TESTIMONY ON "THE GLOBAL FINANCIAL CRISIS AND FINANCIAL REFORM IN NIGERIA: A CAPITAL MARKET PERSPECTIVE"

BY

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Introduction

Thank you, Honorable Gregory W. Meeks and other members of the sub-committee for the invitation to testify at this hearing on the Global Financial Crisis and Financial Reforms in Nigeria. My testimony will focus primarily on the impact of the global financial crisis on the Nigerian capital markets and the reform agenda that the NSEC has embarked upon since I assumed duty on 7th January 2010.

This testimony is both timely and relevant to the challenges facing Nigeria, the United States and the rest of the world. It is also auspicious as we at the Nigerian Securities and Exchange Commission (NSEC) seek to strengthen our partnership with the United States Securities and Exchange Commission (US SEC). We believe a strong partnership with the US SEC is critical to building a world class capital market and mutually beneficial in the fight against financial crime and in our common objective of maintaining capital markets that are of the highest integrity.

As you may know, while Nigeria is the second largest economy in Africa, the 8th largest producer of oil, has the 7th largest gas reserves, and produces 6% of the world's cocoa, it is still one of the poorest nations in the world with a GDP per capita of a little over USD 1,000. We believe that a world class capital market is key for Nigeria as it seeks to better leverage its wealth in terms of natural and human resources to realize its full potential and address its socio-economic challenges. World class capital markets are enablers of socio-economic development because they foster a meritocracy, good corporate governance, innovation and entrepreneurship which in turn create job opportunities that will harness the skills and entrepreneurial zeal of the many hard working people that Nigeria is blessed with. World class capital markets fund business expansions and new opportunities and provide governments long term funds for financing infrastructure and other important projects that transform economies. World class capital markets facilitate the diversification of an economy, enable economic agents to pool, price and exchange risks, encourage savings and create wealth.

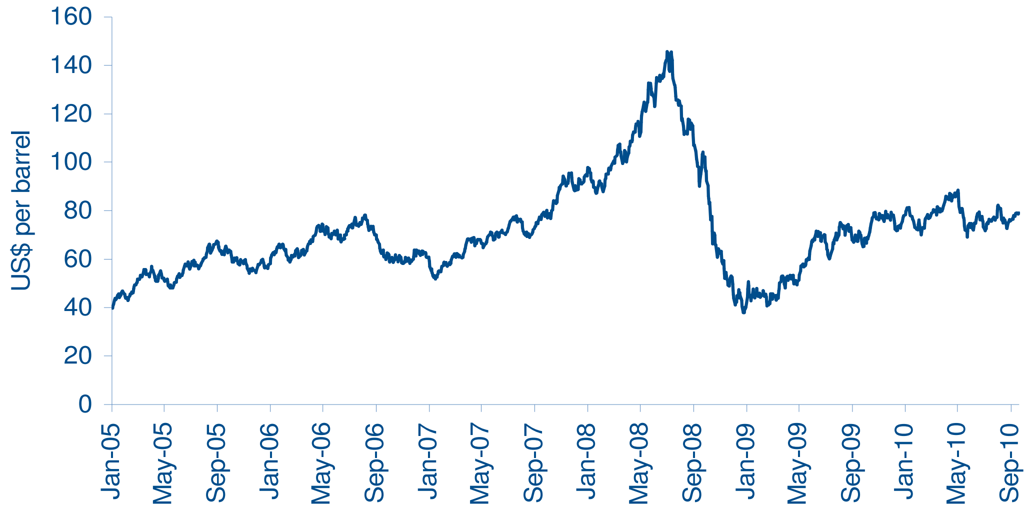
As the apex regulator of the Nigerian capital markets whose mandate is to regulate and develop these markets, the goal of our reform agenda at the NSEC is therefore to build a world class market that will enable Nigeria diversify its economy, finance its huge infrastructure needs and enhance its business climate and environment. A world class market is one that engenders investor confidence, has breadth and depth in terms of product offerings, is characterized by market integrity, has a sound regulatory framework, a strong and transparent disclosure and accountability regime, fosters good corporate governance and is a fair robust and efficient market place. While the global financial crisis has been devastating, we believe that it has created an opportunity for us to build a world class capital market given the lessons that we have learnt. This testimony will outline the impact of the global financial crisis on Nigeria and key elements of the reform agenda that we have embarked upon to build a world class capital market. It will also present the nature of the partnership that we have developed and the support we have received from multilateral organizations and the United States Securities and Exchange Commission.

