# NATIONAL OPEN UNIVERSITY OF NIGERIA

**INTERNATIONAL ECONOMICS**

**ECO 344**

**FACULTY OF SOCIAL SCIENCES COURSE GUIDE**

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**CONTENT**



**INTRODUCTION**

ECO 444 is a two credit unit course designed for final year economics students in the School of Art and Social Science at the National Open University of Nigeria. ECO 444 is a significant course to you in your academic pursuit as it will assist you to gain an in-depth understanding on how the banks and other financial institutions operate. More importantly, this course critically examined the relevant issues regarding money, credit and financial issue. It made some assumptions to serve as a guide to you for you to know the crucial role of the course in enhancing the stability of money in our economy.

Furthermore, this course will broaden your knowledge on how the economy is stabilized using the government monetary and fiscal policies. Subsequently, the course will inform you on what money and banking is and how money can be created in the banking industry. This course guide will provide you some guidance on your Tutor-Marked Assignment (TMA) as contained herein.

**WHAT YOU WILL LEARN IN THIS COURSE**

This course will detailed an in-depth knowledge on the theories of demand and supply, role of bank and international financial system in the economy. Also, you will be expose to knowing the difference between product, money and capital including their various functions and roles in the economy.

**COURSE CONTENT**

This course builds on the foundation of finance and economics on studying the role, function and significance of money and banking. Topics covered include; Theory of money, relevance of money in the economy, link between credit, money and interest rate, financial institutions and Nigerian financial system and its role in the economy etc.

**COURSE AIMS**

The overall aim of this course includes:

i. To introduce you to the basic concepts in money and banking.

ii. To teach you the major theories in demand for money and supply of money.

iii. To expose you to the mode of operation in the banking industries. And also to enhance your knowledge on activities of international monetary system and their operation.

iv. To broaden your knowledge on the roles and functions of the money and capital market in Nigeria.

**COURSE OBJECTIVES**

There are 14 study units in this course and each unit has its objective. You should read the objectives of each unit and bear them in mind as you go through the unit. Each unit of this course has its objectives unit. In addition to these, the course has its overall objectives. At the completion of this course, you should be able to:

- Explain the meaning and the origin of money
- Differentiate the different eras in the evolution of money
- Define the demand for money and explain the theories behind it.
- Differentiate between Classical Approach, the Keynesian Approach and the Post-Keynesian Approach.
- Define money, credit and interest.
- Explain the inverse relationship between interest rate, demand for money and investment.
- Understand the definition and evolution of banking system in Nigeria.
- Distinguish between banking financial institution and non-banking financial institution.
- Identify the activities of the commercial bank from that of the merchant banks.
- Identify the organization structure of the commercial bank from that of the merchant banks.
- Understand the various non-bank financial institutions in Nigeria.
- Distinguish between non-bank financial institution and banks.
- Explain the significance of banks to economic development.
- Examines the financial reforms and it achievements.

**WORKING THROUGH THIS COURSE**

Each unit contains self-assessment exercises and tutor- marked assignment. At some points in this course, you will be required to submit assignments for assessment purposes. At the end of this course, there is a final examination. This course should take about 14 weeks to complete. Some components of the course are outlined under the course material subsection. To successfully complete this course, you are required to read the study units, referenced books and other materials on the course.

**COURSE MATERIALS**

Major components of this course are:

1. Course guide

2. Study units

3. Text books

4. Assignment file

5. Presentation schedule

**STUDY UNITS**

The breakdown of the four modules and 14 units are as follows.

**Module 1: Basic Concepts of Money and Credit**

Unit 1: Meaning and relevance of money

Unit 2: Theory of money

Unit 3: Money, Credit and their Significance to the Economy

**Module 2: Financial Institution and Its Relevance to the Economy**

Unit 1: Meaning of financial institution and its classification.

Unit 2: Central Bank in Action and Its Economic Significance

Unit 3: Nigerian Commercial and Merchant Bank

Unit 4: Non-Bank Financial Institutions

**Module 3: The Nigerian Financial System**

Unit 1: Nigerian financial system and its significance to economic development

Unit 2: The financial market and its role in economy acceleration

Unit 3: Nature of Financial Assets

**Module 4: Roles and Performance of Development, Microfinance, Rural, Cooperative and Islamic Banks**

Unit 1: Organization and function of Development Banks

Unit 2: The Activities of Microfinance Banks in Nigeria

Unit 3: Rural and Cooperative Banking in Nigeria.

Unit 4: Roles and Performance of Islamic Banks in Nigeria

**REFERENCES AND TEXTBOOKS**

Every unit contains a list of references and further reading. Try to get as many as possible of those textbooks and materials listed. The textbooks and materials are meant to deepen your knowledge of the course.

**ASSIGNMENT FILE**

In this file, you will find all the details of the work you must submit to your tutor for marking. The marks you obtain from these assignments will count towards the final mark you obtain for this course. Further information on assignments will be found in the assignment file itself and later in this Course Guide in the section on assessment.

**PRESENTATION SCHEDULE**

The presentation schedule included in your course materials gives you the important dates for the completion of tutor-marked assignments and attending tutorials. Remember, you are required to submit all your assignments by the due date. You should guard against lagging behind in your work.

**ASSESSMENT**

Your assessment will be based on tutor-marked assignments (TMAs) and a final examination, which you will write at the end of the course.

**TUTOR-MARKED ASSIGNMENT**

There are many tutor-marked assignments in this course. You will submit all the assignments. You are encouraged to work all the questions thoroughly. The TMAs constitute 30 per cent of the total score.

Assignment questions for the units in this course are contained in the Assignment File. You will be able to complete your assignments from the information and materials contained in your set books, reading and study units. However, it is desirable that you demonstrate that you have read and researched more widely than the required minimum. You should use other references to have a broad view point of the subject and also to give you a deeper understanding of the subject. When you have completed each assignment, send it, together with a TMA form, to your tutor. Make sure that each assignment reaches your tutor on or before the deadline given in the Presentation File. If for any reason, you cannot complete your work on time, contact your tutor.

## FINAL EXAMINATION AND GRADING

The final examination will be of three hours' duration and have a value of 70% of the total course grade. The examination will consist of questions which reflect the types of self-assessment practice exercises and tutor-marked problems you have previously encountered. All areas of the course will be assessed. You are advised to use the time between finishing the last unit and sitting for the examination to revise the entire course material. You might find it useful to review your self- assessment exercises, tutor-marked assignments and comments on them before the examination. The final examination covers information from all parts of the course.

## COURSE MARKING SCHEME

The table presented below indicates the total marks (100%) allocation.

| Assignment | Marks |
|---|---|
| Assignments (Best three assignments out of four that is marked) | 30% |
| Final Examination | 70% |
| **Total** | **100%** |

## COURSE OVERVIEW

The Table presented below indicates the units, number of weeks and assignments to be taken by you in this course.

| Units | Title of Work | Week's Activities | Assessment (end of unit) |
|---|---|---|---|
| | Course Guide | | |
| | **Module 1: Basic Concepts of Money and Credit** | | |
| 1 | Meaning and relevance of money | Week 1 | |
| 2 | Theory of money | Week 2 | |
| 3 | Money, Credit and their Significance to the Economy | Week 3 | Assignment 1 |
| | **Module 2: Financial Institution and Its Relevance to the Economy** | | |
| 1 | Meaning of financial institution and its classification | Week 4 | |
| 2 | Central Bank in Action and Its Economic Significance | Week 5 | |
| 3 | Nigerian Commercial and Merchant Bank | Week 6 | |
| 4 | Non-Bank Financial Institutions | Week 7 | Assignment 2 |

| | | | |
|---|---|---|---|
| **Module 3: The Nigerian Financial System** | | | |
| 1 | Nigerian financial system and its significance to economic development | Week 8 | |
| 2 | The financial market and its role in economy acceleration | Week 9 | |
| 3 | Nature of Financial Assets | Week 10 | Assignment 3 |

| | | | |
|---|---|---|---|
| **Module 4: Roles and Performance of Development, Microfinance, Rural, Cooperative And Islamic Banks** | | | |
| 1 | Organization and function of Development Banks | Week 11 | |
| 2 | The Activities of Microfinance Banks in Nigeria | Week 12 | |
| 3 | Rural and Cooperative Banking in Nigeria. | Week 13 | |
| 4 | Roles and Performance of Islamic Banks in Nigeria | Week 14 | Assignment4 |
| | **Total** | **14 Weeks** | |

## HOW TO GET THE MOST FROM THIS COURSE

One of the great advantages of distance learning is that; you can read and work through specially designed study materials at your own pace and at a time and place that suit you best. Think of it as reading the lecture instead of listening to a lecturer. In the same way that a lecturer might set you some reading to do, the study units tell you when to read your books or other material, and when to embark on discussion with your colleagues. Just as a lecturer might give you an in-class exercise, your study units provides exercises for you to do at appropriate points.

Each of the study units follows a common format. The first item is an introduction to the subject matter of the unit and how a particular unit is integrated with the other units and the course as a whole. Next is a set of learning objectives. These objectives let you know what you should be able to do by the time you have completed the unit. You should use these objectives to guide your study. When you have finished the unit, you must go back and check whether you have achieved the objectives. If you make a habit of doing this you will significantly improve your chances of passing the course and getting the best grade. The main body of the unit guides you through the required reading from other sources.

This will usually be either from your set books or from a readings section. Some units require you to undertake practical overview of historical events. You will be directed when you need to embark on discussion and guided through the tasks you must do. The purpose of the practical overview of some certain historical economic issues are in twofold. First, it will enhance your understanding of the material in the unit. Second, it will give you practical experience and skills to evaluate economic arguments, and understand the roles of history in guiding current economic policies and debates outside your studies. In any event, most of the critical thinking skills you will develop during studying are applicable in normal working practice, so it is important that you encounter them during your studies.

Self-assessments are interspersed throughout the units, and answers are given at the ends of the units. Working through these tests will help you to achieve the objectives of the unit and prepare you for the assignments and the examination. You should do each self-assessment exercises as you come to it in the study unit. Also, ensure to master some major historical dates and events during the course of studying the material. The following is a practical strategy for working through the course. If you run into any trouble, consult your tutor. Remember that your tutor's job is to help you. When you need help, don't hesitate to call and ask your tutor to provide it.

1. Read this Course Guide thoroughly.

2. Organize a study schedule. Refer to the `Course overview' for more details. Note the time you are expected to spend on each unit and how the assignments relate to the units. Important information, e.g. details of your tutorials, and the date of the first day of the semester is available from study centre. You need to gather together all this information in one place, such as your dairy or a wall calendar. Whatever method you choose to use, you should decide on and write in your own dates for working breach unit.

3. Once you have created your own study schedule, do everything you can to stick to it. The major reason that students fail is that they get behind with their course work. If you get into difficulties with your schedule, please let your tutor know before it is too late for help.

4. Turn to Unit 1 and read the introduction and the objectives for the unit.

5. Assemble the study materials. Information about what you need for a unit is given in the overview' at the beginning of each unit. You will also need both the study unit you are working on and one of your set books on your desk at the same time.

6. Work through the unit. The content of the unit itself has been arranged to provide a sequence for you to follow. As you work through the unit you will be instructed to read sections from your set books or other articles. Use the unit to guide your reading.

7. Up-to-date course information will be continuously delivered to you at the study centre.

8. Work before the relevant due date (about 4 weeks before due dates), get the Assignment File for the next required assignment. Keep in mind that you will learn a lot by doing the assignments carefully. They have been designed to help you meet the objectives of the course and, therefore, will help you pass the exam. Submit all assignments no later than the due date.

9. Review the objectives for each study unit to confirm that you have achieved them. If you feel unsure about any of the objectives, review the study material or consult your tutor.

10. When you are confident that you have achieved a unit's objectives, you can then start on the next unit. Proceed unit by unit through the course and try to pace your study so that you keep yourself on schedule.

11. When you have submitted an assignment to your tutor for marking, do not wait for its return `before starting on the next units. Keep to your schedule. When the assignment is returned, pay particular attention to your tutor's comments, both on the tutor-marked assignment form and also written on the assignment. Consult your tutor as soon as possible if you have any questions or problems.

12. After completing the last unit, review the course and prepare yourself for the final examination. Check that you have achieved the unit objectives (listed at the beginning of each unit) and the course objectives (listed in this Course Guide).

**FACILITATOR/TUTOR AND TUTORIALS**

There are some hours of tutorials (2-hour session) provided in support of this course. You will be notified of the dates, times and location of these tutorials. Together with the name and phone number of your tutor, as soon as you are allocated a tutorial group. Your tutor will mark and comment on your assignments, keep a close watch on your progress and on any difficulties you might encounter, and provide assistance to you during the course. You must mail your tutor- marked assignments to your tutor well before the due date (at least two working days are required). They will be marked by your tutor and returned to you as soon as possible. Do not hesitate to contact your tutor by telephone, e-mail, or discussion board if you need help. The following might be circumstances in which you would find help necessary. Contact your tutor if:

- You do not understand any part of the study units or the assigned readings
- You have difficulty with the self -assessment exercises
- You have a question or problem with an assignment, with your tutor's comments on an assignment or with the grading of an assignment.

You should try your best to attend the tutorials. This is the only chance to have face to face contact with your tutor and to ask questions which are answered instantly. You can raise any problem encountered in the course of your study. To gain the maximum benefit from course tutorials, prepare a question list before attending them. You will learn a lot from participating in discussions actively.

**SUMMARY**

On successful completion of the course, you would have developed critical thinking skills with the material necessary for efficient and effective discussion of economic issues and integration of past events with the present. However, to gain a lot from the course please try to apply anything you learn in the course to term papers writing in other economic development courses. We wish you success with the course and hope that you will find it both interesting and useful.

## MODULE 1: BASIC CONCEPTS OF MONEY AND CREDIT



## UNIT 1 MEANING AND RELEVANCE OF MONEY

**CONTENTS**

## 1.0 INTRODUCTION

In this unit, we will begin the course by introducing and further expatiating the evolution of money, before explaining the meaning and relevance of money. We will also explain the various eras in the evolution of money, such as the era of the spherical venture, the era of subsistence, the era of the Barter System, the era of money exchange-commodity money, the era of money exchange full-bodied money, the era of token or credit money and the era of e-money. Furthermore, we shall look at the significance of money in the economy and also the four major functions of money in the economy.

## 2.0 OBJECTIVE

At the end of the unit, you should be able to:

- Explain the meaning and the origin of money
- Differentiate the different eras in the evolution of money
- Have a broad understanding of the four major functions of money
- Explain the roles or significance of money in the economy

## 3.0 MAIN CONTENT

### 3.1 Evolution of Money

Before the evolution of money, exchange was done based on the direct exchange of goods and services. This direct exchange is known as the barter system. The barter system involves the direct exchange of one good for some quantity of other goods, for instance, exchanging a horse for a cow. Consequently, this exchange at a time becomes more difficult in that people find it very difficult to get someone that can exchange what they have for what they want. This problem of search resulted in the problem of the barter system. Consequent the quest to solve the problem of barter resulted in means of exchange that require no goods for goods but money for goods, which is classified as the monetary evolution of money. To further understand the monetary evolution of money, we will have to discuss each of the Eras in the evolution of money, down to the credit money era.

#### 3.1.1 The Era of Spherical Adventure (Anomalism)

This era was marked by the movement of man from one end of the earth to the other. At last, he discovered that most of the fruit seeds he had dropped in the past had germinated and grown into new fruit-producing trees. Thus, this discovery marked the beginning of agriculture, which called for ownership, possession, and control. The end of this era opened the door for a new era called the subsistence era.

#### 3.1.2 The Era of Subsistence (Autarky or No Exchange)

Autarky is a Greek word from autarkeia meaning self-sufficient. According to Investopedia, it is both a political and an economic term. Autos mean “self” and arkein means “to be strong enough or sufficient” Consequently, it defines autarky as a state of independence and being functional without partaking in any international trade. The era of subsistence was marked by the simple ownership, possession, and control of natural resources. However, man discovered over time that whatever he owned possessed, and controlled in expanding the family could not be enough for him. This development gave rise to the emergence of direct exchange.

### 3.1.3The Era of Barter System (Direct Exchange)

This era of direct exchange was marked by the exchange of goods and services for goods and services within and among the expanding families. The system had no room for any medium of exchange as people exchanged the goods and services at their disposal with what the other party had for exchange. This simply means exchanging directly with your immediate or extended family person without necessarily looking distinct person before exchanging. For instance, if a man who had a goat needed a bag of oranges, he could directly exchange his goat for the bag of oranges without recourse to any medium of exchange.

### 3.1.4 The Era of money exchange-community money (indirect exchange)

This era came to resolve some of the problems posed by the barter system. Thus, unlike the barter system, the money exchange- commodity money era identified and designated a few commodities to serve as a medium of exchange, such commodities as oxen, clothes, slaves; salt, etc. were all used as a medium of exchange. Consequently, some scholars argued that these commodities were acceptable as the medium of exchange in this era because they were the most priced and sought after by the buyers of goods and services (see Element of Banking by Onyia, 2007).

### 3.1.5 The Era of Money Exchange (Full-bodied money)

The era of money exchange or full-bodied money provided solution to some of the persistent barter system problems. The money exchange or the full-bodied money era was the period when metals and subsequent papers were used as money. Iron was the first metal used, but with the effluxion of time, gold, silver, and copper was introduced to replace iron because the latter was prone to rust and very bulky to convey from place to place. The gold metals were replaced by cheaper metals such as silver and copper. At this era, the face and intrinsic values of money were equal (see Element of Banking by Onyia, 2007)

### 3.1.6 The Era of Paper Money

This is the era of goldsmith. The development of paper money started with goldsmiths who kept strong safes to store their gold. As goldsmith was thought to be honest merchant, people started keeping their goldsmiths them for safe custody. Thus, in return, the goldsmiths gave the depositors a receipt promising to return the gold on demand. However, these receipts of the goldsmiths were given to the sellers of commodities by the buyers. Thus, the receipts of the goldsmiths were use as substitute for money. Such paper money was backed by gold and was convertible on demand into gold. This ultimately led to the development of bank notes (see Element of Banking by Onyia, 2007).

### 3.1.7 The Era of Credit Money

Another era in the evolution of money in the modern world is the use of the cheque as money. The cheque is like a banknote in that it performs the same function. It is a means of transferring money or obligation from one person to another. A cheque is made for a specific sum and is not a banknote, as its empires with a single transaction. Thus, a cheque is simply a written order to transfer money (see Element of Banking Onyia, 2007).

### 3.1.8 The Era of E-money (Electronic and Cashless)

This is the era where payment or withdrawal is done by the use of a card. In Nigeria, the concept of e-money was introduced in 1996 when the C.B.N. granted approval to the then All-State Trust Bank Plc to offer ESCA Smart Card product (Onyia and Egungwu, 2004). Consequently, E-money simply means the application of electronic devices to effect payments arising from business transactions without the use of cash. It is important to note that e-money era has not foreclosed the use of note and coins, cheques and other credit instruments in transaction, rather it strictly de-emphasizes the use of cash in making payments in both local and international transactions.

**SELF ASSESSMENT EXERCISE**

i. Describe the various stages in the evolution of money

ii. Explain what led to the emergence of money in the modern world

## 3.2 Meaning of Money

The world 'money' is derived from the Latin word 'Moneta' which was the surname of the Roman goddess of Juno in whose temple at Rome money was coined. Having said that, one can say that money is something that has value that is it is a measure of value. According to the traditional view which is also known as the currency school, money is defined as currency and demand deposits, and its most important function is to act as a medium of exchange. Keynes in view, defined money as currency and demand deposit. Furthermore, Friedman Milton, the head of the monetarist school, defined money as the sum of currency plus all adjusted deposits and commercial bank time deposit. More so, the Radcliffe Committee defined money as note plus bank deposits. That is, it includes money as only those assets which are commonly used as medium of exchange. Assets here refer to liquid assets by which it means the monetary quantity influencing total effective demand for goods and service.

Despite all the definitions given, Crowther, 2011 contribute to existing literature when he gave his definition as Anything that is generally acceptable as a means of exchange and which at the same time acts as a measure and store of value is regarded as money.

## 3.3 Forms or Types of Money

There are many Forms or Types of Money and in this article, we will do justice to them for clarification:

**1. Coins -** Coins are some kinds of precious metal made of silver, which has a reasonable amount of metallic content. They also have an official stamp of authority placed on them. Coins are quite homogenous and cannot be destroyed. In Nigeria, we have coins in the following designation; 50k, 1 Naira, and 2 Naira.

**2. Commodity money**

This is the type of money that has worth when used as money and commodity. Commodity money is valuable for its own sake because it can be used for some other purposes. Commodity money can be used as a medium of exchange, for example, gold, diamond, cattle as well as beads.

**3. Bank Notes**

These are the most common forms of money they are paper slips or currency which is usually issued by the central bank. Paper money came from the receipts which were issued by goldsmiths to those who deposited precious metals, e.g., gold, with them for safekeeping. They usually come in different denominations and are easy to carry about.

**4. Partial money**

These are symbols of money that may be legal tender. They are quite acceptable within a certain area that is restricted. This kind of money is not made mandatory for acceptance by everyone because they are not backed up by law and examples include Cheque, petrol vouchers and tickets.

**5. Legal tender**

A legal tender is usually any form of payment through which a trader is forced to accept it as a means of settlement by the law in the settlement of debts. The legs tender often has the backing of the law and it is regarded as an offence should it be rejected.

**6. Token Money**

This is a kind of money that has a face value and it is greater than the value of the metal content. The intrinsic value of this money is quite lesser than the face value of such.

**7. Deposit Money**

Deposit money is a kind of money that is usually kept in the account of a bank. When money is deposited in the bank, it is usually credited to the account of the depositor. The monies kept in the deposit can often be transferred through the use of a Cheque which is a written order to pay a particular person from one's account.

**8. Flat money**

Fiat money is any kind of money that the government has declared to be legal tender but is not backed by any reserve. Paper money is often considered fiat money because it can no longer be redeemed for gold and its intrinsic worth is almost nullified.

**9. Fiduciary note**

The fiduciary note is an issued banknote that is not backed up by gold but by relevant government securities.

**10. Quasi money**

This kind of money is equally known as near money and can also be described as money assets which may serve temporarily as money and are convertible into money within a short period without lots of value, examples of quasi money are; drafts, bonds, treasury bills, Cheque as well as promissory notes. These are the types of money that exist and we are quite sure that most people only know the conventional Banknotes and coins. Feel free to share.

## 3.4 Characteristics of Money

The first forms of money were very simple. In other countries, tobacco, wooden coins, and receipts from cotton warehouses were used for money. These early forms of money lacked the flexibility and widespread acceptability of current money. For something to be used for money, it must meet the following characteristics:

• **Durability**. Money should be able to stand up under constant use.

• **Portability**. Money needs to be small enough so it can be conveniently carried in clothes, pockets, or purses.

• **Divisibility**. Money must be made in various units. You should be able to make a change. By having various units of money, goods of various values can be paid for, and change for larger units of money can be made. Barter, on the other hand, requires goods that are traded to be of equal value.

• **Uniformity**. Every bill and coin of the same value needs to look the same. Money must be uniform in that one N20.00 bill and another N20.00 bill must be able to buy the same thing. • Acceptable. Money needs to be easily recognizable. Everyone knows what a N5 note looks like, a N20 or a coin looks like. We should also be able to recognize genuine money from counterfeit.

• **Relative Scarcity**. Money needs to be hard to manufacture. If it were possible to manufacture money as easily as any other good, we would be flooded with counterfeit currency. Our money is a hard-to manufacture special paper and metal coins that have proven to be very difficult to duplicate. Money also could not be common substances like sand or clamshells that anyone could pick up on a beach. Money must be made of scarce or difficult-to-make goods

## 3.5 Functions of Money

Money performs several primary, secondary, contingent and other functions which not only remove the difficulties of barter but also oil the wheels of trade and industry in the present-day world. The functions are discussed below:

### 3.5.1 Primary Functions of Money

The primary functions are subdivided into two they are medium of exchange and money as a unit of value

i. **Money as a Medium of Exchange -** Money as a medium of exchange, acts as an intermediary i.e., it facilitates exchange. The introduction of money as a medium of exchange decomposes the single transaction of barter into separate transactions of sale and purchase, thereby eliminating the double coincidence of want. Also, money as a medium of exchange helps production indirectly through specialization and division of labour which in turn increase efficiency and output.

ii. **Money as Unit of Value**: Money as a unit of value means that money is the standard for measuring value just as the yard or metre is the standard for measuring length. The use of money as a standard of value eliminates the necessity of quoting the price of apples in terms of oranges, the price of oranges in terms of nuts, etc. Thus, money as a unit of value facilitates accounting and also helps in the calculation of economic importance such as the estimation of the costs and revenues of business firms, the relative costs, and profitability of various public enterprises and projects under a planned economy.

### 3.5.2 Secondary Function of Money

The secondary functions of money are subdivided into three, they are;

**i. Money as a standard of deferred payment** means that purchase can be made now and payment will take effect in the future. Thus, by acting as a standard of deferred payment, money helps in capital formation both by the government and businesses enterprise. The important thing about these functions is that it develops the financial and capital markets and also help in the growth of the economy.

**ii. Money as a store of value** - Money as a store of value is meant to meet unforeseen emergencies and to pay the debt. In other words, one can store value for the future by holding short-term promissory notes, bonds, preferred stocks, etc. The disadvantages of these functions are that they sometimes involve storage cost, depreciate in terms of money and are illiquid in varying degrees.

**iii. Money as a transfer of value -** Since money is a generally acceptable means of payment and acts as a store of value, it keeps on transferring values from person to person and place to place. A person who holds money in cash or assets can transfer that to any other person.

### 3.5.3 Contingent Functions of Money

Money performs certain contingent or incidental functions, such as;

**i. Money as the most liquid of all liquid assets**: This means that money is the most liquid of all liquid assets in which wealth is held. Individuals or firms may hold wealth in various forms. They may decide to hold their wealth in a currency, demand deposit, time deposit, treasury bills, short term government securities etc. All these are liquid forms of wealth which can be converted into money.

ii. **Basis of the credit system**: Money is the basis of the credit system, meaning that a commercial bank cannot create credit without having sufficient money in reserve.

iii. **Equalizer of Marginal utilities and productivities**: Money acts as an equalizer of marginal utilities for the consumer. The main aim of a consumer in this regard is to maximize his satisfaction by spending a given sum of money on various goods which he wants to purchase.

iv. **Distribution of National Income**: Money also helps in the distribution of national income. Thus, the rewards of factors of production in the form of wages, rent, interest and profit are determined and paid in terms of money

### 3.5.4 Other Functions of Money

Money performs other functions apart from the aforementioned ones such as;

**i. Money helps make decisions**

This means that money is a means of the store of value and the consumer can meet her daily requirement based on money held by him. If the consumer has a scooter and shortly, he needs a car, he can buy a car by selling his scooter and money accumulated by him. In this way, money helps in taking decisions.

**ii. Money as a basis of adjustment**

To carry on trade properly, the adjustment between the money market and capital market is done through money. Similarly, an adjustment in foreign exchange rate and international payments are made through money.

**SELF ASSESSMENT EXERCISE**

i. Explain the various secondary functions of money

ii. Distinguish between contingent functions of money and of primary functions of money

## 3.6 Role of Money in The Economy

Money is of vital importance to an economy due to its static and dynamic roles. Its static role emerges from its static or traditional functions. In its dynamic role, money plays an important part in the life of every citizen and the economic system as a whole (Jhingan, 2010).

### 3.6.1 Static Role of Money

In its static role, the importance of money lies in removing the difficulties of barter in the following ways:

**i.** **By serving as a medium of exchange**, money removes the need for double coincidence of wants and the inconveniences and difficulties associated with barter. The introduction of money as a medium of exchange breaks up the single transactions of barter into separate transactions of sales and purchases, thereby eliminating the double coincidence of wants

**ii.** **By acting as a unit of account**, money becomes a common measure of value. The use of money as a standard of value eliminates the necessity of quoting prices.

**iii.** **By acting as a store of value**, money removes the problem of storing commodities under barter. Money being the most liquid asset can be kept for long periods without deterioration or hostage.

iv. Money removes the difficulty of barter by facilitating the transfer of value from one place to another.

**v.** **Money as a standard of deferred payment**, simplified both taking and repayment of loans because the unit of account is durable. It also overcomes the difficulty of the indivisibility of commodities.

### 3.6.2 Dynamic Role of Money

Money in its dynamic role plays an important part in the daily life of a person whether he is a consumer, producer, businessman, politician, etc. The Dynamic role of money influences the economy in several ways:

**i.** **Money possesses much significance for the consumer**:

That is, the consumer receives his income in the form of money rather than in goods and services. With money in his hand, he can get any commodity and services he likes, in whatever equalizer of marginal utilities for the consumer

ii. **Money is of equal importance to the producer**. He keeps his account of the values of input and outputs in money.

iii. **Money plays an important role in large-scale specialization and division of labour in modern production** i.e., it helps the capitalist to pay wages to a large number of workers engaged in specialized jobs based on the division of labour. By transforming savings into investment, money acts as a means of capital formation. Money in its form is a liquid asset that can be stored and storing money implies savings and savings are kept in bank deposits and earn interest on them.

v. **Money is also an index of economic growth**. The various indicators of growth are national income, per capita income, and economic welfare. These are calculated and measured in money terms. For instance, changes in the value of money or prices also reflect the growth of an economy.

vi. **Money facilitates both national and international trade**. The use of money as a medium of exchange, store of value, and transfer of value has made it possible to sell commodities not only within a country but also internationally.

vii. **Money helps in solving the central problems of an economy**; what to produce, for whom to produce, how to produce, and in what quantities. This is because based on its functions, money facilitates the flow of goods and services among consumers, producers and, the government

viii. **Money facilitates the buying and collection of taxes, fines fees, and prices of services rendered by the government to the people**. It also simplifies the floating and management of public debt and government expenditure on development and non-developmental activities.

**SELF ASSESSMENT EXERCISE**

- Briefly discuss the static role of money in the economy.
- Explain some of the dynamic significance of money in the economy.

