AFRINVEST

THE NIGERIAN BANKING SECTOR REPORT

AN ECONOMIC AGENDA FOR A NEW GOVERNMENT

OCTOBER 2018

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SECTION 1

EXECUTIVE SUMMARY

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Global Economy and Banking Landscape

The positive performance of the global economy in 2017 further consolidated the resurgence in growth, as the appreciation in commodity prices as well as favourable financial market conditions bolstered a broad-based improvement across regions. In Advanced Economies (AEs), especially in the US and Euro area, growth strengthened. In the US, performance was supported by pro-growth expansionary fiscal policy which drove the unemployment level to a record low, while in the Euro Area growth was bolstered by favourable macroeconomic conditions despite the threat posed by Brexit uncertainties. For Emerging Markets & Developing Economies (EMs & DEs), the sustained rally in commodity prices buoyed growth, while currency pressures in some countries, which hitherto weighed on economic performance, abated. Consequently, global growth in 2017 was estimated at 3.7%, an uptick from 3.2% in 2016.

In 2018, new headwinds have appeared, with potential to disrupt the ongoing momentum in global growth. The most noteworthy is intensifying geo-political tensions and raging protectionist sentiments. The trade war between the US and China – the two largest economies in terms of output and trade – have reached unprecedented levels, as both countries have increased tariffs on traded goods, while the US has strengthened intellectual property protection. The uncertainty surrounding these actions have spooked investors and resulted in financial market volatility, reflecting growth concerns in the two economies. Also, in advanced economies, systemically important central banks – the US Fed and the Bank of England (BOE) – have increased policy rates. This has resulted in foreign capital reversals from emerging market and frontier markets, with outsized impacts on external balances which have caused significant currency depreciations. Emerging markets have been disproportionately affected by policy normalisation, more so due to country-specific factors such as high political risk in South Africa and Brazil, and in Turkey, where tensions with the US have had far-reaching repercussions for the country's exchange rate, debt sustainability, investment and growth. These factors combine to present considerable concerns for growth given that emerging markets and developing economies are the key drivers.

Despite these risks, the outlook for 2018 remains largely positive with the uptrend expected to be sustained as the IMF projects world output to expand 3.9%. Despite these risks, the cyclical impact of the expansionary fiscal stimulus by the US is expected to be positive both domestically and internationally, which should keep growth for the AEs upbeat. Furthermore, continued stability in global commodity prices is expected to support sustained improvements in growth. However, given the events that have unfolded since the start of 2018, the pace of growth is expected to differ across regions.

After the weak performance recorded in 2016, SSA economies have been on the uptrend, growing by 2.8% in 2017 while projections for 2018 and 2019 are 3.4% and 3.9% respectively. The growth is largely hinged on the expectation of sustained improvement from Nigeria, which according to the IMF, is expected to grow 2.1% (similar to our projection) in 2018 on the back of the sustained rally in oil prices. Similarly, growth in South Africa was projected to support improvement in the SSA region, however, the economy slid into a "technical recession" in Q2:2018; hence we envisage that growth for the SSA region may underperform expectations.

This report includes an in-depth analysis of the drags and drivers of global performance, with specific focus on relevant themes to the global banking sector, especially in areas such as financial regulation, where we covered the roll-back of the Dodd-Frank Act in the US, and the impact of financial technology (FinTech) on the global banking industry.

Domestic Macroeconomic Highlights

The Nigerian economy has faced challenges, both internal and external, which affected its growth path between 2015 and 2017; a stark contrast to the fortunes of the preceding decade. However, lately, positive signs have started to appear. The economy recovered from the 2016 economic recession in Q2:2017 and sustained this momentum in H2:2017, with growth reaching a modest 0.8% in FY:2017. This performance was mainly driven by the oil sector, prompted by a strong rebound in oil production – as the FG reached a deal to curtail unrest in the Niger-Delta region – while oil prices reached a 3-year high owing to the combined effect of output curbs by major oil producers and firming global oil demand, due to a faster expansion in global economies. Similarly, the agriculture sector, which had sustained a remarkable streak regardless of the recession, supported growth, even as cracks began to appear in its growth trajectory.

In 2018, the economy continued on the path of recovery, although growth has been weak and uneven. In addition, new sources of drags have started to cast doubts on a fast-paced recovery. This is compounded by the lack of urgency by fiscal authorities to adequately respond to a growth downturn. Thus, economic growth has decelerated from the strong finish of 2.1% in Q4:2017 to 1.9% and 1.5% in Q1:2018 and Q2:2018, respectively. In Q1:2018, a slowdown in agriculture, to its weakest quarterly result in five years, and continued underperformance in the broader non-oil economy, were drags. Meanwhile, a relapse in oil production due to maintenance outages in key export terminals caused a negative oil sector growth in Q2:2018. Although these factors paint a gloomy picture, a bright spot was the return to positive growth in services, after suffering seven contractions in the previous eight quarters. However, a notable concern is that the upturn was driven by a few sub-sectors (mainly ICT), as heavy-weights such as trade and real estate sectors stay searching for light.