Impact of the Global Financial Crisis on the Nigerian Economy

The impact of the global financial crisis on the Nigerian economy was multifaceted as it led to a dwindling of government revenues, affected the Nigerian currency, weakened the banking sector and fueled an unprecedented stock market crash, undermining confidence in the financial sector. The effects of the crisis were however mitigated by the dividends of sound macroeconomic management, particularly since 2003, recent rise in oil prices, and decisive measures that have bolstered oil production and fostered confidence in the financial sector.

The global financial crisis resulted in a deceleration in gross domestic product (GDP), worldwide, as consumer spending, consumer demand and industrial output declined, while unemployment rose. Commodity prices fell sharply including oil which fell from a peak of USD 147 per barrel in July 2008 to USD 33 per barrel by December 2008. Given that the Nigerian economy is heavily dependent on the oil sector, a key channel for the impact of the crisis on Nigeria was the decline oil prices which led to a dramatic decline in government revenues as oil makes up 80% of budgeted revenues, 90% of exports and 33% of GDP.

Price of Brent Crude Oil (Per Barrel)



Source: Central Bank of Nigeria

There was also a decline in oil production due to the activities of the militants in the Niger Delta, the oil producing region and ahead of the amnesty/peace agreement reached in 2009. This created enormous fiscal pressures on Nigeria turning the fiscal balance from a surplus of 5% in 2008 to a deficit of 8% in 2009. Since the aggregate credit to oil and gas was about 10% of total banking sector credit exposure, the decline in oil prices also affected the quality of bank assets as a number of oil importers had entered into long term contracts at previously high prices. Nigeria's currency, the Naira (N) depreciated from 118.50 Naira/dollar in 2008 to 150 Naira/dollar, the level it has maintained since 2009.

<u>Mitigating Factors</u>

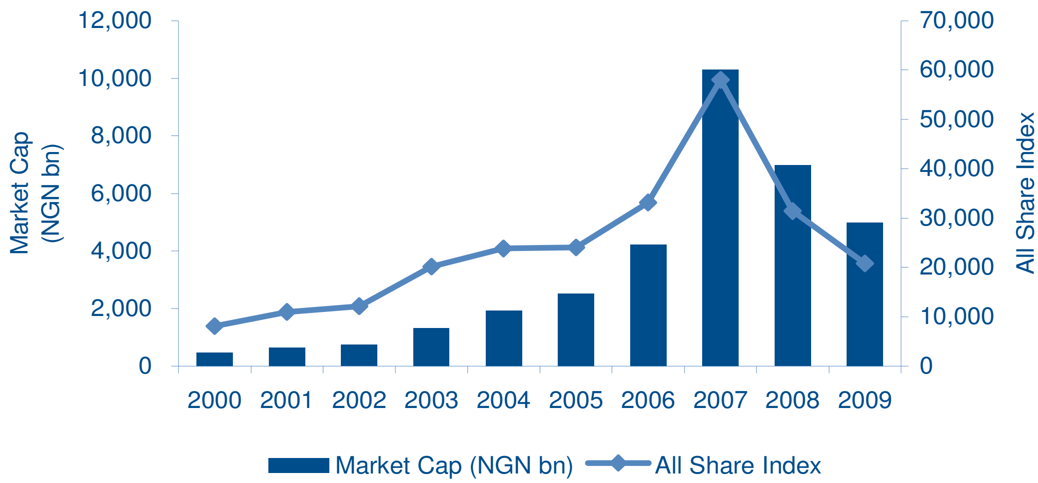
Nigeria's strong macroeconomic framework resulting from efforts of successive governments helped Nigeria to reduce the devastating effects of the global financial crisis on the Nigerian economy. Notably, in 2003, a set of broad macroeconomic and policy reforms were adopted as part of a strategic package to make Nigeria competitive. A major component of the 2003 reform program was the adoption of stringent fiscal principles including the oil based rule. Under this scheme, oil revenues above a benchmark price were set aside in an excess crude account. In addition to the above there was the standard package of policies used by nations seeking support from the multilateral agencies under the Washington consensus. Also Nigeria obtained favorable terms for debt write-offs from the Paris Club of Lenders. In all Nigeria's external debt which was $36bn was partly written off or paid down. The effect of this was a reduction in total external debt to almost nil. Its public debt to GDP ratio reduced to 5.2%. It subsequently obtained a sovereign credit rating and kept inflation under control whilst ensuring positive real rates of return. The government also passed the Nigerian Pension Reform Act of 2004. In line with that Act, the National Pension Commission (PENCOM) granted licenses to eligible pension fund administrators and custodians to begin the receipt, investment, management and administration of defined contribution pension schemes in Nigeria. This has led to an accumulation and professional management of more than USD 12 billion in pension assets which are invested conservatively in the Nigerian capital markets.