## 4.0 CONCLUSION

In this unit, we extensively discussed the meaning and the relevance of money in the economy. Also, the major functions money has in the economy were not ignored. Money being what it is has helped in facilitating and making exchange easy, by putting to an end the problems barter system created.

## 5.0 SUMMARY

This unit treats the fundamentals of money by looking into the various eras in the evolution of money as well as explaining them in detail. Also, a different definition of money was given by different economists, ranging from the traditional definition down to the monetarist definition of money. In the course of writing, we found out that money plays a significant role in the economy.

## 6.0 TUTOR-MARKED ASSIGNMENT

1. Differentiate between money as a medium of exchange and money as the most liquid of all liquid assets.
2. State the static roles of money in the economy.
3. Differentiate between the era of subsistence and the era of spherical adventure.

## 7.0 REFERENCES/FURTHER READING

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## UNIT 2 THEORY OF MONEY CONTENTS

## 1.0 INTRODUCTION

Having discussed extensively the relevance and meaning of money in the previous unit, this current unit will further explain the theory of money, by focusing on the theory of demand for money only. Having said that, one can define the demand for money as the amount of wealth everyone in the society wishes to hold in the form of money balances. In other words, it is the desire of people to hold money balances either in cash or in-demand deposit form. It is important to note that the demand for money is directly related to the level of income i.e., the higher the income level; the greater will be the demand for money. Consequently, in this unit, we will discuss in detail the classical approach to the demand for money, the Keynesian and the post-Keynesian demand for money.

## 2.0 OBJECTIVES

At the end of this unit, you should be able to:

- Define the demand for money and explain the theories behind it.
- Differentiate between the Classical Approach, the Keynesian Approach and the Post-Keynesian Approach.
- Explain the superiority over each and the criticisms of each.

## 3.0 MAIN CONTENT

### 3.1 The Classical Approach to Demand for Money

The Classical economists did not explicitly formulate a demand for money theory, but their views are inherent in the quantity theory of money. The Classical economist which has Irving Fisher and the Cambridge School have slightly different views on the demand for money theory. These two will be explained subsequently in detail.

#### 3.1.1 Irving Fisher View on Demand for Money

Irving Fisher was the first classical economist to develop a theory on the quantity theory of money, although he did not explicitly formulate a demand for money. In his theory postulated in 1928, established the link between quantities of money and the total amount of money spent on goods and services in the economy. In his equation of exchange, he said that MV = PT Where

M is Money stock

V is Velocity,

P is Price Level and

T is the Average Transaction of goods in the economy.

According to his theory, holding velocity and average transaction constant, anything that happens to money stock will also happen to price, that is, if money stock doubles in the economy, the price will also double. Consequently, the Fisher's equation of exchange shows that the right-hand side of the equation i.e., PT represent the demand for money, which depends upon the value of the transactions to be undertaken in the economy and is equal to a constant fraction of that transaction while MV represents the supply of money. Furthermore, the demand for money in Fisher's approach is a constant proportion of the level of transaction which in turn bears a constant relationship to the level of national income. The theory of demand for money by fishers has faced several criticisms. It is said that the theory failed to incorporate or consider interest as a factor and also that there is no way velocity in the economy can be held constant, just to mention a few. Lastly, one of the problems Fisher's theories has among other problems is that he did not explain fully why people hold money and also, he did not clarify whether to include money in such items as time deposit or saving deposit that are not immediately available to pay debts without first being converted into currency.

### 3.1.2 The Cambridge or Cash Balance Approach

The Cambridge economists are a set of classical economists who are interested to know why people want to hold their assets in the form of money. Unlike Irving Fisher who dwelt so much on the transaction motive for demand for money and who also sees money as a medium of exchange, the Cambridge economist views the demand for money from the precaution aspect and also sees money not as a medium of exchange but as a stock of value. Also, just like Fisher, the Cambridge expresses the demand for money function as $M d = KPY$ where $M d$ is the demand for money K is the Constant of proportionality or the fraction of the real money income which people wish to hold in cash P is the price level and
Y is the aggregate real income.

The Cambridge approach to the demand for money includes time and saving deposits and other convertible funds in the demand for money. They also stressed the importance of factors that make money more or less useful, such as the cost of holding it, uncertainty about the future etc. Just the way Fisher's theory was criticized; the Cambridge theory was also criticized.

In a nutshell, the classical economist was subjected to criticism. One of the major criticisms of the classical approach to the demand for money is that they emphasized only on the medium of exchange and store of value function of money without considering other factors that affect demand for money such as interest rate.

Second, it failed to analyze variation in the price level due to saving-investment inequality in the economy.

Third, the theory is weak in that it ignores other influences such as the rate of interest which exerts a decisive and significant influence on the price level.

Fourth, the theory neglected speculative demand for money. The neglect of the speculative demand for cash balance makes the demand exclusively dependent on money income thereby neglecting the role of the rate interest and the store of value function of money.

Fifth, the cash balance approach does not talk about changes in the price level due to changes in the proportions in which deposits are held for income, business and saving purposes.

**SELF ASSESSMENT EXERCISE**

i. Distinguish between Fisher's demand for money and the Cambridge demand for money approach.

**3.2 The Keynesian Approach to Demand for Money: Liquidity preference**

The Keynesians are the set of British economists who believe in the efficiency of fiscal policies as opposed to the use of monetary policies to control economic activities. They hold the view that demand for money falls within the realm of liquidity preference. Lord Keynes in his theory of demand for money suggested three motives to demand for money. These motives are:

**A. Transaction Demand for Money**: This simply refers to the need to hold some money for the daily business transaction. The transaction demand for money arises from the medium of exchange function of money in making regular payments for goods and services. Keynes in his theory of demand for money divided the transaction demand for money into two i.e., Income Motive which means to bridge the interval between the receipt of income and its disbursement and secondly Business Motive which means to bridge the interval between the time of incurring the business cost and that of the receipt of the sale proceeds (see Jhingan, (2011). Consequently, Keynes in his theory further argued that the transactions demand for money is a stable function of the level of income and that the transaction demand for money has a direct proportional relationship with the level of income i.e., L T = f (KY), while L T of transaction demand for money while KY represent the linear and proportional relationship between transaction demand for money and the level of income. Keynes in his transaction demand for money did not stress the role of interest rate.

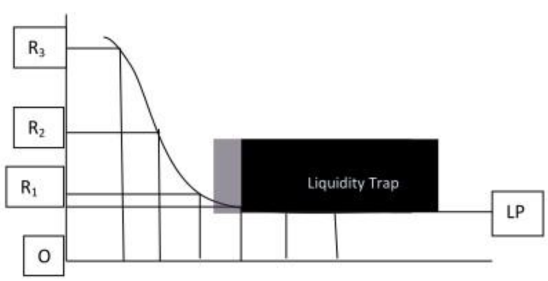
**B. Precautionary Demand for Money**: This is a situation where money is held for unforeseen circumstances and eventualities. Both individuals and businessmen keep money or cash to meet unexpected needs. The precautionary demand for money depends upon the level of income, and business activity, opportunities for unexpected profitable deals, availability of cash, the cost of holding liquid assets in bank reserve etc.

Keynes in his analysis held that the precautionary demand for money like transaction demand is a function of the level of income. But the Post-Keynesian economists believe that like transaction demand, it is inversely related to the high-interest rate. Note both the transaction and precautionary demand for money will be unstable, particularly if the economy is not at full employment level and transactions are, therefore, less than the maximum and are liable to fluctuate up and down.

According to Keynesian, the precautionary demand for money is expressed as LT = f (Y, r).

**C. The Speculative Demand for Money**: The speculative or asset or liquidity preference of demand for money is for securing profit from knowing better than the market what the future will bring forth. Also, it is a situation where people hold money not for transactions or precautionary purposes, but for the purpose of making more profit in the future or taking advantage of investment in the future. Thus, money held for speculative purposes is a liquidity store of value which can be invested at an opportune moment in interest-bearing bonds or securities. According to Keynesian, in his liquidity preference theory, bond prices and the rate of interest are inversely related to each other. This is to say that low bond prices are indicative of a high-interest rate and high bond prices reflect low-interest rates. Note importantly that wealth holders go for capital gain so as to avoid capital loss. For instance, if the rate of interest is higher than normal and so is being expected to fall, wealth holders demand less money, that is, they hold more bonds in anticipation of capital gain i.e., they will buy bonds to sell them in future when their prices rise in order to gain. Conversely, if the rate of interest is low than normal and so is expected to rise, the demand for money will be high, thus giving the wealth holders the opportunity to sell bonds in the present so as to avoid the capital. Thus, it is important to note that the speculative demand for money is a decreasing function of the rate of interest. The higher the rate of interest, the lower the speculative demand for money and vice versa. This is shown graphically below

**DIAGRAM OF THE SPECULATIVE DEMAND FOR MONEY**




Speculative demand for money according to Keynesian is expressed as LS = f (r). Also, he further explains the liquidity trap as a situation where the real interest rate cannot be reduced by any action of the monetary authorities. This is likely to happen when the market interest rate is very low so that the yields on bonds, equities and other securities will also be low.

### 3.2.1 Criticisms of the Keynesian Theory of Demand for Money

The Keynesian theory of demand for money was undoubtedly a radical improvement over the classical and neoclassical theories of money. His theory has however been criticized on the following ground by post-Keynesian theorists;

Firstly, Keynes's division of demand for money between precautionary and speculative motives is unrealistic, because people do not maintain a separate purse for each motive. They have one purse for all purposes. Besides, empirical evidence shows that, contrary to Keynes's postulate, even the transaction demand for money is interest elastic.

Secondly, critics reflect the Keynesian postulate that there exists a normal rate of interest and the current rate of interest may not necessarily be the same as the normal rate: there may always be a difference between the two. According to Keynes, the speculative demand for money is governed by the difference between the normal and the current rate of interest, but the critics argue that if the current rate of interest remains stable over a long period of time, people tend to take it to be normal rate. Consequently, the difference between the current rate and the normal rate disappears.

Thirdly, Keynes assumed unrealistically that the people hold their financial assets in the form of either idle cash balance or bond. In fact, people hold their assets in a combination of both assets.

**SELF-ASSESSMENT EXERCISE**

i. Differentiate between the Transaction motive and the Speculative motive of demand for money.

ii. Explain the term liquidity trap using graph as a support.

### 3.3 The Post-Keynesian Approach to Demand for Money

The Post-Keynesian has their approaches to demand for money. According to Keynes in his approach to demand for money brought out three motives to demand for money. These motives have been extensively analyzed in the Keynes demand for money. Consequently, Keynes in his demand for money believed that the transactions demand was primarily interest inelastic. He analyzed speculative demand for money in relation to uncertainty in the market.

Basically, outside Keynes and the Keynesian approach to the demand for money, we have others who have dealt immensely with the demand for money in recent times. These scholars are Baumol Williams (1952), who analyzed the interest elasticity of the transactions' demand for money based on his inventory theoretical approach, the second scholar is James Tobin (1956) who in his analysis explained liquidity preference as behaviour toward risk and the third scholar is Friedman Milton (1959), who formulated that the demand for money is not merely a function of income and the rate of interest, but also of the total wealth. These three Post-Keynesian approaches to demand for money will be explained subsequently.

### 3.3.1 Williams Baumol Inventory Theoretic Approach

Baumol made an important addition to the Keynesian transaction demand for money. As Keynes regarded transaction demand for money as a function of the level of income and that the relationship between transaction demand and income is linear and proportional. Baumol in his analysis show that the relation between transaction demand and income is neither linear nor proportional, rather changes in income lead to less than proportionate change in the transaction demand for money. Furthermore, as Keynes considers transaction demand as primary interest inelastic, Baumol analyses the interest elasticity of transaction demand for money. Baumol's analysis of transaction demand for money is based on the holding of an optimum inventory of money for transaction purposes by a firm or an individual. Thus, he further writes that a firm's cash balance can usually be interpreted as an inventory of money that its holder stands ready to exchange against purchases of labour, raw materials etc. In a nutshell, Baumol is saying that firms should try to keep minimum transaction balances in order to earn maximum interest from its asset i.e., the higher the interest rate on bonds, the lesser the transaction balance that a firm holds. Thus, the holding of cash balance consists of interest cost and non-interest cost. Interest cost is an opportunity cost because when a firm holds a cash balance for transaction purposes it forgoes interest income, while non-interest cost includes such items as a brokerage fee, mailing expense etc. Lastly, Baumol's inventory theoretic approach to the transaction demand for money is an improvement over the classical and Keynesian in that:

i. The theory has the merit of demonstrating the interest elasticity of the transaction demand for money as against Keynes's view of interest inelastic.

ii. The theory also analyses the transaction demand for real balances

iii. thereby emphasizing the absence of money illusion.

iv. The theory also integrates the transaction demand for money with the capital theory approach by taking assets, interest and non-interest costs into account.

### 3.3.2 James Tobin's Portfolio Selection Mode: The Risk Aversion theory of liquidity preference

James formulated the risk aversion theory of liquidity preference which is based on portfolio selection. His theory removed the two major defects of the Keynesian theory of liquidity preference. Firstly, Keynes's liquidity preference function depends on the inelasticity of expectations of future interest rate and secondly, that individuals hold either money or bonds in wealth has been removed. Furthermore, Tobin's theory does not depend on the elasticity of expectation of future interest rate but he proceeds on the assumption that the expected value of capital gain or loss from holding interest-bearing assets is always zero. James Tobin further in his portfolio selection model described the three categories of investors.

James Tobin starts his portfolio selection model liquidity preference with the presumption that an individual asset holder has a portfolio of money and bonds. In other words, money neither brings any return nor imposes any risk on him, but bond tends to yield interest and also bring income. He further said that income from bonds is uncertain because it involves a risk of capital losses or gains i.e., the greater the investment in bonds, the greater the risk of capital loss from them. For instance, if g is the expected capital gain or loss, it is assumed that the investor bases his actions on his estimate of its probability distribution. He further assumed that this probability distribution has an expected value of zero and is independent of the level of the current rate of interest on bonds. It is important to note that Tobin's portfolio selection consists of a proportion M of money and B of bond where both M and B add up to 1 and has a return on portfolio R i.e., $R = B(r + g)$.

Tobin's further described the three categories of investors.

i. The risk lover who enjoys putting all their wealth into bonds to maximize risk. They accept the risk of loss in exchange for the income they expect from bonds.

ii. The risk plungers, are investors who will either put all their wealth into bonds or will keep it in cash.

iii. The third category is the risk averters or diversifiers. These kinds of investors prefer to avoid the risk of loss which is associated with holding bonds rather than money. In other words, they are preparing to bear some additional risk only if they expect to receive some additional return on the bond.

### 3.3.3 Friedman Milton's Theory of Demand for Money

Friedman Milton's theory of demand for money is a capital or wealth theory because he regards money as an asset or capital good. He developed a model for money demand based on the general theory of asset demand. In his theory, he said that money demand like the demand for any other asset should be a function of wealth and the returns of other assets relative to money. According to his theory, wealth can be held in five different forms such as:

i. Wealth can be held in the form of money, meaning that money is taken in the broadcast sense to include currency, demand deposit and time deposit which yield interest on deposits.

ii. Wealth can be held in the form of Bonds, meaning that the yield on bonds, R b includes coupon interest rate or the expectation of capital profit or loss due to a fall or rise in the expected market rate of interest.

iii. Wealth can be held in the form of equities, that is, the yield on equalities R e includes return on dividend rate, expected profit or loss due to changes in interest rate.

iv. Wealth can be held in the form of physical goods or non-human goods. Physical goods or non-human goods are inventories of producer and consumer durables. The returns are affected by the expected rate of changes in price.

v. Wealth can be held in the form of Human Capital i.e., W = Y/r where W is the current value of total wealth, Y is the total flow of expected income and r is the interest rate.

Thus, the demand for money function in Friedman's theory is given as Md/P = f (Y, W, R m, R b, R e g p, N) were

Thus, the demand for money function in Friedman's theory is given as Md/P = f ($Y$, $W$, $R_m$, $R_b$, $R_e$ $g_p$, $N$) where

$M = total\ stock\ of\ money;$

$Y = is\ the\ real\ income;$

$P = price\ level;$

$W = fractions\ of\ wealth\ in\ non-human\ form;$

$Rm = Expected\ nominal\ rate\ of\ return\ on\ bond;$

$Rb = Expected\ nominal\ rate\ of\ return\ on\ bond;$

$Re = Expected\ nominal\ rate\ of\ return\ on\ equalities\ including\ expected\ changes\ in\ the\ prices;$

$g_p = {}^{1}\!/_{p} . \frac{dp}{rr}$ *is the expected rate of changes of price of goods and hence the expected nominal rate of return on physical assets.*

N = Variables other than income that may affect the utility of service.

It is important to note that the relationship between demand for money and wealth is positive. This is to say that when wealth increases, the demand for money also increases because people hold more wealth. Thus, the empirical evidence is greater than unity which means that income demand for money function is stable and will be relatively interest inelastic.

### 3.3.4 Criticisms of the Friedman Milton Theory of Demand for Money

i. Friedman Milton's theory does not talk about timing and speed of adjustment or the length of time to which his theory applies

ii. The theory ignores the effect of prices, output or interest rates on the money supply, but there is considerable empirical evidence that the money supply can be expressed as a function of the variables earlier given.

iii Friedman`s demand for money function, wealth variables are preferable to income and the operation of wealth and income variables simultaneously does not seem to be justified.

iv Friedman takes the supply of money to be unstable, thus, the supply of money is varied by the monetary authorities in an exogenous manner.

**SELF ASSESSMENT EXERCISE**

i. Briefly explain the superior of Baumol's theory of demand for money over Keynes.

ii. Explain the three categories of investors in Tobin's Risk Aversion of liquidity preference.

## 4.0 CONCLUSION

The unit extensively explains the various approaches to demand for money, ranging from the classical approach to the demand for money down to the post-Keynesian demand for money. Also, a series of criticisms were made. Although the classical approach to the demand for money focuses on the transaction and precautionary demand for money, they tend to neglect or consider interest rate as a factor. Keynes elaborated on what the classical approach did and more so incorporate interest rate by introducing speculative motive or Keynes liquidity preference which considered interest rate. Although Keynes's theory was criticized by the post-Keynesian monetary theorist because the theory has some faults.

## 5.0 SUMMARY

In this unit, we have succeeded in explaining the theories of demand for money, starting from the classical approach to the demand for money, the Keynesian demand for money and the post-Keynesian demand for money. Also, the unit immensely discussed the various criticisms and faults each of the approaches has apart from that of the post-Keynesian approach to the demand for money.

## 6.0 TUTOR-MARKED ASSIGNMENT

i. Distinguish between the Fisher's equation of exchange and the Cambridge's approach to the demand for money.

ii. Explain James Tobin's Risk Aversion theory of liquidity preference.

iii. When should a wealth holder make a capital gain.

iv. Explain the three criticisms in the Keynesian demand for money theory.

v. Describe the five different forms of wealth in Friedman Milton's theory of demand for money.

vi. Explain Fisher's equation of exchange as regards the demand for money.

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## UNIT 3 MONEY, CREDIT AND THEIR SIGNIFICANCE TO THE ECONOMY

**CONTENTS**



## 1.0 INTRODUCTION

In this unit, you will learn more about money, credit and interest rate. Also, the unit will expose us more to 6 C‟s in borrowing and also explain the term structure of interest rate.

## 2.0 OBJECTIVES

At the end of this unit, you should be able to:

- Define money, credit, and interest.
- Explain the six (6) C‟s bank considers before borrowing.

- Explain the inverse relationship between interest rate, demand for money, and investment.

The bank BCA will reserve 20% and lend the reserve, the process goes like that.

## 3.0 MAIN CONTENT

### 3.1 Money and how it is created by Banks

Money since its inception has contributed so much as a medium of exchange and settling of debt in the economy. Before now, that is during the barter system, the exchange has been so difficult since one has to look for someone that will exchange what he has before he can get what he needs. But today, the introduction of money has solved the problem of double coincidence of wants. Having said that, one can say that money is a solution to a problem. Money is defined as an item, income, wealth, credit, provision, and sort of financial resources available as purchasing power in the society i.e., it serves as the gauge, or barometer to determine or measure the wealth of an individual organization and or government. Onyia and Egungun (2004) defined money as anything generally acceptable in a given society or locality as a means of exchange and settlement of debts. Chandler and Adekanye both legal personnel have said from the legal view that money is what the law says it is.

#### 3.1.1 How Banks Create Money

The creation of money by banks is more of a movement of currency in circulation to demand deposits. In an actual sense, no new money is created by the banks in the process of money creation. The money creation process is a record of a chain of events that results from the initial deposit of money into a current account in a bank by a customer dependent. The process of money creation is premised on the principle of a fractional reserve system which posits that a bank need not keep all the deposits in the vault as idle cash, the bank is expected to keep part as a reserve and invest the balance in the business including lending. This is because a depositor will rarely demand his money all at a time. It is based on this principle that banks keep part of the deposit of customers as a legal reserve requirement stipulated by monetary authorities and lend out the excess deposits. The process of money creation is based on the following assumptions.

i. There is a subsisting current account belonging to the depositor.

There is a stipulated legal cash reserve requirement.

ii. There is no cash drain or leakage in the system. That is, withdrawals made by depositors are re-deposited by new depositors less the legal cash reserve.

iii. There is an efficient clearing system.

iv. The commercial banks maintain the stipulated reserve in monetary

v. The borrowing and lending processes are continuous, and banks are willing to lend and borrowers are willing to take loans.

The process of money creation by banks may be explained through the use of a formula. The formula approach is given as:

Total deposit =

1 ID

1

Where I = Constant

C = Excess Reserve (RE) ID = Initial Deposit TD = Total Deposit

Example: Let us assume that Mr. Sunday made an initial deposit of N30, 000 into bank ABC when the ratio was 20%. The excess reserve will be lent to another individual who is expected to deposit some into bank ABC 2.

The bank ABC will reserve 20% and lend the reserve, the process goes like that.

Solution:

TD =

1 ID

1

=

1/1 - (100 - 20) %

×

30000

1

1

1 – (0.8) x 30000

1 = 1/0.2 x 30000 = 150,000

### 3.1.2 Limitation to Ability of Banks to create Money

The limitations to the ability of banks to create money include:

i. Incidence of Cash Drain or Leakage - If there is a cash drain in the system, the bank's ability to create money is constrained. Cash drain or leakage occurs when the borrower decides to withdraw money from the banking system for whatever purpose.

ii. Legal Cash Ratio - The level of the legal cash reserve affects the ability of banks to create money. A higher legal cash reserve will definitely result in the creation of less volume of money in the system.

iii. Savings ability of the people - The more people deposit money into the banks, the more banks are disposed to create credit. If fewer deposits are made into banks, less money may be lent by the banks hence less credit is created.

iv. Interest Rate Structure - The dynamics of interest rate affect the money creation ability of the banks. If the interest rate is excessively higher, fewer people will be willing to borrow from the banks. The incidence of fewer borrowers limits the money creation ability of banks.

v. Effective and Efficient Cheque Clearing System - An effective and efficient cheque clearing system is a prerequisite for banks to create money. This is because such a system guarantees smooth clearing of cheques and settlement of claims that encourages the use of cheques.

vi. Condition attached to the loans - The stiffer the conditionality attached to loans, the lesser the borrowers will be willing to borrow. This will reduce the money creation ability of the banks.

**SELF ASSESSMENT EXERCISE**

i. Explain the economist's definition of money.

ii. Explain the limitation to the ability of banks to create money.

## 3.2 Credit and Importance of Bank Credit to the Economy

Credit can be defined as the value of goods and services enjoyed or made use of by a business firm and on which payment is made sometimes thereafter. It also means the transfer of goods and services from a seller to a buyer without any value being given immediately in return. There are however two types of credit available and these are:

### 3.2.1 Trade Credit

This is a system whereby manufacturers collect money from wholesalers in advance in order to enable them to raise money to produce goods and pay the wholesalers with goods produced with the money collected. Also, the wholesalers allow retailers to collect goods without making immediate payment but pay the old debt when the retailers come to buy new goods on credit. No interest is involved in trade credit. This source of finance is available to all business firms irrespective of size. It involves no cost if there is no cash discount or if the amount is paid within the discount period. The following sources of information are essential for granting trade credit by supplier firms:

i. The supplier's past trading records of the customer.

ii. The customer's application request.

iii. The customer's bank(s) i.e., by making a status inquiry.

iv. The industry to which customers belong.

v. The customer's business associates.

### 3.2.2 Bank Credit

No company operates as an island nor is there any business firm that is self-sufficient financially, there arises the need for businesses to interact with one another for different purposes, especially for financial assistance for the smooth operation of such businesses. The basis of credit financing in any economy is to ensure liquidity and solvency. Thus, bank credit is loans and overdrafts granted by banks to deserving customers on request. Bank credit is usually a short-term loan, which requires adequate security, and it is one of the important sources of income for banks. Thus, Bank Credit is controlled by Central Bank through Credit Sectoral allocation and credit ceiling and depending on how reasonably liquid the bank is. Note it is a known fact that bank credit facilities are granted or extended only to the deserving bank customer.

### 3.2.3 The Six Cs in Credit

Before credit can be given, certain things need to be considered. These things are the six C's that are involved in credit. They are:

i. **Character** - This is a situation where the character of the customer is questioned. That is, the character of the customer is examined in detail by considering the following; the integrity of the customer, his social standing, and the experience of the customer in the line of business he engages in. Thus, in assessing character, the manager's personal experience based on past dealings with the customer is very important. If the customer has been in the branch for some time, his account should be scrutinized to ascertain the nature of his business. The purpose of making these inquiries is to assess the customer and reduce the risk of lending to an unknown person.

ii. **Capital** - This refers to capital contributed by the owners of the business, its adequacy or not, and the form or types of capital they are since the amount and size of company capital signify the degree of commitment of the owner of such business, their seriousness and one of the premises on which lending banker counts in determining the amount to be extended. The assessment of capital in the case of an individual will include his salary and other sources of income and in the case of the business firm through analysis of its financial statement.

iii. **Capability** - This means that the lending banker must take into consideration the type of customer requesting credit and whether an individual or business firm uses the credit for what is meant for. Also, it is the duty of the bank or the banker to assess the ability of the borrower to repay both principal and interest within a satisfactory future period.

iv. **Collateral** - This is important because banks can easily recover that money back when they have an asset that has greater value than the amount they gave out. The purpose of taking collateral or security is to ensure that borrower does not default in the long run when the loan has been given out. Examples of securities requested are Real Estate, Documentary Credits, and Quoted Shares, Government Securities such as Treasury Bills etc. and plants and equipment.

v. **Condition** - This may include the cost of fund, that is at what interest rate and the term of repayment. Other conditions could be the submission of a half-yearly management account to the borrower's company, statement of sources and application of funds, cash flow analysis statement i.e., cash budget and yearly audited accounts of the company etc.

vi. **Connection** - Connection may be direct or indirect. In a direct connection, the customer is personally involved, for example, M.D of the company, which maintains a valuable credit balance with a bank, if such a director should request a reasonable amount and his request is declined, the bank will run the risk of losing the account of his company. In the case of indirect connection, the customer is not directly involved but in his relationship.

### 3.2.4 Credit Facilities Available in Nigerian Banks

There are many avenues for raising credit from the bank as there are various types of banking services and banking institutions in the economy. The following are some of the credit facilities or instruments available in Nigerian Banks.

i. **Bank Overdraft** - This is a short-term source of finance on which interest is charged on outstanding balance by the bank and such interest charged is allowable for a tax deduction. Bank overdrafts are largely repayable on demand; therefore, they should be applied to assets, which are readily realizable or disposable. It is generally unsecured but, in some cases, banks coupled with the provision of collateral.

ii. **Bank Term Loan** - These are usually issued for a definite period of time, unlike overdraft. They normally carry higher interest charges because of the period covered and the fact that banks might want to avoid the problem of fluctuations in interest charged on loans.

iii. **Inventory Financing** - Under this financing system only finished goods and raw material quality as a form of collateral as there is no market for work-in-progress. The lender will usually provide finance in the amount of one half of the collateral that qualifies.

iv. **Lines of Credit** - This is not a loan but a favourable method of securing a loan. The company can go to the bank and arrange for a line of credit or borrow when she did not need it. A line of credit is an advance reservation that makes funds available to be used only when needed.

v. **Credit Cards** - This is a convenient method of payment which affords the holder enjoyment of credit and an immediate payment on the transaction. Thus, more and more customer orders are being placed by phone or by computer over the internet allowing the customer to pay with a credit card. Credit cardholders are allowed credit facilities by the concerned bank for a specified period of time without any security from them.

vi **Project Financing** - This source though relatively new is normally made available after consideration, analysis and assessment of the project has been carried out by the bank.

vii. **Equipment Leasing** - This is an agreement whereby a person called the lessor conveys to another person called the lessee in return for rent the right to use an asset for an agreed period of time.

viii. **Bill Discounting** - This is a situation where a company in need of funds obtains credit from a bank against its bills. The bank purchases or discounts the borrower's bills by providing an amount less than the face value of the bill after assessment and consideration of the creditworthiness of the borrower.

### 3.2.5 Importance of Bank Credit to the Economy

Credit is of vital importance for the working of an economy. It is the oil of the wheel of trade and industry and helps in the economic prosperity of a country in the following ways:

i. Mobilization and Intermediation of funds by banks from the surplus to the deficit units of the economy is no doubt has facilitated a tremendous increase in investment activities by reducing the incidence of idle funds and thereby promoting the growth of the money market in the economy

ii. Availability of Bank Credit enables firms to purchase raw materials needed for production at the right time, right source and the right quality and at competitive prices and this is more pronounced with a business that import a substantial part of their raw materials from overseas.

iii. Bank Credit enables certain productive activities, which would have been impossible to be available locally, thus improving the economy.

iv. Bank Credit has made it possible for highly sophisticated equipment such as farm tractors, harvesters etc. to be readily available to the developing economy.

v. Bank Credit has not enabled many firms to gain access to the capital market, it has enabled such firms to develop their research and development department which invariably leads to improvement in the quantity, quality and variety of goods and services made available by such companies.

