THE Nigerian STOCK EXCHANGE

The Nigerian Stock Exchange Operational Guidelines for Fixed Income Market Makers

Fixed Income Market Making (FIMM) Program

In line with the Nigerian Stock Exchange (NSE) focus to diversify its product offering and further develop the Nigerian Capital Market, the Exchange is working on rolling out a Fixed Income trading platform. In order to achieve this, a vibrant a Fixed Income Market Making (FIMM) framework is required. The Fixed Income Market Makers (FIMMs) shall be required to make a two way quote (Bid/Offer) at which it is prepared to deal in all pre-qualified/defined fixed income securities listed on the Exchange in which it is registered as a market maker.

The fixed income two way quotes on the Exchange is a system where a FIMM gives both binding buy (bid) and sell (offer) prices on the same quote through the Exchange's Automated Trading Systems (ATS). This implies the dealer is willing to buy on his bid and sell at his offer if the counter-party so desires. The counter party will be a broker representing his clients' interest in an agency capacity or a dealer trading for his proprietary account.

Benefits of the FIMM Program

- **Retail-focused Liquidity:** This will attract retail market participants to invest in bonds through the Exchange's facilities, as the FIMMs will provide liquidity to the retail market, which had hitherto been absent in the Nigerian Bond Market.

- **Price Discovery/Transparency:** Trading of Bonds on the Exchange platform will not only enhance efficient price discovery but will also demonstrate full transparency in Bonds rather than the current trend of subjective pricing seen on the OTC.

- **Deeper Bond Market:** This will add to the depth of liquidity available in the Nigerian Bond market, by extending market making beyond FGN bonds to all bonds listed on the NSE.

General

Bonds are essentially long-dated interest-bearing borrowing instruments issued by governments or corporations to raise money for expansion, or capital. The investor, generally referred to as the Bondholder is loaning money to the issuer in return for the Interest. The bond can be traded off for cash or exchanged for another instrument (as seen in Swaps -a strategy in which an investor sells a bond and at the same time purchases a different bond with the proceeds from the sale) at any time before maturity. Though the coupon-paying Bond instruments are common and often called Plain Vanilla Bonds, there also exist other types of Bonds like the Zeroes, generally called Zero-coupon/ deep discount Bonds, which are issued at deep discounts for full face value redemption upon maturity.

Bond coupon is simply the interest paid on the instrument by the issuer and it typically represents a percentage of the total principal or face value. Coupons are mostly paid semi-annually.

For example, N100,000.00 worth of the current benchmark 7-Year FGN Bond instrument, ***16.00% FGN Jun 2019*** with a known coupon of 16.00% will pay a coupon of N8,000.00 half-yearly throughout the life of the instrument whilst the principal sum of N100,000.00 is redeemed upon maturity in June 2019.

Background

FGN BONDS

The Federal Government resumed the issuance program of FGN Bonds in October 2003 after its initial suspension in 1988. Since, then the Bonds market has witness significant growth in volume and trading activity. The issuance of bonds helps lengthen the domestic market's yield curve, encourages long-term savings and also assists in developing a vibrant Pension Funds sector. The Bond market capitalization currently stands at over N7trillion with the yield curve stretched to 20-Year length. The market capitalization of FGN bonds listed on the NSE is N3.878 trillion.

STATE BONDS (SUB-NATIONAL)

The paucity of funds, dwindling allocations from the Federal Government via the Federation Account, coupled with an ineffective internal revenue collection mechanism have led State Governments (Sub-nationals) to depend on alternative financing arrangements to fund their year-on-year budget deficit and infrastructure projects. For years, bank loans at high interest rates have played a significant role in funding these activities. However, with the re-emergence of the bond market in 2003, the issuance of same by sub-nationals has offered them a viable option to reducing the said deficit and investing in numerous long term capital projects at comparatively lower cost. Currently, twelve (12) State Government bonds are listed on the bourse with their tenor ranging from 5 – 7 years. The market capitalization of State Bonds listed on NSE is N381 billion.

CORPORATES

In the private sector, corporate bonds are not often or have not been considered as an option by many companies in funding expansion and innovation. The total amount of bonds issued in the private sector is less than two hundred billion naira (<N200 billion). Considering the size of Nigeria's economy, this is indeed small and is a reflection on the inability of companies to issue Bonds, secured by their assets or debentures issued on the strength of their balance sheets, to mobilize critical funding outside of the banking system. In addition to regular corporate bonds, the bonds issued by Asset Management Corporation of Nigeria (AMCON) are categorized as corporate Bonds on the NSE. The total market capitalization of corporate Bonds on the NSE is N1.934 trillion.

Characteristics of Bonds

- All Bonds listed on the Nigerian Stock Exchange use the Central Securities Clearing System (CSCS) as the Depository. The CBN acts as both the Registrar and Agent Bank to the Issue for FGN and AMCON bonds while 'Registrars' acts as registrar for state and corporate bonds such as First Registrars.

- All FGN Bond instruments qualify as liquid assets for the purpose of statutory liquidity ratio compliance purposes for Deposit Money Banks (DMBs).

