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Consumer lending and risk diversification: The potential market for credit securitisation and credit derivatives in Nigeria

Nigeria is inadvertently developing a tradeable underlying asset in credit obligations. The Central Bank of Nigeria (CBN)'s drive to push bank loans to the real sector, along with different investment initiatives by state governments and other alternative financiers to advance debt to individuals and businesses in Nigeria, has expanded the portfolio of private debt and has made debt and credit of growing significance to the Nigerian economy. These increased lending requirements and activities will result in an increase in banks' credit exposure to different sectors of the Nigerian economy, from payday loans to small-scale retail and the micro, small and medium enterprise services industry.

It will therefore be necessary for Nigerian banks to consider ways to diversify their loan portfolios and manage their risk exposure. To this end, Nigerian banks may consider two available but not readily used structured finance products for mitigating credit risk exposure – credit securitisation and credit derivatives. The credit obligations derived from bank loans are useful assets for developing a credit securitisation and derivatives trading market in Nigeria. This article will consider this potential market, as well as the opportunities and challenges they present.

Structured finance techniques: credit securitisation and credit derivatives

Nigerian banks may consider securitising the assets within their loan portfolios and managing their risk exposure using cash flow or synthetic structures.

Cash flow securitisation structure

A cash flow credit securitisation structure will involve the pooling of homogenous loan assets which have common payment patterns. These assets are thereafter transferred to a special purpose vehicle (SPV) which issues securities in public offerings or private placements, to investors. The payment obligations under the securities are directly funded by receivables

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from the portfolio of securitised assets. The legal structure for this arrangement is similar to other debt capital market issuances in Nigeria. The SPV will act as issuer of the securities and the bank will act as originator of the pooled loan assets to be securitised. The bank will also act as a service agent to manage the cashflows received under the portfolio. Placing agents will be appointed to structure the transaction and place the securities. A trustee will be appointed to represent the interests of potential investors and oversee the disbursement of payments to investors. Rating agencies will assign ratings to each loan comprising the securitised assets as well as the securitised asset as a whole and will monitor these ratings throughout the life cycle of the security issuance.

The securities issuance may be secured by the receivables from the portfolio. Perfection requirements such as stamping and registration will also apply to the issuance as with other debt capital market issuances in Nigeria.[1] The warehousing stage of the transaction where the loan assets are acquired by the SPV will follow the general legal structure of an acquisition financing, involving a sale and purchase agreement to acquire the loan assets, which will usually be funded with a facility extended to the SPV by the originator or the placing agent.

Synthetic securitisation structures

Synthetic credit securitisation structures make use of derivative products such as swaps[2] and options[3] to give investors, through the SPV, some risk exposure to the securitised loan asset portfolio. For example, where a synthetic structure adopts a credit default swap arrangement, the SPV, acting as a protection seller/risk buyer, issues securities to investors and the proceeds from the issue are used to meet the SPV's obligations under the swap arrangement. Under a credit default swap agreement, the SPV receives premium payments from the protection buyer/risk seller (usually an arranger for the portfolio) and uses those payments to settle its payment obligations to investors. In the occurrence of a credit event, the SPV is obligated to pay for any losses to the protection buyer, to the extent agreed under the agreement. Synthetic structures operate as insurance mechanisms against systemic and unsystematic risk of default inherent in each loan asset and the whole portfolio.

Toward the end of 2019, the Securities and Exchange Commission (SEC) issued rules on derivatives trading governing exchange traded and over the counter (OTC) derivative products. While detailed rules are provided for exchange traded derivatives, credit default swaps or other options to purchase credit risk exposure under synthetic structures are more likely OTC derivative transactions. The rules provide that where these derivative products under the synthetic structures are standardised, they must be traded on an exchange. Both the SPV and the arranger, as parties to the derivative contract, are required to report the transaction to a trade repository or an exchange.[4] If the derivatives are standardised and subsequently traded on an exchange, there are SEC and exchange registration requirements[5] along with the standard disclosure and reporting requirements. In order to protect the securities' investors need for up to date information on the portfolio assets, the Trust Deed under the securities' issuance may stipulate that the information received from the derivatives' disclosures be made available to the trustee on behalf of the investors.

Opportunities and challenges

Encouraging credit securitisation and credit derivatives as a risk mitigation strategy for banks and other alternative financiers ensures liquidity in the consumer lending market and reduces lending costs. They encourage banks and other lenders to extend credit facilities as their risk exposure is limited and distributed, and they open the consumer lending market to non-conventional investors. Secondary trading markets for these securities already exist in Nigeria, including the FMDQ and NASD markets.

Some practical and regulatory concerns exist in implementing a market for securitised credit in Nigeria, including concerns on rating, reporting and other disclosure requirements. While these requirements exist for the usual debt capital market issuances under Nigerian law, regulation may be required to address issues peculiar to securitised credit issuances. For example, it is necessary that regulators issue reporting, disclosure and risk assessment requirements for originator/banks that are specific to securitised credit transactions to ensure that banks are dissuaded from packaging riskier loans to move them off their balance sheets. These rules are also important to ensure that banks issue investors and relevant trading exchanges regular reports on the loan assets and the obligors under them showing that the payment obligations continue to be viable throughout the life cycle of the issuance.