**SELF ASSESSMENT EXERCISE**

i. Briefly explain the importance of bank credit to the economy.

## 4.0 CONCLUSION

The unit explained the various factors that determine the term structure of interest rate and also went further to discuss the C`s in credit which is seen as an important factor to reckon with when banks are considering giving out loans to their customers. However, we also explain money and credit can be created by banks.

## 5.0 SUMMARY

In this unit, we have succeeded in explaining extensively the money, credit and their significance to the economy. The unit also discussed the six C`s of credit in the bank.

## 6.0 TUTOR-MARKED ASSIGNMENT

i. Briefly list six assumptions involved in the process of money creation.

ii. Explain some of the credit facilities available in Nigerian banks.

iii. Explain the following; (a) cost of funds and (b) expectations and uncertainty.

iv State five importance of credit to the economy.

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## MODULE 2: FINANCIAL INSTITUTIONS AND THEIR RELEVANCE TO THE ECONOMY



## UNIT 1 MEANING OF FINANCIAL INSTITUTION AND ITS CLASSIFICATION

**CONTENTS**

## 1.0 INTRODUCTION

In this unit, you will understand why financial institutions are established as an intermediary between individuals with surplus funds and those with deficit funds. You will also understand the evolution of financial institution, their relevance and their classification.

## 2.0 OBJECTIVES

At the end of this unit, you should be able to:

- Understand the definition and evolution of the banking system in Nigeria.
- Distinguish between banking financial institutions and non-banking financial institutions.
- To state the relevance of financial institutions.

## 3.0 MAIN CONTENT

### 3.1 Evolution and Definition of Financial Institutions in Nigeria

Banking which is also referred to as a financial institution had its origin with the goldsmith in London in the 17$^{th}$ century. The goldsmiths had facilities for storing valuables; therefore, they accept money and other valuables from merchants for safekeeping. The first banking function was accepting deposits of cash from merchants who had no safe place to keep their money. The second stage came when the receipt for these deposits began to be used as means of payment by merchants. This made the early bankers issue banknotes of fixed denominations, which were more generally acceptable.

The next stage in the development of the banking system was the development of money lending to customers with interest charged on it. This provided a profitable business; hence bankers began to offer the inducement of interest to encourage merchants and others to increase their deposits. The ideology of goldsmith on banking has spread abroad and today practice banking in the continent of the world including Nigeria. Nigeria’s banking system commenced in 1892, and they copied the London banking system since Goldsmith is a British citizen. Having said briefly about the evolution of banking, one can now define the financial institution.

Financial Institution refers to all business organizations which hold money for individuals and institutions and may borrow from them in order to give loans or make other investments. Financial institutions are very important for the economic development of a nation. They represent the main channel or medium by which funds can flow from lenders to borrowers.

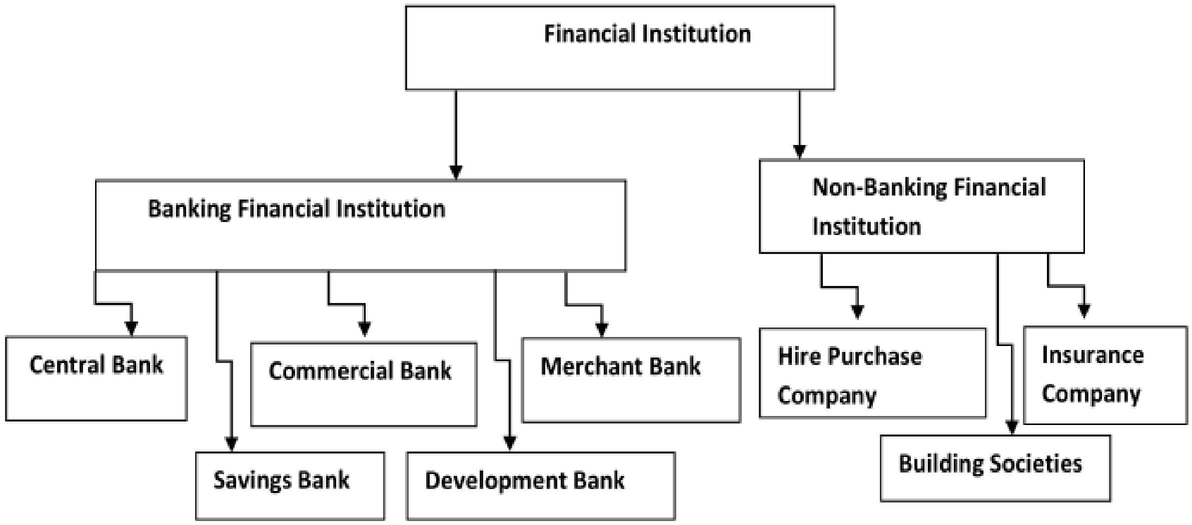
**SELF ASSESSMENT EXERCISE**

In detail explain the various stages in the evolution of Banking

## 3.2 Classification of Financial Institution

Financial Institutions may be divided into two major groups i.e., banking and non-banking financial institutions. The major difference between the banking and the non-banking financial institutions is that the liabilities of the banking institutions are counted as part of the total supply of money while those of the non-banking institutions are excluded from the money supply.

**STRUCTURE OF THE FINANCIAL INSTITUTION**




- Central Bank is the apex financial institution in the economy, that is empowered by the law to supervise and regulate the financial system. It also includes the formulation of policies that will influence the management of money and credits hence enhancing the achievement of set government economic objectives.
- Commercial Banks are financial institutions which accept deposits and other values from the public for safekeeping with the sole aim of making profits. In other words, they are financial institutions that perform the services of holding people's money and accounts and using such money to make loans and other financial services available to customers.
- Merchant Banks are financial institutions which perform specialized functions, such as acceptance of bills of exchange, issuance of loans for foreign trade transactions, issuance of new shares and provision of medium and long-term loans. They are sometimes referred to as Acceptance houses.
- Development Banks are specialized financial institutions which provide long-term credit or loans to other enterprises for capital

projects. They provide loans for projects in the area of agriculture, commerce and industry. Examples of development banks are the Bank of Industry (BOI), the Bank of Agriculture (BOA) etc.

- Insurance Companies are financial institutions that are concerned with insurance. It can also be defined as a contract between an insurer and an insured, under which an insurer promises to indemnify (compensate) the insured against loss, that he may suffer in future, upon the payment of a premium.

**SELF ASSESSMENT EXERCISE**

1. Distinguish between Banking and Non-Banking Financial Institutions

### 3.3 Relevance of Financial Institution

Financial Institutions provide consumer and commercial clients with a wide range of services and different types of banking products, like the sale of treasury bills, treasury certificates etc. The importance of financial institutions to the wider economy is apparent during market booms and recessions. During economic upturns, financial institutions provide the financing that drives economic growth and during recessions, banks curtail lending. Another thing is that financial institutions are encouraged or even compelled to lend money loans to small businesses, that is, the readily made available loans to prospective investors which will help in enhancing growth in the economy. Thus, outside of giving loans to small businesses, they also provide the liquidity needed for the economy to function and also offer important risk management services.

### 3.4 Advantages of Financial Institutions

There are several different advantages of financial institutions. Some of these are as follows:

• Financial institutions carry out key roles with regard to the new firms that might face difficulties in obtaining funds from the general public. In such a situation, they can make the funds accessible to these firms. Furthermore, expansion, as well as modernization, can also be funded without much strain by the firms.

• They provide both risk and loan capital. These institutions provide underwriting facilities. Along with these services, professional guidance or advice can also be obtained from them for successful planning and supervision of the company's projects.

• If the companies need to import machinery or equipment outside their home country, they can make use of the support provided by financial institutions since they offer loans and guarantees for foreign currencies along with facilities for deferred payments.

• The basic facilities of the repayment process and interest rates of these financial institutions are usually suitable and economical. Along with these facilities, the repayments of loans in simple instalments are also made available to deserving concerns.

**3.5 Disadvantages of Financial Institutions**

The disadvantages of financial institutions include the following:

• There are several documentation and bureaucratic procedures through which an individual/organization needing funds from financial institutions have to experience. This takes the time and efforts of these individuals/organizations needing the funds. Furthermore, most worthy individuals/organizations might be unsuccessful due to difficult conditions laid down by these institutions.

• Every now and then, clauses are included in the loan agreements for these loans given out to the parties, thus placing restrictions on the autonomy of the management of the concerned individual. Furthermore, from time to time, they are adamant about appointing their nominees to the company's board of directors.

**SELF ASSESSMENT EXERCISE**

1. Briefly explain three relevance of Financial Institutions in Nigeria.

## 4.0 CONCLUSION

A financial institution is an institution established as an intermediary between individuals with surplus funds and those with a deficit of funds. Consequently, financial institutions are classified as banks and non-bank financial institutions play significant roles in economic growth and development, by giving loans and overdrafts to individuals who are willing to invest in the economy. This unit has succeeded in explaining the relevance of financial institutions in developing economies like Nigeria.

## 5.0 SUMMARY

Here you have learnt more about the evolution of financial institutions, having explained in detail the stages of development of the banking system in Nigeria. Also, you should have understood the different classifications of financial institutions in Nigeria. The Central bank is seen as the apex bank that is empowered by law to regulate and supervise the financial activities of the commercial banks and other financial institutions. However, commercial banks, merchant banks and other banks are seen as banks for receiving and giving out loans to prospective business individuals.

## 6.0 TUTOR-MARKED ASSIGNMENT

i. Distinguish between the central bank and commercial bank in Nigeria

ii. State five instruments that the central bank can use to control the activities of the commercial banks.

iii. List some banking products that is provided by the banking sector in Nigeria.

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## UNIT 2 CENTRAL BANK IN ACTION AND ITS ECONOMIC SIGNIFICANCE

**CONTENTS**



### 1.0 INTRODUCTION

Over the years, the Central Bank of Nigeria (CBN) has performed a significant task in the nation's economy as well as in formulation of sound macroeconomic policies. This unit shall focus on the history, functions as well as core mandate of the Central Bank of Nigeria.

### 2.0 OBJECTIVES

At the end of this unit, you should be able to:

• Discuss the origin of the Central Bank of Nigeria

• Explain the traditional and development functions of the Central Bank of Nigeria • Evaluate the core mandate of the Central Bank of Nigeria.

## 3.0 MAIN CONTENT

### 3.1 History of Central Bank

A central bank is an authority in charge of policies that have an effect on a country's money supply and credit. More specifically, a central bank employs its instruments of monetary policy such as open market operations, discount window lending, changes in reserve requirements to influence short-term interest rates as well as the monetary base (currency in the hands of the public plus bank reserves) to achieve modern monetary policy goals.

There are three vital goals of modern monetary policy. The first as well as most significant is price stability or stability in the value of money. Nowadays, this implies keeping a sustained low inflation rate. The second goal is a stable real economy, frequently understood as high employment as well as high and sustainable economic growth. To put it in a different way, it is said that monetary policy is anticipated to level or even the business cycle as well as counterbalance or offset macroeconomic shocks to the economy. The third goal is financial stability. This includes a well-organized as well as an efficient running payments system and the avoidance of crises in the financial system.

The story of central banking dates back at least to the 17th century, to the origin of the first organization identified as a central bank, the Swedish Riksbank. Founded in 1668 as a joint-stock bank, it was licensed to provide/lend funds to the government as well as to operate as a clearing house for commerce. Some decades later, precisely in 1694, the most renowned central bank of that time, the Bank of England, was established also as a joint stock company to pay for government debt. Later in Europe, other central banks were established with the same intention, despite the fact that some were set up to manage monetary disorder or monetary hysteria. For instance, in 1800, the Banque de France was founded by Napoleon to stabilize the currency following the hyperinflation of paper money all through the French Revolution, and to assist in public finance. Ancient central banks gave out private notes which acted as currency, and they frequently had a monopoly over such note issue.

While these ancient central banks assisted in funding the government’s debt, they were in addition private bodies that participated in banking activities. Since they kept the deposits of other banks, they acted as banks for bankers, making transactions easy between banks or offering other banking services. They turned out to the repository for nearly all banks in the banking system as a result of their huge reserves as well as wide-ranging networks of correspondent banks. These factors enabled them to become the lender of last resort during the period of a financial crisis. In other words, they became keen to supply emergency funds to their correspondents in times of financial distress.

Central banks hold huge gold reserves to make sure that their notes could be converted into gold, as was needed by their charters. When their reserves fall owing to a deficit in the balance of payments or an unfavourable domestic situation, they would increase their discount rates (the interest rates at which they lend money to the other commercial banks). Doing so would usually increase interest rates which will attract foreign investment, thus, bringing additional gold into the country. Central banks stick to the gold standard’s rule of upholding gold convertibility above all other considerations. Gold convertibility acted as the economy’s nominal anchor. That is, the amount of money banks can supply was limited by the value of the gold they keep in reserve, and this determined the existing price level. Since the price level is attached to a recognized commodity whose long-run value was ascertained by market forces, expectations about the future price level were attached to it as well. Based on this, ancient central banks were solidly dedicated to price stability. They were not too concerned about one of the contemporary goals of central banking (the stability of the real economy) because they were restrained by their commitment to stick to the gold standard.

Presently, central banks also learned to act as lenders of last resort during times of financial distress when occurrences such as bad harvests, defaults by railroads, or wars caused a rush for liquidity (in which depositors ran to their banks and attempt to convert their deposits into cash). The lesson started early on in the 19th century as an outcome of the Bank of England's usual response to such panics. At the time, the Bank (and other European central banks) would frequently guard their own gold reserves first, turning down their correspondents that were in need. Doing this caused major panics in 1825, 1837, 1847, and 1857, and led to harsh criticism of the Bank. In response, the Bank adopted the "responsibility doctrine," suggested by the economic writer Walter Bagehot, which necessitated the Bank to include its private interest in the public interest of the banking system altogether. The Bank adopted Bagehot's rule, which entails lending freely based on any sound collateral provided—but at a penalty rate (that is, above-market rates) to avert moral/ethical risk. The bank learned its lesson properly because no financial crises took place in England for almost 150 years after 1866. It was not until August 2007 that the country encountered its next crisis.

The U.S. experience was most fascinating because it had two central banks in the early 19th century, the Bank of the United States (1791–1811) and a second Bank of the United States (1816–1836). Both were established on the Bank of England's model, but unlike the British, the Americans generally bore a deep-seated suspicion of any concentration of financial power, and specifically of central banks, so that in each scenario, the licenses were not renewed.

There followed an 80-year period typified by substantial financial instability. Between 1836 and the beginning of the civil war (a period identified as the Free banking era) states permitted practical free entry into banking with negligible regulation. Throughout this period, banks failed often, and quite a few banking waves of panic took place. The payments system was disreputably incompetent, with thousands of different state banknotes as well as counterfeits in circulation. In response, the government initiated the national banking system during the civil war. Although the system made the effectiveness of the payments system better by providing a uniform currency based on the national banknotes, it still offered no lender of last resort, and this era was rife with stern banking panics.

The crisis of 1907 was the straw that broke the camel’s back. It led to the establishment of the Federal Reserve in 1913, which was given the mandate of providing a uniform and elastic currency (that is, one which would accommodate the seasonal, cyclical, and secular movements in the economy) and to act as a lender of last resort.

### 3.1.1 Brief Origin of the Central Bank of Nigeria

The history of the creation of the Central Bank of Nigeria (CBN) rests in the features as well as imperfections of the monetary system, which came before it. This was the currency board system. The West Africa Currency Board (WACB) was created in November 1912 owing to the recommendation of the Emott committee. Furthermore, due to the shortcomings and disadvantages of the board, there was a pressing necessity for the creation of an organization in the form of the Central Bank of Nigeria (CBN). The supporters of Nigeria’s independence mounted pressure on the colonial government and the outcome was the setting up of the Paton commission by the colonial government in

1952. Based on the outcome of this report by the commission, the first banking legislation in Nigeria was passed in 1952 referred to as the banking ordinance of 1952.

The proposal for the creation of the Central Bank of Nigeria (CBN) was originally trounced however the call could not be completely overlooked. Therefore, Mr., J. L. Fisher of the Bank of England 1953 inquired into the appropriateness as well as possibility of creating a Central Bank of Nigeria (CBN) through his report was not practicable in setting up a Central Bank.

Nevertheless, in 1957, Nigeria achieved an inner autonomy supported by the report of the World Bank mission on the subject matter, the federal government set up a committee led by the Mr J.B. Loynes, again of the Bank of England in 1957, to proffer recommendations on the creation of Central Bank of Nigeria (CBN), the launching of the Nigerian currency as well as other related matters. These recommendations culminated in the creation of CBN on March 17th 1958 by the Central Bank of Nigeria (CBN) ordinance of that year. The bank came into existence and started full operation on 1st July 1959, thus getting ahead of the country's Independence Day on October 1st 1960. At the moment, Nigeria has a Central Bank with approximately seven branches as well as seven currency centres.

**SELF-ASSESSMENT EXERCISE**

Discuss the history of the Central Bank

**3.2 Functions of the Central Bank of Nigeria**

The Central Bank of Nigeria does not do business directly with the general public. It carries out its functions with the assistance of commercial banks. The Central Bank of Nigeria is responsible for ensuring financial stability as well as economic growth and development of the Nigerian economy.

Aside from this, the Central Bank of Nigeria in addition plays an important role in circumventing the cyclical fluctuations by regulating the money supply in the market. In the view of Hawtrey, a Central Bank ought to first and foremost be the "lender of last resort."

Conversely, Kisch and Elkins accepted as true that "the maintenance of the stability of the monetary standard" is a fundamental role of the Central Bank. The functions of the Central Bank of Nigeria are generally divided into two parts, namely, traditional functions and developmental functions.

**3.2.1 Traditional Functions of the Central Bank of Nigeria**:

The traditional functions of the Central Bank of Nigeria include the following:

**(i) Bank of Issue**: The Central Bank of Nigeria has the sole right to issue notes (currency) in the Nigerian economy. In the early years of banking, the right of issuing notes proliferated. However, this led to numerous problems, for example, currencies were over-issued and the currency system became muddled. Thus, the federal government of Nigeria authorized the Central Bank of Nigeria to issue notes. The issue of notes by the Central Bank of Nigeria led to uniformity in currency circulation as well as balance in the supply of money.

**(ii) Government's Banker**, **Agent, and Advisor:** This implies that the Central Bank of Nigeria carries out diverse roles for the government. As a banker, the Central Bank of Nigeria carries out banking functions for the federal government as commercial banks do for the public by accepting government deposits as well as giving out loans to the government. As an agent, the Central Bank of Nigeria handles the public debt, undertakes the payment of interest on debt, as well as offers all other services associated with the debt. As an advisor, the Central Bank of Nigeria offers advice to the federal government concerning macroeconomic policy matters, financial markets as well as government loans. Aside from this, the Central Bank of Nigeria plans as well as implements fiscal and monetary policies to control the supply of money in the economy and manage inflation.

**(iii) Custodian of Cash Reserves of Commercial Banks:** The Central Bank of Nigeria deal with the cash reserves of commercial banks. Commercial banks are obliged to maintain a certain amount of the public deposits as a cash reserve, with the Central Bank, and the other part is kept with commercial banks themselves. The ratio of cash reserves is determined by the Central Bank. A specific fraction of these reserves is kept with the Central Bank with the intention of giving out loans to commercial banks Thus, the Central Bank is also called a banker's bank.

**(iv) Custodian of International Currency:** The Central Bank of Nigeria keeps a minimum reserve of international currency. The major goal of this reserve is to meet up urgent situation requirements of foreign exchange as well as prevail over the unfavourable condition of deficit in the balance of payments.

**(v) Bank of Rediscount:** The Central Bank of Nigeria serves the cash requirements of people as well as businesses by rediscounting the bills of exchange through commercial banks. This is an indirect means of loaning out money to commercial banks by the Central Bank. Discounting a bill of exchange means obtaining the bill by buying it for a sum less than its face value. Rediscounting means discounting a bill of exchange that was beforehand discounted. When the owners of bills of exchange require cash, they approach the commercial banks to discount these bills. If these commercial banks themselves are in need of cash they approach the Central Bank to rediscount the bills.

**(vi) Lender of Last Resort:** This refers to the most vital role of the Central Bank. The Central Bank of Nigeria in addition loans money to commercial banks. Instead of rediscounting bills, the Central Bank offers loans against treasury bills, government securities, as well as bills of exchange.

**(vii) Bank of Central Clearance, Settlement, and Transfer:** This means that the Central Bank of Nigeria assists in resolving common indebtedness amongst commercial banks. Banks depositors offer checks as well as demand drafts drawn from other banks. In such a case, it is not probable for commercial banks to approach each other for clearance, settlement, or transfer of deposits. The Central Bank makes this process trouble-free by putting a clearinghouse under it. The clearinghouse serves as an organization where mutual indebtedness among banks is settled. The agents of different banks meet up in the clearinghouse to resolve inter-bank payments. This assists the Central Bank to be acquainted with the liquidity condition of the commercial banks.

**(viii) Controller of Credit:** This means that the Central Bank of Nigeria has the power to control the credit creation by commercial banks. Credit creation depends upon the number of deposits, cash reserves, as well as the rate of interest given by commercial banks. All these are directly or indirectly managed by the Central Bank. For example, the Central Bank can manipulate the deposits of commercial banks by carrying out open market operations as well as making alterations in the cash reserve ratio to regulate a variety of economic conditions.

### 3.2.2 Developmental Functions:

This refers to the functions that are associated with the encouragement of the banking system and economic development of the country. These are not obligatory functions of the Central Bank of Nigeria. They include the following:

**(i) Development of Specialized Financial Institutions:** This refers to the most important functions of the Central Bank of Nigeria for the economic development of the nation. The Central Bank of Nigeria sets up institutions that handle credit requirements of the agriculture sector as well as other rural businesses. Some of these financial institutions include the Bank of Agriculture (BOA) and the Bank of Industry (BOI). These are referred to as specialized institutions as they assist the specific sectors of the economy.

**(ii) Influencing the Financial Market:** The Central Bank of Nigeria assists in controlling the money and capital markets. The money market is the market that deals in short term credit while the capital market deals in long term credit. By regulating the activities of these markets, the Central Bank of Nigeria promotes the country's economic growth as well as development.

**(iii) Collecting Statistical Data:** The Central Bank of Nigeria collects and analyzes data associated with the banking, currency as well as foreign exchange position of the country. These data are very helpful to researchers, policymakers, as well as economists. For example, the Central Bank of Nigeria publishes a magazine called the Central Bank of Nigeria's Bullion; in addition to the statistical bulletin, it produces yearly data that are important for formulating diverse policies and making macroeconomic decisions.

### 3.3 The Core Mandate of the Central Bank of Nigeria

The mandate of the Central Bank of Nigeria (CBN) is gotten from the 1958 Act of Parliament, as amended in 1991, 1993,1997,1998,1999 as well as 2007. The Central Bank of an Act of 2007 of the Federal Republic of Nigeria charges the bank with the complete management, control as well as administration of the monetary and financial sector policies of the Federal Government. The objectives of the Central Bank of Nigeria are as follows:

- Guarantee monetary and price stability;
- Issue legal tender currency in Nigeria;
- Sustain external reserves to protect the international value of the legal tender currency;
- Encourage a sound financial system in Nigeria; and

• Serve as Banker as well as offer economic and financial advice to the Federal Government.

As a result, the Bank is charged with the obligation of administering the Banks and Other Financial Institutions (BOFI) Act (1991) as amended, with the sole purpose of making sure that there is a high standard of banking practice and financial stability due to its surveillance activities, as well as the encouragement of an effective payment system.

In addition to its main functions, the Central Bank of Nigeria has over the years carried out a number of key developmental functions, focused on all the vital sectors of the Nigerian economy (financial, agricultural as well as manufacturing sectors). In general, these mandates are performed by the Bank through its numerous units.

## 4.0 CONCLUSION

The Central Bank of Nigeria (CBN) plays a significant role in the economic growth and development of the economy. It performs a promotional, financial, operational, regulatory as well as participatory function in the Nigerian financial market. Thus, there is a necessity for close incorporation between the Central Bank of Nigeria's policies and those of the federal government in order to achieve macroeconomic stability. In addition, there is the necessity to ensure the Central Bank of Nigeria's autonomy so that there ought not to be any interference from the federal government.

## 5.0 SUMMARY

In this unit, you learnt the history of the Central Bank of Nigeria, its authorising legislation and its origin. You also learnt the functions of the Central Bank of Nigeria and its policy implementation and criticism.

## 6.0 TUTOR-MARKED ASSIGNMENT

1. Discuss the traditional and development functions of the Central Bank of Nigeria.

2. Explain the core mandate of the Central Bank of Nigeria.

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**UNIT 3 NIGERIAN COMMERCIAL, MERCHANT AND RURAL BANKING**

**CONTENTS**

7.0 References/ Further Reading

## 1.0 INTRODUCTION

This unit will focus on Nigerian Money Deposit Bank which is also known as the commercial bank. Also, the unit will also focus on the History of the origin of commercial banks in Nigeria, their roles in the economy and the challenges and prospects in the economy.

## 2.0 OBJECTIVES

At the end of this unit, you should be able to:

- Identify the activities of the commercial bank from that of the merchant banks.
- Identify the organization structure of the commercial bank from that of the merchant bank

## 3.0 MAIN CONTENT

### 3.1 Evolution of Commercial Banks in Nigeria

(i) African Banking Corporation (Now First Bank of Nigeria Plc).

In 1892, the African Banking Corporation opened a branch office in the Lagos area of Nigeria. The British Bank for West Africa took over the operations of this bank in 1894 and changed its name to Bank of West Africa in 1957. The name was again changed to Standard Bank of Nigeria Limited in 1965. In 1977, the name was again changed to First Bank of Nigeria Limited following the government's acquisition of 60% of the equity as the marth of the indigenization policy. The bank has since become a publicly quoted company.

(ii) Barclays Bank of Nigeria Limited now Union Bank of Nigeria Plc.

The Barclays Bank of Nigeria Limited opened for banking business in Nigeria in 1917. In 1979, its name was changed to Union Bank of Nigeria Limited. The company is quoted on the Nigerian stock exchange as Union Bank of Nigeria Plc.

(iii) British and French Bank now United Bank of Africa Plc.

The British and French banks opened for banking business in Nigeria in 1949. Its name was changed to United Bank for Africa Limited in 1961. The bank has since been publicly quoted on the Nigerian stock exchange as United Bank of Africa Plc.

The three banks discussed above owe their origin to colonial interest hence; Nigerian indigenous banks were conspicuous by their absence till the early 1930‟s. The high level of discrimination over employment and credit practised by the then foreign banks was one of the reasons that fueled the agitation for self-rule by Nigerians. As a result of this unpleasant development, Nigerians were compelled to enter into the banking business between 1933 and 1952.

The National Bank of Nigeria Limited was established in 1933 as the first indigenous commercial bank in Nigeria. The bank's inability to satisfy the stringent requirement of the 1952 banking ordinance almost forced it to extinct but for the lifeline received from the then Western Regional Government. The regional government was able to raise money for that purpose from the cocoa sales. The bank later transformed into a universal bank in 2000 and merged with Wema Bank in 2005.

Another indigenous bank is Agbomagbe Bank Limited now Wema Bank of Nigeria Plc. the bank started as a private enterprise in 1945. With the effluxion of time, the then Western Nigerian Regional Government took over the bank and changes its name to Wema Bank of Nigeria Limited.

The last before the current establishing ones is African Continental Bank Limited then called Spring Bank Plc and now called Enterprise Bank Limited. The African Continental Bank Limited was an offshoot of the Tinubu Bank then part of Lagos 53 Properties Limited. It was acquired by the then Eastern Nigerian Regional Government in 1945 and subsequently had its name changed to African Continental Bank Limited. The name was later changed to ACB International Limited and merged with a few other banks to form the Spring Bank Plc in 2005. In 2010, the name was changed from Spring Bank Plc to Enterprise Bank Limited, which is owned by Government.

**SELF ASSESSMENT EXERCISE**

i. Distinguish between the 1892 banking system and the 1933 banking system.

ii. Briefly explain the evolution of UBA

### 3.2 Definition, Functions and its Organizational Structure of the Commercial Bank

The Nigerian money deposit bank also known as a commercial bank can be defined as a financial institution which carries out retail bank services, set up for keeping and lending money to people, owned by individuals, organizations or governments, for the purpose of making profits. Ozoani defines it as an institution that accepts deposits of money from the public withdrawal by cheque and is used for lending. Also, John Paget defines a commercial bank on the basis of functions performed by the bank.

#### 3.2.1 Functions of Commercial Banks

Commercial banks perform a variety of functions which can be divided as follows:

**i. Accepting Deposit:** Commercial banks accept deposits from the public for safe custody through three methods, viz savings, current and fixed deposit accounts. The depositors are allowed to draw their money by cheques for a current account or withdrawal slip or ATM for the savings account and fixed account. For the current account, banks do not pay any interest to it but a little percentage of interest is paid into savings and fixed deposit accounts.

Note importantly that the current account is known as a demand deposit while the fixed deposit account is known as a time deposit.

**ii. Advancing Loan:** One of the primary functions of a commercial bank is to advance loans to its customers. A bank lends a certain percentage of the cash lying in deposits at a higher interest rate than it pays on such deposits. The bank advances loans in the following ways:

**a. Through Cash Credit:** This means that the bank advances a loan to a businessman against certain specified securities. The amount of the loan is credited to the current account of the borrower, then the borrower can withdraw money through cheques according to his requirement by paying interest on the full amount.

**b. Through Call Loan:** These are very short-term loans advanced to the bill brokers for not more than fifteen days. They are advanced against first-class bills or securities such loans can be recalled at very short notice.

**c. Through Overdraft:** This means that banks often permit a businessman who has been their old customer with a good credit record to draw cheques for a sum greater than the balance lying in his current account. This is done by providing the overdraft facility up to a specific amount to the businessman.