The Impact of the Global Financial Crisis on the Nigerian Capital Markets

The Nigerian capital market was established almost fifty years ago to complement the banking system in providing vehicles for mobilizing formal savings and financing government initiatives and private enterprise. While the Nigerian Securities and Exchange Commission was established in its current form, thirty years ago, its predecessor, the Capital Issues Committee was established in 1962 to regulate public issues of securities. To provide stronger institutional support, the Capital Issues Commission was created in 1973 to take over the activities of the Committee. Following a financial system review, the government decided to establish the NSEC as the apex regulator of the capital markets by an Act in 1979. The Nigerian Securities Exchange derives its mandate from the Investment and Securities of 2007 following reviews to strengthen the legal framework that governs the capital markets. Similarly, the Lagos Stock Exchange, the predecessor to the Nigerian Stock Exchange began actually trading in 1961. In 1999, the Investment and Securities Tribunal (IST), a dedicated fast track civil court for the resolution of disputes arising from investment and securities transactions in an accessible, transparent and cost effective was established. The IST awards and judgments are enforced as judgments of the Federal High Court and appeals go to the Court of Appeal. The Abuja Securities and Commodities Exchange commenced trading as a commodity exchange in 2001.

The Nigerian capital market has evolved with the growth of the Nigerian economy. It has been predominantly equities driven with the banking sector making up an important proportion of total market capitalization. At its peak in March 2008, the equity market capitalization was USD 100 billion with the banking sector making up more than 60% of total equity market capitalization. Following the global financial crisis, market capitalization plummeted to USD 40 billion and has since recovered to about USD 60 billion.

NSE Market Capitalization and All Share Index



Source**:** Nigerian Stock Exchange

Prior to the correction in 2008, the market enjoyed a decade of unprecedented growth driven principally by the banking sector reform. In 2004, the CBN increased the minimum capital requirements for commercial banks by 1150%, from N2bn to N25bn. This recapitalization increased the capital base of banks from N400 billion to approximately N1.12 trillion, and reduced the number of banks from 89 to 25 by the end of 2005. This was achieved through a wave of capital raising exercises, mergers and acquisitions and listing of companies on the NSE. Banking sector consolidation attracted over USD1.5 billion in foreign investments. By the end of 2007, the capital of many banks were in excess of USD1 billion. While in 2004, there was no Nigerian bank amongst the top 1000 banks in the world, by the end of 2006, there were 12 banks in the top 1000. That period also saw a significant increase in the number of brokers, asset managers, issuing house that were established. Consolidation efforts and the ensuing capitalization opened up the Nigerian financial landscape to the international space.

