



**NATIONAL OPEN UNIVERSITY OF NIGERIA**

**FACULTY OF MANAGEMENT SCIENCES**

**COURSE CODE: BFN306**

**COURSE TITLE: COMPARATIVE BANKING**

**COURSE GUIDE**

**Course Code:** **BFN306**

**Course Title:** **COMPARATIVE BANKING**

**Course Writers:** **DR. CHARLES JEGEDE**  
**Department of Banking and Finance**  
Lagos State University

**&**

**SUFIAN JELILI BABATUNDE**  
**Dept of Financial Studies, NOUN**

**Content Editor:** **Professor Patrick Eriki**  
**Department of Banking and Finance**  
University of Benin

**Course Coordinator:** **Mrs Olakunbi Lawal**  
**Dept of Financial Studies, NOUN**

**HEAD OF DEPT:** **Dr. (Mrs.) Ofe I. Inuwa**  
**Dept of Financial Studies.**

## TABLE OF CONTENT

|                                                 |    |
|-------------------------------------------------|----|
| 1.1. Introduction .....                         | 3  |
| 2.0. Course Objectives .....                    | 3  |
| 3.0. Course Materials and Structure .....       | 4  |
| 4.0. Study Plan .....                           | 5  |
| 5.0. How to get the most from this course ..... | 7  |
| 6.0. Tutor-Marked Assignments (TMAs) .....      | 9  |
| 7.0. Final Examination and Grading .....        | 10 |
| 8.0. Conclusion .....                           | 10 |

## **1.0 INTRODUCTION**

You are welcome to BFN306: Comparative Banking. BFN306 is a three credit unit course at 300 Level B.Sc. in Banking and Finance. It is an introduction to the study of Comparative Banking System. The course has eighteen units with appropriate local content for the Nigerian learner.

This course guide is intended for the distant learners enrolled in the B.Sc. Programme of National Open University of Nigeria (NOUN). The guide is one of the diverse resource tool made available to the learner to facilitate timely completion of the programme.

The guide provides quite useful information on the course aims, objectives, what the course is all about, the course materials that the learner will be using, available support services for learning, information guidelines on assignments and examination, such as planning of the timing on the assignments and each unit. This guide also provides answers to several questions that you may ask. Thus, it is strongly recommended that the learner goes through this course guide.

The learner is however advised to contact his/her study centre if there are further questions. I wish you all the very best in your experience and successful completion of this study.

### **Course Aims**

The course applies analytical approach, aim at developing the economic way of thinking, makes the careful step-by-step introduction of different analytical models, uses a number of applications and examples from different banking systems. The primary aim of this course is to acquaint you with the basic theoretical, principles, concepts and practical knowledge of bank management

## **2.0. Course Objectives**

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

- i. Make a general overview and explain the evolution, origin and growth of political economy of banking.
- ii. State and explain the functions of banking Institutions and discuss their role in economic development of Nigeria.
- iii. Identify and explain the theories and comparism of banking system
- iv. Describe the objectives, Instruments and the role of central bank in the Nigeria economy.
- v. Explain the role of the money and capital markets in the development of the Nigerian.
- vi. Describe the various universal banking system.
- vii. Identify and discuss the role of Non-bank Financial Institutions in economic development of Nigeria.

## **3.0. Course Materials and Structure**

The learner is admonished to read through this course guide to get familiarized with the structure of the course. This is to be done by reading the study units properly and attempting all self

assessment exercises, completing and submitting all tutor marked assignments for the course and consulting recommended sources for further reading.

Each unit contains self assessment exercises and in appropriate places you are required to submit assignments for assessment purposes. There will be a final examination at the end of the course.

Each unit should take you about two (2) hours to complete, giving you a total of about thirty (30) hours to complete the course. In order to successfully complete the course on time, you are advised to draw up a personal time schedule that will enhance the achievement of this goal.

Find below the components of this course.