**d. Through Discounting Bills of Exchange:** This means that if a creditor holding a bill of exchange wants money immediately, the bank provides him with the money by discounting the bill of exchange.

**iii. Credit Creation:** This is another function of commercial banks like other financial institutions, they aim at earning profits. For this purpose, they accept deposits and advance loans by keeping small cash in reserve for day-to-day transactions.

**iv. Financing Foreign Trade:** Commercial bank finances foreign trade of its customer by accepting foreign bills of exchange and collecting them from foreign banks. It also transacts other foreign exchange businesses and buys and sells foreign currency.

**v. Agency Services:** This means that banks act as an agent of their customers in collecting and paying cheques, bills of exchange, draft, dividend, etc. it also buys and sells shares, securities, debentures etc. for their customers. Further, it pays subscriptions, insurance premiums, rent, electric and water bills and other similar charges on behalf of its clients. More so, the bank acts as an income tax consultant to its clients.

### 3.2.2 The Balance Sheet of a Commercial Bank

The Balance Sheet of a Commercial Bank provides a picture of its functioning. It is a statement which shows its assets and liabilities on a particular date at the end of one year. The assets are shown on the right-hand side and the liability is shown on the left-hand side of the balance sheet.

The assets of a bank are those items from which it receives income and profit, while the liabilities of commercial banks are claims on it. These are the items which form the sources of its fund.

The assets and liabilities side of the commercial bank is shown below: Commercial Banks Balance Sheet

**Commercial Banks Balance Sheet**

| **Liabilities** | | **Assets** | |
|---|---|---|---|
| Share Capital | xx | Cash | xx |
| Reserve Funds | xx | Balances with the central bank and others | xx |
| Deposit | xx | Money at Call and Short Notice | xx |
| Borrowing from other banks | xx | Bills Discount and Purchased Investment | xx |
| Bill is payable | xx | Liabilities of Customers for Acceptance, Endorsement and other obligation | xx |
| Acceptance, Endorsement and other obligations | xx | Property,furniture,fixtures less depreciation | x |
| Contingent Liabilities | xx | Profit & Loss | xx |
| Profit and Loss | xx | | |

Note, money at call means short term loans to bill brokers, discount houses and acceptance houses. Contingent liabilities relate to those claims on the bank which are unforeseen such as outstanding forward exchange contracts, claims on acknowledged debt etc.

Acceptance, Endorsement and other obligations by the bank on behalf of its customers are the claims on the bank that it has to meet when the bills mature. Bills payable refer to the bills that the bank pays out of its resources. Bill for collection is the bills of exchange that the bank collects on behalf of its customers and credits the amount to their accounts.

**SELF ASSESSMENT EXERCISE**

1. State five functions of Commercial Banks
2. Explain four ways in which Commercial Banks can advance loans

### 3.3 Roles of Commercial Banks in Nigeria

Besides performing the usual commercial banking functions, banks in developing countries play an effective role in economic development. These roles are:

i. Commercial Banks help in mobilizing savings through a network of branch banking. People in developing countries have low incomes but the banks induce them to save by introducing a variety of deposit schemes to suit the needs of individual depositors.

ii. Commercial Banks finance the industrial sector in a number of ways. They provide short term, medium-term and long-term loans to the industry. They also underwrite the shares and debentures of large-scale industries, and also help in developing the capital market which is undeveloped in such countries.

iii. They help in financing both internal and external trade i.e., they provide loans to retailers and wholesalers to stock goods on which they deal on. They also keep in the movement of goods from one place to another by providing all types of facilities such as discounting and accepting bills of exchange.

iv. They help the large agricultural sector in developing countries in a number of ways. They provide loans to traders in agricultural commodities and also open a network of branches in rural areas to provide agricultural credit.

v. The Commercial Banks finance employment generating activities in developing countries. They provide loans for the education of young people studying in engineering, medical, and other vocational institutes of higher learning.

vi. Commercial Banks help in the economic development of a country by faithfully following the monetary policy of the central bank. More so, the central bank depends on commercial banks for the success of its policy of monetary management in keeping with the requirements of a developing economy.

### 3.3.1 Problems of Commercial Banks in Nigeria

Commercial banks in most developing countries, especially Nigeria are faced with problems. These are as follows:

i. **Urban Concentration:** The majority of the commercial banks are located in urban centres thereby denying the rural areas banking services.

ii. **Corruption and Low Saving:** There is a high level of corruption in the banking industry as some bank managers and officials embezzle money and grant unauthorized loans to friends and relatives because of their selfish interests. This odd attitude has discouraged so many from saving since they believe their monies can be taken without being returned.

iii. **Government's Frequent Interventions:** The government's frequent intervention in the operation of banks sometimes makes things difficult for commercial banks to operate smoothly and efficiently.

iv. **Lack of Innovative Banking Practices:** Most commercial banks are not innovative in their banking practices as customers are not given the prompt attention they desire.

v. **Capital shortage and high-interest rates:** Most commercial banks have a low capital base and this makes it impossible to grant loans to prospective customers. In spite of the low capital, they have, they tend to charge high interest when the loan is given out.

vi. **Non-Repayment of Loans:** Some customers that took loans sometimes fail to repay the loans as a result of the high-interest rate charged and this has led to the collapse or failure of some commercial banks.

Importantly, some of the aforementioned challenges of the commercial have been solved through improved technology. Today, most rural areas have commercial banks in them and also withdrawal and depositing of cash have been made easier through ATM cards.

### 3.3.2 Advantages of Commercial Banks

Commercial Banks have a lot of advantages, some of which are listed and explained below.

i. **Savings -** The operation of commercial banks encourages savings. They provide facilities for saving. People could therefore save money. With help of fintech, people can save as little as 1$ from the comfort of their homes using their cellphones without having to walk down to the bank's branches. This function of the banks helps individuals find the temptation of spending money extravagantly and mobilize capital which can then be lent to investors. Although, money saved in banks is not regarded as an investment, then, it yields some interest to the savings fixed deposits, and other forms of savings account holders. They, therefore, encourage capital accumulation which helps to scale up economic advancement.

ii. **Safe Keeping of Public Wealth -** Without commercial banks, people will be pilling up money in their homes. Before the advent of banks, people used to keep their money in containers, under their beds and pillows, bury it beneath the soil, in grain stock, etc. There were records of incidents of money being stolen and eaten up by rodents and termites. Keeping money at home in this modern time will lead to a high rate of theft and robbery.

iii. **Provision of Loans -** Commercial banks give out loans and advances thereby providing short-term and medium-term capital for businesses. The loans and advances may be in the form of direct loans, overdrafts, or the discounting of bills. With the amount borrowed, the investors could finance various projects in the areas of industry, agriculture, and commerce. This, therefore, helps in the modern economy. Raising capital through a bank loan is easier than raising capital in the capital market, which has along with protocol, high qualification requirements and high cost of raising capital.

iv. **Financial Prudence Advice -** They give financial, technical, and management advice to their customers in matters relating to the investment. They advise their business customers on how best they can carry out their business operations. They advise investors on the various ways of raising finance for investment purposes. The managers of businesses who are customers of a bank can get management advice. Advice got.

v. **Facilitation of Business Transactions and Payments -** Commercial banks facilitate business transactions by making the use of cheques, and bank drafts online transfers possible. Traders and individuals who handle plenty of money, therefore, find it easier and safer to carry a large amount of money in the form of cheques, bank drafts, ATM cards, or online wallets from one place to another. The money lost by businessmen and investors is thereby reduced. In this present modern economy, which is basically a digital economy, commercial banks make the transactions possible by providing digital payments and technological platforms available.

vi. **Facilitation of Global Trade** - They facilitate international trade and travel by making foreign exchange transactions easier. They help in making overseas payments for their customers. They also assist in international trade by issuing letters of credit to importers and providing travellers' cheques to overseas travellers. With globalization, the modern economy is a borderless economy, there is always a need to settle international indebtedness. Commercial aid in remittance of cash, exchanging one currency for another; aids in export and import by transferring documents and payments; lend money to government, institutions and other world organizations. The reach of the banks is unlimited and it has helped in making the world a global village.

vii. **Reference -** Banks act as referees as to the integrity and financial standing of their customers. Local investors who want to go into partnership with foreign investors could obtain references from bankers. Investment opportunities can therefore be created within an economy. This speeds up economic progress.

**viii. Conversion of Digital currency** - There has been a proliferation of digital assets, which are held electronically. Commercial banks still facilitate the transaction settlements of these cryptocurrencies. People who hold digital assets may wish to convert their digital currencies to fiat currencies, commercial banks facilitate the transfer and conversion.

### 3.3.3 Disadvantages of Commercial Banks

Some of the disadvantages of commercial banks include the following:

i. **Leakages** - There may be some leakages in the banks' systems which may be caused by over blotted costs by the banks' management, bank staff tampering with customers' deposits, bad loans etc.

**ii. Risk of Robbery and Fraud -** Piling up cash in publicly known places like banks can attract robbers. There have been prevalent cases of robbers breaking into the banks and emptying the vaults. The increase in internet banking in recent times has as well led to an increase in cybercrime. Commercial bank customers are now exposed to criminal attacks through stolen ATM cards, passwords, hacking of accounts, etc. There have been robberies where robbers have stolen millions of dollars through the internet, without physically entering the bank premises. With the rise in internet banking, fraudsters now devise more innovative ways to swindle and rob people of their money. Commercial banks are investing heavily in their internet and database infrastructure to wall off cyber acts. This adds to the operating costs of the banks which the customers have to bear.

iii. **Bankruptcy** - Mismanagement of the depositors and shareholders' funds by the banks' management can lead to commercial banks going bankrupt. Global or regional economic recession and/ or depression where economic activities were negatively impacted can lead to customers doing more withdrawal transactions than deposits, and also make the borrowers unable to meet up with their loan repayment obligations. Banks may not have enough cash to meet up with withdrawal demands. We recently witnessed the impact of the Covid-19 pandemic on the global economy. Some national governments were bailing out some financial institutions, taking up wage bills of bank staff so as to save their jobs and save the banks from going bankrupt.

iv. **Incumbrance Process of Getting Loans** - The number of collateral securities required by commercial banks before offering loans is usually high which the borrowers may not be able to provide. If people do not have the necessary collateral securities with which to borrow money from the banks, the banks will be reluctant to make loans available. This, therefore, tends to hamper the ability to create money.

**SELF ASSESSMENT EXERCISE**

1. State the problems or challenges faced by commercial banks in Nigeria and identify one solution to it.

## 3.4 Merchant Bank and Its Functions

### 3.4.1 Meaning of Merchant Banking

The dictionary meaning of merchant banking sees it as an organization that underwrites securities for corporations, advises such clients on mergers and is involved in the ownership of commercial ventures. Merchant banking has been defined differently in different parts of the world. In the UK, it signifies the 'accepting and issuing houses', while in the USA it is recognized as ‘investment banking’. The term merchant banking has been so extensively used that from time to time, it is referred to banks who are not merchants, every now and then to merchants who are not banks and at times to those intermediaries who are neither merchants nor banks. Therefore, merchant banking can be described as a nonbanking financial activity similar to banking, began, developed and sustained in Europe, got enriched under American influence and is at present practised all over the world by both banking and non-banking institutions. Under the Banks and Other Financial Institution Act, Merchant Bank is described as a bank whose business includes receiving deposits on the deposit account, provisions of finance, consultancy as well as advisory services relating to corporate and investment matters, making or managing investments on behalf of any person. The Nigerian Banking Amendment Decree (No.88) of 1979 sees a merchant bank as an individual in Nigeria who is involved in wholesale banking, medium and long-term financing, equipment leasing, debt factoring, investment management, issue and acceptance of bills and the management of unit trust (Anyanwu, 1997). They are as well-referred to as Acceptance Houses or Discount Houses. Merchant banks manage the commercial banking requirements of international finance, long-term company loans, as well as stock underwriting. This kind of bank does not have retail offices where a customer can go and open a savings or checking account. Occasionally, it can be seen as a wholesale bank or involved in the transaction of wholesale banking owing to the fact these banks are inclined to deal first and foremost with other banks of the same category, as well as big financial institutions. (Jhingan, 2004)

3.4,2 **Origin of Merchant Banking**

Merchant banking can be traced back to the 13$^{th}$ century when a small number of families possessed and controlled firms engaged in buying as well as selling goods and were in addition, discovered to be involved in banking activity.

These firms did not just act as bankers to the kings of European States, and financed coastal trade but in addition, borne exchange risk.

With the intention of making profits, they put in their cash where they anticipated larger returns in spite of the huge degree of risk involved. They charged extremely high-interest rates for financing very risky projects. In turn, they experienced huge losses and had to shut down. A number of them restarted very similar activities after acquiring financial strength. Thus, merchant Banking survived as well as continued during the 13th century.

Afterwards, merchant bankers were recognized as “commission agents” who controlled the coastal trade on a commission basis as well as offered finance to the owners or producers of commodities. They carry out investments in commodities produced by manufacturers and made big profits. In addition, they financed continental wars. The one and only aim of these merchant bankers was maximization of profit by undertaking investments in risky projects.

Next was the industrial revolution in England. The scope of international trade broadened to include North America as well as other continents. Most people were fascinated to start merchant banking activities to convey the machine-made goods from European countries to other countries and colonies as well as bringing raw materials from other countries and colonies to Europe and finance such trade. Throughout the early nineteenth century, merchants indulged in overseas trade and got a decent reputation. They received bills of the lesser presumed traders by ensuring the holder got full payment on the due date. Over the years, this practice of accepting bills has increased with growth in trade and has turned out to be part of merchant banking activity.

### 3.4.3 Evolution of Merchant Bank

Merchant Banking in Nigeria will truly say to have begun with the registration of both Philip Hill Nigeria Ltd on 14th September 1960 and Nigeria

Acceptance Ltd (NAL) on 25th November 1960. These two banks functioned in Nigeria as the only licensed merchant banks between 1960 and 1969. These two banks merged in 1969 to become the Nigerian Acceptance Ltd. NAL merchant bank remained the only merchant bank functioning in Nigeria until 1973.

The operations of merchant banks in Nigeria increased as a result of the following: the indigenization decree (which requires 60:40 per cent indigenous expatriate equity ownership in the banking industry), the oil boom of the 1970s and the Third National Development Plan. Not only did these factors increase the operations of merchant banks in Nigeria, but they also led to a rise in the number of merchant banks in the country.

Union Dominion Trust Bank Nigeria Ltd was the second merchant bank to come into the market and was licensed in 1973. In April 1974, it changed its name to UDT Nigeria Ltd and as of 1997, its name was Nigerian Merchant Bank (NMB). Also, in 1974, the First National Bank of New York Nigeria Limited was licensed. This was followed by the First National Bank of Chicago Nigeria Limited later recognized as International Merchant Bank Nigeria Limited in 1975. After the Federal Government decided to take part in every foreign-owned bank functioning in the country, the First National City Bank of New York Nigeria Ltd surrendered its license in objection and brought to an end its operations in late 1976.

Two other banks namely Chase Merchant Bank Nigeria Ltd licensed in 1974 and Investment Company of Nigeria (ICON) Merchant Bankers were enlisted as merchant banks in 1975. Chase Merchant Bank subsequently changed to the Continental Merchant Bank in 1975. The Nigerian-American Merchant Bank Ltd (NAMBL) started its operations as a merchant bank in 1979. In 1982, two merchant banks namely: Merchant Banking Corporation Nigeria Ltd and IndoNigerian Merchant Bank Ltd started their operations even though they were granted the license in 1981. Furthermore, in 1982, three merchant banks namely: Merchant Bank of Africa Nigeria Ltd, First City Merchant Bank Ltd and ABC Merchant Bank Ltd were given licenses. The first two started operations in 1983 while the third commenced its business in 1984. Also, in 1984, Grindlays Merchant Bank got its license to start its operation. In 1986, Financial Merchant Bank Ltd was granted a license. Thirty-four merchant banks were operating in Nigeria by 1989, though this number significantly rose to fifty-four by December 1991. However, by December 1995, this number fell to fifty-one with a total branch network of one hundred and forty-nine.

Amazingly, quite a few of the merchant banks that rebounded in the nation were a result of the commercial banks SAP-induced. Therefore, a turnaround of a few of the policy thrusts of SAP that was suitable for the growth as well as the development of these merchant banks rapidly hampered the development of the merchant banking subsector. This partially explains the distress syndrome that saturated this subsector and caused a complete collapse of several merchant banks, for instance, Kapital Merchant Bank, Financial Merchant Bank, Alpha Merchant Bank etc.

### 3.4.4 Functions of Merchant Banks

The functions of merchant banks may be grouped into five as follows:

**1. Portfolio Management Function:** Merchant banks do undertake to manage the portfolio investments of some investors at a fee for such services.

**2. Banking Function:** The banking function include

i. Mobilization of deposits from both the private and public sectors of the economy.

ii. Granting of loans/advances to individuals, corporate bodies and the government.

iii. Equipment leasing which involves the purchasing and leasing of equipment for rental fees to the banks.

iv. Loan syndication (consortium lending) which involves the coming together of banks or groups of banks to provide credit to a customer.

**3. Corporate Finance Services:** The corporate service includes acting as issuing house to issuers, assisting in the private placement, stock brokerage services, and investment and advisory services.

**4. Treasury Services:** The merchant banks do invest in money market instruments such as treasury bills, treasury certificates etc. They also issue short-term instruments such as certificates of deposits, commercial papers etc.

**5. Operational Services**: This includes the remittance and receipt of funds for their customers at both local and international levels. Merchant banks also open letters of credit and accept bills on behalf of their customers in favour of foreign creditors and issued by the creditors respectively.

### 3.4.5 Sources of the fund to Merchant Banks

The main sources of funds to merchant banks include:

**i. Statutory Reserves:** The funds statutorily required to be transferred from profit to reserve account are available for use by the bank.

**ii. Share Capital:** Funds are raised through the issuance of shares subscribed to, by the individuals, corporate bodies and the government.

**iii. Interest arising from credit facilities and other charges:** The cost of funds provided to borrowers as well as various charges for services rendered from part of merchant bank’s funds.

**iv. Retained Profit:** This is the percentage of net profit retained for future expansion. Retained profit remains part of shareholder equity.

**v. Debentures:** Merchant banks raise money through the issuance of debentures.

**vi. Mobilized Deposits:** The huge deposits mobilized from the economy forms part of merchant bank funds.

vii. Borrowing: Merchants banks may borrow money from lending institutions including the central bank of Nigeria.

**SELF ASSESSMENT EXERCISE**

i. State five ways in which merchant banks can raise money.

## 4.0 CONCLUSION

Commercial banks as financial institutions play a very important role in the development of any country, be it developing or developed. Their roles as a matter of fact cannot be neglected, in the sense that they are seen as the major backbone of the country. Despite the functions and roles, they play, they still face a series of challenges which was discussed in the unit.

## 5.0 SUMMARY

In this unit, we have succeeded in explaining the origin of commercial banks in Nigeria and also the different functions and roles it plays growth and development of the country. Also, some problems of commercial banks in Nigeria were also entrenched in the unit, not neglecting the ways in which they can source funds.

## 6.0 TUTOR-MARKED ASSIGNMENT

i. Write a short note on the following African Banking Corporation and Barclay Bank of Nigeria.

ii. Distinguish between Bill payable and Bill for collection.

iii. Explain five roles of commercial banks in Nigeria.

iv. State four ways in which commercial banks can advance loans to customers.

v. Discuss any three functions of a merchant bank.

vi. Explain the challenges faced by commercial banks in developing countries.

## 7.0 REFERENCES/FURTHER READING

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## UNIT 4 NON-BANK FINANCIAL INSTITUTION

**CONTENTS**



## 1.0 INTRODUCTION

This unit focuses on non-bank financial institutions in Nigeria. Non-Bank Financial Institutions are institutions created or established to provide long-term loans to individuals, government and prospective business individuals. Subsequently, the unit will explain the various classifications of non-bank financial institutions such as insurance companies, pension schemes, traditional financial institutions, finance companies and discount houses etc.

## 2.0 OBJECTIVES

At the end of this unit, you should be able to:

- Understand the various non-bank financial institutions in Nigeria.

Identify their functions.

- Distinguish between each of them.
- Distinguish between non-bank financial institutions and banks.

## 3.0 MAIN CONTENT

### 3.1 Classification of Non-Bank Financial Institution

Non-Bank Financial Institutions are institutions that provide medium and long-term loans to a prospective business firm or government. These institutions pool funds from net savers and lend them to finance the expenditure of business firms and local bodies. The non-bank financial institution outside the commercial banks has contributed immensely to enhancing growth and development in the nation. Consequently, they are classified as insurance, pension scheme (fund), traditional financial institutions, finance companies etc. Subsequently, the aforementioned institutions will be explained in detail.

#### 3.1.1 Insurance Companies

An insurance company may be defined as a financial institution involved in the protection of a person and objects against risk. These companies as financial institutions collect large sums of money called premiums from individuals and organizations in order to insure lives and properties. Thus, people save money with the insurance companies in form of life assurance which is paid to them after a period of time if they do not die before then under an endowment assurance policy. On the other hand, under the whole life assurance, the bulk of the money is paid to the beneficiaries of the assured after his death.

Insurance in Nigeria is both owned by Nigerians and foreigners. However, ownership had significantly remained more companies being controlled by indigenous interests while few have mixed ownership. In any case, a consolidator exercise could introduce a new ownership character as all the insurance companies may desire to be quoted on the Nigerian stock exchange.

Apparently, insurance companies in Nigeria tend to provide some functions in the economy, such functions include:

i. Protection of persons and objects under different types of insurance like a motor vehicle, fire, burglary, marine, life insurance etc.

ii. They serve as a pool of risks; that is, they are an umbrella under which all forms of risks are covered.

iii. They offer both short and long-term loans to individuals, organizations etc., from the money they collected from other clients as premiums.

iv. Through the money and capital market, they make funds available to industry and commerce thereby contributing to the development of nations where they exist.

vi. They offer advice to individuals, organizations, governments etc., on the best way to secure lives and properties.

**3.1.1.1 Roles of Insurance Companies**

• To mobilize long term funds in the form of premium by providing life or non-life protection to customers

• To encourage economic growth by investing its premium and other income in the economy

• To promote the insurance business by giving part of its income to a fund in the Nigerian Reinsurance Corporation

• They operate pension schemes on behalf of companies

• They grant loans on mortgages

• They act as underwriters in the capital market

• Insurance policies are used as collateral securities for bank loans

• Insurance companies facilitate risk transfer

• They help to improve the balance of payments position of the country by insuring imports and exports and through re-insurance

• Through their life and pension businesses they help to develop the financial market

**3.1.1.2 Operations and Regulations of Insurance Companies**

A good number of insurance operations are regulated by the states, but there are certain areas where the federal government uses its regulatory authority. For instance, federal law imposes penalties for fraud as well as false statements made in connection with insurance transactions. Anybody who is involved in the insurance business and makes a false statement with the intention of manipulating their actions can be subject to punishment. Also, several federal regulations and actions have an effect on insurance directly, for instance, the Fair Credit Reporting Act and some programs that make coverage for horrible losses available, such as FEMA's (Federal Emergency Management Agency) National Flood Insurance Program, insurance is regulated mainly at the state level.

**Operations**:

The operations of an insurance company are as follows.

• Rate making

• Underwriting

• Claim settlement

• Re-insurance etc.

It is the state that regulates insurance using some guidelines such as

• Rates must be adequate

• Rates must not be excessive

• Rates must not be unfairly discriminatory

### 3.1.2 Pension Scheme

A pension scheme is an arrangement designed by the government through the constitution or other statute which guarantees an employee some financial benefits on leaving employment.

In Nigeria, the first pension Act was promulgated in 1951 and was later replaced by the 1979 Pension Act. The public sector had its own pension arrangement different from that of the private sector.

The public sector pension scheme is a non-contributory scheme while the private sector pension scheme is contributory in nature. Employees are expected to contribute a certain percentage of their total emolument to the pension scheme. The 2004 pension perform Act has brought in it numerous changes ranging from the introduction of pension regulators, administrators and managers in Nigeria.

### 3.1.3 Traditional Financial Institutions

These are non-bank financial institutions whose existence predates both the invasion of Africa by the colonialists and the emergence of conventional financial institutions. The traditional institutions have continued to thrive in most African countries especially Nigeria due to some Unique characteristics surrounding their activities. Their operations are secretive, require a little amount of money and mutual trust exists between and among members. Some of the traditional financial institutions are Esusu, Local Money Lenders, Community Development Associations, Co-operative, Thrift and Credit Union, Social Club, and Town Union Monthly Associations.

The Modus Operandi in the traditional financial institutions is that members are encouraged to save their money together, which all or part of it may be lent to any member that is in need.

Basically, the major advantage of traditional financial institutions is that;

i. They encourage their members to form the habit of saving money

ii. They encourage their members to invest the big sum of money they have saved.

iii. They lend money they have saved.

iv. They save their members the pains of going to banks to borrow money with their embarrassing collateral securities.

v. They inculcate the principles of democracy in their members.

vi. They discourage their members from being extravagant in their spending so that they can save money.

In spite of all the enticing advantages, the traditional financial institution still faces enormous problems which range from:

i. High embezzlement of cash

ii. Weak management i.e., they are managed by those who lack administrative and managerial acumen.

iii. The institution also lack effective means of recovering loan granted to their members, if they default in repayment.

iv. They have low financial resources at their disposal as a result of some of their members making their contributions.

v. They use arbitrary means in fixing interest on loans.

### 3.1.4 Finance Companies

Finance Companies are non-bank financial institutions regulated and supervised by the Central Bank of Nigeria under the provision of the BOFIA 1991 (as amended). These institutions provide short-term financial services such as local purchase order financing, project financing, leasing of equipment and debt factoring. The main sources of funds to finance companies include the public offer of bonds, Issuance of Commercial Paper, Issuance of equity shares, commercial bank credit facilities, insurance companies etc.

Finance Companies in the course of providing financial services, use to charge higher interest on their financial accommodation, discounts, loans fees and other services to the average for high operating costs.

The greatest challenge to finance companies in Nigeria has remained the crisis of confidence question between the operators and the public. Fortunately, this appears to have been taken care of by the emergence of a vibrant post-consolidation financial system in Nigeria.

### 3.1.5 Discount Houses

The discount house sub-sector is a very important part of the Nigerian financial system. The idea of discount houses was muted and nurtured by the Central Bank of Nigeria in the 1990‟s to strengthen and sustain the ailing banking system.

Sections 28 of the Central Bank of Nigeria Act 1991 and section 59 of BOFIA 1991 charged the bank with the responsibilities of licensing, regulating and supervising discount house business in Nigeria.

A discount house is a non-bank financial institution engaged in the discount house business. The business of a discount house includes the trading in and holding of money market instruments such as treasury bills, treasury certificates, commercial bills etc.

Discount Houses serve as conduits through which banks were able to channel excess liquidity to the Central Bank of Nigeria.

Discount houses also serve as a secondary market for the trading of treasury bills and other commercial bills.

Currently, many of the discount houses have identified with corporate finance and hence establish advisory services units in order to provide additional services to their clients.

Discount houses that are owned by a group of financial institutions can source funds to finance the business in the following ways. They can source funds through:

i. Paid-up capital - this is part of the called-up capital which the shareholders have actually paid.

ii. Income from advisory services.

iii. Reserves in their vault.

iv. Call money

iv. Short-term borrowing

v. Selling of short-term bills to the CBN

vi. Outright borrowing from the CBN through night advances.

**SELF ASSESSMENT EXERCISE**

i. Distinguish between finance houses and discount houses

### 3.2 Importance of the Institution by Funds Mobilization and Contribution to the Economy

i. Although the non-bank financial institutions are not legally mandated to act as the conventional banking institutions, they do mobilize funds from the private and public sectors of the economy. For instance, the insurance companies do mobilize funds arising from the payment of premiums part of which they may lend to people and organizations on special arrangements. Similarly, the Traditional financial institutions do mobilize funds from members and in most cases lend to them from the pool for overall economic growth and development of the country.

ii. The non-bank financial institutions offer greater accessibility in the borrowing of funds at the micro level to the members of the society. The provision of microcredit guarantees both grass root and even economic growth and stability necessary for meaningful economic development.

iii. The non-bank financial institutions offer specialist services in the economy. These services enhance the efficiency of the operation of both the banking and other sectors of the economy. For instance, the insurance companies reduce the risks associated with various businesses through underwriting, while the pension funds and schemes provide reassurance to the workers by promising them wonderful post-active days etc.

iv. The non-bank financial institutions have continued to provide employment for over twenty-one per cent of the entire Nigeria workforce.

**SELF ASSESSMENT EXERCISE**

i. Explain the importance of Non-Bank Financial Institutions to the economy

## 3.3 Similarities between Banks and Non-Banks Financial Institutions (NBFIs)

i. Commercial banks create demand deposits when they borrow from the central bank, and NBFIs create various forms of indirect debt when they borrow from commercial banks.

ii. Both commercial banks and NBFIs act as intermediaries in bringing ultimate borrowers and ultimate lenders together and facilitate the transfer of currency balance from non-financial lenders to non-financial borrowers for the purpose of earning profits.

iii. Both commercial banks and NBFIs provide liquid funds. The bank deposits and other assets of commercial banks and the assets provided by NBFIs are liquid assets.

iv. Both banks and NBFIs are the important creators of loanable funds. The commercial banks by net creation of money and the NBFIs by mobilizing existing money balance to exchange for their own newly issued.

v. Like NBFIs, commercial banks acquire the primary securities of borrowers, loans and deposits and in turn, they provide their own indirect securities and demand deposits to the lenders.

**SELF ASSESSMENT EXERCISE**

1. State the similarities between banks and NBFIs financial institutions.

## 3.4 Roles of Non-Financial Institutions

The roles of non-bank financial institutions are as follows:

**i. Reduce Hoarding -** This is done by bringing the ultimate lenders and ultimate borrowers together. Outside that, they also reduce hoarding of cash by ensuring that they make funds available to people.

**ii. They help both the Household sector and the business sector -** The household sector relies on NBFIs for making profitable use of its surplus funds and also to provide consumer credit loans, mortgage loans etc. On the other hand, they help the business sector by financing them so as to facilitate their investment in plants, equipment and inventories.