The banking system which accounted for 36% of total market capitalization in 2002 had risen to over 60% of the market capitalization by 2007. This reform created capacity for Nigerian banks and prepared them to become relevant players in the global market. he blind pursuit of size between 2005 and 2008 saw industry total assets grow by a compound average growth rate of 44% while industry capital grew by a compound average growth rate of 78% from There was an aggressive expansion in delivery channels between 2005 and 2008. The number of offshore subsidiaries doubled, the number of physical branches rose from 3,357 to 4,824, installed Automatic Teller Machines (ATM) grew 500 to over 7,800, and payment cards rose from 1.5 million to 29.3 million. Offshore credit lines to Nigerian banks are estimated to have risen from USD 3 billion to USD 11 billion. There was an unprecedented level of optimism fueled rising oil prices, speculation and access to easy money and credit. Specifically, the additional capital raised by the banking sector went to speculative lending to the oil and gas sector, and unregulated margin finance to brokers, and individual investors fueling an asset bubble. There was also a regulation-driven insurance sector consolidation and some domestic entrepreneurs opened up their companies to public ownership. Between 2005 and 2007, new equity issues tripled in value. While all this buoyed investor confidence, emphasis on risk management and corporate governance did not evolve commensurately to support the fast growth. In hindsight, regulators were neither sufficiently prepared nor well-positioned to monitor and sustain the explosive growth in the capital markets.

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When therefore the global financial crisis triggered large portfolio outflows as international investors exited the Nigerian capital markets to address challenges in their home countries, stock prices started to decline, prompting margin calls and local investors who were unaccustomed to huge and persistent declines started to panicked, fueling more sell orders, further depressing prices and eroding investor confidence. The situation was exacerbated by the huge borrowing and margin finance exposure of individual investors, brokers and banks. While the market recovery to date has been limited because different categories have taken advantage of any recovery to reduce their exposure, the recent establishment of the Asset Management Corporation promoted by the Ministry of Finance and the Central Bank of Nigeria is expected to bring make the sustain the recovery since AMCON will take over about USD 12 billion in non-performing assets and manage them through an orderly disposal of the assets.

Nigerian Securities and Exchange Commission Reform Agenda

The impact of the global financial crisis while devastating for the Nigerian capital markets, has given the Commission an opportunity to reposition the Nigerian Capital Market to play a pivotal role in capital formation and the development of the Nigerian economy. Our aim is to build a world class market which will effectively compete for long term capital internationally, attract and retain domestic capital and be the principal source of medium to long term capital to our industries, both large and small.

As a first step towards reforming the market, the Commission constituted a Committee of experts to undertake a diagnostic review of the Nigerian Capital Market. The recommendations made by this Committee on the vital building blocks of a world class market have been taken into account in the Commission's reform agenda. Some of the areas of focus for the Commission's reform program are outlined below.

Strengthened Enforcement and enhanced regulatory oversight

We believe that we cannot have a strong market or command investor confidence and public trust if our enforcement machineries are weak. Our greatest strength is in our ability to take enforcement actions without fear or favor and without regard for whose ox is goad. The Commission therefore has zero tolerance on market infractions and indeed any act which could undermine the integrity of the market. Recently, the Commission took various enforcement actions against operators and issuers with respect to inadequate filing of periodic returns and other market infractions.

Following the audits of banks in 2009, led by the Central Bank, the Commission launched investigations into possible cases of market abuse that were associated with the capital raising exercises of banks. This has resulted in the Commission instituting legal proceedings against some 260 individuals and entities at the Investments and Securities Tribunal (IST). The Commission is alleging that these individuals and entities were involved in market abuse including insider dealing and share price manipulation. The Commission is seeking the disgorgement of any illegally gained profits and restitution to investors. With the various enforcement actions and stance of the Commission on inappropriate behavior, we have observed improved compliance with the securities law and our rules. We do realize that the cooperation of the law enforcement agencies is very vital to the overall success of our enforcement actions. We have therefore strengthened our relationship with these agencies to the point that, the Commission now has a resident Nigerian Police desk to deal with matters which involves criminal violations of the securities laws. In addition, the Attorney General and Minister for Justice recently seconded some prosecutors to the Commission. These developments will no doubt aid in the swift dispensation of cases before the Commission.

We are also overhauling the complaint management system in the market for better efficiency and alignment with international best practice. It is hoped that the new system will become effective by the beginning of 2011 and strengthen investor confidence as complaints are more speedily resolved. Currently, the bulk of complaints are handled by the Commission which puts a lot of strain on its resources. As part of the reform of the market, the self regulatory organizations (SRO) are expected to assume a frontline role in the resolution of investor complaints in the market. Our inspection and monitoring activities are being intensified, including undertaking more frequent onsite inspections.

