Credit Ratings: Opportunities and Challenges

The Nigerian Experience

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Introduction

- *Agusto & Co.* created the Nigerian Credit Ratings Industry in January 1992, when it commenced business and began rating Nigeria’s 120 banks on an unsolicited basis.

- In the mid-nineties, the Nigerian banking industry was characterized by widespread distress, and investors needed a means of measuring risk.

- *Agusto & Co* gained market acceptance when many banks it rated as high risk went into distress and were subsequently liquidated.

- Over the years, *Agusto & Co’s* ratings coverage has grown to include corporate, municipal, insurance, fund, other non-bank financial institutions and structured ratings.
Overview of the Nigerian Credit Ratings Industry

• Nigeria has a vibrant Credit Ratings Industry, with:
  
  - Five domestic rating agencies registered by the SEC.
  - Two agencies together control over 90% market share.
  - Regulated by the Securities and Exchange Commission (SEC).
  - Two international foreign rating agencies – Fitch Ratings and Standard & Poor's “fly in” to carry out ratings.
The SEC Regulatory Role

- The Securities and Exchange Commission is responsible for registering and regulating Credit Rating Agencies in Nigeria.
- SEC ensures:
  - Capital requirements and prudent financial management.
  - Independence
  - Transparent and objective rating procedures.
  - Standards of field work.
  - Procedure in place for preventing the misuse of non-public information.
  - Character, qualification and maturity of owners and key personnel.
- Credit Rating Agencies are required to submit quarterly returns to the SEC.
- The SEC requires credit rating agencies to renew their licenses every five years.
Role of Credit Rating Agencies in the Nigerian Bond Market

- **Investor**
  - Investor protection via independent 3rd party credit evaluation
  - Information disseminating
  - Imparting transparency.
  - Common yardstick to evaluating credit risk.
  - Pricing securities
Role of Credit Rating Agencies in the Nigerian Bond Market

- **Issuers**
  - Independent and internationally recognized way of communicating the financial strength of an issuer to lenders and the public.
  - Enhances access to debt capital market.
  - Raise money at a reduced interest cost.
  - A cheap way of getting “Consulting Advice” as credit ratings provide management with an independent opinion on the organization and its operations.
  - Improve image.
Role of Credit Rating Agencies in the Nigerian Bond Market

Financial System

- Fosters the development of the capital market
- Broaden the investor base and the range of borrowers
- Reduces dependence on the banking system for intermediation
- Increased transparency
- Promotes merit based access to funding
- Complements the role of regulatory authorities
Credit Ratings – Opportunities

- SEC Mandatory Rating for Bonds
  - In February 2003, the SEC issued a circular mandating all capital market operators to ensure that bonds issued in the Nigerian Capital Market are rated before applications for registration of these bonds are filed with the Commission.

  - The Commission is of the view that compliance with this rule will enhance proper assessment of such bonds, as well as enhance investor confidence in the bond market.

  - This circular applies to both government and non-government bonds.
Credit Ratings – Opportunities

- **Pension Funds**
  - The 2004 Pension Reform Act saw the birth of a contributory pension scheme in Nigeria.
  - Cumulative Pension funds currently stand at $16 billion, growing by 30% annually (2016: $60 billion).
  - This is the largest pool of long term funding in Nigeria.
  - The Pension Commission’s investment guidelines stipulate that investments in Infrastructural bonds, State government bonds, local government bonds, Corporate bonds (Including REIT’s and Mortgage Asset backed debentures) and money market instruments should be determined by Credit Ratings.
Credit Ratings – Opportunities

- **Infrastructural Development**
  - Huge infrastructure financing gap that exists in Nigeria (Housing, Power, etc) can be funded by the debt capital market.
  - State government bonds dominate the non sovereign debt market in Nigeria.
  - State government bond issuance is driven by a need to fund long term infrastructural developmental projects.
  - To date, 10 state governments (of 36) have issued 5-7 year bonds totalling USD 2.1 billion.
  - Credit enhancements in the form of Irrevocable Standing Payment Orders (ISPOs) ensured these bonds achieve investment grade ratings, thereby qualify for pension assets.
  - This credit enhancement ensures repayments to bond holders are deducted at source.

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Credit Ratings – Opportunities

Breakdown of Bonds in Issue
(USD' billions)

- Bank, USD 473 (15%)
- Non Bank, USD 623 (19%)
- State Government, USD 2,110 (66%)
Credit Ratings – Opportunities

• Corporate Bonds
  • Corporate debt instruments in issue presently amounts to just over $1.1 billion (comprising bank issues of $473 million and non-bank of $623 million).
  • This constitutes only 7% of pension fund assets.
  • PENCOM guidelines allows Pension Fund Administrators invest up to 35% of their portfolio in corporate bonds.
  • The Federal government has made concerted efforts to revive the corporate bond market:
    – By providing tax waivers.
    – The SEC has reduced the cost of issuing debt.
    – The National Pension Commission has relaxed its investment guidelines by allowing Pension Funds invest in corporate bonds rated Bbb (previously “A”).
Credit Ratings – Opportunities

• Lull in the Equities Market
  – The Nigerian Stock Exchange (NSE) All Share Index has dropped 68% from its peak of 5 March 2008.
  – The loss of confidence in the equities market following the collapse of the market in 2008, has meant that companies need to seek alternative funding sources, such as corporate bonds.
  – All proposed bonds must be rated by at least 2 Credit Rating Agencies.
Credit Ratings - Challenges

• Impediments to the Growth of Corporate Bonds in Nigeria.
  • Historically, companies have relied on bank loans for funding.
  • Ease at which top tier companies obtain financing from banks.
  • Process - Complicated, Lengthy, Costly.
  • Reluctance to go through rating process
  • Absence of an active secondary market
  • High interest rate environment is a low incentive for bond issuance
Credit Ratings - Challenges

- Corporate Bond Ratings
  - Low volume of ratable instruments.
  - Credit Ratings culture still underdeveloped.
  - Reluctance to open up to scrutiny.
  - Unpublished ratings.
  - Resistance to validation to annual bond ratings reviews.
Credit Ratings - Challenges

- Information gathering
  - Credit Ratings can only be provided when there is adequate information available to form a credible opinion, and after applicable quantitative and qualitative analysis are performed.

- Challenges with information gathering process include:
  - Slow response to information gathering requests
  - Unwillingness to part with information
  - Quality and credibility of information
  - Transparency and validity of data
Credit Ratings - Challenges

- Client Expectations
  - Rating process
  - Unrealistic timelines
  - Bloated expectations of rating outcome
  - Perception of fee paying model
Credit Ratings - Challenges

- Reputational Risk
  - Adverse impact of sub-prime crises on domestic operations.
  - Reputation is the key aspect of the ratings franchise.
  - A reputation for technical competence, continuity, transparency, objectivity and impartiality comprises the principal asset of the rating agencies, without which there would be no justifiable demand for their ratings.
- Reputation and image of credit rating agencies particularly international rating agencies has been tarnished with wrong ratings assigned mainly to structured finance transactions.

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Conclusion

- Rating agencies play a key role in the infrastructure of the modern financial system.
- Reputation and credibility is a rating agency’s key selling tool.
- In Nigeria, the regulatory authorities consider the Credit rating agencies and important part of the development of the long term debt market.
- Credit rating should complement, not replace investors’ fundamental analysis.
- The regulatory bodies are actively promoting the development and growth of the Nigerian bond market.
- The potential abounds for bond issuance, given the infrastructural deficiencies in the Nigerian economy.
- Africa must learn lessons from mistakes made in more developed economies e.g. the sub prime crisis.
Thank you for your attention
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