Despite these issues, the external sector which strengthened on the back of double-digit growth in oil exports, renewed investors' interest, weak imports growth and sizeable remittance receipts, supported stability in the overall macroeconomic environment. Thus, external reserves remain at strong levels despite portfolio flow reversals, thus sustaining CBN's intervention in the foreign exchange markets to stabilise the multiple exchange rates. Stability in exchange rate, base effects and a deceleration in food inflation led to continued disinflation, which allowed for the gradual easing of rates in the debt capital market, although the MPR has stayed at 14.0% for more than two years.

The main threat to the stability enjoyed in the early part of 2018 have come in two dimensions. The first issue is rising political risk due to uncertainties created by the friction between the executive and legislature, and the idiosyncrasies of political parties. Secondly, increasing treasury yields in advanced economies such as US and UK have prompted portfolio reversals, and country-specific risk factors in emerging and frontier markets have intensified this due to contagion-effects.

Growth Outlook: Election Spending and Oil Sector Expansion as Drivers

We project growth to reach 2.1% Y-o-Y in FY:2018, revised downwards from our initial expectation of 2.6%, given the slower than expected recovery in the non-oil sector. To achieve this, we believe that increased spending ahead of the 2019 elections will support non-oil sector activities, while increased oil output due to an additional 0.2mb/d from the Egina Oil Field will drive oil sector growth. The key downside risks to our projection are poor agriculture harvests, a sharp moderation in oil prices and oil production outages.

Overall, our assessment of performance so far reveals that the economy continues to trail its long-term growth performance and levels seen prior to the recession. Indeed, more worrying is the fact that growth remains below population growth, which indicates that people have grown poorer on average – this trend will persist into 2020. In our opinion, breaking out of this cycle requires structural reforms, without which investments and growth will remain poor.

Price Level: Persistent Disinflation Driven by High Base Factor

Sustaining the deceleration which started in February 2017, when inflation reduced to 17.7% from a record high of 18.7% in January 2018, there have been eighteen successive months of moderation, settling at 11.8% in July 2018. These notable improvements have been driven by numerous factors, which have not come smoothly. The biggest driver of the fall in inflation in 2017 was initially the base effect, considering that

inflation averaged 15.6% in 2016. In 2018, the gains in disinflation have persisted through H1:2018, driven by continued stability in exchange rates, and base effects from food inflation. Hence, inflation decelerated by 423 basis points to 11.1% from 15.3%. Meanwhile, food inflation has moderated from its peak of 20.3% in November 2017 to 12.8%in July 2018, supported mainly by base effects, although this was slower than anticipated as food supply was pressured by insecurity.

Looking forward, the outlook for inflation is slightly negative in the near term. This is mainly due to continued food insecurity which will exert pressure on headline inflation. Also noteworthy is an expected increase in aggregate demand in H2:2018 due to election spending and capital budget releases, given the currently weak productive base of the economy. An upward revision in the minimum wage is another near-term downside risk factor to inflation, given extensive deliberations between the FG and labour unions that have reached closing stages.

Polity Stability: 2019 General Elections... Crowded by Uncertainty

Four years after the 2015 general elections, Nigeria proceeds to the polls again in 2019 to determine its leadership, for Sub-Nationals and the Presidency. In predictable fashion, the political environment is heating up, new alliances are emerging and defections across the biggest parties have punctuated the polity. In our assessment, the frenzy has auspiciously been underlined by events in the National Assembly, where many members have crossed to the major opposition party, with the most notable being the defection of the Senate president. This provides explanation for the rift between the executive and the legislature, with negative impacts on quick passage of the appropriation bill, and lately, the inability of the executive to get the legislature to approve the supplementary budget which ironically could affect election preparations.

These events are evidence of the prevailing political risk factor in Nigeria, creating uncertainty in the environment, with potential impacts on business and investor confidence. The clearest depiction of this was the lack of clarity on the direction of monetary policy brought by the delay in the confirmation of new appointments to the CBN Monetary Policy Committee (MPC), as the policymaking body could not sit in the first quarter of the year. While the extent to which the executive-legislative friction has affected investment and economic activities cannot be reliably measured, we suspect that investors are concerned, with many waiting on further clarity post-elections to proceed with investment plans.

Fiscal Policy: 2018 Budget of Wishful Spending

Sustaining its expansionary stance, the FG plans to spend N9.1tn in the 2018 fiscal year; a strong increase of 19.7% over the previous year. Once again, non-debt recurrent expenditure, at N3.5tn, accounts for a disproportionate share of the budget at 38.4% of total, increasing 20.6% over the previous year due to a rise in government payroll. Debt servicing at N2.0tn continues to gulp a large share of the budget at 21.9%, higher by a modest 8.7%, due to FG's recent strategy to extend the tenor of its loans and scale down T-bills issuances, while also sourcing cheap external borrowing through Eurobonds. Capital spending of N2.8tn accounts for 30.7% of total planned spending, with the ministry of power, works and housing receiving the highest allocation of 7.8% of the total.