In line with the principles of 40 + 9 recommendations of the Financial Action Task Force (FATF) and money laundering Prohibition Act of 2004, the Commission drew up framework and guidelines which capital market operators are required to adopt to minimize or indeed eliminate anti-money laundering risks in the securities market.

Recent changes to the Commission's rules and regulations

Mr. Chairman and Honorable members will agree with me that market rules are meant to shape behavior, set standards and create a level playing field for participants. They are also meant to promote orderly trading, transparency and market efficiency. Our assessment of the crisis revealed that the absence or inadequate rules in some respect contributed to the scale of the crisis in Nigeria. A good example is the heavy margin trading exposures of banks and brokerage firms which was fueled by the absence of adequate margin trading regulation. New rules have been introduced, while some existing rules were amended and others completely expunged to ensure alignment with international best practice. Some of the new rules were introduced to encourage the emergence of new products, strengthen the protection of customer assets in the market and improve financial reporting and governance of public companies. Some of the rules have emerged from the collaborative efforts of financial sector regulators. An example is the margin trading rules which were developed and have been jointly issued to banks and market operators by the Central Bank and the Commission.

Reforming the Nigerian Stock Exchange

You will agree with me that a Stock Exchange is a visible symbol of the capital market and must not only exhibit but be perceived by the public to exhibit the highest level of good governance, transparency, fairness and accountability. Investors obviously will not want to participate in a market which lacks these attributes and nor would issuers. The Commission, in early August 2010 intervened in the Nigerian Stock Exchange, replacing the leadership with an interim administration. This was necessitated by certain developments in the Exchange which was significantly eroding investor confidence and undermining the integrity of the market. The Interim Administration whose principal mandate is to conclude a credible and transparent selection process for the Chief Executive and Executive Directors of the Exchange has with the approval of the council of the exchange undertaken some measures to reposition the exchange and bolster confidence. It is hoped that by the beginning of 2011, the new executives would have assumed duties. We are pleased that with the exit of the previous management progress is being made with the process. Steps are also being taken to replace the trading platform with a more efficient and robust system that will ensure that the Exchange is in good stead to respond to future growth in the Nigerian capital markets. The Commission believes that the Nigerian Stock Exchange should be ultimately demutualised and is examining the best model for Nigeria with the various initiative to reform the exchange a more focused, transparent and efficient exchange would emerge.

Developing the Nigerian Fixed Income Market

Given the importance of the fixed income market to both infrastructural and industrial development, and also as a key asset class for institutional investors such as pension funds and insurance companies, the Commission is working assiduously with various stakeholders to develop a strong and virile bond market. To this end, the Commission is enhancing the framework for bond issuance and has introduced rules on book building and shelf registration and simplified disclosure rules for fixed income which are sold to institutional investors and high net worth individuals. These rules have shortened the average issuance time line in the market and improved the price discovery process for securities. These and other measures have increased appetite for bonds and will complement the first class sovereign bond market that the Federal Government has nurtured over the last seven years. We expect more fixed income activities in view of a recent revision of the tax regime to eliminate tax discrimination which previously existed between sovereign bonds on the one hand, and corporate and sub-national bonds on the other hand.

Promoting Collective Investment Schemes

The experience of the recent past clearly revealed that most retail investors do not have the capacity for direct investing in the capital market. The Commission is therefore encouraging a more institutional market with retail participation principally through Collective Investment Scheme (CIS). Currently, there are over 40 CIS schemes many of which are specialized to cater for the various appetites of investors. Existing funds include bonds, equity, balanced, guaranteed, money market, Islamic and Real Estate Investment Trusts (REITs). There are presently applications before the Commission for the establishment of Exchange Traded Funds (ETFs). In view of increased interest in mutual funds, the Commission has intensified it examination and monitoring of fund managers and trustees of such schemes and recently encouraged the establishment of an industry trade group for mutual fund managers.

