivity gains
- Becoming the back-bone for economic development through infrastructure/privatization such as long term domestic capital funding the development of roads, bridges, railways, air and sea ports and long term domestic capital financing for the revitalization of newly privatized companies or institutions
- Development of the mortgage market through long term domestic capital for the funding of mortgages that invariably creates jobs thereby impacting some leverage into the economy
- Enables the creation of a secondary mortgage market and the development of mortgage backed securities industry
- The insurance industry is not left out as the development of the market will spur a vital component of the mortgage industry, which is the provision of life insurance
- There will also be increased financial Intermediation from the significant improvement in the ability of private and public companies and institutions to source debt capital away from traditional banks at cheaper and often longer tenors which will then reduce cost of goods and services.
- Capital market product development and penetration, for instance, the development of fixed and floating rate financing with the ability to swap one kind of financing for the other and the development of securitization with respect to Asset Backed Securities where companies can source funds for themselves from the capital market on the strength of their receivables rather than their balance sheet.

There is however growing activity at the longer end. Nigeria, with its \$500 million Eurobond issue, is one of a number of African countries that have accessed international debt capital markets. Nigeria now has visibility in the ICM. In addition, the offer aimed to establish a benchmark for future borrowings by

the public and private sector; attract foreign direct investors to Nigeria; and develop an investor base in the ICM for securities, including equities to be issued out of Nigeria.

The Nigerian FGN Bond market is opening new opportunities for investments and risk management strategies. We are also seeing more REPO transactions which further create depth and liquidity in the market. Analysts expect the market to continue to grow. The switch from short to longer term funding has helped to reduce the pressure on interest rates making the development of other debt instruments feasible. With 42 listed bonds (16 corporate and 36 government) we have successfully developed a yield curve over a period of twenty years of long term maturities of up to 20 years as well. Market capitalization continues to grow due to the growth of the domestic bond market providing a steady source of fixed income investment opportunities to pension fund investors and the Bond market growth significantly out-pacing that of the equity market in the past year.

Notwithstanding the illiquidity in the bond markets, internationally competitive yields, Nigeria's current credit rating and the emergence of actively managed pension funds may be expected to continue to support extensions of Treasury Bond duration in the short to intermediate term. The demand for bonds is constantly on the rise with an average of over 1000 deals weekly, which we are optimistic of bringing to the Exchange before the end of 2012.

As sovereign balance sheets improved following external debt relief and the implementation of sound macroeconomic policies, the number of sovereign ratings in sub-Saharan Africa, an important precondition for issuing debt on international markets, has multiplied. The number of countries in sub-Saharan Africa with a sovereign rating continues to increase, compared to only three countries (South Africa, Senegal and Mauritius) eight years ago.

Developing the Private Sector and Creating a Platform for Access to the International Financial Markets

Let us look briefly at ways in which we can make our companies more accessible to international markets. An integrated platform for accessing the international capital markets by the private sector in Africa is necessary as it allows quick and efficient access to foreign capital at attractive rates and deepens the pool of funds available to the sector. Methods by which this could be achieved include:

- Streamlined rules and regulations between African exchanges and the major global bourses

- Development of integrated, electronic, secondary market trading and settlement platforms for securities
- Registering and settling securities in Euroclearable format to enhance marketability of cross-border transactions
- Development of a derivatives market to provide interest rate and currency hedging solutions (for benefit of both issuers and offshore investors) with subsequent evolution also of a credit default swaps market (primarily for investors)
- The role of market makers is also essential in enhancing the price discovery process and promoting efficiency

In addition, African Stock Exchanges need to review and strengthen the rules guiding company listings and reporting standards with the aim of aligning to global best practices. One major area that comes to mind is the adoption of IFRS as the reporting standard for listed companies. This would certainly enhance the attractiveness of African listed companies to the international investing community. In Nigeria, IFRS reporting is mandatory for all listed companies from this year. Furthermore the Stock Exchange should be promoted as an exit mechanism for private equity and other investors and we must aim to develop products and standardize our market structure to reflect those that investment firms are familiar with in the major global financial centers. By so doing investors will be less wary of accepting the risk of African institutions. We should also encourage dual listings between African exchanges and externally. Our capital market rules would therefore need to be at par with international standards and our product offerings suitable for foreign investors.

Nigerian private institutions, notably the banks, have made some inroads into international capital markets, mostly through GDR issuance. At the NSE we realize that our companies must meet the highest standards of disclosure and governance in order to access international capital. We have introduced a bouquet of value added services to improve governance and visibility in areas such as investor relations, corporate access, independent analyst coverage, corporate governance and institutional services (primarily for our SMEs).

In addition to promoting transparency in our exchanges and listed companies, Africa also needs to register its presence strongly in global bodies like the World Federation of Exchanges and showcase our listed companies more. This will in no small measure help to diffuse any negative perception the international investing community may have about our markets.