Our major worry is that the FG's ambitious spending plans contrast poorly with revenue realities. Revenues are estimated to reach N7.2tn, 40.9% above 2017 levels, even though this is a 176.9% increase when compared with actual revenues of N2.6tn in 2017 - only 52.3% of the targeted revenues of N5.0tn was realised. The FG plans to generate 41.6% of its revenues from oil and the remainder from taxes, independent revenues and recoveries. While the assumption for oil revenue is achievable, the major concern relates to independent revenues and recoveries, which both account for 40.5% of total projected revenues, and have historically underperformed. Given these considerations, as well as political distractions, we estimate a significant underperformance in revenues by c.40.0%. Hence, we estimate the fiscal deficit to expand to N4.4tn (to be funded mostly through monetary financing), above budget estimate of N1.9tn, representing 3.5% of nominal GDP – well above the 3.0% threshold prescribed by the Fiscal Responsibility Act – relative to an estimated 1.7%.

Considering the departure of Minister of Finance, Kemi Adeosun, in September 2018, after more than three years of heading the Fiscal Policy Team, we do not expect any deviation from the current fiscal policy of the FG. Although the erstwhile Minister facilitated

efforts to collect more revenues through initiatives such as VAIDS, we believe such efforts will be sustained as it aligns with the broader plan of the executive. Furthermore, while the Minister's resignation could have affected investor confidence, the controversy surrounding her departure and the swift replacement by the President should allay investors' concerns.

Investment Policy: How Far Reaching?

The investment policy drive of the current administration has focused on reforms that make it easier to do business and forge investment partnerships with other sovereigns, notably Morocco. Following the roll out of business reforms by the Presidential Enabling Business Environment Council (PEBEC) in February 2017, far reaching reforms have been implemented in three phases, with 8 of the 10 ranking indicators used by the World Bank Ease of Doing Business (EoDB) serving as metrics. In the first phase, there was a 60-day national action plan with focus on these areas which generated traction, with a 70.0% success rate based on the outlined objectives – increasing to 82.0% upon a 30-day extension. These strides translated to an improvement in Nigeria's ranking in the 2018 edition of the EoDB rankings to 145th from 190th in 2017. Subsequent phases have followed the same pattern, with deeper reforms, although the momentum waned as 52.0% and 68.0% success rates were achieved in the second and third phases respectively, showing that there is still much to be done. Our expectation is that Nigeria will move higher in the rankings in 2019.

Yet, this and other initiatives are inadequate and can only go so far without attracting significant private capital, considering the wide scale rejig required in multiple sectors of the economy such as oil & gas, telecommunications, manufacturing and power. While the 2016 economic recession and the consequent slowdown in growth are disincentives to investment, given that soft business spending is usually associated with recessions, the lack of urgency subsequently has also contributed to tepid investments. We believe the delay of structural reforms and the failure to liberalise sectors to attract investments are more urgent concerns acting as deterrents to private investment. As the elections approach, a period usually associated with politicking than actual policymaking, we do not expect a significant deviation from current investment trends.

Monetary Policy and Financial Regulatory Environment

The monetary policy environment has remained largely calm since April 2017 when the Central Bank of Nigeria (CBN) launched the Investors and Exporters' (I&E) window for accessing foreign exchange. Strategies for conducting monetary policy, which is traditionally focused on controlling aggregate money supply through the deployment of monetary policy management tools, has gradually shifted since the 2014 global oil price crash from monetary aggregate targeting to a subtle concentration on short-term management of liquidity. Although monetary policy stance signalled a hawkish disposition since July 2016 - especially given the frequency of OMO sales, stability of Monetary Policy Rate (MPR) at 14.0% and the Apex Bank's intervention funding into critical sectors – annual historical growth in monetary aggregates within the same period has intermittently implied a dovish stance.

Although most central banks across the world conduct monetary policy to achieve price stability (low and stable inflation) whilst managing economic fluctuations using differing policy frameworks (deploying either monetary aggregate or inflation targeting strategy), the CBN's strategy in recent years has sought to achieve single digit inflation rate (between 6.0-9.0%), with efforts directed mostly at containing money supply growth. Unequivocally, the price and exchange rate stability objective of the CBN remains clear and was rigorously pursued in the review period. After peaking at 18.7% in Jan 2017, headline Inflation consistently decelerated, printing at 11.2% as at August 2018, while Core Inflation also fell progressively from as high as 18.2% in Nov 2016 to a low of 10.0% in August 2018. Since monetary policy management strategies are often targeted at influencing core inflation that is less susceptible to volatility in food and energy prices, sustained deceleration of core inflation even in most parts of 2017, when there was sustained pressure on headline inflation, supported stability of monetary policy actions.