**iii. Help the state and local government -** This means that NBFI helps the state and local bodies financially by purchasing their bonds.

iv. NBFIs provide liquidity and safety to financial assets and help in transferring funds from ultimate lenders to ultimate borrowers for productive purposes.

v. NBFIs help in the growth process of the economy, that is, the intermediate between lenders and borrowers. By performing this function, they discourage hoarding by the people, mobilize their savings and lend them to investors.

vi. NBFIs are of immense help in the working of financial markets, in executing monetary and credit policies of the central bank and hence in promoting the growth of an economy, by transferring funds from surplus units to deficit units.

**SELF ASSESSMENT EXERCISE**

i. Briefly explain the major roles NBFIs play in the economy

## 4.0 CONCLUSION

In this unit, we extensively discussed the meaning and relevance of non-banking financial institutions in the economy. Also, the major similarity between Banks and non-bank financial institutions was also explained in detail in the unit.

## 5.0 SUMMARY

This unit treats the fundamentals of non-bank financial institutions by looking into the different non-bank financial institutions as well as explaining them in detail. Also, the significant roles NBFIs play in the country were also integrated into the unit including the roles NBFIs play in the economy.

## 6.0 TUTOR-MARKED ASSIGNMENT

i. State five functions of an insurance company in Nigeria

ii. Briefly explain the major advantages of traditional financial institution

iii. Discuss the major problems in traditional financial institutions

iv. List five ways in which discount houses can raise funds.

v. Write a short note on the pension scheme

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## MODULE 3 THE NIGERIAN FINANCIAL SYSTEM

Unit 1 Nigerian financial system and its significance to economic development

Unit 2 The financial market and its role in the economic acceleration

Unit 3 Nature of Financial Assets

## UNIT 1 NIGERIAN FINANCIAL SYSTEM AND ITS SIGNIFICANCE TO ECONOMIC DEVELOPMENT

**CONTENTS**

7.0 References/ Further Reading

## 1.0 INTRODUCTION

In the recent past, the financial sector all over the world has witnessed remarkable changes, given the increasing depth of globalization, structural and technological changes, and integration of the financial market. These have also been driven by the quest to implement strategies that engender sustainable economic development. These units focus on the financial system and its crucial importance to economic development in the Nigerian context.

## 2.0 OBJECTIVES

- Define the term financial system
- Explain the elements of an ideal financial system
- Examines the financial reforms, their issues, challenges and prospects

## 3.0 MAIN CONTENTS

### 3.1 Meaning of Financial System

The financial system comprises the structure, institutions, markets, infrastructure, and mechanisms through which financial assets (loans, bonds, stocks, and other securities) are sourced and channelled or traded, interest rates determined and financial services delivered to the economy.

Typically, the financial system consists of the banking sector and non-financial institutions. The financial sector plays important role in economic development as economic activities cannot occur efficiently without the proper functioning of the financial system.

**SELF ASSESSMENT EXERCISE**

- Define the term financial system

### 3.2 Significance of The Financial System

The significance of the financial system includes the following:

**1. Links Savers and Borrowers -** The financial system serves as an important source for bringing together the savers and borrowers. It bridges the gap between the one who has an excess of funds lying idle with them and one who is in need of them. The financial system enables in pooling of funds from one person to another person across the economy.

**2 Provide Payment Mechanism -** It enables people to successfully do financial transactions by providing various convenient modes of payment financial system supports the payment mechanism which facilitates the smooth flow of funds in the economy. Buyers and sellers are easily able to complete transactions the for sale and purchase of goods using payment methods like cheques, UPI, debit cards, credit cards etc.

**3. Improve Liquidity**

The financial system plays an efficient role in enhancing overall liquidity in the market. It serves as a mediator for facilitating the free movement of funds among people. Households are provided with different investment avenues for deploying their funds that have better liquidity rates i.e., can be easily converted into cash. It motivates the lenders in doing investments that ensure the regular availability of appropriate funds in the market.

4. **Risk Allocation**

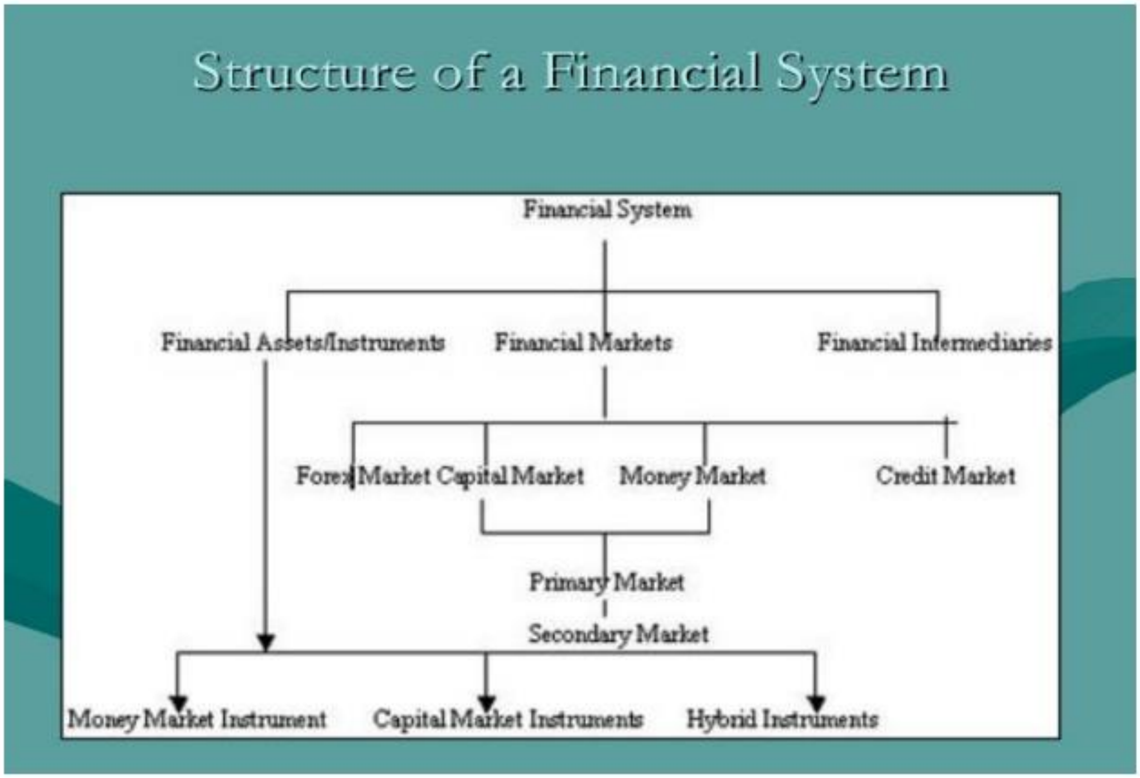
Risk diversification is one of the important features of the financial system. Investors are provided with a wide range of investment securities in the financial market to choose from as per their choice. The financial system enables the allocation of people’s funds among various sources due to which risk is minimized.

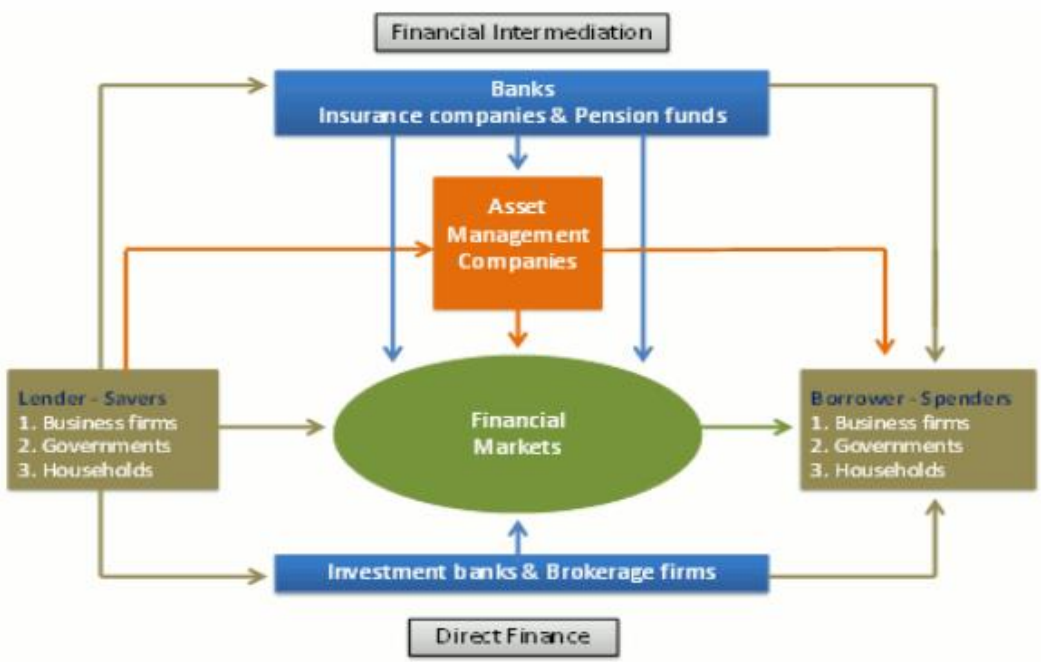
**5. Promote Capital Formation** - Financial system accelerates the rate of capital formation in a country. It assists businesses in acquiring funds from banks, financial institutions and the general public for financing their activities. Availability of funds at right time enables businesses in maintaining their continuity and attaining growth. The government also require funds for financing its different infrastructural development and social welfare activities. The financial system supplying the right amount of funds supports the capital formation in the nation.

6. **Employment Growth** - An efficient financial system of the country is capable of generating large employment opportunities for people. It supplies the required amount of funds to businesses and large organizations for carrying out their activities and expanding their size. With the growth in the business and industrial sectors, it will consequently generate more employment opportunities for both organized as well as unorganized sectors.

7. **Attracts Foreign Capital** - Financial system enables the attraction of a sufficient amount of foreign capital in an economy. The capital market constitutes an important part of a country's financial system. If this market is properly developed and promoted, then it is capable of attracting funds not only from the domestic market but also from the foreign market. When there is sufficient capital available, the investment will widen which will result in speeding up the economic development of the nation.

8. **Balanced Regional Development** - It has a significant role in achieving balanced regional development in a country. The financial system enables the overall development of rural and backward areas by offering concessions and sops. Balance development mitigates political and several other disputes in the nation. It also controls the migration of rural peoples toward urban areas.



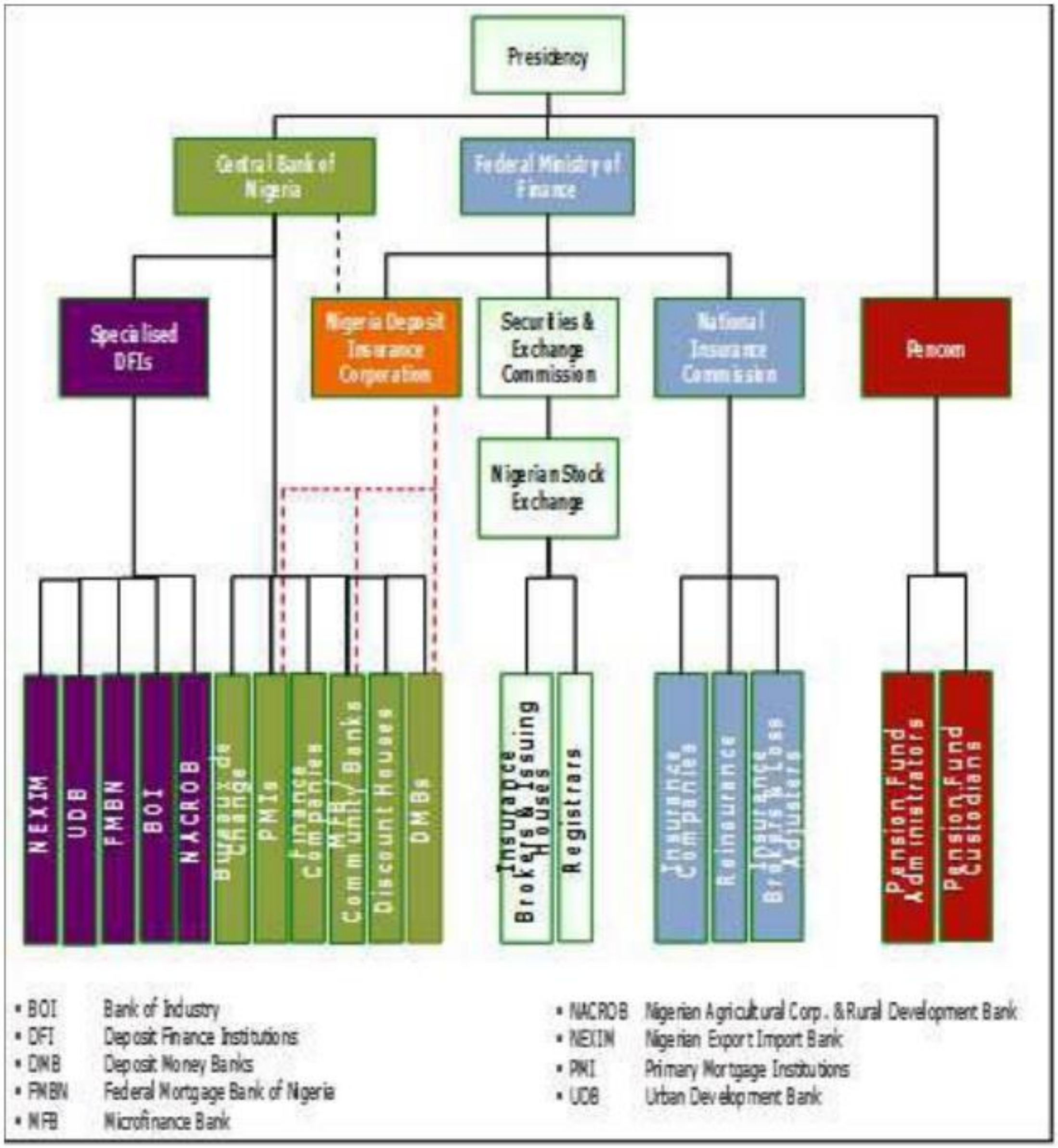




**Source:** *CBN's Monetary Policy Department (2017)*

## 3.3 An Overview of the Financial System

The financial system in Nigeria comprises markets related to finance such as the money and capital markets; institutions that deal with finance and these including the regulatory and supervisory establishments; development finance organizations, for example, the Bank of Agriculture (which deals in agriculture), the Bank of Industry (deals on commerce and industry); the Federal Mortgage Bank of Nigeria (deals on housing); the Nigeria Export-Import Bank (deals on net foreign trade); the National Economic Reconstruction Fund (deals on long-term financing to profitable SMEs), The Infrastructure Bank (deals on the provision of finance to assist long-term infrastructure projects) and other financial institutions such as Insurance companies, pension funds, finance companies, Bureau de change, and Primary Mortgage Institutions), among others (CBN's Monetary Policy Department 2017). In addition, it provides instruments used in the financial markets, for example, treasury bills, treasury certificates, certificates of deposits etc. The Nigerian Financial System's structure has been through extraordinary modifications, for instance, changes in ownership structure, variations in duration and size of financial instruments utilized, alterations in the number of institutions set up, transformation in regulatory and supervisory structures and the entire macroeconomic environment in which they carry out their operations. Furthermore, the Nigerian Financial System encompasses interrelationships among the people and the institutions that constitute the economy. Generally, commercial banks are the pertinent financial institutions that promote and mobilize savings and in addition, transfer savings into productive investment units.

**Diagram of an Overview of the Nigerian Financial System**




**Source:** CBN's *Monetary Policy Department (2017)*

## 3.4 Structure and Roles of the Nigerian Financial System

The Nigerian financial system is made up of the following:

**i. Formal Sector** – This comprises of the bank and non-bank financial institutions.

a. The banking financial institutions are made up of the central bank, commercial banks, retail banks and internet banks (Horton, 2020).

b. The non-bank financial institution does not have a complete banking license and cannot accept deposits from the general public. Though they do facilitate alternative financial services, for instance, investment, risk pooling, financial consulting, brokering, money transmission, and check to cash. In addition, they are a source of consumer credit. Examples of nonbank financial institutions include insurance firms, venture capitalists, currency exchanges, some microloan organizations, and pawn shops (World Bank, 2016).

**ii. Informal Sector** –This sector covers an extensive variety of market activities. Firstly, the informal sector is created by the actions of persons and families in an economy where employment opportunities are inadequate. Secondly, this sector is an outcome of the reasonable behaviour of entrepreneurs that wish to stay away from state regulations, which plainly means they function outside the regulatory purview of the government (CBN's Monetary Policy Department, 2017). The activities of this sector are not easy to measure and it cuts across a broad range of sectors, such as economic, socio-economic and information covering activities like causal jobs, unpaid jobs, subsistence agriculture etc. Each of these business activities has implications for the formulation and implementation of public policy. The informal sector comprises of the local money lenders, saving associations, etc. The banking financial institutions are monitored by the Central Bank of Nigeria (CBN), Federal Ministry of Finance, Nigeria Deposit Insurance Corporation (NDIC), Securities and Exchange Commission (SEC), the National Insurance Commission (NIC), and the Federal Mortgage Bank of Nigeria (FMBN). The informal sector is for the most part not properly organized with the absence of any form of formal regulation. To explain the financial system and appraise its operations, one needs knowledge of its functions in the economy. With regards to the allocation of resources as well as economic efficiency, the financial system performs these vital roles, which are important to economic growth and development. These roles include

• It provides a suitable as well as effective payments system without which specialization in production would to a great extent be obstructed.

• It pools savings from net surplus economic units and channels them to productive investment.

• It augments the economic performance of the players by making the general welfare of the people better.

• It offers a platform for financial infrastructure to assist in allocating resources to individuals/units that are possibly more productive, to invest those resources.

• It gives room for further efficient transfer of resources/funds. In any economy, problems of inefficient allocation of financial resources as well as information asymmetry might take place as one financial institution has superior information to the other parties.

• It offers a balance between those who have funds to invest and those in need of funds if the problem of information asymmetry is solved.

The transfer of funds from surplus economic units (particularly households, corporations and governments) to deficit economic units (particularly business, government and a number of households) can occur directly, whereas direct finance, as the process is called is not convenient both for the final provider of funds as well as the final user of funds because the intermediation of banks is eliminated.

**3.5 Essential Features of an Ideal Financial System**

According to Anyanwu (1996), an ideal financial system is typified by the following strongly interrelated features: it ought to be stable, efficient, competitive, flexible and balanced. He briefly discussed these features below:

• **Stable** - It is very important for confidence to be sustained in the financial system, particularly in times of financial panic. It has to be capable in taking in macroeconomic shocks stemming from business cycles, and able to control a contractionary effect on activity and trade, as well as any inflationary impact on prices.

• **Efficient** - An efficient financial system directs savings to investments with the highest rate of return, allowing for risk. This comprises of allocative, operating, as well as dynamic efficiency.

• **Competitive** – An ideal financial system must have an adequate number of participants.

• **Flexible** - The instruments utilized as well as the procedures of operation must be capable to adapt to changes in the economic and financial structure.

• **Balanced** - A balanced financial system requires that there ought to be an optimal blend of numerous kinds of the financial system with regard to both transfer of current savings and the stock of past savings. The optimal blend would be such that changes in one part can be absorbed by changes in another without having too much effect on the providers and users of savings and giving both a sufficient period of adjustment. It is significant to note that the ideal blends of these strongly interrelated features will vary as the process of economic growth proceeds.

**3.6 Financial System Stability**

When systemic risks, macroeconomic shocks or crises are non-existent in a financial system, it is said to be stable. Macfarlane (1999) sees financial system stability as basically the prevention of financial crisis in an economy. In this definition, macroeconomic shocks or systemic crises are emphasized because financial instability does not only mean the financial ill-health of a specific household, firm, or bank but extended to the whole financial system in a country. Foot (2003), opined that for financial stability to be attained in an economy, the following have to be realized:

• the level of employment in the economy has to be close to its natural rate;

• monetary stability has to be achieved

• the general public ought to have high confidence in the operations of vital financial institutions and markets

• there has to be relative stability in the price movements of both real and financial assets.

Some time ago, inadequate wide-ranging regulatory frameworks by the regulatory and supervisory authorities to avert, and resolve the banking distress/crisis management caused a major test to financial system stability. It was against this backdrop that the regulatory authorities in Nigeria (CBN and the NDIC) made a decision in December 2001, to establish the framework for distress resolution and deal with a number of systemic issues encountered by the financial sector. Consequently, several policies have been put together and implemented to make the financial sector stronger and more robust.

**SELF ASSESSMENT EXERCISE**

1. Examine the significance of the financial system in the Nigerian economy

### 3.7 Financial Sector Reforms

A peculiar feature of the reform program in Nigeria is the associated inconsistency in policy implementation. The financial sector in Nigeria is dominated by the banking sector, especially commercial banking. The deposit money banks (DMBs) account for 93.0 per cent of non-central assets in 2000 (World Bank, 2000) and 94.0 and 95.2 per cent of the aggregate financial savings in 2002 and 2003, respectively as well as above 60.0 per cent of the stock market capitalization (Note 4). Commercial banking started in 1892 with the establishment of the first banking firm, British Bank for West Africa (now First Bank). Since then, the number of commercial banks has exploded. Thus, an understanding of the structural changes in the financial sector as a whole is of great importance to all stakeholders; as it would help in designing appropriate legislation to enhance competition. The Nigerian banking system has undergone remarkable changes over the years, in terms of the number of institutions, ownership structure, as well as depth and breadth of operations. These changes have been influenced largely by challenges posed by deregulation of the financial sector, globalization of operations, technological innovations and adoption of supervisory and prudential requirements that conform to international standards.

### 3.7.1 1986 Reforms

At the commencement of comprehensive financial sector reform in Nigeria in 1987, the sector was highly repressed. Interest rate controls, selective credit expansion and the use of reserve requirements and other direct monetary control instruments were archetypal characteristics of the financial system. Access to banking business was limited and government-owned banks dominated the industry. The reform of the foreign exchange market, which until then was also controlled, began in 1986. Indeed, the financial sector reform was a component of the comprehensive economic reforms programmed, the Structural Adjustment Program (SAP), which was adopted in 1986.

Although the policy planks of SAP in Nigeria were the prototype prescriptions of the Bretton Woods institutions, the program was sold to Nigerians by the government as Nigeria's alternative to IMF loan-based adjustment. The introduction of the program was on the heels of the rejection of the IMF loan package with its conditionalities, a decision that reflected the consensus of a nationwide debate. The main financial sector reform policies applied were deregulation of interest rates, exchange rate and access to banking business.

Other reform measures included the establishment of the Nigeria Deposit Insurance Corporation (NDIC), strengthening the regulatory and supervisory institutions, upward review of capital market deregulation and introduction of indirect monetary policy instruments. Some distressed banks were liquidated while the Central Bank of Nigeria took over the management of others. Government shareholdings in some banks were also sold to the private sector. The reform of the foreign exchange market in 1986 began with the dismantling of exchange controls and the establishment of a market-based autonomous foreign exchange market. Bureau de changes were allowed to operate from 1988. However, a fixed official exchange rate has continued to exist alongside the autonomous market.

In 1994, the gradual market-based depreciation in the official exchange rate was truncated by a sharp devaluation in a bid to close the widening gap between the official and the autonomous exchange rate. Unsatisfied with the observed further widening of the gap between the two exchange rates, the government outlawed the autonomous foreign exchange market and reintroduced exchange controls in 1994. But after a full year of exchange controls, the autonomous market was brought back in 1995 to co-exist with the fixed official exchange rate. The continued operation of the official exchange rate brings with it a lot of distortions in the domestic allocation of resources within the public sector. This is very pronounced in the vertical distribution of export earnings among the three levels of government. A similar pattern of policy reversals applies to the reform of interest rates. First introduced in 1987, the market-determined interest rates ruled until 1991 when interest rates were capped. But after only a year of controls, market forces were permitted once more to determine all interest rates in 1992 and 1993. While indirect monetary instruments (open market operations) have been initiated since 1993, some measures of control such as sectoral credit allocation guidelines have continued to be applied. In the sphere of bank licensing and regulation, the reform was ushered in with the deregulation of bank licensing in 1987. When the increase in the required banks' paid-up capital in 1989 and the reform of their accounting procedure (1990) appeared insufficient to curb the "excesses" of the sector, the government placed a total embargo on bank licensing in 1991 In Nigeria, the liberalization of interest rates and entry into banking business gave rise to sharp increases in nominal interest rates. With the additional effects of currency devaluation and higher Central bank-financed public sector deficits within the period, the rate of inflation soared.

However, despite the SAP Reforms, the seemingly lacklustre performance of banks in lubricating the economy was the precursor to the emergence of the widespread banking crisis in the early 1990s. The linkage between the sector and the growth of the economy remained weak throughout this period. Not only was industrial finance appalling, but the cost of capital was also prohibitive. The Nigerian banking system has undergone remarkable changes over the years, in terms of the number of institutions, ownership structure, as well as depth and breadth of operations. These changes have been influenced largely by challenges posed by deregulation of the financial sector, globalization of operations, technological innovations and adoption of supervisory and prudential
requirements that conform to international standards.

### 3.7.2 2004 Reforms

Prior to the reforms starting in 2004, the Nigerian banking sector was still weak and fragmented, often financing short-term arbitrage projects rather than productive private investments. For clarity, we can summarize the major problems of many Nigerian banks as follows:

a) Weak corporate governance, evidenced by high turnover in the Board and management staff, inaccurate reporting and non-compliance with regulatory requirements, falling ethics and de-marketing of other banks in the industry;

b) Late or non-publication of annual accounts that obviate the impact of market discipline in ensuring banking soundness;

c) Gross insider abuses, resulting in huge non-performing insider related credits;

d) Insolvency, as evidenced by negative capital adequacy ratios and shareholders' funds that had been completely eroded by operating losses;

e) Weak capital base, even for those banks that have met the minimum capital requirement, which currently stands at N1.0 billion or US$7.53 million for existing banks and N2.0 billion or US$15.06 million for new banks, compared with the RM2.0 billion or US$526.4 million in Malaysia; and

f) Over-dependency on public sector deposits, and neglect of small and medium-class savers.

CBN assessment of 2004 shows that while the overall health of the Nigerian banking system could be described as generally satisfactory, the state of some banks was less cheering. Specifically, as of end-March, 2004, the CBN's ratings of all the banks, classified 62 as sound/satisfactory, 14 as marginal and 11 as unsound, while 2 of the banks did not render any returns during the period. The weaknesses of some of the ailing banks were manifested by their overdrawn positions with the CBN, high incidence of non-performing loans, capital deficiencies, weak management and poor corporate governance.

The poorly managed liberalization reform of the 1980s' is partly responsible for the sector's weaknesses mentioned above. Supervision remained weak and there was evidence that many banks had bad balance sheets, conducting only very limited lending to the private sector while engaging in short term foreign exchange arbitrage. To strengthen the financial system and improve on the ending of the private sector; the consolidation exercise was launched in mid - 2004. The CBN required all deposit banks to raise their minimum capital base from about N2 billion to N25.0 billion by the end of 2005(Note 5). The banking sub-sector reform of 2005 was adjudged as the most successful, with the emergence of 24 strong banks (down from 89) a, larger capital base (from under US$3.0 billion to over US$9.0 billion), rating of Nigerian banks by international rating agencies (S & P; Fitch) for the first time, branch network increased from 3,200 in 2004 to 3,866 in April 2007. The 919 Community/Micro Finance Banks (capital requirement of about US$156,000) and 11 banks had a market capitalization ranging between US$1.0 billion and US$5.3 billion (Soludo, 2007).

Also, the insurance sector went through the process with only about 71 insurance companies sailing through. The industry is now recapitalized to the tune of over N200.0 billion from the pre-consolidation position of just N30 billion. These reforms were complemented by improved regulatory and oversight functions by the Central Bank. The Bank started the process of migration from a prudential supervision system to a risk-based approach within

the framework of the Basel – II Accord. Various measures were similarly implemented to ensure a smooth liquidation of banks that failed to meet the capitalization requirements. Three important legislations (CBN/BOFI Act, NDIC Act and Microfinance Act) were submitted to the National Assembly to strengthen the Consolidation programme. The bills sought to improve the autonomy of the Central bank in its monetary policy decisions; a comprehensive framework for addressing the case of private depositors, who may be affected by the liquidation process; and to support the development of the microfinance industry in Nigeria.

**7.2.3 2009 Reforms**

Eight main interdependent factors are believed to have led to the creation of an extremely fragile financial system that was tipped into crisis by the global financial crisis and recession. These factors include; macroeconomic instability caused by large and sudden capital inflows; major failures in corporate governance at banks; lack of investor and consumer protection; inadequate disclosure and transparency about the financial position of banks; critical gaps in regulatory framework and regulations; uneven supervision and enforcement; unstructured and management process at the CBN; and weaknesses in the business environment in the country.

The Central Bank of Nigeria (CBN) in response to the above problems, unveiled a ten-year reform blueprint anchored on four cardinal reform programmes for the stabilization of the banking sector and the finance sector in general. The four cardinal programmes for the sector's transformation involves enhancing the quality of banks; establishing financial stability; enabling healthy financial sector evolution and ensuring the that financial sector

contributes to the real economy. The CBN plans to initiate a five-part programme to enhance the operations and quality of banks in Nigeria, which would consist of industry remedial programmes to fix the key causes of the crisis, implementation of risk-based supervision, reforms to regulations and regulatory framework, enhanced provision for consumer protection and internal transformation of the CBN (Note 6). It would also include the development of directional economic policy and counter-cyclical fiscal policies by the government and further development of capital markets as an alternative to bank funding. Some of the potential levers for the new macro-prudential rules may include limiting capital market lending to a set proportion of a bank's balance sheet, prohibiting banks from using depositors' funds for proprietary trading, private equity or a venture capital investment, adjusting capital adequacy and forward-looking capital requirement driven by stress tests by the CBN. Although the financial system has undergone substantial changes over the last two decades, the system remains by and large unstable and under-developed, since it is yet to achieve that degree of financial intermediation, that the economy requires to foster growth and development

**7.2.4 Issues, Challenges and Prospects**

The Nigerian financial system is vulnerable to a number of risks, and there are serious concerns about the soundness and stability of the banking system. The Nigerian anti-money-laundering (AML) legal framework and enforcement are also considered inadequate, making the system vulnerable to financial abuse. Inefficiencies, such as delays and backlogs, in the administration of justice by courts are also major impediments to the smooth functioning of the financial system.