Disclosure Issues

Any meaningful reform of the capital market and indeed the financial market must of necessity include the reform of the governance of entities and players in the market. Such governance reform must not only be beamed at public companies but should also focus on regulated entities. For the Commission, the capital market reform agenda includes a review of our 2003 Corporate Governance Code in order to address weaknesses in current practices and strengthen governance and disclosure by public companies. The draft of the new Corporate Governance Codes which is comparable to internationally acclaimed codes has already been exposed to the public and will soon be released in the near future. The Central Bank and the Commission has also been sponsoring sensitization and awareness programs for company directors.

The importance of transparency and disclosure cannot be over-emphasized in enthroning good corporate governance. The public want to believe the numbers they see and information they are given by companies. As is well known, financial information is a key barometer of the state of health of a business entity and should be timely, accurate and reliable to be meaningful to others. Information that is outdated would not serve investors much purpose in taking timely investment decisions. The Commission has therefore continued to strengthen its disclosure rules and to penalize issuers who violate the rules. Additionally, the auditor of a public company is now expected to issue a statement in his audit report to the company of the existence, adequacy and effectiveness or otherwise of the internal control system. This is borne out of the fact that a strong internal control system is important in promoting good governance of entities.

The adoption of International Financial Reporting Standards (IFRS) by listed companies and regulated entities should improve the quality of financial reporting in the country. Through the efforts of the Commission and other stakeholders, the Federal Government has approved that Nigeria should adopt IFRS, and publicly listed companies and significant interest entities such as banks are required to comply by January 2012.

Greater emphasis Capacity Building and Investor Education

In addition to enhancing the rigor with which it evaluates capital market operators, the Commission is reviewing ways to enhance the programs offered by its training institute, the Nigerian Capital Markets Institute to ensure that the capacity of the industry continues to evolve in line with the growth in the size and complexity of the capital market product offerings. It is supporting trade groups and associations and encouraging them to develop and enhance their continuing education programs, and develop accreditation schemes

A well informed investing public will be better placed to protect itself, forming the first layer in investor protection. For instance, an investor who understands his right is most likely to assert his right and seek redress when such rights are violated. Similarly, an investor who understands the workings of the market is less likely to be taken advantage of by unscrupulous market participants than one who has a low knowledge of the market. When investors are knowledgeable about the workings of the capital markets, they are also better able to assess the risks and rewards of investment opportunities and participate in the market.

In this respect, the Commission has developed various investor education initiatives including providing educational materials for various investor types, sponsoring seminars, town hall meetings, quiz competitions, and capital market studies in universities. It also has capacity building programs for financial journalists and judges.

<u>Support from American Regulators and Multilateral Organizations</u>

Given the breadth and depth of the relationship between Nigeria and the United States, we appreciate very much the partnership that we have developed with the US SEC. The recommendations made by the US SEC carried in their peer review of our capital markets are very useful for us in our bid to build a world class market. We have participated actively in their training programs both in Washington DC and in Africa and expect to jointly host a regional program next year. Also important is the sharing of information and partnership that we have developing in the fight against financial crime.

The Commission has been a member of the International Organization of Securities Commissions (IOSCO) for several years. In June this year, I was elected the Chairperson of the African Middle-East Regional Committee (AMERC) of IOSCO. We feel that membership of IOSCO is extremely important in the global fight against financial crime and are pleased to be one of the ten AMERC members that are 'A' signatories to the IOSCO memorandum of understanding. Membership of IOSCO enables us to share knowledge and benchmark our capital markets with other markets.

Nigeria continues to participate actively in multilateral organizations and continues to benefit from their programs. The USD 500 million Financial Sector and Public Management Development Policy Credit Nigeria received from the International Development Association (IDA) helped provide fiscal space at a time when government revenues were under pressure due to effects of the global financial crisis and attendant dramatic decline in oil prices. We have also found useful, the support the World Bank Group on the Financial System Strategy 2020 as well as through technical assistance programs such as the the provision of an experienced resident expert to assist the Commission with developing the fixed income market in Nigeria.

<u>Conclusion</u>

I hope my submission has contributed to an understanding of the impact of the global financial crisis on the Nigerian capital markets. As I have indicated, while the impact of the financial crisis has been devastating, the silver lining is the opportunity that it gives us to build a world class capital market as this is critical to Nigeria's economic and social progress.

Once again, I wish to sincerely thank this honorable body for the opportunity to give this testimonial and look forward to your continued support.