We do not foresee a significant departure in monetary policy strategy of the CBN in 2018/19 compared to 2017/18, although we note the additional pressure on policy as electioneering politicking intensifies. The CBN will likely stick to its twin objectives, much more in an election year, with effective use of OMO. This may force

short term rates closer to the high levels of 2016 and 2017. In our view, the monetary policy rate will continue to be echoed by the MPC as a key to achieving a tightening or loosening objective, although the developments of the last two years confirm that OMO rates are more effective in guiding other market rates. The independence of monetary policy, as encapsulated in the trilemma principle, will continue to be violated until a market pricing mechanism for exchange rate determination is established. This forms the crux of our standpoint on MPR. The Effective Cash Reserves Requirement (E-CRR) debate is gaining more prominence and may necessitate the CBN aligning with regulatory dictates. Although the CBN's recent guidelines for accessing DCRR may serve as a cushion to the rising cost of deposits to the banks, we believe that if liquidity pressure injected to the system due to election spending becomes uncompromising, possible adjustment in CRR may not be ruled out towards the last MPC meeting in 2018.

As the CBN continues to persuade commercial banks to lend to the real sector, lending growth has peaked in 2018, thus prompting an innovative means to channel credit to the real sector. The CBN introduced a new initiative, the Differentiated Cash Reserves Requirement (DCRR) - a real sector support programme targeted at manufacturing, agriculture and other sectors considered by the CBN as employment generating and growth stimulating. Whilst we laud the initiative of the MPC and the CBN in facilitating credit through the DCRR and Corporate Bonds Funding Programme (CBFP), we are not certain of the impact targeted funding would have on overall growth, given the grounds that need to be covered. In our opinion, the challenges of lending to the real sector transcends the paucity of deployable funds. There are structural issues that need to be addressed to de-risk lending to most sectors and reduce the incidences of Non-Performing Loans (NPL) in the system.

Preventing further deterioration of the banks' capital buffers was what preoccupied the mind of the CBN at the beginning of 2018. This necessitated an update of the guidelines to DMBs and Discount Houses (DHs) on dividend payment. On the basis of a Bank's NPLs ratio and CAR, the CBN guided on positions that qualify DMBs and DHs to pay dividend to their shareholders. On the 31st of January 2018, the Central Bank of Nigeria (CBN) released an update on an earlier issued (8/10/2014) Circular on Internal Capital Generation and Dividend Pay-out Ratio of Nigerian Banks. The major focus of the circular is on the capital reserves of the banks as well as the proportion of NPLs, in a bid to forestall any threats to customer deposits in the system.

Also, analysing market data suggests that there may not have been consistency in the number of banks qualified as Domestic Systemically Important Banks (D-SIBs) based on the CBN's indicator-based approach, although the Apex bank holds the prerogative on which of the banks qualify using its supervisory judgment. Attempting to cross check D-SIB's qualifications, using H1:2018 numbers and applying the indicator-based approach, suggests that only six banks – FBNH, UBA, ETI, ACCESS, ZENITH and GUARANTY – with overall score above 5.0% recommended in the guideline will qualify as D-SIBs. DIAMOND appears to be disqualified from the list based on quantitative measure; yet, the CBN holds the prerogative, based on the qualitative measure (supervisory judgement), to enlist or delist any D-SIB.

Setting an Agenda for a "New CBN" as the Incumbent Rotates Out

Since a new Monetary Policy Framework was adopted in the 195th MPC Meeting in November 2006, under the leadership of the then Governor – Prof. Charles Chukwuma Soludo, the office of the CBN Governor as well as the person's policy disposition, in terms of monetary policy administration, has gained enormous attention. More importantly, the aftermath of the 2006/07 global financial crises has popularised the study of monetary policy expectations, intentions and actions as well as outcomes by market actors, most especially, by domestic and foreign investors. Nigeria has had three Governors of CBN, with differing policy agenda, between then and now.

On June 1, 2019, a new CBN Governor who could be appointed for another 5-year tenor, is expected to assume office, coinciding perhaps with a new President being sworn in for another 4-year term. While the current CBN Governor, Godwin Emefiele, is entitled to a second term of 5 years, no CBN governor has been able to achieve this feat since 1993. As characteristic of market expectations, there will be speculation and recommendation for the ideal CV that fits the job description of the most intellectual office in the land in light of global developments and the complex and, sometime conflicting, ambitious objectives of monetary

policy. Interestingly, over the last 15 years (2004-2018), the tenors of the three Governors of the Apex bank have been characterised by peculiar economic challenges requiring appropriate monetary and regulatory policy actions.

The current Governor, Mr. Godwin Emefiele, assumed office at the most challenging time in the history of monetary policy conduct. The fall in global oil prices in H2:2014 created FX shortages that crystallised into significant diminution of the external reserves. The consequence of this was a sequence of official and tacit devaluations (including the creation of multiple exchange rates) which culminated in high inflationary pressures. Demand side management of FX then, eventually led to the economic recession of 2016.