On the part of banks, the challenges are enormous. We recognize that banks and their owners are primarily in business to make a profit, and we are conscious of the need not to jeopardize this key driving motivation for innovation and entrepreneurship. However, we all know that the banking system occupies a unique position in every economy and that is why it often attracts more than casual regulatory attention. Our industry in the 21st century must have a moral face and live up to some modicum of social responsibility. Capitalism must have a social face and a human soul to be sustainable. This is the lesson of world history. It is in this context that we view with serious concern the spate of frauds, ethical misconduct, falsification of returns by the banks to the Central Bank, unprofessional use of female staff in some banks in the name of 'marketing' and 'sourcing of funds', etc. Collectively, we can stop these misconducts and give the system a new face.

One of the most central economic policy challenges is to strike a balance between stability and reform in the financial sector. Clearly, there is no single "right" place on this continuum. Ultimately, the issue is about balancing the economic, financial, and social costs in the short term to medium term with potential gains in the long term. Allowing problems in the financial sector to fester may preserve stability in the short run, but could lead to pronounced distress and higher costs later on. At a minimum, sufficient progress has to be made to avoid deepening existing vulnerabilities, while building the capacity to manage financial distress when and if it occurs in the future.

Secondly, a key challenge will be to develop a credit culture. With the stock of non-performing loans already high, it is crucial to avoid a further build-up. This goal is interdependent with developing a credit culture and with improvements in corporate governance and sustainable economic growth. Fostering a credit culture and better governance, in turn, hinge on a reliable legal framework, supportive of private sector activity.

Thirdly, a closely related task is to resolve the stock of distressed debt in the economy. In essence, distressed debt is the counterpart to a portion of the capital stock and enterprises that need to be restructured or written off and closed. Once these restructurings and write-offs take place, resources - currently locked up would be freed up to finance new investment and consumption opportunities.

Fourthly, in the longer term, the financial sector needs to adapt to a new economic environment. The Nigerian economy is becoming increasingly market-oriented and opening up to foreign competition among others. The financial sector, in particular, may have to compete for creditworthy borrowers and skilled banking personnel. As flexibility is introduced into the exchange and interest rates over time, financial institutions would have to become adept at pricing credit risks and managing market risks.

Fifthly, another long-term challenge is to deepen capital markets in order to diversify the sources of investment financing. Greater equity financing can help transform the ownership structure of the economy, attract strategic investors capable of restructuring their firms, and bolster market discipline. As with bank lending, the efficiency of equity financing would be a function of the quality of investment decisions made by investors and their ability to monitor and manage firms under their ownership through effective accounting, disclosure, and governance standards. Capital markets would also provide opportunities for risk diversification by investors, whose savings are still primarily invested in low-yielding bank deposits or in shares on the relatively undeveloped stock market.

**SELF ASSESSMENT EXERCISE**

1. What are the achievements of the 2009 financial reform?

## 4.0 CONCLUSION

In this unit, we have been able to examine the nature, structure and background of the Nigerian financial system and we have also checked out the recent reforms in the financial sector and its achievement.

## 5.0 SUMMARY

We hope you have clearly understood the content of the Nigerian financial system and the recent reforms in the financial sector coupled with the issues, challenges and prospects. We hope you are enlightened about it.

## 6.0 TUTOR-MARKED ASSIGNMENT

i. Explain the essential elements in an ideal financial system.

ii. Explain the structure and roles of a financial system

iii. Discuss the 2004 financial sector reforms

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## UNIT 2 THE FINANCIAL MARKET AND ITS ROLE IN ECONOMIC ACCELERATION

CONTENTS

3.3.4.2.1 Roles of the Nigerian Stock Exchange (NSE)

4.0 Conclusion

5.0 Summary

6.0 Tutor-Marked Assignment

7.0 References/Further Reading

**1.0 INTRODUCTION**

In this unit, we shall study the financial market which comprises the money and capital market. Our discussion shall take us to the definition of the financial market. Furthermore, we shall extensively look at the definition as well as the roles of both the money and capital market.

**2.0 OBJECTIVES**

At the end of this unit, you should be able to:

• define and explain both the money and capital market

• explain features of a developed money market and sections in a capital market • discuss the aims for the establishment of the Nigerian money and capital market

• list and explain the roles of the money and capital market

• discuss common money market instruments and participants in the capital market

**3.0 MAIN CONTENT**

**3.1 Meaning of the Financial Market**

The financial market is an arrangement where there exists an exchange of commodities, securities as well as other important items at transaction costs. A number of these securities are stocks, bonds, agricultural products and precious metals. It comprises institutions, agents, brokers and intermediaries (banks, insurance companies, pension funds) transacting purchases and sales of securities. In the financial sector, the financial market on a regular basis refers only to markets that are employed to raise funds which might be long term, for instance, the capital market or short term, for instance, the money market. Furthermore, the term can usually be used for all markets in the financial sector, for example, the capital market which comprises stock and bond markets, commodity markets, money markets, derivatives markets, futures markets, foreign exchange markets and spot markets, interbank market.

The financial market is in general divided mainly into two markets namely:

• Money Market and

• Capital Market

**3.2 Money Market**

This is a market where financial instruments that are deemed to be very liquid with extremely short maturities are traded. In the short term, it offers participants an opportunity to borrow and lend for a period of overnight to one year. The securities traded in the money market are specifically IOU by large corporations, governments and financial institutions and are extremely safe and liquid.

**3.2.1 Features of a Developed Money Market**

A developed money market is quite effective since it is open to changes in demand for and supply of finance in any of its parts, and any influence/impact that starts in any part rapidly spread to others with no significant time lags. Based on this definition, Anyanwu (1996) was of the opinion that a money market ought to have the following features:

• **Existence of a Central Bank**: There must be a central bank that has the expertise to commence, initiate as well as implement monetary policy; has sufficient legal powers, and adequate significant information and is a lender of last resort.

• **Existence of a developed commercial banking system**: A developed money market ought to have a developed commercial banking system, together with wide-ranging banking habits on the part of the general public.

• **Sufficient supply of a range and quantity of financial assets**: There ought to be a sufficient supply of a range and quantity of short-term financial assets or instruments, for instance, trade bills, treasury bills, etc.

• **Existence of well-developed sub-markets**: The presence of well-developed sub-markets as well as their adequate reaction to small changes in interest rate develops the money market. If the demand and supply of specific instruments rules, the interaction between different interest rates will be limited

• **Presence of specialized institutions**: The presence of specialized institutions in certain kinds of assets, for instance, specific discount houses, accepting bills, or specialized dealers in government securities etc. can bring about competitiveness and efficiency.

• **Presence of contributory legal and economics**: The presence of suitable legal provisions to decrease transaction costs, and safeguard against default in payments, while economic forces, for instance, the fast and inexpensive transmission of information, inexpensive fund remittance, and sufficient amount of trade and commerce have to exist.

### 3.2.2 Aims for the Establishment of the Nigerian Money Market

The following are the aims for the establishment of the Nigerian money market: • To make the desired mechanism available for the government's short-term financing requirements

• To efficiently mobilize resources with the aim of carrying out investments

• To indigenize the credit base by offering local investment outlets for the retention of funds in Nigeria as well as for the investment of funds repatriated from overseas due to the influence of the government to that effect.

• As a necessary step on the path to independent nationhood, hence it was part of a modern financial and monetary system which was to allowed the nation to set up the monetary autonomy which is part of the mechanism of an independent, modern state.

• To carry out all the roles which the money market conventionally performs in a country, for instance, providing the basis for operating and implementing an effective monetary policy.

**SELF ASSESSMENT EXERCISE**

Discuss the features of a developed money market

### 3.2.3 Roles of the Money Market

The money market performs the following roles:

• It provides the foundation for operating and executing an effective monetary policy.

• To encourage an orderly flow of short-term funds.

• To ensure supply of the essential means of expanding and contracting credit.

• It is a central pool of liquid financial resources upon which it can make payments when it holds funds surplus to its needs.

• It provides the machinery through which the banking system liquidity is sustained at the desired level.

• To provide banks with the fundamental financial requirements for efficient management of their resources. Therefore, assisting them to generalize their assets held by offering a medium for the investment of their surplus cash.

• To offer the mechanism desired for the government's short-term financial requirements, hence, achieving even seasonal alternatives in the usual flow of revenue.

• Mobilization of funds from savers (lenders) and transmission of such funds to borrowers (investors).

• It offers a channel for the injection of central bank cash into the economy.

• To preserve stable cash and liquidity ratios as the foundation for the operation of the open market operation (OMO).

• It assists commercial banks to reduce cash reserves through the provision of the first line of defence for cash shortages through bills.

**3.2.4 Money Market Instruments**

The following are familiar money market instruments:

• **Treasury Bills** – Their issue for the first time in Nigeria (in April 1960) was provided for under the Treasury bill ordinance of 1959. They are issued by the federal government of Nigeria and are sold at a discount and mature within 91 days of the day of issue and are default-free. They offer the government a highly flexible and relatively cheap means of borrowing cash. In addition, they offer sound security for dealings in the money market, and the Central Bank of Nigeria specifically, can operate in that market by dealing in treasury bills. Therefore, treasury bills were IOUs, utilized by the federal government to borrow for short periods of about three months, pending the collection of its revenues.

• **Treasury certificates** - These are like treasury bills and were introduced in 1968 to replace commercial bills. They have a maturity between one and two years. The amount paid on the acquisition of the certificate is normally less than the discount on the bill but the actual amount is repaid by the CBN at maturity.

• **Commercial bills** – They were introduced in 1962 and are normally utilized by the commodity board and it is re-discountable by the CBN. However, they were abolished in 1968 when banks declined to carry on with their involvement in the World Cocoa Market

• **Call money**- They were introduced in 1962 and guarantee the payment of money on demand to the issuing bank. In addition, they allow commercial banks and non-banking financial institutions to keep their temporary surplus cash with the CBN who in turn invests the fund. It was abolished in 1974 but up till now, banks do operate it among themselves.

• **Certificate of deposit** – It is a time deposit, usually given to consumers by banks, thrift institutions, as well as credit unions. It was introduced in Nigeria in 1985 to channel commercial banks' surplus funds into merchant banks issued in multiple of N50, 000 and re-discountable by the CBN in case the issuing bank cannot redeem them at maturity. The maturity period ranges between 3 and 36 months. For those with a maturity of fewer than 18 months, the discounts may be utilized in the required ratio of the holding bank.

• **Stabilization security** - This is an efficient monetary policy introduced in 1976 to mop up banks' excess liquidity with the empowerment of CBN to issue the security and sell them by allocation to banks and other financial institutions who are in turn required by law to take up any allocated amount in which failure to do so causes imposition of penalty

### 3.3 The Capital Market

This is a group of financial institutions established with the aim of granting long-term loans. It is a market where long-term instruments are traded such as government securities, corporate bonds, corporate shares (stocks) as well as mortgage loans. In other words, it is the market for the mobilization and utilization of long-term funds for the growth and development of the financial system.

#### 3.3.1 Section of the Capital Market

There are two sections of the capital markets namely primary and secondary markets. They are briefly discussed below:

**A. Primary market**: It deals with the issue and sales of new securities of companies which beforehand are not quoted on the stock exchange market. Means of raising funds in the primary capital market include.

• **Offer for sale**: A firm can sell the whole issue of shares or debentures to an issue house or merchant banker at a settled price, which is usually below the par value. The shares or debentures are later resold by issue house/merchant bankers to be public.

• **Obtaining term loans**: Firms can raise long term cash by getting hold of long-term loans, more often than not from financial institutions. Term loans are also called term finance which symbolizes a source of debt finance and are usually repayable in more than one year but less than 10 years.

• **Right issue**: This means selling securities in the primary market by issuing shares to existing shareholders.

• **Private placing**: The issue is sold directly to a small group of investors mostly institutional investors like insurance companies, banks, mutual funds, a few private investors, etc.

• **Public issue**: Firms can borrow funds from the primary market by means of public issues of shares and debentures. To handle its issue a firm can take the assistance of merchant bankers. The cost of raising funds via public issue is high as compared to other methods.

**B. Secondary market**: It is a market for buying and selling second-hand securities. In this market holders of existing shares who wish to sell them can have contact with individuals or institutions interested in buying them.

### 3.3.2 Aims for the Establishment of the Nigerian Capital Market

The following are the aims for establishing the Nigerian capital market:

• To launch the code of conduct, curb abuses as well as regulate the activities of operators in the market.

• To offer domestic opportunities for borrowing and lending for long-term purposes.

• To allow the authorities to mobilize long-term capital for the economic development of the nation.

• To offer services for the quotation and set marketability of shares and stocks and opportunities as well as facilities to raise new capital in the market.

• To offer overseas businesses the facilities to offer their shares, and the Nigerian public a chance to invest and take part in the ownership of overseas businesses.

• To provide a vibrant and equally suitable environment for participation and co-operation of indigenous as well as expatriate capital in the combined effort to develop the Nigerian economy for the mutual benefit of both parties.

### 3.3.3 Roles of the Capital Market

The following are the roles of the capital market:

• To promote the speedy formation of capital.

• To provide adequate liquidity for any investor or group of investors.

• To generate built-in operational as well as allocational efficiency inside the financial system in order to guarantee that resources are optimally used at fairly little cost.

• To mobilize savings from various economic units for economic growth and development.

• To promote a more efficient allocation of new investment via the pricing mechanism.

• To offer alternative sources of funds other than taxes for the government.

• To expand the ownership base of assets and the formation of a vigorous private sector.

• To promote an efficient allocation of a specified amount of tangible wealth via changes in wealth ownership as well as composition.

• To offer an efficient medium for the allocation of savings among competing productive investment projects.

• To mobilize long-term financial resources for industrial development.

• It is essential liquidity means for investors through a formal market for debts and equity securities.

### 3.3.4 Participants in the Capital Market

The key participants in the capital market are the Central Bank of Nigeria (CBN), the Securities and Exchange Commission (SEC), the Nigerian Stock Exchange (NSE), and the Stock Brokers. We shall be discussing only the Securities and Exchange Commission (SEC) and the Nigerian Stock Exchange (NSE) in this subsection

#### 3.3.4.1 Securities and Exchange Commission (SEC)

The Securities and Exchange Commission (SEC) is a vital institution in the capital market after the CBN. Initially called the Capital Issues Committee (1962-1972), and the Capital Issue Commission (1973-1979), SEC was established by the SEC Act of 27th September 1979 which was re-enacted by the SEC Decree. The SEC is the apex regulatory body of the capital market and has the objectives of encouraging an orderly and efficient capital market in Nigeria by providing a suitable environment for savings and investment required for economic development; to making sure that the prices of stocks and shares are fair and appropriate, and to make sure that there is adequate protection of the investing public. However, it should be noted that, unlike the CBN, SEC does not take part in the capital market as a buyer or seller of securities.

##### 3.3.4.1.1 Roles of the Security and Exchange Commission (SEC)

In general, SEC's main roles include:

• To determine the price and time at which companies' securities are to be sold • To register all securities planned to be offered privately with the aim that they would be held eventually other than by those to whom the offers were made

• To register all stockbrokers, investment advisers, registrars and marketplaces in the industry such as stock exchange branches with a view to maintaining good codes of conduct as well as professionalism in the industry.

• To maintain general surveillance of the market to make sure that there are orderly, just and reasonable dealings and to take steps to forestall illegal and unethical dealings, such as insider training at the expense of the public

• To determine the basis for allotment of securities offered to the market to ensure spread and equity; and

• Determining the volume of issues coming to the market with a view to preventing the market from being over flooded with issues.

**3.3.4.2 The Nigerian Stock Exchange (NSE)**

The Nigerian Stock Exchange (NSE) was established in 1961 by the Lagos Stock Exchange Act, the Lagos stock exchange was reconstituted into the Nigerian Stock Exchange (NSE) in 1977, and presently has six trading floors in Lagos, Port Harcourt, Kano, Kaduna, Onitsha and Ibadan. It is the trading floor of the capital market and it is a secondary market where there is sale and purchase of existing securities. The main participants are the stockbrokers as the dealing members with the CBN acting as the buyer of last resort of government securities not absorbed in the market. In terms of organization, the NSE comprises the following:

• Council members responsible for the everyday management of the exchange and

• Dealing members who are the stockbrokers licensed by the council to deal in government and industrial securities quoted on the exchange and whose conduct is guided by the exchange's rules and regulations.

**3.3.4.2.1 Roles of the Nigerian Stock Exchange (NSE)**

The Nigerian Stock Exchange (NSE) performs the following roles:

• Provision of the mechanism to mobilize private and public savings as well as make them accessible for productive investment through stocks and shares.

• Provision of a meeting place for dealing members to buy and sell existing stocks and shares, plus the provision of opportunities for raising new capital.

• To make the purchase and sale of securities easy.

• To make dealings in government securities easy and therefore provide the government with finance for development purposes.

• Protection of the general public from crooked deals and practices through its rules, regulations, as well as operating codes, with the aim of ensuring just dealing.

**4.0 CONCLUSION**

The money market is a perfect place for firms or financial institutions to keep surplus funds until they are required. It also provides an efficient source of funds to firms, governments and intermediaries that need short-term funds. While capital markets are institutions where intermediate and long-term funds are pooled and made available to individuals, businesses and governments. These two markets are significant to the growth and development of the Nigerian economy.

**5.0 SUMMARY**

You learnt in this unit the definition and explanation of roles of both the money and capital market. Furthermore, the features of a developed money market and sections in a capital market were also discussed. The aims for the establishment of the Nigerian money and capital market as well as the common money market instruments and participants in the capital market were also explained to give an in-depth understanding of both the money and capital market.

**6.0 TUTOR-MARKED ASSIGNMENT**

1. Discuss the aims for the establishment of the Nigerian money market.

2. Explain the roles of the Security and Exchange Commission (SEC).

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**UNIT 3 NATURE OF FINANCIAL ASSET**

CONTENTS



## 1.0 INTRODUCTION

In this unit, we shall study the financial assets/instrument. Our discussion ought to take us to the meaning of financial assets. In addition, we shall take a wider look at the types, features, denominations as well as liquidity of financial assets. **2.0 OBJECTIVES**

At the end of this unit, you should be able to:

• define financial assets

• explain the types of assets

• discuss the features of financial assets

• list and explain the types of financial assets

• discuss the denomination as well as the liquidity of financial assets

## 3.0 MAIN CONTENT

### 3.1 Meaning of Financial Assets

They are tangible liquid assets whose values are obtained from their contractual claim, for example, bank deposits, bonds, stocks, etc. In essence, they do not have material worth unlike land, properties, commodities or other tangible physical assets. Normally, their values vary as the assets do not have value prior to being changed to cash specifically in the case of stocks. Conversely, monetary contracts amongst interested parties that can be bought and sold, formed, moderated and even cleared up are seen as financial instruments. Examples include shares showing ownership interest or bonds which signifies the contractual right to distribute or receive cash. In addition, financial assets are usually more liquid than other assets (tangible), like commodities or real estate. The financial asset might additionally be bought and sold in financial markets. Assets that can be bought and sold and in addition serve as packages of capital are financial instruments. They could be cash, contractual rights of delivering or receiving cash or other types of financial instruments or they can be in the form of proof of one's ownership of the entity.

### 3.2 Types of Assets

Generally, assets are divided into tangible and intangible assets

- **Tangible assets**: These are the physical form of an asset. It includes both fixed and current assets. The fixed assets are land, buildings, and machinery whereas an example of a current asset is inventory. These assets are the spine of firms and enable them to carry on with production but are not accessible to clients. Fixed assets can also be described as assets that have material form such as cash, equipment, plant or property that could exist in physical form for a long period of time. Its purchase is for the operation of the business and not essentially for sale to customers.
- **Intangible assets**: These are those assets that do not take physical form, like goodwill, copyrights, trademarks, patents as well as brand recognition. They

are long-term resources, but they cannot be touched or felt as they have no physical existence. Normally, these assets are categorized into two broad groups namely:

a. Definite or Limited-life intangible assets, such as goodwill, copyrights and patents and

b. Indefinite or Unlimited-life intangible assets, like trademarks.

In addition, intangible assets exist contrary to tangible assets like land, vehicles, equipment, inventory, stocks, bonds and cash. An example of a firm's indefinite asset is its brand name because it stays with it all through its period of operation.

**SELF ASSESSMENT EXERCISE**

List and explain the types of assets

**3.3 Features of Financial Assets**

Financial Assets generally have the following features

- **Moneyness**: The capacity to without difficulty change an asset into cash within a specified period of time and determinable value is known as the moneyness of the financial asset. The inference of financial assets being moneyness is the simplicity of changing it to cash in an obviously definite period of time.
- **Reversibility**: Given that they work as customers' deposit accounts, financial assets are tremendously reversible. There is an insignificant cost involved in investing in financial assets and their reversal. Due to this insignificant cost, the process of reversing financial assets is over and over again seen as a roundtrip or turnaround cost. The important part of these costs is called the 'bid-ask spread' for embedding the delivery cost of the commission.
- **Cash Flow**: When an investor holds a financial asset, he/she is likely to obtain some returns on the basis of cash distributions of the asset to holders. A financial asset’s returns on investment are influenced by repayment principal

in terms of the debt instrument as well as shocks anticipated price alteration. In the process of calculating financial assets' anticipated returns, we will have to take into consideration non-cash payments such as yield in stock dividends and additional stock purchases.

• **Maturity**: Maturity in the context of financial assets refers to the period of time within which a financial instrument is held before it is repaid to the holder. For instance, a corporate body can hold a bond for twenty years and a government can extend the period to say eighty years before repayment to the holders.

• **Convertibility**: Financial assets and instruments that pay regular interest can be converted to other assets and instruments on the basis that prices are appreciating to a predetermined level. The convertibility feature means that a financial instrument or asset can be converted into another asset class. The conversion can be carried out by the same corporate body that held the financial asset or instrument to persist to raise money for its operations.

• **Predictable Returns**: For investors to shop for financial assets, their returns must be predictable. The percentage of interest accruable to a particular debt instrument ought to be known to investors before they are ready to risk their funds on such an instrument. This is meant to keep away from the manipulation of records by Boards and Management.

• **Returns & Tax Status**: The returns associated with financial assets being taxable earnings are subject to tax status. The concern of tax authorities is in collecting taxes on earnings associated with financial assets which are regarded as securities and investors' income. Nevertheless, the tax status on financial assets is different for the reason that they change from one economy to another. In addition, changes in such tax rates are equally the case occasionally on financial assets and this depends on the concern of the government which is articulated by means of the tax/fiscal authority.

Furthermore, the status of tax on financial assets differs in terms of the type of security compared to the other based on the issuing institutions or companies in terms of being Federal, State, or local government.

### 3.4 Types of Financial Assets

According to CBN's Monetary Policy Department (2017), generally, we have the following types of financial assets/instruments. These include:

• **Equity Instruments**: This can lawfully serve as proof of ownership right in a company such as a share certificate. Usually, it is issued to shareholders of companies for funding the business. There are numerous classes of equity instruments such as common stock, convertible debenture, preferred stock, depository receipt, and transferable subscription right (TSR).

• **Debt instruments**: These are assets that oblige a holder to be paid a fixed amount of money, normally with interest. Mortgages and bonds, both corporate and government, are good examples of debt instruments.

### 3.5 Denomination of Financial Assets

Usually, the financial assets of various countries are denominated in their different currencies. For example, the Nigerian financial system's financial assets are denominated in Naira. A number of these assets are treasury certificates, treasury bills, federal government loan stock, shares and corporate and state government bonds (CBN, Monetary Policy Department 2017).

The assets in the U.S. are denominated in American dollars, the financial assets in France are denominated in French Franc or Euros, and those in Switzerland are denominated in Swiss Francs. In Egypt and Kenya, they are denominated in the Egyptian Pound and Kenyan Shilling respectively.

These financial assets are utilized for transactions and are denominated in different currencies. In spite of the existence of different currencies globally, a number of financial assets (currencies) are traded internationally and not just for domestic markets alone. These are the financial instruments utilized in the highly developed capital markets like U.S., U.K. Japan, France, etc. In these economies, financial assets are normally denominated in American dollars and any other international currencies like the pound sterling and euro that are acceptable all over the world. These international currencies are also said to be internationally convertible.

### 3.6 Liquidity of Financial Instrument

The categorization of a financial instrument as near money is due to the fact that they are highly liquid. This characteristic arises from the ease at which they can be exchanged for cash. Examples of highly liquid financial instruments are; treasury certificates, treasury bills, shares of blue-chip entities like UBA, Zenith Bank, etc. A financial instrument is said to be illiquid when it is hard to exchange it easily into cash. In this case, the holder might need to keep hold of it until it matures or it could only be traded at a very insignificant value in the capital markets where jobbers are keen on holding them as part of their securities' stock. Presently, jobbers do not exist on Nigeria's Stock Exchange. Therefore, brokers in the Nigerian stock exchange are not regularly keen on trading in weak financial instruments of corporations.

## 4.0 CONCLUSION

Thorough knowledge of financial assets/instruments gives you an insight into how they are traded in the financial markets and how they are handled by financial institutions. In this unit, we gave a blueprint on financial assets/instruments concentrating on their definition, features, types, denomination as well as liquidity. Furthermore, we broadly looked at the types of assets

## 5.0 SUMMARY

This unit has introduced you to the meaning, features, types, denomination as well as the liquidity of financial assets/instruments. Furthermore, types of assets were also discussed.

## 6.0 TUTOR-MARKED ASSIGNMENT

1. List and explain the types of financial assets/instruments
2. Discuss the denomination and liquidity of financial assets/instruments

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# MODULE 4 ROLES AND PERFORMANCE OF DEVELOPMENT, MICROFINANCE, RURAL, COOPERATIVE AND ISLAMIC BANKS



## UNIT ONE - ORGANIZATION, AND FUNCTIONS OF DEVELOPMENT BANKS

CONTENTS

## 1.0 INTRODUCTION

This unit looks at the organization, performance and roles of development banks. Evolution and roles of development banks in Nigeria such as Bank of Agriculture, Bank of Industry, Federal Mortgage Bank of Nigeria (FMBN), Nigeria Export Import Bank (NEXIM), National Economic Reconstruction Fund (NERFUND)

## 2.0 OBJECTIVES

At the end of this unit, you should be able to:

• explain the meaning of development banks

• trace the origin of development banks in Nigeria

• analyze the functions of development bank

• discuss the features of development banks

• list the objectives of development banks

• trace the history of Bank of Agriculture

• describe the Federal Mortgage Bank of Nigeria (FMBN)

• discuss the Bank of Industry (BOI)

• state the objectives of National Economic Reconstruction Fund (NERFUND) • explain the facilities available to exporters from the NEXIM bank

**3.0 MAIN CONTENT**

**3.1 Definition of Development Banks**

Development banks are those banks which have been established chiefly to supply infrastructure facilities for the industrial growth of a nation. They offer financial support for both public and private sector industries. In addition they are seen as financial institutions devoted to finance new and upcoming businesses and economic development projects by offering equity capital and/or loan capital.

Anyanwu (1997) defines development banks as specific financial institutions offering medium- and long-term credit for the formation or growth and development of agricultural, industrial as well as commercial businesses in developing economies like Nigeria, Ghana, Sierra Leone, India etc. They are mainly set up by governments. Globally, examples of development banks include the Islamic Development Bank (IsDB), Inter-American Development Bank Group (IDB, IADB), African Development Bank, European Bank for Reconstruction and Development (EBRD), Asian Development Bank etc. In

Nigeria, they include the Nigerian Agricultural and Cooperative Bank (NACB), the Nigerian Bank for Commerce and Industry (NBCI), the Nigerian Industrial Development Bank (NIDB). In India, there is the Industrial Finance Corporation of India (IFCI), In Uganda there is the Uganda Development Bank, In Ghana there is the National Investment Bank etc. These banks are set up in Sub Sahara Africa and other developing regions to fill up the financial gap in commerce, industries as well as agriculture

**3.1.1 Origin of Development Banks**

Development Banking started after the destruction of the Second World War at the end of which state heads, predominantly in Europe as well United States of America came together on how to pick up their world-torn economies. This led to the establishment of the first development bank called The International Bank for Reconstruction and Development (World Bank). The World Bank was set up in 1946 subsequent to the Bretton Wood Agreement of 1944 between the World leaders at the time, and symbolizes International Development Banking at its zenith. Subsequent to this, the progress for establishing regional as well as national development banks commenced and almost immediately extended to a good number of nations globally.

In Nigeria, failure or dearth of indigenous private investments is more often than not as a result of lack of capital. Over the years, the Nigerian Government has made an attempt to solve this setback to a great extent by setting up numerous development banks or loan Boards as they were in the beginning known. These are fundamentally intended to manage government investments in chosen targeted sectors of the economy, focused on filling the gaps formed by the failure or dearth of private capital as well as investment. Hence, they have turned out to be financial institutions which design, fund as well as perform investment projects or programmes for or on behalf of the government. They have made it feasible for the nation to commence numerous thriving projects that would in no way have or else become visible, and these are positive operations

Development banks offer the essential elements for economic growth, development as well as modifications, for instance, the required finance enterprise, technical as well as managerial support which have been in inadequate in supply. Incidentally, they carry out not just the banking role of making funds obtainable for development projects, but in addition the development function of offering technical as well as managerial support to the deprived sectors of the nation's economy.