- The CBN in September 2010 issued the "Guidelines for Granting Liquid Asset Status to State Government Bonds". The aforesaid Guidelines were issued, inter alia, with a view to boosting investors' confidence (both domestic and foreign) in the Nigerian capital market.

- Aside from the tax-exempt status of all FGN Bonds State and Corporate bond, The Debt Management Office (DMO) ensures continued Bond supply on the FGN Bond space through its monthly primary auctions. This helps sustain an active secondary FGN Bond market.

The following guidelines shall be applicable to the FIMMs on this Exchange.

1. Applicability

These guidelines are applicable to all registered FIMMs on the Nigerian Stock Exchange.

2. Registration

The Dealing member-firm desirous of acting as a FIMM shall apply to the Exchange in writing. Any member of the Exchange would be eligible to act as FIMM provided the criteria laid down by the Exchange are met.

Criteria to qualify as a FIMM on the NSE

a. Must be a licensed Broker-Dealer
b. Must be registered with SEC and CSCS
c. Must meet the minimum net capital requirement
d. Experience, expertise and past performance

e. Operational capability in terms of appropriate staffing, technology and risk management tools.

f. Disciplinary history

g. Applicant and its promoters must be in good standing with SEC, NSE, CSCS and AMCON as well as other regulatory bodies.

3. Eligibility

NSE in collaboration with market makers will agree on the listed Bonds that will be considered as liquid and tradable on the Exchange's Automated Trading System.

4. Obligations and responsibilities of FIMM

The FIMM shall fulfill the following conditions to provide depth and continuity on the Exchange Bond trading platform:

a. The FIMM shall be required to provide a two-way quote for 90% of the time in a trading day;
b. Every quote given by the Fixed Income Market maker must be guaranteed as firm by the Market Maker;
c. The Market Maker will be eligible to change quotes if no transaction has been executed at the displayed quote;
d. The quote shall be provided in such a way that the quotes are not absent from the screen for more than fifteen (15) minutes at a time;
e. Once a Broker-Dealer application for FIMM status is approved, the company has to start providing quotes within ten (10) trading days of registration.
f. Once registered as a FIMM, the company has to mandatorily act in that capacity for a minimum of three months.
g. The FIMM firm is required to designate a qualified and experienced Trader with a minimum of three years bond trading within the firm as its Bond securities market maker. The FIMM firm represents that the designated trader has the necessary skill and expertise to perform such function;
h. The FIMM Firm shall provide the Exchange with the names of all designated traders acting as market makers, and forthwith advise the Exchange of any changes to such information within 24 hours of such a change;
i. A FIMM shall be allowed to deregister by giving '90 days' notice to the Exchange in writing of its intention to resign as a FIMM.

5. Compulsory De-registration

If a FIMM fails to fulfill its obligations as a Fixed Income Market maker for more than ten (10) consecutive trading days, it will automatically stand de-registered and may not be permitted to act as a FIMM for a minimum period of three month.

6. Benefits of FIMMs

The FIMM shall have the following benefits:

a. The right to determine the opening price and closing price of the security where they act as FIMM;

b. Possibility to influence. Market Makers at NSE have an important role when it comes to discussion and feedback on upcoming changes, possible improvements etc. and are thereby given a large possibility to influence the market structure.

7. Dissemination of Information and Market Data

The Exchange shall disseminate a list of all eligible Bond instruments with their performance-price and volume of turnover to the public daily via The Exchange's website and Daily Official List. The Exchange will also disseminate a list of appointed FIMMs to the public via its website.

The Exchange will also make pre and post trade market data available via vendors, and direct real time feeds. This will include best bid, best ask and last trade information.

8. Minimum Capital

The minimum capital requirement of N500,000,000.00 (Five Hundred million naira), unimpaired by losses or commitment to other activities, would apply for FIMMs. The Exchange might demand additional capital based on the risk profile of the FIMM.

9. Monitoring Fixed Income Market Maker activities

The Exchange shall monitor the activities of FIMMs. Any violation of these requirements or rules and regulations of SEC and NSE would be liable for punitive action to be taken by The Exchange.

10. Risk Management and Technology Requirement

The FIMM shall have a risk management tools that has facilities for measuring risks, reporting trading activities and implementing proper financial controls. The Nigerian Stock Exchange expects the risk management tools/technology to have the following features:

a. Computation of Value-at-Risk (VAR)

b. Inventory of all borrowed Bond securities (Repo), with appropriate administration data to manage borrowings, associated collaterals, coupon payments etc.

c. Stress Testing – to look at extreme market conditions.

d. The system must be able to carry out mark-to-market at any time.

e. Alerts – automatic triggers based on specified risk levels.

f. Robust Database with the ability to store current and historical prices
g. The FIMM shall also have internal technical capabilities for providing current market updates and information to the market- the NSE and other regulatory authorities. Such information shall include, but not limited to;

- Daily Inventory Position;
- Daily Profit and Loss;
- Daily Mark-to-Market valuation;
- Trading Activity;
- Customer Activity; and
- Credit review of current open trades with counterparties

Lastly, the NSE shall periodically carry out compliance-Inspection visits to the FIMMs' offices to ensure that FIMMs are complying with its rules.