We believe the pertinent issues that will occupy the front burner as "a New Government" shops for a replacement in 2019 will be, the profile of an ideal Governor for the highest economic job in the land. We believe the ideal candidate would need to be a seasoned economist and astute professional with sound knowledge of economics and markets and must be a tough believer in the efficacy of market systems.

Seeking an attractive credential is absolutely necessary as the ideal candidate will be confronted with contemporary issues of a fast changing regulatory and monetary policy environment; Flexibility for regulatory framework on Fintech's evolvement and blockchain technology. More importantly, the need for enthroning a truly flexible foreign exchange framework with alignment of FX rates in all market segments will be required to restore investor confidence and advance the course of inclusive and less-jobless growth and development. Overall, optimal monetary policy framework - supportive of market systems as well as regulatory efficiency devoid of policy shocks or policy flip-flops or poor regulatory communication – will have to be deployed.

Nigerian Banking Sector in 2017/18

Industry Remains Resilient Despite Economic Woes

The banking sector proceeded into 2017, on the back of successive years of growth in revenues and earnings. With economic conditions deteriorating, the expectation was that the industry was entering a low-growth phase when strong return on equity (ROE) performances of the past would fade away. However, the industry remained resilient in the face of significant pressure as the Nigerian economy entered a downturn. In fact, ROE rose as revenues and profits accelerated, while banks' capitalization was stronger – average capital adequacy increased to 20.0% in 2017 from 18.4% in 2016. Also, price-to-book value was on the rise just as loan-to-deposit ratios stay tethered due to risk aversion and high yielding alternative investments; all of which are signals of a resilient sector with ample room for growth.

The financial performance of the sector was driven by the tight monetary policy stance of the CBN, which with its overarching responsibility for price stability, kept rates high and system liquidity low – by conducting persistent open market operations, along with its normally scheduled auctions. Consequently, at the start of the year, banks were able to lock in high yield investments – which crowded out private sector borrowing – while in the latter part of the year market volatility allowed some operators to record substantial trading gains.

The impact of these factors allowed banks to offset reduced FX revaluation gains, which had buoyed the performance of 2016, and only marginally impacted in 2017 – given the stability in the FX market witnessed since the institution of the Investors' & Exporters (I&E) FX Window in April 2017. This drove income generation and set the industry on a pace for strong performance relative to 2016. Consequently, the aggregate gross earnings (for the banks within our coverage: 15, of which 13 had published results), grew by 17.1% in FY:2017, relative to 16.4% in FY:2016, while profit-before-tax and profit-after-tax increased by 42.2% and 54.8% respectively Y-o-Y, over the same period.

However, based on estimates within Afrinvest's coverage, despite improving macroeconomic fundamentals, asset quality deteriorated further in 2017, with industry non-performing loans (NPL) increasing to 9.3%, even as banks enacted strategies to manage the growth of impaired assets – elongation of tenors for problem loans and aggressive remediation. Notwithstanding, industry credit impairment charges reduced given the levels of provisions taken in the prior year.

The resilience of the sector in the year allayed long-term fears about the industry, which in conjunction with the

exit from recession in Q2:2017, drove investments in the sector, with the market capitalization of the sector's banks growing by 87.8% Y-o-Y to N4.2tn in 2017 from N2.2tn in the preceding year. As the landscape clears and the country continues its slow, stuttering pace of recovery, new headwinds emerge, and banks will need to embark on a fundamental transformation to protect their balance sheets and by extension, future growth Following our review of the performance of the industry as well as potential risks which could weigh on growth of the industry, we present our outlook on the industry below:

1. **Asset Quality Pressure**

   Given the implementation of IFRS 9, we expect pressure to be exerted on credit impairments and NPLs; this is directly related to the new method of impairment recognition.

   While the risk of the oil & gas sector has somewhat dissipated with the ascent of crude oil prices, there are still risks on the horizon for the banking sector such as the power sector, which continues to be plagued by liquidity concerns as well as inefficiencies across the value chain. Given that banks have now adopted the ECL model, we expect provisions for exposures to these high-risk sectors to surge as well as increased NPLs.

2. **Capital Buffers May Deteriorate**

   We expect the implementation of IFRS 9 to result in downward pressure on capital buffers across banks in the sector. While the impact will be more pronounced on banks with weaker regulatory risk reserves and Tier-1 capital levels, the impact should still result in either a new bout of debt raising or increased retention of profits to boost Tier-1 capital by FY:2018.

3. **Weaker Gross Earnings Growth**

   We expect the double-digit growth recorded by the sector over the past few years to taper over the near-term, given the expectation of moderation in growth from both funded and non-funded sources.