Enhancing Liquidity in the African Bond Market

The creation of a more liquid debt market for both African sovereign and corporate bonds lies in creating a competitive trading environment with the following features:

- Advanced and integrated IT platforms
- Competitive and dynamic rules and regulations
- Enhanced credit research coverage
- International documentation and reporting standards e.g. IFRS
- Liberalised currency regime and the removal of currency restrictions
- Live data streams
- Competitive trading fees
- Reduced and standardised settlement period
- Integrated settlement systems

All the listed features will lead to the development of a liquid secondary market for debt instruments and develops a capacity to support the yield.

At The Nigerian Stock Exchange, one of our major initiatives for 2012 is to improve liquidity in the bond market. Focusing initially on government bonds, we plan to work closely with the Debt Management Office to create a retail market in government bonds, to meet strong private investor demand for greater access to fixed income securities. In addition, planned initiatives around market making, short selling and securities lending in the equities market will also be deployed to our listed bonds.

The role of the market maker in providing liquidity is widely recognized, but liquidity can also arise from other aspects of the trading mechanism. In particular, rules and market practices governing the trading process, such as how trading orders are submitted and what trading information must be disclosed, can affect the creation of liquidity.

At the NSE we are on the verge of introducing market making. The idea is for market makers to use our current systems and applications to manage trades and portfolio risks using probability algorithms that take into consideration their open positions, borrowing inventory and collateralised obligations. To support this initiative we are simultaneously introducing securities lending and short selling.

A vibrant securities market should necessarily provide for lending and borrowing of securities. Securities markets all over the world, mostly, have an active market for securities lending and

borrowing scheme, which beside complimenting short selling in securities also enable the investors earn returns on their idle stocks. Vibrant securities lending and borrowing is therefore, considered necessary to provide impetus for short selling. While international securities market regulators have recognized that short selling can exacerbate market falls and lead to manipulative activities (for those who allow naked short selling), most of the jurisdictions have also recognised short selling as a legitimate investment activity that has contributed significantly to market liquidity and price efficiency. International securities market regulations have, therefore, permitted short selling with adequate safeguards to prevent any abusive/manipulative market practice.

The Role of Pension Funds in Promoting Capital Market Development

One key motivation for countries to reform their pension systems has been the expectation that these pension funds would play a dynamic role in the development of capital markets, fostering private sector savings and reducing the cost of capital for corporations, in the context of a broader strategy to achieve more developed, market oriented financial systems.

For pension funds to have a positive impact on capital market development, they need to reach sufficient size, their regulations must allow for a variety of investments and not otherwise prohibit investments in equities, and optimal investments must be pursued.

In Nigeria as a result of pension system reform that started in 2004, pension fund assets are growing rapidly and are increasingly providing a source of investment funds to their domestic financial markets. Reform was driven by the recognized need for pension savings to provide long-term capital in order to develop financial markets and improve economic growth. Pension fund assets have since grown rapidly, amounting to over \$16 billion dollars currently. Pension fund investments are expected to increase the availability of long-term funds, enhance competition, induce financial innovation, and improve corporate governance. Since 2004, revisions around regulations for investment of pension assets have focused on broadening the scope of allowable assets (e.g. private equity, REITs) while ensuring proper checks and balances to protect contributors' funds.

Since pensioners are required to hold their investments in at least one pension fund until retirement, this gives stability to the system as a whole. Furthermore, given their size and commission fees, pension funds should be able to professionally manage the asset allocation, diversify risk appropriately, and overcome problems of asymmetric information and transaction costs that pervade financial markets. Also, given that pension funds face the regulatory requirement to allocate a large fraction of

their capital domestically and given the large size of their capital, they are expected to invest in a broad range of domestic assets and diversify risk as much as possible within the country. Therefore, relative to other institutional investors, pension funds are thought to be the ones which contribute the most to the development of domestic capital markets.

Conclusion

In closing, let me reiterate some of the benefits we can look forward to from more efficient debt markets. These include:

- Reduced cost of funding for both the sovereign and corporates
- Diversification of funding sources for both the public and private sector
- Development of heterogeneity of market participants
- Development of a reliable yield curve and the term structure of interest rates.
- Infrastructure development
- Job creation
- Promotion of transparency
- Increased revenues and as a result higher GDP

A stock exchange as a platform for the listing and trading of securities has a crucial role to play in developing a more efficient debt market by introducing cutting edge technology, standardising processes and paying attention to market structure.

However, the success of a domestic bond market does not lie wholly within the control of an exchange. There must be sound fiscal and monetary policy, an effective legal and regulatory framework, secure and efficient settlement and custodial system, effective information disclosure system, a diversified investor base, favourable tax policies, an effective financial system and for treasury bonds, a sound and prudent debt management and credible and stable government. In addition, the development of a well-functioning money market is essential in enhancing liquidity of the market; an active money market is the precursor to an active secondary bond market.

Ladies and gentlemen, it is clear that we must get the participation of the key economic sectors on stock markets as well as attract the attention of local, regional and international investors, in order for the stock market to play the role of an economic barometer, as it does in more developed economies. A broad based stock exchange has numerous benefits which I have detailed in this paper. It is time for us to strengthen and deepen our interaction for the benefit of the continent and I believe this conference provides an excellent opportunity to do so.

Thank you for your kind attention.