Granting Liquid Asset Status to State Government Issued Sukuk

November 2016

Granting Liquid Asset Status to State Government Issued Sukuk

The Central Bank of Nigeria (**CBN**), in an effort to deepen the Nigerian financial market, enhance the diversification of revenue sources for development at sub-national levels and promote investment and capital market activities on 6 October, 2016 issued the *Guidelines for Granting Liquid Asset Status to Sukuk Instruments Issued by State Governments* (the **Guidelines**).

Sukuk is a certificate of equal value representing undivided shares in the ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects or special investment activity. A number State governments in Nigeria have adopted the issuance of Sukuk as an alternative means of financing public expenditure, however, the illiquid nature of the instrument has not encouraged a wide-spread embrace of this alternative source of revenue for the state. The Guidelines is aimed at providing for the eligibility of Sukuk instruments issued by state governments for the grant of liquid asset status. It further details the benefits of the liquid assets status granted to qualifying Sukuk instruments held by a Nigerian bank.

Key Provisions

Eligibility Criteria

In order for a State Government issued Sukuk to be granted liquid asset status, the following requirements must be met: (i) the Sukuk issuance must be backed by a law enacted by the relevant State House of Assembly, specifying the establishment of a sinking fund which must be fully funded from the consolidated revenue fund account of the State; (ii) the State must have a fiscal responsibility law, with provisions for public debt management and establish a debt management department in order to ensure transparency and professional management of debt issues; (iii) the credit rating of the Sukuk at inception and throughout its tenor must be of investment grade as determined by a credit rating agency duly accredited by the Securities and Exchange Commission (**SEC**); (iv) the repayment structure of the Sukuk issuance must be from a funded sinking fund account, supported by a legislated irrevocable standing payment order (**ISPO**) and other legislated sources of repayments disclosed in the offer documents; (v) an irrevocable letter of authority must be issued by the Attorney General of the State, which must be approved by the Federal Minister of Finance, to deduct at source from the statutory allocation due to the State in the event of default; and (vi) the tenor of the Sukuk must not be more than ten (10) years.

A review of extant laws applicable to Sukuk instruments reveals that the Guidelines have mainly unified the requirements for Sukuk issuances under other relevant laws such as the Rules and Regulations of the Securities and Exchange Commission (**SEC Rules**), the Investment and Securities Act, the Debt Management Office's (**DMO**) External and Domestic Borrowing Guidelines for Federal and State Governments and their Agencies, and the Nigerian Stock Exchange's (**NSE**) Rules Governing the Listing of Sukuk and Similar Debt Securities into the Guidelines. This approach in our view lends credence to the purpose of the Guidelines which is to confer liquid status on Sukuks without making the terms on issuance more onerous.

Investment Limits in State Government Sukuk

In addition to its provisions on eligibility for liquid status for Sukuks issue by State Governments, the Guidelines go on to prescribe investment limits for banks investing in State Government Sukuks. The maximum investment a Nigerian bank can make in a State Government Sukuk is now limited to 10% (ten per cent) of the total amount outstanding of that State Government Sukuk per issue. It is however unclear whether in a situation where the Sukuk is issued in tranches, the limit will apply to each tranch or to the entire programme.

The Guidelines also stipulate that the aggregate portfolio of a Nigerian bank in Sukuk issued by a State Government and their agencies must not exceed 30% (thirty per cent) of the bank's total portfolio in debt securities. In calculating this, debt securities is defined to include, Nigerian Treasury Bills, FGN Bonds, FGN-guaranteed notes, Sovereign debt notes, and any other Nigerian sovereign debt securities, CBN bills, bond collaterised with FGN bonds, state government bonds, state government agency bonds, corporate bonds and dated preference shares. It would appear by this definition that the CBN seeks to create more wriggle room for banks to invest in liquid status Sukuks. This is further buttressed by the provision of the Guidelines which excludes the underwritten positions of state government Sukuks from the calculation of investments in Sukuks but rather imposes an obligation on underwriter to render monthly returns to the Director, Banking Supervision Department of the CBN on the sell-off strategy and the underwritten positions of the Sukuks.

It is however important to note that the Guideline provides that liquid asset status Sukuks will not to be included in the computation of the 10% (ten per cent) ceiling on lending to all tiers of government prescribed by the CBN.

The Benefits a Liquid Asset Status

According to the Guidelines, in calculating the Capital Adequacy Ratio of banks, State Government Sukus with liquid asset status shall be assigned a risk weight of 20% (twenty per cent) or as may be prescribed by the CBN from time to time, and these Sukuks will also qualify as a liquid asset for the purpose of computing banks' liquidity ratio in contrast with non-liquid asset status State Government issued Sukuk which will be assigned a risk weight of 50% (fifty per cent). In addition, Sukuks with liquid asset status will be eligible for repurchase transactions at the CBN. The CBN will however apply a haircut, (which shall be prescribed by the CBN from time to time) to the collateral provided by counterparties towards the repurchase transaction.

Conclusion

In view of the current economic downturn, the grant of liquid asset status to State Government Sukuk is another attempt by the CBN to improve economic growth and development and specifically enhance funding sources by State Governments for economic development. The Guidelines provides an important incentive to Nigerian banks to invest in qualifying State Government Sukuks which may in turn increase the issuance of Sukuk instruments as an alternative source of funding for economic development by State Governments.

For an in-depth discussion on this important topic, please get in touch with your usual Olaniwun Ajayi contact, or any of the lawyers listed below:

YEWANDE SENBORE
Partner, Lagos office, Nigeria
T: +234 1 2702551 EXT 2715
YSenbore@olaniwunajayi.net

OLUWATOMI OLULEYE
Associate, Lagos office, Nigeria
T: +234 1 2702551 EXT 2708
OOluleye@olaniwunajayi.net

FEYISAYO OGUNDIPE
Associate, Lagos office, Nigeria
T: +234 1 2702551 EXT 2616
FOgundipe@olaniwunajayi.net