4. **Increased Level of Collaborations**

   There has been a trend of collaborations between banks and telecommunications companies over the past decade, such as Diamond Bank and MTN, with "Diamond Y'ello account"', aimed at driving financial inclusion and boosting both businesses. We expect renewed verve for such collaborations over the medium term, with FinTech firms. The partnerships would be symbiotic, allowing banks to utilise data and analytics to enhance risk assessment and drive revenue growth. In addition, other channels such as USSD services have gained prominence, with banks such as GTB and First Bank having over 3 million customers on their respective platforms each. We note that improved access to the internet through free data plans provided by Google and Facebook will help to deepen the adoption of digital banking and prompt more investment in capacity for service offerings from banks.

5. **D-CRR Utilization Will Remain Weak**

   The CBN, in its latest attempt to increase credit access for the real sector, introduced the Real Sector Support Facility (RSSF), which would allow banks to access restricted deposits held with the Bank as cash reserves – cash reserve ratio for commercial banks is 22.5%.

   This is not the first iteration of this initiative – a similar initiative was instituted in January 2016, after the MPC (in its 104th meeting held in November 2015) reduced the CRR by 500bps (from 25.0% to 20.0%) expressly for the increased liquidity to be channelled to real sector development. That iteration failed to address its objectives, and the CRR was subsequently increased to the current level. While this initiative is more detailed in the specifications of how the funds are to be utilised, the same issues remain – these are high risk sectors which pose significant credit risk to banks. Hence, in our opinion, utilisation is unlikely to be significant.

An Economic Agenda for a New Government

The Nigerian economy has endured several challenges in the past three years which have derailed progress towards the objectives of strong economic growth and development. The main source of this challenge has been in the oil sector, where oil price shocks in mid-2014 negatively impacted exports and government revenues. Consequently, oil production shocks brought by militancy in the Niger-Delta in 2016 resulted in a deeper downturn in the oil sector, which filtered into

the non-oil economy, as the deteriorating external balance resulted in an FX liquidity crisis, multiple devaluations and record inflation. The broader impact of these challenges on the economy is mainly reflected in the slowdown in growth; there was an economic recession in 2016 and although a slight recovery buoyed positive growth at 0.8% in 2017, the recovery has been uneven and weak. Hence, growth remains below historical trend of 6-7% and population growth rate of 2.6%, indicating that Nigerians have been poorer on the average – every year since 2016. This is affirmed by increasing poverty statistics, which according to the World Data Lab in Vienna, Austria puts Nigeria as the country with the highest number of extremely poor people in the world. Indeed, the triple salvo of weak growth, double-digit unemployment and inflation already removes all doubts of a retrogression in the economy.

Looking forward, and in view of the insufficient response to economic frailties so far, we believe that these challenges are bound to persist. The two pillars of growth since the start of the millennium within the non-oil sector – agriculture and services sector – have come under enormous pressure of late and only a rejig of the current economic structure and fundamentals through reforms will provide respite. As critical structural reforms have been abandoned, we only anticipate anaemic growth, making a return to trend over the next five years highly elusive. Already, forecasts from the IMF also paint a worrying picture with the suggestion that Nigeria could suffer declines in per capita income up till 2023 – this would indicate eight-consecutive declines from 2016.

With these issues in mind, the 2019 elections present the best chance to reset governance and build new growth levers that would put the economy on a path to prosperity. In this section of the report, we provide extensive analyses of current economic challenges and provide probable solutions. In our analysis, we believe implementing structural reforms is key to building a strong and sustainable foundation for growth. Indeed, we posit that an annual double-digit growth which is required for sustained employment creation and poverty eradication is not impossible if critical reforms are passed. We reiterated the need for wide scale infrastructure deployment but also affirmed that substantial and sustained improvements to the quality of human capital – through investments in education and health – is required to effectively utilise physical capital and achieve strong economic performance. In addition, we constructively assessed FG's current poverty eradication efforts through cash transfers, as well as its plan to provide affordable financing for credit deprived sectors and programmes targeted at boosting youth employment. We went further to cover sector-specific strategies to boost competitiveness and drive growth & investment in critical sectors such as power and oil & gas. Finally, we propose a rethinking of current approaches to trade and import substitution, and we shed light on uneven growth and development in Nigerian states with socio-economic evidence, elevated insecurity, and weak agricultural productivity.

1. Oil & Gas Sector... Revisiting the PIB and Full Deregulation of the Downstream Sector

Reminiscent of a huge blast from the past, the oil and gas industry in Nigeria is still beset by prolonged issues that are far from reaching close. The Petroleum Industry Bill (PIB) which had been in the pipeline for over a decade also gained increased traction between 2015 and 2016, as the new strategy adopted involved breaking the omnibus bill into three separate bills covering: Petroleum Industry Governance Bill (PIGB) – which provides regulatory direction, The Host Community Fund (HCF) – which caters to the development of host communities, and The Petroleum Industry Fiscal Bill (PIFB) – which provides fiscal terms guiding oil and gas investments. The plan was that these bills would be easier to work with, as stakeholders would respond quickly to issues and resolve them, thus aiding quick passage.