Investors will also need to be encouraged to invest and may require credit enhancement mechanisms to manage their own risk exposures. This enhancement may take the form of guarantees or other insurances from the originator/ bank which would serve the dual purpose of managing investor risk and ensuring that banks act in good faith when selecting assets to be securitised. Furthermore, given that these loan assets are a result of increased lending activities mandated by the CBN, some form of CBN guarantee will be helpful to spur investor action in the market.

Banks may also need to institute strict due diligence and information disclosure exercises when extending credit to borrowers to ensure that potential investors are fully informed on the portfolio and that assets within the portfolio remain viable. However, information disclosure requirements for the securities issuance may necessitate privacy concerns from the borrowers whose loans comprise the portfolio. The Nigerian Data Protection Regulation requires that data controllers, in this case the bank, inform and receive consent from data subjects/ borrowers when their information is being transferred to third parties.[6] Regulation from the SEC and the CBN may be necessary to balance the considerations of individual borrowers who are doing business with a single bank and providing proprietary information under those transactions and the important disclosure requirements under a securitisation of those loans.

Conclusion

It is important for regulators interested in deepening access to credit, to consider and encourage the importance of risk mitigation techniques such as securitisation and derivatives in the Nigerian lending market. Nigerian finance lawyers should consider optimal legal structures for these transactions that attend to all the considerations of the parties under the arrangement.

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Endnotes

1. Sections 22 and 90 of the Nigerian Stamp Duties Act and the Companies and Allied Matters Act respectively require the stamping and registration of certain loan and security documents.
2. Under a swap, parties agree to exchange future cash flow obligations.
3. An option contract is an agreement under which parties agree to buy or sell an asset at a future date, however, the option holder has an opportunity, not an obligation to buy or sell the asset in question.
4. Rule 15 of the SEC Rules on the Regulation of Derivatives Trading.
5. Rules 3 and 4 of the SEC Rules on the Regulation of Derivatives Trading.
6. See section 2.3 of the Nigerian Data Protection Regulation 2018.

Sustainable rating agencies and the competition conundrum

A recent *Financial Times* (*FT*) article[1] entitled "Heavy flows into ESG funds raise questions over ratings" attempts to shine a light on the business of environmental, social and governance (ESG) rating agencies, or sustainable rating agencies, as the process of incorporated ESG considerations into investment decisions is becoming more mainstream. However, upon reflection, the sentiment of the article is a little understated so, in this analysis, the sentiment presented by the *FT* will be more closely analysed, with a particular objective being to ascertain what it may mean for the trajectory of the relatively modern industry. Its trajectory is both dominated by the development of "sustainable finance" as a concept, but also the machinations of its much larger brethren, the credit rating industry. What will be of particular concern will be how the structure of the sustainable rating industry *interacts* with the needs of the marketplace, which is a very important issue with the credit rating industry and its "consumers".

The importance of ratings

The *FT* article begins by making valid points regarding the increasing importance of such ratings, with the discussion focusing on the fact that a growing number of investment indices are now focusing on the ratings much more as well as banks now offering better borrowing terms for entities that can demonstrate stronger ESG scores. This trend was analysed in *The Role of Credit Rating Agencies in Responsible Finance*,[2] as well as in an article entitled "Sustainable Finance Ratings as the Latest Symptom of 'Rating Addiction'"[3] and it is indeed true that a number of elements are fuelling this mainstreaming of the ESG considerations, rather than traditional models such as thematic or ethical investing: a reaction to the crisis-era version of investing; entities such as the Principles for Responsible Investment (PRI); and the entrance into the field of the large credit rating agencies, which has essentially formalised and certified the niche investment models for the mainstream investors (as there is less focus on purely ethical or thematic investment principles and more on the returns-based aspects). However, the article quickly shifts towards research conducted by MIT Sloan School of Management, which suggests that there is a large divergence between the ratings of the sustainable rating agencies, especially when compared to the credit rating agencies – which themselves are ostensibly incorporating ESG into their rating decisions much more – with the example of Facebook being docked points and concerns raised from Standard & Poor's, whilst MSCI maintains average ratings.[4]

Yet, Berg, Kölbel, and Rigobon attempt to "quantitatively disentangle" the divergence witnessed between the ratings of the top five sustainable rating agencies, which they find can be substantial. Their analysis leads them to conclude that the divergences witnessed in the field are because of an inherent issue – ESG ratings are very subjective, and the differences in underlying methodologies between the agencies is at the core of the divergence. The sentiment is that the methodologies are so radically different between the sustainable rating agencies, as opposed to the credit rating agencies, for example (whose ratings on entities are often much closer), that it is difficult for investors to know which is useful and which is not. The *FT* article then looks at issues that underpin this divergence, including potential