Development Banks started to develop in Nigeria as a characteristic of the banking system immediately at roughly the time the economy began to launch development plans. The first of such development plans commenced in 1946 for the period 1943-1956, and almost immediately after that, the Nigerian Development Board was set up by the Federal Government to assist in promoting the attainment of the Plan. This Board was later on dissolved in 1949 and substituted with four new boards namely: the Eastern, Western, Northern Regional Development Boards and Lagos (Colony) Development Board. These Boards took over the activities of their predecessor and almost immediately started to expand financial support to the industrial as well as agricultural sectors. In 1956, the Lagos (Colony) Development Board was dissolved and substituted with two new boards namely: The Western Region Finance Corporation and The Federal Loan Board. Furthermore, in the same year, the Eastern Nigerian Development Corporation (ENDC) and the Northern Nigeria Development Corporation (NNDC) were set up and charged with likewise responsibilities in their respective regions. Presently, all these boards have stopped existing.

The recent stance in Nigeria is that the Federal Government has from time-to-time established development banks to develop particular sectors of the economy. According to the Central Bank of Nigeria, the development financial institutions in Nigeria presently include: The Bank of Agriculture, The Bank of Industry, Federal Mortgage Bank of Nigeria (particularly for housing), The Nigeria Export-Import Bank (NEXIM), National Economic Reconstruction Fund (NERFUND)

**3.2 Features of Development Bank**

The following are the major characteristics or features of development banks:

• It is a specialized financial institution, offering medium and long-term finance to business units.

• It does not accept deposits from the public like commercial banks; it is not just a term-lending institution. It’s a multi-purpose financial institution.

• It is fundamentally a development-oriented bank. Its main goal is to foster economic development by promoting investment as well as entrepreneurial activity in a developing economy. It supports new and small entrepreneurs and seeks balanced regional growth.

• It offers financial support not just to the private sector but also to public sector undertakings; it aims at encouraging the saving and investment habit in the nation.

• It does not compete with the usual finance channels, i.e., finance previously made accessible by the banks and other regular financial institutions. Its main function is of a gap-filler, i.e., to fill up the shortages of the previous financial facilities.

• Its purpose is to serve the general public interest rather than to make profits. It acts in the general interest of the nation.

**3.3 Functions of Development Bank**

Some vital functions of development banks are as follows:

• **Financial Gap Fillers**: - Development banks do not offer medium-term and long-term loans only but they assist industrial firms in numerous other ways too. These banks subscribe to the bonds and debentures of the companies, underwrite their shares and debentures and, guarantee the loans gotten from foreign and domestic sources. Also, they assist undertakings to get machinery from within and outside the country.

• **Undertake Entrepreneurial Role**: - Developing countries are short of entrepreneurs who can begin the job of establishing new projects. It might be as a result of inadequate expertise as well as managerial capability. Development banks were given the task of entrepreneurial gap filling. They assume the task of finding investment projects, promotion of industrial enterprises; provide technical and managerial support, undertaking economic and technical research, carrying out surveys, feasibility studies, etc. The promotional function of development banks is very important for increasing the rate of industrialization.

• **Commercial Banking Business**: - Development banks usually offer medium and long-term funds to industrial enterprises. The working capital requirements of the units are met by commercial banks. In developing countries, commercial banks have not been capable to commence this task correctly. Their traditional approach in dealing with lending proposals and assistance on securities has not helped the industry. Development banks extend financial assistance for meeting working capital requirements to their loan if they fail to organize such funds from other sources. So far as taking up other functions of banks such as accepting of deposits, opening letters of credit, discounting of bills, etc. there is no uniform practice in development banks.

• **Joint Finance**: - Another characteristic of the development bank's operations is to take up joint financing along with other financial institutions. There might be restraints of financial resources and legal problems (prescribing maximum limits of lending) which may compel banks to relate with other institutions for taking up the financing of some projects jointly. Also, it might not be possible to meet all the requirements of concern by one institution; thus, more than one institution might join hands. Not only in large projects but also in medium-sized projects it may be desirable for a concern to have, for example, the requirements of a foreign loan in a particular currency, met by one institution and under the writing of securities met by another.

- **Refinance Facility**: - Development banks also extend the refinance facility to the lending institutions. In this scheme, there is no direct lending to the enterprise. The lending institutions are provided funds by development banks against loans extended to industrial concerns. In this way, the institutions which provide funds to units are refinanced by development banks.
- **Credit Guarantee**: - The small-scale sector is not getting proper financial facilities due to the clement of risk since these units do not have adequate securities to offer for loans, lending institutions are cautious to extend the loans. To overcome this challenge many nations including Nigeria, India and Japan have devised the credit guarantee scheme and credit insurance scheme.
- **Underwriting of Securities**: - Development banks obtain securities of industrial units through either direct subscribing or underwriting or both. The securities might also be obtained through promotion work or by converting loans into equity shares or preference shares. These banks do not hold these securities permanently. They try to disinvest in these securities in a systematic way which should not influence the market prices of these securities and also should not lose managerial control of the units.

### 3.4 Objectives of Development Bank

The main objectives of the development banks are:

- They promote industrial growth.
- Grow and develop backward areas.
- Create additional employment opportunities.

• Encourage additional exports as well as encourage import substitution.

• Promote modernization and improvement in technology.

• Encourage more self-employment projects.

• Revive sick industrial units.

• Enhance the management of large industries by providing training.

• Remove regional disparities or regional imbalance.

• Promote science and technology in new areas by providing risk capital

• Improve the capital market in the country.

**3.5 Bank of Agriculture**

It is a federal government of Nigeria's sponsored bank that offers credit facilities to both small as well as large scale farmers and small businesses in rural areas. It is an upshot of the restructuring of federal government's sponsored microcredit institutions, the bank was established in 2000 and took up the assets of the National Agriculture and Cooperative Bank (NACB), People's Bank and the Family Economic Advancement Project (FEAP).

**3.5.1 A Brief History of the Bank of Agriculture (BOA)**

The history of Bank of Agriculture can be traced to the setting up of the Nigerian Agriculture Bank (NAB) in 1973. NAB was a federal government's plan to finance agriculture development projects in the nation, especially small-scale farm holders that might not possess sufficient collateral to acquire credit facilities from commercial banks. At the time, most farmers were deemed high risk borrowers by commercial lenders and NAB was set up to offer microcredit to small farmers and on-lending to agricultural firms. When Umaru Mutallab was cooperatives minister in 1977, the federal government of Nigeria kicked off new guidelines for financing cooperatives. Furthermore, the federal government of Nigeria offered additional capital to NAB to assist cooperative societies in the nation. Afterwards, NAB was converted into the Nigerian Agriculture and Cooperative Bank (NACB). In addition, the federal government specified new guidelines for commercial banks to reserve a minimum percentage of their loan portfolio to the agricultural sector. Banks that were not able to meet up the threshold transferred the remainder of funds to the Central Bank of Nigeria for onward disbursement to farmers by means of NACB.

In 2000, the federal government merged the activities of NACB, People's Bank and Family Economic Advancement Programme to form the Nigerian Agriculture Cooperative and Rural Development Bank (NACRDB). Prior to the merger, all three institutions were involved in micro-financing.

Bank of Agriculture has struggled to manage the number of non-performing loans in its portfolio which has hindered its capacity to offer sustainable assistance to the agricultural sector.

### 3.5.2 Roles of Bank of Agriculture

Some functions of Bank of Agriculture include:

• Provision of agricultural credit to assist every part of agricultural value chain activities.

• Provision of non-agricultural micro-credits to poor people from rural areas.

• The bank facilitates the mobilization of savings

• Capacity development through promotion of co-operatives, agricultural information systems, as well as the provision of technical support and extension services.

• Provision of opportunities for self-employment in the rural areas, thus reducing rural-urban migration.

• Inculcation of banking habits at the grass-roots of the Nigerian society

**SELF ASSESSMENT EXERCISE**

List and explain the objectives of the development bank

### 3.6 The Bank of Industry (BOI)

Bank of Industry is the oldest and biggest Development Financial Institution presently operating in Nigeria. It is owned by the Ministry of Finance Incorporated (MOFI) Nigeria (94.80%), the Central Bank of Nigeria (CBN) (5.19%) and private shareholders (0.01%). The bank has 11 members on its board and its chairman is Aliyu Abdulrahman Dikko.

### 3.6.1 A Brief History of the Bank of Industry

Bank of Industry Limited commenced its operations in 1959 as the Investment Corporation of Nigeria (ICON) Limited. In 1964, ICON Limited metamorphosed to become the Nigerian Industrial Development Bank (NIDB) Limited under the leadership of the World Bank. At first, International Finance Corporation (IFC) held 75% equity in NIDB and brought the first Managing Director. However, the equity arrangement was reduced in 1976 owing to the indigenization decree.

In 2001, the Bank of Industry was restructured out of the merger of the Nigerian Industrial Development Bank (NIDB), Nigerian Bank for Commerce and Industry (NBCI) and the National Economic Reconstruction Fund (NERFUND). Though the bank's share capital was in the beginning set at ₦50 billion in the wake of NIDB's reconstruction, it was increased to ₦250 billion in 2007.

### 3.6.2 Roles of Bank of Industry

The following are some of the roles of the Bank of Industry

• Provision of financial support for the set-up of large, medium and small projects

• Provide assistance in the expansion, diversification and modernization of existing enterprises

• Helps in the rehabilitation of existing enterprises

• Lays emphasis on prudent project selection as well as management

• Supports of quality projects with high developmental impact such as job creation and poverty alleviation to enhance the socio-economic standard of Nigerians.

• Strategic positioned to manage foreign grants and aids that are given to facilitate attainment of the nation’s developmental aspirations.

**3.7 The Federal Mortgage Bank of Nigeria (FMBN)**

It was set up in 1956, at that time recognized as the Nigerian Building Society. With the launch of the Indigenization Policy, the Federal Government through the Indigenization Act of 1973 assumed 100% ownership acquisition of the Nigerian Building Society and as a result renamed it as the Federal Mortgage Bank of Nigeria. The Bank function as an efficient tool for enhancing the mobilization of long-term funds, lending volume as well as increasing mortgage lending services to every section of the Nigerian populace. It was set up as a corporate entity with powers to sue as well as be sued, to obtain and to seize and get rid of properties for the achievement of its goals, and for the execution of its roles. The Federal Mortgage Bank of Nigeria commenced the running and management of the contributory savings scheme, recognized as the National Housing Fund (NHF) set up by Act 3 of 1992. The National Housing Fund is a kitty that mobilizes long term funds from Nigerian employees, banks, insurance companies as well as the Federal Government to advance loans at low interest rates to its contributors. The Federal Mortgage Bank of Nigeria through the promulgation of the FMBN Act 82 of 1993 as well as the Mortgage Institutions Act 53 of 1989 obtained the rank of the apex mortgage institution in 1994, and therefore gave up its retail function to an autonomous corporation named the Federal Mortgage Finance Limited (FMFL), which was cut out from the Federal Mortgage Bank of Nigeria itself and completely owned by the Federal Government of Nigeria.

With the reform of the housing sector rooted in the Federal Government's 2006 National Policy on Housing and Urban Development, the Federal Mortgage Bank of Nigeria was restructured into a Federal Government sponsored Enterprise (FGSE) with extra concentration on secondary mortgage as well as capital market roles. It plays a significant function in developing a healthy mortgage finance system for the nation.

### 3.7.1 Functions of the Federal Mortgage Bank of Nigeria (FMBN)

The Federal Mortgage Bank of Nigeria performs the following main functions: • Openly offer long term credit facilities to individual Nigerians who desire to get houses of their own at such rates and upon such terms as perhaps decided by the Board in line with the policy of the Federal Executive Council

• Provide long term credit facilities to mortgage institutions to allow these institutions give comparable facilities to Nigerian citizens that desire to have possession their houses

• Supports and develop mortgage Institutions, both at the National and State levels

• Manage as well as control mortgage institutions in Nigeria in line with such directive as might be given by the FMBN on behalf of the Federal Executive Council;

• Offer credit facilities at competitive commercial interest rates to commercial Property Developers, Estate Agents and Developers of offices and other particular kind of buildings (with the approval of the Minister of Housing).

## 3.8 The Nigeria Export Import Bank (NEXIM)

The Federal Government of Nigeria has complete ownership of the Nigeria ExportImport Bank with an authorized share capital of fifty billion naira, equally subscribed to by the Federal Ministry of Finance and the Central Bank of Nigeria. The NEXIM was set up by the NEXIM Act 38 of 1991 as an

Export Credit Agency. The NEXIM is different from other banks for the reason that it is a development finance institution and does not accept deposits like the regular banks. Its major focus is on the developmental role of creating jobs as well as assisting the exports of Nigerian goods and services. It is not in competition with the commercial banks, but complements their roles in growing and developing the economy. It deals mostly on non-oil exports in different sectors of the market as compared to the regular banks. More often than not, there are new sectors of the market which the commercial banks are not prepared to service.

### 3.8.1 Roles of the Nigeria Export Import Bank (NEXIM)

The roles of NEXIM include the following:

• To provide export credit guarantee to investors seeking to invest in the country within this sector.

• Empowered to provide funds in local money, that is, the Naira to support export business operations in Nigeria.

• Setting up and management of funds associated with exports.

• Conservation of a foreign exchange revolving fund for lending to exporters who need to import foreign inputs to facilitate export production.

• To provide domestic credit insurance where such a facility is probable to support exports.

• Maintenance of a trade information system in support of export business

## 3.9 The National Economic Reconstruction Fund (NERFUND)

The National Economic Reconstruction Fund (NERFUND) was set up by Decree No. 2 of 1989 to operate as a catalyst in the direction of stimulating the rapid rise of real production enterprises in the nation. Specifically, the NERFUND was given the authorization to offer long/medium term loans to entrepreneurs through commercial/merchant banks for Nigeria’s industrial growth. The National Economic Reconstruction Fund (NERFUND) grand objectives are to increase the quantum of goods and services available for local consumption and export, provide needed employment, expand our production base and add value to the economy. Up to now, the NERFUND has granted loans for one thousand four hundred and ninety-seven projects, worth over five billion naira (N5b) and disbursed to one thousand three hundred and thirty-two projects, worth four billion, five hundred million naira (N4.5b). This figure does not include those of legacy projects which were sanctioned in the first decade of the Fund's operation between 1989 and 1999

### 3.9.1 The Rationale for the Establishment of NERFUND

Despite of the acknowledgement of the functions of small and medium scale enterprises (SMEs) in advancing economic growth and development through the encouragement of indigenous technology, employment-generating activities as well as expansion of the production base, the influence of Nigerian SMEs on economic development has been less than desirable. A vital cause for this is their limited access to institutionalized credit owing to banks' opinion of SMEs as highrisk ventures. Certainly, in spite of the directive of the Central Bank of Nigeria that banks grant not less than 16 per cent (up till end 1989) and afterwards a minimum of 20 per cent (from January 1990) of their total loans and advances outstanding to small enterprises, the banks granted less than 10 per cent of their loans and advances outstanding to small enterprises within the period 1980-1986. With the launch of the Structural Adjustment Programme (SAP) and the unavoidable devaluation of the naira, most SMEs found it very hard to deal with the attendant high cost of production, due to high cost of imported inputs, higher interest rates. Furthermore, banks' loans to SMEs were likely to be short-term in nature due to their portfolio structure. Thus, SMEs were inclined to borrow short for some of their long-term financing requirements. In addition, they experienced limited access to foreign exchange.

With the intention of bridging the perceived gap in banks' lending to SMEs, the Federal Government established the National Economic Reconstruction Fund (NERFUND) through the NERFUND Decree No. 2 of 9th January, 1989.

### 3.9.2 Objectives of NERFUND

NERFUND is aimed at offering soft, medium to long term finance for fully Nigerian-owned small and medium scale enterprises. SMEs are seen as those with new investment cost up to, but not more than Nl0 million. SMEs via NERFUND have access to local as well as foreign loans over a period of five to ten years. Specifically, the objectives of NERFUND are to

- Fix any perceived insufficiencies in the provision of medium or long-term funds to small and medium scale industrial enterprises (SMEs), particularly manufacturing and agro-allied enterprises, mining, quarrying, industrial support services, equipment leasing as well as other ancillary projects.
- Offer medium to long term loans to participating commercial as well as merchant banks for on-lending to SMEs.
- Facilitate the provision of loans with 5-10 years maturity including a grace period of 1-3 years, depending on the type of enterprises or project.
- Offer loan in local and/or foreign currency depending on the funds available to NERFUND and the project being funded

## 4.0 Conclusion

Development banks are financial institutions that promote industrial growth as well as entrepreneurship, create employment opportunities and revive sick industrial units. They underwrite securities; fill financial gaps, refinance facilities and offer joint finance. Therefore, development banks administer a mixture of financial and development services.

## 5.0 Summary

In this unit you learnt the meaning of development banks, the origin of development banks in Nigeria and the functions of development banks. The discussion also took you to the study of the history of Bank of Agriculture, Bank of Industry, the Federal Mortgage Bank of Nigeria, the Nigeria Export Import Bank, and the National Economic Reconstruction Fund

## 6.0 Tutor-Marked Assignment

List and explain the objectives of NERFUND

Explain the roles of NEXIM

## 7.0 References/Further Reading

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# UNIT 2 THE ACTIVITIES OF MICROFINANCE BANKS IN NIGERIA

## CONTENTS

1.0 Introduction

2.0 Objectives

3.0 Main Content

3.1 Definition of Microfinance

## 1.0 INTRODUCTION

This unit shall discuss microfinance banks and co-operative banks. Microfinance banks will be discussed in terms of their aims, challenges, prospects as well as reforms carried out in this subsector so that their services can be accessed by small and medium scale businesses.

## 2.0 OBJECTIVES

At the end of this unit, you should be able to:

- Discuss an overview of microfinance banks in Nigeria
- Explain the rationale for the formulation of the national microfinance policy
- Elucidate the aims of the microfinance policy
- List the stakeholders in the microfinance subsector in Nigeria
- Discuss the challenges facing microfinance banks in Nigeria
- Explain the prospects as well as the reforms of microfinance banks in Nigeria

## 3.0 MAIN CONTENT

### 3.1 Definition of Microfinance Banks

A Microfinance bank is any financial institution licensed by the Central Bank of Nigeria (CBN) to carry out the business of providing microfinance services such as savings, loans, domestic funds transfer, and other financial services that are needed by the economically active poor, micro, small and medium enterprises to conduct or expand their businesses as defined in the guideline for microfinance banks in Nigeria. In 2005, the Central Bank of Nigeria (CBN) put together the National Microfinance Policy and this gave birth to the formal microfinance subsector in Nigeria.

**3.2 An Overview of Microfinance Banks in Nigeria**

Microfinance banks were established as a result of the observed shortcomings in the existing financing programmes for the poverty-stricken populace as well as small businesses. They were licensed to commence operations in 2007 and existing community banks and non-government organization microfinance institutions that met the conditions specified by the Central Bank of Nigeria for licensing were permitted to transform into microfinance banks.

To qualify for a microfinance, license an existing community bank was obliged to increase its paid-up capital from N5m to N20m. Not like the community banking policy framework which compulsorily restricted every community bank to unit banking, the microfinance banking guidelines allowed the branching of microfinance banks inside a state. For microfinance banks with the intention of establishing branches inside a state, their paid-up capital was put at N1 billion. A further point of divergence between the community banks and their microfinance successors is in those which the regulatory guidelines permit to own them. In addition to individuals, group of individuals, community development associations, private corporate entities which can own community banks, foreign investors and commercial banks, foreign investors can also own microfinance banks.

These alterations in the policy framework of setting up microfinance were as a result of the observed failure of the existing microfinance framework. Adeyemi (2008) summarized this thus, “in spite decades of public provision and direction of provision of microcredit, policy orientation, as well as the entry of new players, the supply of microcredit is still inadequate". He identified some of the difficulties which microfinance institutions encounter that intrude on their capability to act including; undercapitalization, inefficient management and regulatory and supervisory loopholes. In addition to these (Mohammed, and Hassan 2009) included usurious interest rates as well as poor outreach. Further reinforcing the difficulties microfinance banks encounter, Nwanyanwu (2011), identified diversion of funds, insufficient finance, regular changes in government policies, huge transaction costs, enormous loan losses, inadequate capacity and poor technical skill in the industry as obstacles to the growth and development of this subsector. These challenges most of which played a part in the failure of previous microfinance programmes are still bedevilling the microfinance banking programme in Nigeria.

### 3.2.1 Rationale for the Formulation of the National Microfinance Policy

The Central Bank of Nigeria provided the following rationales for the formulation of the National Microfinance Policy: These rationales include:

- **Insufficient Capital Base**: The insufficient capital base of previous microfinance institutions could not offer protection against the risk associated with the lending activities of micro institutions.
- **Weak banking culture as well as inadequate financial literacy**: A number of people particularly in rural areas that are not financial literates do not see microfinance institutions as business enterprises but merely a source for loans and advances. These people have never had any banking experience in their lives either as a result of remoteness from bank locations or complete ignorance of what banking involves. This inevitably led to poor banking culture which affect their views about microfinance

• **The rising interest of indigenous and foreign investors in microfinance**: Most indigenous, as well as foreign investors, have shown interest in investing in the nation's microfinance sector.

• **Poor Institutional as well as Network Capacity**: The lingering sub optimal operations of most former community banks, microfinance as well as development finance institutions is due to the ineffectual management, poor in-house controls and inadequate deposit insurance schemes. Other factors include deplorable corporate governance, insufficiency of well-defined roles and restrictive regulatory/supervisory pre-requisites.

• **The Presence of an Enormous un-served market**: The size of the unserved market by previous financial institutions is huge. For example, in 2005, Nigeria's total microcredit facilities comprised approximately 0.2 per cent of Gross Domestic Product (GDP) and below one per cent of aggregate credit to the economy. This exposed the presence of an enormous gap in offering financial services to a huge number of the poverty-stricken populace as well as low-income groups.

• **Financial Empowerment of the Poor**: Internationally, micro small and medium enterprises (MSMEs) are recognized to play an active role in alleviating poverty via their ability to create employment. As individuals become employed, they earn money from which their basic necessities of life are met. However, in Nigeria, the employment creation abilities of small businesses have been badly restricted by inadequate access to fiancé to start-up, increase or re-engineer their current capacities of economic activities in order to create employment

• **Urban Prejudice in banking services**: A good number of accessible banks are found in the urban area and numerous endeavours made previously to encourage them to set up branches in the rural areas did not yield the required outcome. With a high rate of Nigerians still dwelling in the rural areas, it has become completely vital to develop an institutional framework to get to the hitherto un-served population with banking services.

### 3.2.2 Aims of the Microfinance Policy

The major aims of the microfinance policy include:

• Generation of employment opportunities as well as increase in the productivity of the poor in the nation thus advancing their personal household income as well as increasing their living standards.

• Improvement of service delivery by every microfinance institution to micro small and medium scale enterprises and offering of specialized services such as payment of salaries, gratuities and pensions licensed by the Central Bank of Nigeria.

• Encouragement of linkage programmes between microfinance institutions on one hand and deposit money banks, development financial institutions and specialized funding institutions on the other.

• Encouraging the synergy and mainstreaming of the informal microfinance subsector into the formal financial sector, thus, making sure of efficient organized and focused participation of the poor in socio-economic development and resource allocation.

• Mobilization of savings for intermediation and contribution to rural transformation.

• To provide diversified affordable and reliable financial services to the poor to enable them to commence as well as develop long term sustainable entrepreneurial activities.

• To provide sustainable opportunities for the management of the microcredit programmes of government and high net worth persons on a non-recourse basis, as well as the encouragement of a conducive environment for microfinance service providers to network and exchange viewpoints and experiences on their products and processes

**SELF ASSESSMENT EXERCISE**

Discuss the aims of the microfinance policy

**3.3 The Stakeholders in the Microfinance Subsector in Nigeria**

The stakeholders in the microfinance subsector in Nigeria can be categorized as government regulatory authorities, investors, development partners, financial institutions, technical assistance providers as well as donor agencies. These are: • Regulatory Environment Stakeholders: this includes the Central Bank of Nigeria, the Nigeria Deposit Insurance Corporation, Securities and Exchange Commission, Federal and State Departments of Cooperatives, and apex associations like the National Association of Microfinance Banks.

• Donor Agencies as well as Funds Providers like Human Rights Organizations and Corporate Establishments using microfinance to achieve their corporate social responsibility objectives.

• Microfinance Institutions and Operators: this includes Microfinance Banks, NGO-MFIs, Cooperative Societies, Community Based Development Institutions, Deposit Money Banks offering microfinance services, Development Banks, Government Intervention Programmes and Trade Associations.

• Microfinance support institutions comprising professional service providers in accounting, audit law and technology, and

• Microfinance beneficiaries or microfinance clients who are basically low-income people and micro-entrepreneurs.

**3.4 Challenges Facing Microfinance Banks in Nigeria**

Microfinance encounters numerous challenges and some of these include:

• Inadequate basic infrastructure: This compounds the operational difficulties of microfinance banks, which normally encounters high operational costs due to the nature of business. By managing many small customers, microfinance banks' cost of transactions is more often than not higher than those of conventional banks. Regrettably, microfinance banks are also compelled to encounter additional costs to provide themselves with electricity and water. Inadequacy of good roads particularly in the rural areas also interferes with their outreach. All these challenges drive the cost of operations up and put them at a very big competitive disadvantage.

• Insufficient banking culture in the rural areas and among the urban poor: Usually, these people borrow money from friends as well as relatives and repay the same amount of money borrowed no matter the tenure of such loans. Thus, they find it hard to understand the payment of interest on bank loans. In the northern part of the nation, the problem of frowning at interest on loans assumes a religious dimension. This part of the country is populated by mostly Muslims, a religion which hates usury. This has hindered the growth and development of microfinance banking in that part of the nation. This was buttressed by (Mohammed and Hassan 2009) who were of the opinion that traditional micro financing defies Islamic principles by charging interest. This issue is of concern for Muslims owing to the outcome of dealing with interest (ribia). This might account for the lopsided location of microfinance banks in nation as above 75% of them are located in the southern part of the nation while the northern part with a higher incidence of poverty has less than 25%.

• The failure of most community banks and the withdrawal of the license of 224 microfinance banks in 2010 have gravely harmed the public confidence in these banks. A number of microfinance banks set up in communities where failed community banks existed are confronted with an uphill job of proving to these communities that they will not go through the ill-fated experience of losing money in a bank failure. The immediate withdrawal of the license of 224 of these banks has increased the lack of the general public confidence which community banks bequeathed them. Most of the customers of these banks have abstained from dealing with them in fearing the same fate would befall them. Conversely, the Central Bank of Nigeria has continually assured the public that it will not allow any commercial bank to fail; this, places the microfinance banks at a great disadvantage by tilting public confidence in favour of commercial banks that are usually bigger and stronger.

• Limited assistance for human an institutional capacity building. The scarcity of human capacity in the microfinance sub-sector in Nigeria has been a major concern from the days of community banking. One of the key challenges of the microfinance sub-sector is recruitment of effective and suitable manpower. This is as a result of the inability of the sector to sufficiently remunerate staff. Other human resource challenges encountered by microfinance banks include insufficient training opportunities as well as poor conditions of service. The quality of manpower in these banks is revealed in the poor performance of most of them, inefficiency and high levels of frauds and forgeries. In addition, these banks suffer from high labour turnover a further sign of inadequate staff motivation as well as poor personnel practices.

• Corruption is a cankerworm that has caused havoc in most sectors of the Nigerian economy. The microfinance sub-sector is not excluded from the ravages of corruption. This is illustrated in many ways, for instance, corporate governance failures, frauds and forgeries, theft and refusal by customers to repay loans. The standard of corporate governance in a number of microfinance banks in Nigeria is poor. Board members are identified to use their positions wrongly to get facilities way above the regulatory limit for insider related loans and worse still with no intent of repaying such facilities. Furthermore, they use their positions to overly influence and manipulate the recruitment processes in favour of their cronies. Frauds and forgeries by both insiders and outsiders to the banks are rife and people normally get loans with no intent to repay.

• It is significant to note that there is over nine hundred microfinance banks presently in Nigeria and they are regulated and supervised by the Central Bank of Nigeria (CBN). The CBN in addition has the responsibility of supervising commercial banks, development finance institutions, primary mortgage institutions, and bureau de change and credit bureaus. The multiplicity of the institutions as well as their diverse nature possesses a regulatory challenge. This is against the backdrop that given that for example, commercial banks and microfinance banks differ in operational method and scope, a regulator trained to inspect/supervise the functions of one may be limited in the supervision of another.

• The appearance of miracle or magic banks every now and then has done a lot of disservice to microfinance banks image. These banks spring up with no any license, guarantee to pay bizarre interest on deposits, mobilize deposits from uninformed and/or greedy and disappear. Most of the victims of these scams are customers that microfinance banks ought to service although become cynical about banking after their miracle bank experience. Many others do not see any difference between those magic banks and the licensed microfinance banks.

• Copying, competing as well as mimicking the practices of commercial banks: A number of microfinance bank managers and other management staff were initial commercial banks' staff who were either retired or sacked by their former employers. To these staff, microfinance banking is merely an extension of the commercial banking they know. In addition, they come with their organizational orientation, viewpoint and philosophy. They refuse to understand that micro finance is not micro-commercial banking but a different type of banking that requires a different approach, philosophy and client base. This might be why most microfinance banks spend huge amount on office complex, exotic cars and the wardrobe of their staff. Furthermore, they take part in inordinate competition with the commercial banks. This class of staff lack orientation as to the real meaning of microfinance.

• The continuous change in government policy offers its set of difficulty to microfinance banks. In 2007, commercial banks were consolidated; they became so huge clearly leaving the not too wealthy client segment to microfinance banks. Presently, banks have been reclassified into regional, national and international, increasing fears that the regional banks might be in direct competition with microfinance banks. Furthermore, Islamic banks are being licensed and might end up in the same market segments as microfinance banks.

• The rate of interest charged by microfinance banks leaves a lot to be desired. Microfinance banks charge between 30% - 100% interest on loans while they pay 4.5% to 6% on savings. Microfinance banks rates are way too high and may not augur well for the smooth development of this sector.