Almost three years after, none of the bills is yet to reach a close. The PIGB has gained the most traction – consultations have been concluded and the revised bill is awaiting presidential assent. Yet, there is little hope of success before the elections, given that the executive has reservations about areas such as the powers of the minister of petroleum and the split of NNPC. Currently, it is unclear how the legislation will proceed, as elections take centre stage over the next six months. Potentially, going forward, we see the bills gaining more traction if the incumbent wins the election, and a potential setback if a new party emerges and decides to tweak terms.

The downstream sector continues to be heavily regulated with price controls. In the absence of adequate local refining capacity, this has worsened as the country relies on importation for 80.0% of its petrol consumption. Petrol subsidies have been in place for a while, and although this eased off following the sharp adjustment in petrol prices in April 2016, there is now a resurgence in subsidies due to the recent increase in oil prices and devaluation of the currency. If local refining capacity expand by 2019 as planned, we expect reduced importation. As the private refineries reach peak capacities, we believe sourcing challenges will ease. What remains unclear and will continue to be a militating factor if unresolved is the pricing of petroleum products. Deregulating the downstream sector will allow private operators to develop the local value chain and even serve regional markets.

2. Power Sector Reform... Improving Bankability of the Sector

The traditional challenges in the power sector are not new, but over the past one year, they have festered into a nasty boil. The industry is fraught with liquidity challenges – itself a result of poor tariffs – and stakeholders are at odds with each other, as the escalation of internal struggles in the sector is reaching a tipping point. The power industry is in search of bold and tough reforms, which may not guarantee quick fixes – but can offer a promising future. Across the value chain of the power industry, there are significant deficiencies.

Value-chain specific challenges include gas pricing & supply shortages, centralisation of the transmission grid and poor metering in distribution. Decentralisation of transmission is necessary to avoid grid collapse. The Transmission Company of Nigeria (TCN) is currently in charge of all transmission infrastructure, covering inter-state networks. The same issues that have affected other segments of the value chain obtain in transmission, ranging from illiquidity to weak transmission infrastructure. With decentralisation, mini-grids can be introduced. This will enable effective and efficient management of the transmission network as transmission losses and grid collapse in one network will not affect other mini-grids. While this heralds promise, its regulation, framework and implementation remain contentious.

For metering, the NERC has proposed a new regulated operator – Meter Asset Provider – with a view to hastening the deployment of meters to close the current over 60.0% metering gap. The benefit of this approach is that it provides additional investment into the industry, as players in the metering space free distribution companies of additional investment and administration – which are all costs that cannot be sufficiently met by illiquid Discos. The challenge impeding implementation is that pricing and the manner of billing are yet to be agreed, and the choice of the operator best suited to collect payments is contentious.

As the performance agreement guiding the privatisation of Discos elapses after five years in 2019, it presents the best opportunity to take stock of progress and to re-strategize. While the outcome of the 2019 elections may dictate the long-term outlook of the power industry, we believe the current situation of the industry is untenable, and as such, massive pricing adjustment looms immediately after 2019 elections.

3. Boosting Competitiveness: Removing Tariff and Non-Tariff Barriers to Trade

Nigeria is on the lower rung of the ladder of trade and investment in Africa, despite bright growth prospects due to its attractive demographics. To be certain, this has persisted for an extended period, and it is a sign of the lack of strong will to turn the tide. Academic literature and historical evidence have demonstrated that trade and investment are necessary to create jobs, raise incomes, upgrade domestic supply chains for efficiency and effectiveness, develop expertise, and make cheaper goods and services available. These are all important for advancing human development.

To fully participate in this ecosystem of trade and investment, there is a need for competitiveness. This entails having good infrastructure and institutions that enable strong business growth – indeed, countries which have made rapid advancements in trade and investment have demonstrated gains in this regard. Nigeria is not competitive, and

the World Competitiveness Index asserts this by ranking Nigeria 125th of 137 countries. The index measures basic requirements such as institutions, infrastructure, macroeconomic environment and health & primary education, as well as select efficiency enhancers such as innovation and sophistication.

4. Transportation and Infrastructure: Plugging the Infrastructure Deficit through Public Private Partnerships

The infrastructure gap in Nigeria is massive, and this has continued to widen. In the past two decades, population has increased by more than 50.0%and yet there have been no noteworthy infrastructure upgrades. As population has expanded, especially in urban areas, the infrastructure stock has failed to catch up. The consequence is revealed in slow travel times, frequent accidents, high cost of transport – especially for businesses – and high cost of residential and commercial buildings in cities such as Lagos, Abuja and Port Harcourt.

In power and telecommunications, there is modest participation by the private sector, with the government acting as regulator. The hand of the regulator weighs heavily on expansion in this market, especially given price controls. Yet, without private sector partnerships, government lacks the capability to adequately fund the infrastructure gap. Public Private Partnerships (PPPs) have been recommended as a tested and worthy method to close the infrastructure gap, particularly in road infrastructure. The benefits of PPPs in the provision of effective and efficient project management and infrastructure maintenance are well documented. The projects are usually self-financing as users access the service after paying a fee, and government only parts with a small amount. Usually, policy inconsistencies and political instability, amid weak enforcement of contracts and slow judicial processes are the bane of PPPs in Nigeria. This is the case of the Lekki-Epe expressway, where the government revoked the PPP contract .Setting these challenges aside, there is room for rapid infrastructure development through PPPs.

