



DEBT MANAGEMENT OFFICE
NIGERIA

SUBNATIONAL BORROWING GUIDELINES

2008 - 2012

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1.0 Introduction¹

During the 1990s, the Nigerian economy recorded low growth rates averaging less than 3 percent per annum, low domestic investment, high unemployment and wide balance of payments deficits. Nigeria was in a situation of debt overhang, i.e. its debt stock exceeded its future repayment capacity. This situation discouraged investment in the Nigerian economy and created difficulties in accessing funds from the international capital market, not only for the government but also by the private sector.

After about three decades of military rule, the civilian government which was elected in 1999 launched a home-grown development strategy, namely the National Economic Empowerment and Development Strategy (NEEDS). This was complemented by State (SEEDS) and Local Government (LEEDS) strategies. NEEDS aimed at value reorientation, poverty reduction, wealth creation and employment generation.

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

Although the above achievements did not directly impact on the country's external debt sustainability, the reforms enabled Nigeria to resume dialogue with creditors on debt relief. Through high level diplomatic initiatives, the government garnered the support of the international community and was eventually able to get the Paris Club, Nigeria's leading creditor, to agree to a historic debt relief deal that allowed the country exit from all its Paris Club debt obligations between October 2004 and April 2005. This was followed by the exit from its London Club debt obligations in 2006.

In addition to the progress made on the external debt front, the government began the restructuring of the domestic debt portfolio, which was dominated by short term instruments, resulting in a portfolio with a substantial long-tenored component. Furthermore, it started working on recognising and settling contingent liabilities that emerged from unfunded pension arrears and local contractors' debts through the issuance of sovereign bonds.

Given the country's recent experience with an unsustainable public debt portfolio, it is important that measures are taken to prevent a relapse into debt unsustainability. This challenge is quite demanding because the Federal and State Governments need to mobilize substantial resources, in order to fund the growth and development of the economy.

In this context, it is necessary to have Sub-national borrowing guidelines in addition to the existing borrowing provisions, so that the States could be assisted to be prudent in their borrowing and debt management activities. The following guidelines complements the existing provisions as contained in the constitution of the Federal

¹ This Sub-national borrowing guideline was culled from the National Debt Management Framework. Details of the guidelines can be accessed at the DMO website: www.dmo.gov.ng

Republic of Nigeria, The Debt Management Office (Establishment) Act, 2003, Act no 18, The Local Loans (Registered Stock and Securities Act), The Treasury Bills Act, The Treasury Certificate Act, The Government Promissory Notes Act, CAP 164, Central Bank of Nigeria (CBN) Act 2007, and The Fiscal Responsibility Act 2007.

2.0 Borrowing Guidelines

2.1 Domestic Borrowing:

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

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

2.2 CATEGORIES OF SUB-NATIONAL DEBT:

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

2.2.1 Domestic On-lending from the FGN:

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

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

- The FGN, either from its internal sources or by borrowing from the market (either domestic or external) can on-lend funds to the Sub-nationals.

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

2.2.2 Guarantees by the FGN:

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

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

- i. In the DMO Act, all external loans will either be contracted directly by the Federal Government or by Sub-Nationals through the Federal Government which must

guarantee such loans. Therefore, the limit for guarantees is the total amount of foreign debt to be contracted, which is included in the budget approved by the National Assembly. Consequently, the legislation and Guidelines for External Borrowing are particularly relevant.

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

The following guidelines would therefore, apply to the FGN Guarantees:

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

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

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

2.2.3 Borrowings from the Capital Market:

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

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

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

The provisions of the Act include the following:

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

Other required documentations under the ISA include:

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

2.2.4 Borrowing from Commercial Banks:

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

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

- All commercial banks lending to a sub-national must make a provision (currently 50%) on all such loans in line with the Prudential Guidelines of the CBN.
- Sub-nationals should immediately, upon contracting a commercial bank loan, furnish the DMO with details of the loan. The lending bank should furnish DMO and the borrowing Sub-national's DMD (where in existence), on a periodic basis with reports on various stages of drawdown on the facility and utilization of same by the borrower.

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