12. Trading Technology

The Nigerian Stock Exchange will operate Straight-through-process (STP) for the End-to-End (E2E) transactions. This may require the Broker-Dealer's internal systems to be fully integrated with the Exchange's systems, enabling effective flow of market information that will facilitate and improve the decision making process. The Broker-Dealer's internal systems should support the following;

a. FIX-Enabled Execution Management System

b. Real-time Market data

c. Secure and capable connectivity

Glossary of Definitions

Accrued Interest
Interest due from issue or from the last coupon date to the present on an interest bearing security. The buyer of the security pays the quoted price plus accrued interest (cum interest).

All-in-price (Dirty Price)
The clean price plus the accrued interest of a bond expressed as a percentage of the nominal value.

Auction
This is the mechanism through which the primary issue of government securities occurs. Bids are invited for a particular issue from primary dealers and the general public with the total size of the auction pre-disclosed. The auction amount is placed from the highest price (lowest yield) onwards till the auction amount is reached.

Bid
For outright transactions this can be expressed in terms of interest rates or prices. The actual convention varies from market to market. In the Nigeria market, bonds trade on price. The bid is the price at which the quoting party is willing to buy a security.

Book Value
This is the value at which a debt security is shown on the holder's balance sheet. Book value is often acquisition cost ± amortisation/ accretion of premium/ discount on purchase.

Clean Price
The present value of the future coupon payments and redemption proceeds of a bond discounted at the yield to maturity and expressed as a percentage of the nominal / par value.

Consideration
The cost of or amount paid for the bond. (i.e., all-in-price).

Coupon Rate
It is the rate of interest payable on the nominal value of a bond.

Cum Interest
When a bond is sold cum interest, the buyer receives the interest.

Discount
A security is said to be trading at a discount when the price at which the price at which the security is trading is below the issuer's par value.

Discount Securities
This is non-interest bearing money market instruments that are issued at a discount and redeemed at maturity for full face value.

Face Value
This is the par value of the security, i.e. the principal.

Future or forward Value
This is an agreement to do a repo/reverse or buy/ sell a security outright sometime in the future at a specified date, at a specified rate and with a specified tenor.

Last Twelve Months (LTM)
Last twelve Months (LMT) is also referred to as Trailing Twelve Months (TTM), is a term used to describe financial results during the last 12 months of a calendar year.

Long
A net position in securities refers to owning a stock of securities which is more than what has been contracted to deliver.

Mark-To-Market
This is to value a securities contract at market rates. It is done to determine the profitability of outstanding contracts.

Market Value
The price at which a security is trading and could presumably be purchased or sold.

Offer
For outright transactions, as explained above, this can be expressed in terms of interest rates or prices. The actual convection varies form market to market. In the Nigerian market, bonds trade on price. The offer is the price at which the quoting party is willing to sell the security.

For Repo/ Reverse transactions the offer is expressed in terms of interest rates. This is the rate at which the quoting party is willing to do a reverse repo (i.e. lend)

Outright
This refers to a straight forward (absolute) sale or purchase of a security without a simultaneous forward transaction (repurchase) component.

Par Value
This is the principal amount at which the issuer of a bond contracts to redeem the bond at maturity (also known as face, nominal, or redemption value).

Premium
The amount by which the price at which an issue is trading exceeds the issue’s par value.

Price of Security
The price of a security is inversely related to interest rates. An increase in interest rates reduces the price of a security. Conversely, a decrease in interest rates increases the price of a security.

Primary Market
This refers to direct dealing with the issuers of the security during first issuance or re-opening of securities, for the purpose of this product program, the Central Bank of Nigeria/ Debt Management Office conducts Primary market auctions.

Repo/ Reverse
The Repo/ Reverse repo bid is expressed in terms of interest rates. This is the rate at which the quoting party is willing to do a repo (i.e. borrow).

Rollover
This is the extension of a maturing transaction in such a way that no cash flows are exchanged.

Trade Date
The date on which a deal is entered into.

Secondary Market
This is the market in which previously issued securities are traded.

Securities Swap
This refers to selling a security and buying another one at the same time.

Short
A market participant assumes a short position by selling a security he does not own. The seller makes delivery by borrowing the same security sold for settlement date.

Spread
The spread is difference between the bid and offer price or rate.

Value Date
The day on which a financial transaction is to be settled, i.e., on which payment is actually made or received in exchange for securities. Current practice is (T+2) for bonds and Treasury bills.

Yield Curve

The interest rates for each different tenor or maturity of a financial instrument, the graph of the yield curve has interest rates on the vertical Y axis and time-to maturity on the horizontal X axis.

Yield to Maturity

This is the interest rate that will make the present value of all the future cash flows of the bond equal to the market price. In essence, it is the internal rate of return (IRR) of the bond cash flows.