5. Human Capital Development... the Key to Unlocking Economic Potentials

Developing a strong healthcare system and promoting education are crucial to the extent that these provide gains to society, in addition to the individuals who are direct beneficiaries. Building a healthy and educated workforce is especially important for accelerating economic development. Academic literature has established that countries with quality human capital are more productive, innovative and have higher income levels. The advanced economies such as US, UK, and Luxembourg all have quality human capital, making them the source of innovation across the world. The human development index ranks these countries very highly, and this is visible in the median per capita income of the economies. A healthy workforce is also important to harness labour, as less time off work frees income and time for productive use. Countries with a healthy workforce are more productive.

In Nigeria, human capital has been relegated, as physical capital has taken centre stage. For instance, over the past decade, the FG has put more funds into infrastructure than health and education combined. Similarly, Nigeria's spending on these two have trailed peer countries despite the clamour by civil society and global agreements which should put health and education spending at a minimum of 26.0% of budget and 5.0% of GDP respectively. Hence, developments in health and education continue to be dire.

To realise Nigeria's demographic dividend, there is need for a quick turnaround in these sectors, otherwise, the next generation of workforce will be ill prepared to advance economic prosperity. The lack of a coherent and practical policy to tackle this, resulting from weak political will and poor leadership vision, continue to be fundamental issues. The experience of countries which have rapidly improved health and education outcomes are models Nigeria can learn from, and tweak for local fit.

6. Security Concerns... the Need for a Decisive Executive Stance

Elevated insecurity has persisted for several decades in Nigeria, as interventions are mostly temporary and gains short-lived. Since the democratic dispensation started in 1999, the initial challenge was insecurity in the Niger-Delta, as local communities fought for resource control given underdevelopment in oil producing areas. The exploration and production activities of upstream companies had destroyed aquatic and land resources, thus eroding the occupations of majority of the people in the Niger-Delta. The resulting militancy usually lead to attacks on oil and gas infrastructure with impact on oil production, and consequently Nigeria's revenues. Given its relevance to maintaining macroeconomic stability and sustaining growth, the FG typically quickly intervenes to pacify communities – even though a resurgence would emerge after a brief spell of calm.

Today, insecurity has assumed manifold dimensions. In the South-South, militancy still rages, but government has managed this more effectively by engagement and dialogue with community leaders – though the possibility of a resurgence is a latent security risk in Nigeria. In the South-East, the desire for self-actualisation has lately re-emerged following decades of marginalisation of the region since the 1967-70 civil war which was based on the same reason. Between 2016 and 2017, these sentiments raged, and the movement gained momentum, leading to frequent protests and confrontation with the state military – with losses of lives, and the leader imprisoned for more than a year. Although calm has since returned as government intensified clandestine efforts to avert an uprising – its solutions are not public knowledge – this is still a latent security risk. In the North-East and pockets of places in the North-West, Islamic insurgents continue to sack communities and take hostages. Although remarkable gains have been made since 2015, over 1.7 million people displaced are yet to return to communities to restart their life. In the North-Central, the conflict between farmers and herders has intensified due to adverse climate change impacts on grazing in Northern-Nigerian, leading to the destruction of lives and properties – especially in Benue.

There are no automatic fixes to insecurity because the incidents differ fundamentally as well as the ideologies behind them. Mostly indecisive until security issues reach untenable levels, government's slow response to insecurity is a militating factor, as well as its refusal to go beyond the surface in dealing with insurgency beyond the deployment of military forces. This results in escalation rather than ease. There is a need to rethink the current approaches to dealing with unrests. Creating a framework for engagement, building the capacities of public sector workers to respond, strengthening security and legal institutions and abiding by the dictates of the laws are critical success factors.

7. Building Democratic Institutions and Imbibing Professionalism in Governance

A painful reality that underlies governance, regulation and ultimately development is weak institutions. The quality of the public sector workforce, the policies promoted, and the processes and operations, are all determinants of a country's growth and development. In Nigeria, there is lack of openness in public institutions as procurement, licenses and permits, recruitment and contract bids are couched as "Top Secret" information. Even when these are advertised, the information is usually insufficient, thus creating a situation where there is a lack of meritocracy in government processes, which constitute a drag on productivity. Public institutions are also not accountable, as funding, projects, annual reports, are not made public – and even when these are available, they are not timely and exhaustive.

In the economic agenda of the current government, public sector reform was touted, but the role of institutions and development of institutions – especially as it relates to regulation, policy, transparency and accountability – have not been considered a priority, and no clear policies back this up. Transparency in governance and sound institutions are necessary to enhance public trust, thus generating support that make passing tough reforms slightly easier.