

DEBT SERVICE CRISES: SUKUK BOND, A POTENTIAL PANACEA

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Debt Service

Debt servicing means making payments to satisfy a debt obligation, including principal, interest, and applicable late payment fees. Countries with solid financial positions will want a low ratio of debt service payments, relative to revenue. The ideal debt service ratio is somewhere between 0 and 20%. This typically indicates available cash flow to pay current and possible future debt obligations. Conversely, a high national debt service ratio may indicate a country's potential difficulty in servicing its debt obligations with existing revenue streams.

Debt Service Crises

Since Nigeria's current administration came to power in 2015, the country's debt profile has grown geometrically. This peaked in 2021 when it was reported that the debt servicing obligations of the Nigerian government had gulped about 97% of total revenue in 2020. 2020 revenue stood at ₦3.42 trillion, with ₦3.34 trillion of that, spent servicing the federal government's debt. Similarly, with the debt service ratio remaining the same, ₦4.22 trillion of ₦4.39 trillion earned in 2021 was spent servicing debt. The latest reports referencing the first quarter of this year (2022), indicates that debt service in the sum of ₦1.94 trillion exceeded revenue in the sum of 1.63 trillion. The gulf is in the region of 20%. This portends a crisis in any emerging or frontier market. The crisis is further exacerbated with weaker applications of laws incapable of enforcing micro loans let alone sovereign debts.

In parallel to this crisis, increased borrowing to fund the budget is leading to a rapidly increasing debt-to-Gross Domestic Product (GDP) ratio, currently standing at 23.27%. While this is well below the self-imposed limit of 40%, it is no less worrisome. GDP does not actually translate into revenue for any country if the right macroeconomic structures are not in place. If the rate of borrowing is not urgently decreased, and sustainable fiscal performance realized within the next several months and beyond, Nigeria may well be on the brink of its own looming economic crisis. Sri Lanka offers a cautionary tale.

Nigeria Tending Toward Sri Lanka

Sri Lanka's economic woes are likely the fodder of much discussion in economic circles around the world. The crisis is characterized by a high rate of inflation at about 54.6%; a decline in electricity, fuel, and cooking gas consumption, paper shortages, and many more. It is the country's worst economic crisis since independence. The road to Sri Lanka's perdition has been fraught with government policies involving huge tax cuts that led to declining government revenues; money printing to cover government spending; mounting external debts despite an inability to repay the same, and a decline in foreign remittances.

While Sri Lanka's economic crisis is not on all squares with the Nigerian situation, there are disturbing similarities. With the chunk of Nigeria's revenue channeled towards debt servicing, the government is left with little or nothing to finance capital projects and other aspects of the economy, or even to run the government itself. The effect of this is that Central Bank of Nigeria may soon be forced to resort, in the absence of other feasible options, to creating more money than is otherwise healthy for the economy.

It would then not be long before Nigeria would be faced with possible default in servicing its loans, potentially damaging her reputation with future lenders even more than is already the case. Consequently, not only would Nigeria be unable to access more foreign debt capital, upon which it currently places sole reliance in funding its budget, but it would also repel or dissuade prospective foreign direct investments given the economic uncertainty that would abound. Another potentially worrying effect of the slippery slope Nigeria now finds herself is that when the country runs out of money, it may not be able to import necessary goods and services from abroad because of the scarcity of foreign currency exchanges. In the same vein, it may lead to more devaluation of the Naira. Long term measures such as refining its own crude and eliminating importation and subsidy of PMS had since been suggested. It is expected that steps will be taken to enforce these recommendations.

Sukuk Bond

A short-term measure that must however be readily re-considered by the Nigerian government is its current funding mechanism for infrastructure weighed against its social policy. The government had borrowed to develop and maintain railways, highways, as well as to construct new bridges. This bucket of infrastructure can easily generate income, yet government elects to continue to pay this debt from its balance sheet. Accordingly, it sets aside a sum in its yearly budget to meet its commitments. There is now a desperate need to commercialize existing and future infrastructures such that income streams from such commercialization are channeled towards the repayment of monies obtained in building such infrastructure. Sukuk bonds may provide the answer.

A Bond simply represents a loan from an investor issued to a Government or a company. The borrower issues a certificate admitting the debt and promises to pay at a future date. The certificate will also reflect all the lenders right, title and interest against the borrower. Sukuk bond differs from conventional bonds in two fundamental respects. Firstly, interest is not paid to investors, rather investors are issued certificates that represent a proportion of undivided ownership right in an underlying asset or business venture. In addition, profits derived from such underlying assets are paid back to investors in accordance with the dictates of Shariah Law. This simply means that the underlying asset upon which the sukuk are based, must be sharia compliant. There is some sought of ethical exclusion. Typically, no investment in alcohol, Tobacco and gambling.

The Federal Government through the debt management office has since issued sukuk bonds. It is often oversubscribed. This is because a unique model that is harmful and dangerous to the economy is constantly being applied. Government offers to satisfy debt obligation, not from proceeds generated by the underlying asset, but from an already

overstretched balance sheet. Investors are paid directly by budgeting a portion of government revenue generated from other sources. This model ostensibly promoting social policy bears little or no similarity to what obtains in other organised and structured economies where Islamic finance is practiced. Permitting passengers, regardless of their income bracket, to travel by rail at less than the commercial rate, or suspending payment altogether on public holidays, can only but breed inefficiency leading to insolvency.

Commercialising Infrastructure

Commercialising infrastructure such as roads, necessitates a system of tolling. The Minister of works and housing seems to have indicated that tolls will shortly resurface. On the negative side, it is not unusual to witness push back by citizens, objecting to tolls. In the face of such opposition the government may want to explore the alternative, Shadow Tolling. Shadow tolling is a payment structure where the road user does not pay any toll; instead, the concessionaire collects revenue from the government in proportion to the number of vehicles using the road. The government in turn levies the toll indirectly through taxes or other official payments like car license fees etc. Another way of levying shadow tolls may be to levy such tolls on businesses, landholders and other public and private entities whose assets increase in value because of their proximity to the road infrastructure subjected to tolling.

Sukuk Bond Edges Profligacy

Sukuk bonds typify important drivers that can be considered to influence economic performance from a governance viewpoint. The underlying infrastructure upon which such bonds are issued must be managed in such a way that bond investors are repaid. As a result, investors ordinarily will be keen to ensure a level of integrity in the evolution and management of any underlying project. There will be a focus on how funds that the Federal Government receives are being invested. Given that repayment on FG bonds are not directly satisfied from proceeds derived from the underlying assets, it may prove intricate to draw a connection between exposure to infrastructure and FG's inability to pay its debt. Still, the connection between simply borrowing (issuance of traditional bonds) without parameters, and the level of economic decadence remains straightforward. At a sovereign level, risk associated with public health standards, natural resources management and corruption, can affect balance of trade, tax revenues, and foreign investment. This in turn will affect bond price volatility and increase the risk of default. In order to circumvent this scenario, it is imperative to tie bonds to underlying infrastructure. This is the correct application of the sukuk bond; Such application may act as a check on profligacy of government. It is expected that the next administration will adopt a more prudent and efficient way of generating and managing its debt portfolio.