### 3.5 Prospects of Microfinance Banking in Nigeria

There are a lot of opportunities for the microfinance subsector in Nigeria. Academics as well as macroeconomic policy makers all agreed that there is a huge untapped market for microfinance banks. It is estimated that approximately 70% of the Nigerian population is engaged in the informal sector or agricultural production. With the country's population of over one hundred and fifty million people we can infer that approximately one hundred and five million are in this sector. In the same line though differing in figures, Mohammed and Hassan (2009) were of the opinion that microfinance banks in Nigeria only serve fewer than one million people against the over 40 million that need their services. Furthermore, the gap in this subsector was shown when it was revealed that microcredit facilities in Nigeria account for approximately 0.2 percent of GDP and less than one percent of total credit to the economy.

The situation above is implying that there is a huge market which microfinance banks can take advantage of. This huge untapped market in the microfinance subsector is additionally enhanced owing to the fact that more than 65% of the total Nigerian populace has no access to banking services. To say that this leaves a large vacuum for existing microfinance banks to enlarge their operation capacity as well as for new ones to come into the market will be stating the apparent fact.

The federal government of Nigeria renewed interest as well as enhanced regulatory environment in the microfinance sub-sector in addition improves the prospects for the development and success of microfinance banks. One indication of this is the implementation of training programmes for regulators, promoters as well as practitioners by the Central Bank of Nigeria (CBN). In addition, the Central Bank of Nigeria subsidizes the training of practitioners in the sector to decrease the financial load on the banks. Presently, the Central Bank of Nigeria pays 60 per cent of the cost of training the management staff of these banks; this is targeted at enhancing the capacity in the industry. The programme which the Central Bank of Nigeria administers in collaboration with Nigerian Deposit Insurance Corporation (NDIC) will conclude in these managers passing a certification examination set by the Chartered Institute of Bankers of Nigeria (CIBN). The regulators are taking this certification/human capacity building programme so seriously that they have authorized a guideline that only certified persons will qualify to manage microfinance banks in the near future.

Another indication of the regulatory will to guarantee vibrancy in the micro financing banking subsector is the inclusion of microfinance banks' deposits in the deposit insurance scheme. This has increased public confidence in the subsector. In addition, the review of the deposit insurance limit from one hundred thousand (N100, 000.00) naira as stipulated by the NDIC Act of 2006 to two hundred thousand (N200, 000.00) naira is a further sign of regulatory intention to build confidence in these banks.

### 3.6 Reforms of the Microfinance Bank Subsector in Nigeria

A number of efforts have been made to reform and the microfinance bank subsector for improved service delivery and these include:

- Strengthening on site regular inspection
- Withdrawal of the operating licenses of one hundred and three microfinance banks in 2010
- Incessant sanitization of the microfinance banks operating in the country as well as revocation of licenses of failed microfinance banks
- Implementation of firm sanctions as well as penalty system
- Facilitation of the setting up of a top association for the subsector; the National Association of Microfinance Banks in Nigeria
- Recommendation of prosecution for criminal activities of delinquent directors as well as management staff found guilty of mismanagement of the affected banks
- The setting up of the Microfinance Certification Programme to develop capacities in the subsector.
- Zero tolerance for regulatory violations
- The review of the Microfinance Policy framework
- The adoption of risk-based supervision in the subsector

## 4.0 CONCLUSION

Microfinance is essential to economic growth and development of any nation, thus, there ought to be renewed efforts by all tiers of the Nigerian government to ensure that the microfinance policy and its reforms are implemented effectively.

## 5.0 SUMMARY

In this unit, you have discussed an overview of microfinance banks in Nigeria; explained the rationale for the formulation of the national microfinance policy; learnt the aims of the microfinance policy; listed and explained the stakeholders in the microfinance subsector in Nigeria; discussed the challenges facing microfinance banks in Nigeria; explained the prospects as well as the reforms of microfinance banks in Nigeria

## 6.0 TUTOR-MARKED ASSIGNMENT

1. Explain the reforms of microfinance banks subsector in Nigeria?
2. Discuss the prospects of Microfinance Banking in Nigeria?

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## UNIT 3 RURAL AND COOPERATIVE BANKING IN NIGERIA

**CONTENTS**

**1.0 INTRODUCTION**

In this unit, the evolution of rural and cooperative banking shall be discussed. With reference to; meaning, origin and roles of rural as well as cooperative banking

**2.0 OBJECTIVES**

At the end of this unit, you ought to be able to:

- define rural banking
- discuss the objectives of rural banking scheme
- explain the advantages and problems of rural banking
    - Define cooperative banking
    - Discuss the Evolution of Co-operative Banks in Nigeria
    - Explain the roles of Co-operative Banks in Nigeria

**3.0 MAIN CONTENT**

**3.1 Rural Banking**

Rural banking can be described as the act of accepting money deposit as well as giving out loans and carrying out other services to customers in rural areas (Anyanwu, 1997). It can be brought into fruition either in two ways namely:

• Persuading, forcing or directing existing banks to establish rural branches or

• Setting up special banks that will establish their presence in the rural areas (Ojo and Adewunmi, 1982).

Therefore, a rural bank is positioned mainly in a rural area for the mobilization as well as relending of idle cash inside the area in order to develop and raise the standard of living for those living in these rural areas

**3.2 An Overview of Rural Banking in Nigeria**

Before 1975, the CBN embrace moral suasion by asking banks to set up branches in rural areas to assist in rural specifically agricultural development. The banks ignored this appeal, thus the CBN changed its strategy via section 4 of the Banking Decree of 1969 where banks were compelled to get approval of the CBN before setting up a new branch. As a result, banks were not given approval to set up new branches in urban areas if they refused to set up branches in rural areas at the same time (Olashore, 1979). Nevertheless, these banks refused, thus making it obvious that no persuasive or delicate means would force these banks to set up branches in rural areas.

Based on the request of the CBN, the Financial System Review Committee in 1975 suggested that the federal government of Nigeria approve a scheme of geographical spread of banks branches specifically planned to make sure that these banks infiltrate into rural areas that is the intentional and purposeful attempt to direct banks into rural areas. Therefore, the Rural Banking Scheme was launched in July 1977 with the pronouncement of allocating recognized rural areas to banks based on a formula which associated the number of each bank's rural branches to its total branch network all through the country. Thus, the basis for setting up such banks were locations in local government headquarters with a population of 5000 people or more with significant economic activities and recognized institutions such as hospitals, schools etc.

The banks were to set up new branches close to their existing branches to ease communication problems. Numerous incentives were provided by the CBN to promote the setting up of rural banks. These incentives include: giving banks a reasonable monopoly period in rural branches location to allow them establish substantial branches in the same locality; not including rural bank credits from total loans and advances; ignoring feasibility study for rural branches; permitting a 5% (from April 1980) investment allowance in excess of what is usually permissible in industrial firms (normal initial 15% and annual 10% permitted by banks as industrial firms)

### 3.3 Objectives of the Rural Banking Programme

The specific objectives of the rural banking scheme include:

- Mobilize rural savings for the issuance of credit to the rural farmers and businesses
- Offering banking services to rural areas
- Promoting increase in banking density in the nation
- Improving development of rural areas and thus reduce the rate of rural urban migration

### 3.4 Phase of Rural Banking Scheme in Nigeria

Owing to the huge number of rural areas that required banking services, it was decided to phase the scheme for comfortable implementation and management

- **First Phase (1977 – 1983)** – The first phase of the scheme covered July 1977 – June 1983 with two hundred branches scheduled to be launched by nineteen commercial banks in the rural areas. By June 1980, one hundred and eighty-eight branches of the two hundred branches allocated were opened. The deficits were grouped together into the second phase and had since been opened
- **Second Phase** – The second phase of the scheme was from 1980 – 1983 with two hundred and sixty-six branches scheduled to be launched. Initially,

this phase was designed to end on 31st December, 1983 but was pushed forward by a year to 31st December, 1984 to allow banks totally meet the directives of the CBN. Nonetheless, only two hundred and twenty-nine of the two hundred and sixty-six allocated were opened. Owing to the refrain of the CBN, nineteen additional branches were launched in 1985 leaving eighteen branches remaining as at the end of 1985. Under the second phase, a total of two hundred and forty-eight branches of the number allocated were launched. Due to the continuous pressure by the CBN on the concerned banks to launch the remaining eighteen branches, a total of two hundred and fifty-eight branches were launched as at the end of 1988 leaving eight remaining under the second phase.

• **Third Phase -** In August 1985, the scheme entered the third phase and lasted to July, 1989 with three hundred branches allocated to be launched in rural areas by the twenty-eight commercial banks operating in the country by 1985 with the largest banks (First Bank of Nigeria, United Bank for Africa and Union Bank of Nigeria) being allocated twenty-eight each, while the new banks got five each. As at December 31st 1989, the number of branches launched under the third phase was two hundred and ninety-three with seven remaining.

**SELF ASSESSMENT EXERCISE**

Discuss the various phases of the rural banking scheme in Nigeria

**3.5 Problems of Rural Banking in Nigeria**

The following difficulties were encountered in establishing rural banks:

• **Inadequate Manpower** – Usually there is insufficient personnel in the of banking sector, thus extending banking services to these rural areas further stretched the capacity of these banks, therefore hindering total compliance as at when due

• **Security Challenges** – A number of rural areas do not have security facilities that are required to safeguard bank properties including cash particularly from armed robbers, hence, banks are hesitant in opening branches in these areas

• **Inadequate infrastructural Facilities in the Rural Areas** – Most rural areas lack infrastructural facilities such as electricity, good roads, portable water etc. This hinders the setting up of banks in such areas. It is hoped that later in the future, numerous rural development efforts will assist to reduce this problem

• **Low Rural Income or Poverty** – The profitability of banks in many rural areas is not ensured since the rural population income is low as a result of the rural economy not sufficiently monetized. In fact, most rural branches are unprofitable and are thus sustained by profits made in the urban areas. This does not encourage the setting up of new rural branches particularly in the period of high competition as well as profit drives

• **Customs and Poor Banking Habits** – A number of rural areas are still ancient and weighed down by customary practices of borrowing from private local money-lenders or individuals rather than from banks. Additionally, as a result of high level of illiteracy as well as poverty, there are usually poor banking habits such that a number of rural branches stay without business and hence cannot even break even talk less of making profits.

• **Inadequate Provision to Advertise the Rural Branches** – There is absence of provisions to encourage banks to advertise rural branches in order to create awareness and hence attract customers

• **Short Period of Implementation -** The rate of executing the programme is rather high (3 years) therefore consuming much of the bank's resources. This is made much difficult by insufficiency of reasonable adjustment period between the different phases

• **Communication Problems** – The rural areas do not have sufficient communication facilities which are required for the successful operation of banks. Furthermore, poor and ineffective communication challenges in the banking industry have hindered the management of diffused branch network thus, restricting the setting up of new ones

• **Accommodation Problems** – Most rural areas do not have suitable building to house these banks and the banks are unwilling to put up their buildings due to high cost of capital involved particularly when compared with the anticipated economic returns from such rural operations. In order to reduce the accommodation difficulty, the CBN enjoined state and local governments to give maximum support to banks in finding suitable buildings or providing lands for the setting up of new building required for the successful implementation of the rural banking programme

• **High Cost of Establishing Rural Branches** – As a result of SAP, the cost of items increased significantly including building cost, rents, banking facilities, wage bills etc. Thus, it became difficult to meet the required number of rural branches to be established. Moreover, this was made more difficult in the face of inflexible incentive package, for instance, while construction is increasing at a much higher rate, the allowance for investment did not change

**3.6 Advantages of Rural Banking**

The following are some of the advantages of rural banking

• It promotes banking habits, particularly when the people in rural areas are meant to believe in the banking system's integrity as well as efficiency

• It assists to make loans available to those in rural areas particularly to support agricultural production as well as cooperative activities

• It increases the mobilization of rural savings which are utilized for productive investments

• It aids to protect people's funds as well as other valuables not only from thieves; but also, from damages such fire, etc.

• It assists to increase business activities in rural areas as a result of increased monetization and lending credit operations of banks

• It assists to further develop rural areas since banks attract other infrastructural facilities such as electricity, good roads, etc.

**3.7 Co-operative Banking**

These are financial institutions particularly set up to provide better access to sings as well as borrowing facilities for co-operative societies and their members at moderately cheaper costs and terms than those offered by the conventional banking institutions (Ojo and Adewunmi, 1980). Since conventional commercial banks are seen are serving the interests of big businesses as well as the wealthy in the society, such co-operative banking institutions are referred to as People's Bank in Canada as well as Germany, whereas in Britain, they are recognized as Consumer's Bank

**3.8 Evolution of Co-operative Banks in Nigeria**

Co-operative Bank of Western Nigeria later known as Co-operative Bank Limited established formally as a bank in 1961 was the first co-operative bank in Nigeria. It was followed also in 1961 by the establishment of Co-operative Bank of Eastern Nigeria later called Co-operative and community bank of Nigeria and co-owned by Imo and Anambra States.

The North Central Co-operative Bank later called Kaduna Co-operative Bank and in 1988 called the Tropical Commercial Bank Limited was set up in 1975. The Sokoto Co-operative Bank started operation in 1983 but in 1988 changed its name to Gamji Bank of Nigeria Limited. In 1987, the Co-operative Development Bank Limited was set up. As a result of the country's emphasis on the use of co-operative societies for the social and economic development, the federal government of Nigeria transferred the Nigerian Agricultural and

Co-operative Bank (NACB) to the Co-operative division of the ministry of trade. Under this special arrangement, NACB was directed to be in charge for financing viable co-operative projects of numerous types in addition to its conventional role of financing agriculture, including agricultural co-operatives. In this fashion, NACB has emerged as a significant co-operative institution in the nation.

It is informative to observe that although co-operative banks in Nigeria, in numerous cases, channel their resources to co-operative institutions, they more or less function as conventional commercial banks with profit motive the principal objective

Based on this development, there is the need to formulate as well as implement separate co-operative banking regulations with the NACB as the controlling institution. Though some people may argue that the people's bank as well as the community bank now performs some of the roles of co-operative banks. This can be partially true.

### 3.9 Roles of Co-operative Banks in Nigeria

The roles of co-operative banks in Nigeria include the following:

• Co-operative banks are meant to fill the financial gaps left by the conservative as well as the profit-oriented financial practices of traditional/commercial banking institutions in Nigeria which resulted in the neglect of large majority of the masses in the provision of financial resources needed for development activities of the country. These co-operative banks, thus, provide for these neglected groups who have organized themselves into co-operative societies.

• Co-operative banks provide increased access to banking facilities and resources to cooperative societies and their members at both lower costs and better terms than those offered by traditional commercial banking institutions

• Employing established co-operative principles and practices, co-operative banks provide primarily for the economic well-being of its members

• With proper managerial and professional thrust, they can efficiently tap the rural resource potential in the country in a massive way

**4.0 Conclusion**

Rural banks can be seen as the business of accepting money deposits and performing other services to customers in rural areas. They mobilize rural savings, extend banking services to rural areas and enhance development of rural areas. Thus, rural banks play a key role to curb the alarming rate of rural urban migration. Furthermore, the roles co-operative banks play in the Nigerian economy should not be neglected and government should ensure that co-operative societies are encouraged in one way or another to improve the living standards of their members.

**5.0 Summary**

You learnt in this unit, the evolution of rural banking in Nigeria, their objectives, problems and the roles they play in the economy. Furthermore, the origin and functions of cooperative banking is discussed extensively.

**6.0 Tutor-Marked Assignment**

1. Explain the problems of rural banking in Nigeria?
2. Discuss the evolution of cooperative banks in Nigeria?

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## UNIT 4 ROLES AND PERFORMANCE OF ISLAMIC BANKS IN NIGERIA

**CONTENTS**

## 1.0 INTRODUCTION

This unit shall discuss Islamic banks in Nigeria. They will be discussed in terms of their origin, specific form of their activities and roles in the Nigerian economy

## 2.0 OBJECTIVES

At the end of this unit, you should be able to:

• Discuss the origin of Islamic banks in Nigeria

• Explain the specific forms of Islamic Banking activities

• Discuss the Islamic Financial System in Perspective

• Explain the challenges confronting Islamic banking system in Nigeria

• Analyse the prospects of Islamic banking in Nigeria

## 3.0 MAIN CONTENT

### 3.1 Origin of Islamic Banking in Nigeria

In the early 1970s, Islamic banks came into existence as key participants in the field of finance. However, the rules and regulations that preside over Islamic banking system have been there for centuries. The foundation of Islamic banking is the prohibition of Riba (interest). Similarly, in non-Muslim literature, such as the Old and New testaments deem interest as vile.

During the 19th century, scholars such as William Shakespeare, Saint Thomas Aquinas, Charles Dickens, etc constantly were against money lenders and interest. In addition, renowned Indian authors like Rabindranath Tagore, Munshi Premchand, and Sarat Chandra illustrated the evil associated with the occurrence of interest charges in an economy.

Islamic finance became prevalent and was extensively acknowledged and put into practice during the Middle Ages. In Muslim societies, it assisted in promoting trade and businesses. Also, during this era, Islamic merchants performed a significant role in the commercial liberation of southern Europe that includes Spain, Baltic States and the Mediterranean. Islamic financial became more renowned when key cities of the Islamic Caliphate at that time became main commercial centers that drew the attention of European interests and capital. Though, the increasing pressure of capitalism and the free market economic principle in Europe overshadowed the Islamic financial system.

Around 1975-1976, saw the renaissance of the Islamic banking owing to increased earnings from crude oil exports that gave Middle East oil producing countries the financial power to look for other banking and financial systems. Those that championed this course were mostly from the private sector. The 'Dubai Islamic Bank', a private institution, was established in 1975 by a collection of businessmen from a number of countries. In 1977, two additional private banks were set up with the name 'Faisal Islamic Bank' in Egypt and Sudan. Also in the same year, Kuwait finance house which was the first government Islamic financial institution was established by the Kuwaiti Government. Within a decade of setting up the first privately owned Islamic bank in Dubai, over fifty Islamic banks have been established. However, majority of these are in Muslim nations, though there were quite a few in Western Europe specifically in the UK, Denmark, Switzerland and Luxembourg. As previously mentioned above, apart from the Kuwaiti bank the setting up of Islamic banking, had been by private individuals and restricted to the startup banks. However, in Iran and Pakistan, it was set up by government covering the entire banks in both countries. In 1981, the governments in these nations concurrently took steps to initiate Islamic Banking, on a global scale.

Islamic banking in Nigeria commenced in January 2012, when the Central Bank of Nigeria practically approved Jaiz Bank to function as a local interest-free bank in the northern part of the country. Accordingly, Jaiz bank became the foremost and the only developed Islamic bank in the nation. If you take into account how famous this phenomenon is, and the number of Muslims in

Nigeria, it is expected that in due time, the number of Islamic banks will increase in Nigeria.

The most significant difference between this and other banks in Nigeria is that Islamic banks firmly adhere to the norms customs and values of Islam, in which lending with interest (usury) is forbidden. Each and every one of Islamic financial instruments is designed in such a way to satisfy this clause and at the same time to earn profit from their activities.

**3.2 Specific Types of Islamic Banking Activities**

According to www.legit.ng, the following are specific types of Islamic banking activities. These include:

- **Musharakah -** It is a dual execution of a project by the bank and an entrepreneur. In the outline of this process, the bank sponsors a particular project. The origin of these operations dates back to the caravan trade when a number of merchants made goods available, others distributed it to their various destinations and put them up for sale.

  Under musharakah, the bank performs financing that is not connected to the collection of a specific percentage but takes part in the profits obtained. The sharing of profits is as follows: a specific part is given to the partner in payment for his job, managerial skill or additional contribution in the transaction or project. The other part is shared between the partner and the bank that provided the financing, in a ratio proportional to the payment of each participant, to the entire costs of the project. Losses are shared in proportion to contribution in financing.
- **Mudarabah** - This is a contract in which a customer of a bank transfers funds to the bank for later investment of this fund into a particular project or kind of activity. The profit gotten during the execution of the project is shared in a specified amount. This process is an analog of an

inert banking procedure — raising money. Islamic distinctiveness lies in the fact that the customer is aware of where his money goes. The bank cannot invest in forbidden activities such as the production and selling of alcoholic drinks, the running of gambling-houses, or other prohibited acts. In addition, mudarabah does not include interest in pure form.

- **Murabaha** - It entails the funding of saleable transactions, diverse collection of the contract of sale. The bank obtains a particular good for resale. Such activities do not contradict the Shariah as trade involves certain individual participation and endeavours. The bank takes over the management of transactions, storage, transport, etc. For instance, the bank obtains goods at its own cost for the customer's order. In this case, the bank takes up the whole risk of the trading operation. Afterwards, the bank resells the product to the customer at a price that includes the additional cost specified in the contract. This markup turns out to be the income of the bank.

Other activities that are distinctive to Islamic banking include:

• **Ijar** — long-term lease, an analog of leasing operation.

• **Salam** — advance funding, mostly in the agricultural sector.

• **Ijarah-wal-iqtina** — a contract in line with which a customer gets the right to buy earlier leased machineries and facilities for the purpose of production**.**

• **Sunset** - According to the Koran, this is an obligatory tax (2.5%), levied on the assets of rich Muslims and directed to assist the poor populace of the Muslim community and generate projects for making daily life better.

• **Qard al Hassan** - This is an interest-free loan. The bank gives an interest-free loan to an individual or institution that is paid back on a specific time. The bank can assign an interest-free loan to the government or institution for the execution of community projects (building of roads, plant, fundamental amenities/facilities).

• **Bai bi Sila** – It is an onward transaction in which the buyer pays part of the advance for goods.

• **Sukuk (interest-free Islamic bonds)** - This is given out for a particular tangible asset, where the issuer is deemed as a shareholder of the asset. The earnings of Sukuk rely on the profit on the fundamental asset, and the issuer gives the investor an irreversible entitlement to repurchase the asset at a fixed cost. The benefit of this kind of bond is also in the low instability and tendency of investors to hold these securities prior to maturity. According to global researchers, presently, the world goes well with Sukuk in the amount of US$90 billion, and the start of the fall in the volume of their issue in 2008 (three times compared with 2007 - from $50 to $15 billion) was related with the fatwa of Islamic theologians, who acknowledged 80% of the entire volume of Sukuk releases that do not meet the Sharia customs. A damaging feature affecting the Sukuk's attractiveness is the reality that the lower boundary of the volume of loan, which decides the convenience of giving out the Sukuk, is the bar of US$100 million.

**SELF ASSESSMENT EXERCISE**

Discuss the origin of Islamic banking in Nigeria

### 3.3 An Outlook on Islamic Financial Systems

The ideas, theories and perceptions with respect to Islamic financial system sent a wave down the foundation of financial systems that were based on capitalist principles. The notion of a financial system that is interest free appears quite attractive but those that were used to the regular/normal financial system believed that a financial institution with no interest could not last.

The individuals who attached significance to ethics, beliefs, morals and other societal values disapproved of the regular financial system as depending a great deal on capitalistic procedures. Standard financial system engineers the charging of high interests on loans and advances, vehemently seizing buildings if the loans are not paid back, maltreatment of those who fails to payback, are all being complied with as on the amiss part of the law. Financial institutions are pestered by human rights bodies and new rules and regulations support the customers. Customers are unwilling to cope with institutions which do not provide appropriate recognition to moral values and ethics. They detested investments in unethical activities as well as those activities harmful to the society.

Islamic banking system has produced a gateway to invest morally and in a useful way to the society, consequently increasing its acceptance. Socio-demographic tendencies have been the means for continuous growth in Islamic banking and financial system. The rise in population growth rate in Islamic communities globally has been supported by rising wealth and affluence, specifically across Asia. With this development, customers are looking for Islamic banking and Islamic moral and ethical values as described in Shari'ah law, while providing the advantages of diversification and a full variety of banking products.

### 3.4 Challenges facing Islamic banking System in Nigeria

According to Olaoye, Dabiri, and Kareem (2013) some of the challenges facing Islamic banking system in Nigeria include:

**• Awareness**

There is seemingly inadequate consciousness, knowledge and familiarity of Islamic banking concept in Nigeria. Therefore, for a banking system that is free of interest to work competently in the country, there is an immense necessity for sensitization of all the stake holders (government, private establishments and the general public) by Islamic experts, scholars and economists. This is due to the fact that Nigeria is a secular state. For this reason, government ought not to be seen as attempting to Islamize the nation's banking system. This denotes that the inclination of non-Muslims to misunderstand the philosophy or ideology owing to its religious diversities and thus, this calls for a nation-wide awareness.

**• Manpower**

It is commendable to note that for Nigeria to institutionalize Islamic banking system there is a necessity to include this idea into the Nigerian university prospectus or set of courses to set up a decent foundation as well as human resources for the business of Islamic banking system. In other words, scholarship can be given to students to go abroad for useful training from those nations that have succeeded in the execution of the Islamic banking. For example, Malaysia, Bahrain, Saudi-Arabia. Etc.

**• Requisite legal framework**

The Central bank of Nigeria which is the overseer as well as the watchdog of the banking industry is anticipated to come up with adequate details of regulations that control the operations of Islamic banking in Nigeria (legal frame work) that agrees with the beliefs of the Qur'an and Hadith of the holy prophet Muhammed (SAW). Nonetheless, the policy framework ought to be such that allows the Islamic banks to be competitive with the regular banks. More significantly the validation for the existence of an alternative is to put out the thirst of Muslim faithful for banking services that will be in complete adherence to the law of Islam.

**• Societal Belief and Socio-Political Environment**

Due to the society's belief on banking services that generates interest; it would be difficult to be eradicated. For example, a good number of the rich and wealthy in the society frequently make up the key shareholders in most or if not all banking institutions. Therefore, to get rid of such interest from what they have been benefiting from might become a knock on their affluence and an assault on their sources of riches and prosperity. However, if the federal government is really honest about this course of action as commanded by the Almighty Allah, then, the concerned authorities might enact laws that will put down the foundation for the setting up of Islamic banking system in Nigeria.

• **Equity Capital/Cash Requirements and Orientation Challenge**

Owing to the risk involved in putting large sum of money for setting up Islamic banking, individuals tend to be unwilling to make such investments. For example, the current CBN's bank capitalization or cash requirement for international License of banks is N50billion, National license (N25billion) and regional license (N10billion) respectively. Thus, one would barely notice businessmen investing such amount of money on uncertainties, simply in the name of Qur'an and Hadith of the holy prophet (SAW).

**3.5 Prospects of Islamic Banking**

The prospect for Islamic Banking is extremely vivid. Globally, Muslims are clamouring for this system of banking. For example, in Bangladesh, approximately 80% of the regular banks opened separate Islamic banking windows in recent times. The Islamic Bank of Bangladesh Limited has one hundred and thirty two branches in the nation and five hundred applications are pending with Islamic Bank Bangladesh Limited for starting up of new branches

The state of affairs might not be similar across countries. But if Islamic Banking thrives in any nation, the arrangement might be the same in all Muslim-populated nations. This signifies that the first Islamic Bank in Nigeria ought to be properly managed, controlled, coordinated and successful so that individuals would have adequate confidence in the system. The country ought to go into effective working relationships with nations that have established

Islamic Banks to provide capable and experienced officials to help out in setting up Islamic Banks. According to Olaoye, Dabiri, and Kareem (2013), the following points summarizes the advantages as well as the opportunities for the setting up of an Islamic bank in Nigeria: These include

**• Population**

According to the 2006 census in Nigeria, the population of Muslims was approximately 50 percent of the entire populace in the country. This is an effective source of patronage; furthermore, Islamic banks will not only cater for Muslims but also impoverished non-Muslims who would use the opportunity to build micro, small and medium scale enterprises with slight concern for their sustainability owing to high rate of interest.

**• Economic Growth**

The setting up of the Islamic banks will assists in advancing trade and businesses among a good number of the most susceptible of the population resulting in a rise in the growth as well as development of the real sector of the economy. Nevertheless, it ought to be noted that when a business does well, it provides opportunities for employment generation, increase in GDP, development of human capital and productivity.

**• Attraction of Investors**

An environment that is conducive as well as interest free will obviously attracts investors will likely gain from the backing of the interest free financial system. Investment can only flourish fruitfully in an environment in the absence of strict conditions attached to obtaining money to fund investment. This implies that Islamic banking system has the ability and means to facilitate and accelerate the growth and development of infrastructures which the nation has been longing for.

**• Egalitarian Society**

Islamic banks have the propensity to promote equity in the distribution of income as well as wealth in the society. This will facilitate the transformation of the Nigerian economy into a more balanced state with decrease poverty rate. A feeling of fitting in would also be generated owing to funding of the business of customers based on the modus operandi of Islamic financing

• **Prevention of Fraud**

Lately, the Central Bank of Nigeria has emerged with the record of bank executives that have involved in un-secured loan lending that resulted to bankruptcy of a good number of sound conventional banks. This act could be traced to the fact that they were not directed by the set of laws of the Qur'an as well as the Hadith. Islamic banks are operated on the basis of trust and there are calamitous outcomes, both spiritual and physical, for breaking the laws that guides such trust

## 4.0 CONCLUSION

Islamic banking system has created an opportunity to morally, ethically and decently performed banking services in a helpful way to the nation, thus increasing its acceptance as well as recognition. The increased rate in population growth particularly in Islamic societies globally has been aided by increasing affluence, riches as well as wealth. With this occurrence, customers are seeking for Islamic banking as well as Islamic moral and ethical values as depicted in Shari'ah law, whilst providing the benefits of diversification and a complete range of banking products.

## 5.0 SUMMARY

In this unit, you have discussed the origin of Islamic banks in Nigeria, explained the specific forms of Islamic Banking activities, talked about Islamic Financial System in Perspective, give details on the challenges confronting Islamic banking system in Nigeria as well as examined the prospects of Islamic banking in Nigeria

## 6.0 TUTOR-MARKED ASSIGNMENT

1. Give an outlook on Islamic Financial System
2. Discuss the prospects of Islamic banks

## 7.0 REFERENCES/FURTHER READING

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