## **Study Units**

### **MODULE ONE: POLITICAL ECONOMY OF BANKING**

**UNIT 1:** Definition and Characteristics of Political Economy of Banking

**UNIT 2:** Evolution of Political Economy of Banking

**UNIT 3:** Principles of Money and Banking

**UNIT 4:** Merchant Bank and Development Bank

**UNIT 5:** Banking Under Capitalism

### **MODULE TWO: UNIVERSAL BANKING**

**UNIT 1:** Universal Banking

**UNIT 2:** Branch Banking

**UNIT 3:** Unit Banking

**UNIT 4:** Islamic Banking

**UNIT 5:** Inter-Country Comparison of regulations and conduct of banks

**UNIT 6:** Inter-temporal comparison of banking in Nigeria

### **MODULE THREE: INTRODUCTION TO BANKING**

**UNIT 1:** Origin, Growth and Development of Banking

**UNIT 2:** Functions of Banks

**UNIT 3:** Structure of Banking System

**UNIT4:** The Nigerian Financial System

**UNIT 5:** Credit Instruments and Credit Creation by Commercial Banks

## **MODULE FOUR: ROLE OF CENTRAL BANK AND NON BANKING SYSTEMS**

**UNIT 1:** The Role of Central Bank in a Developing Economy

**UNIT 2:** Development of Banking in Nigeria

**UNIT 3:** Money and Capital Markets

**UNIT 4:** Non-Bank Financial Intermediaries (NBFIs)

**UNIT 5:** Monetary Policy

### **Course Summary**

Module 1 introduces you to political economy of banking. Module 2 discusses universal banking. Module 3 discuss introduction to banking while Module 4 discuss role of central bank and non-banking system.

There are eighteen study units in the course and each unit consists of one week's work which requires about three to four hours (3-4 hrs) to complete there are specific objectives, guidance for the study, reading materials, self assessment exercises and tutor marked assignments to assist you in achieving the learning objectives in each individual study unit and the course in general.

### **4.0. STUDY PLAN**

Find below the presentation of the course and how long it takes you to complete each study unit and the assignment that accompany each unit. This is to help you plan your own personal timetable.

| Unit/Module     | Title of study unit                                            | Week/activity | Assignment               |
|-----------------|----------------------------------------------------------------|---------------|--------------------------|
|                 | Course guide                                                   | 1             | Course guide form        |
| <b>Module 1</b> |                                                                |               |                          |
| Unit 1          | Definition and Characteristics of Political Economy of Banking | 2             | Tutor- Marked Assignment |
| Unit 2          | Evolution of Political Economy of Banking                      | 3             | Tutor- Marked Assignment |
| Unit 3          | Principles of Money and Banking                                | 4             | Tutor- Marked Assignment |
| Unit 4          | Merchant Bank and Development Bank                             | 5             | Tutor- Marked Assignment |
| Unit 5          | Banking Under Capitalism                                       | 6             | Tutor- Marked Assignment |
|                 |                                                                |               |                          |
| <b>Module 2</b> |                                                                |               |                          |
| Unit 5          | Universal Banking                                              | 6             | Tutor- Marked Assignment |
| Unit 6          | Branch Banking                                                 | 7             | Tutor- Marked Assignment |
| Unit 7          | Unit Banking                                                   | 8             | Tutor- Marked Assignment |
| Unit 8          | Islamic Banking                                                | 9             | Tutor- Marked Assignment |
| Unit 5:         | Inter-Country Comparison of regulations and conduct of banks   | 10            | Tutor- Marked Assignment |
| Unit 6:         | Inter-temporal comparison of banking in Nigeria                | 11            |                          |
| <b>Module 3</b> |                                                                |               |                          |
| Unit 9          | Origin, Growth and Development of Banking                      | 12            | Tutor- Marked Assignment |
| Unit 10         | Functions of Banks                                             | 13            | Tutor- Marked Assignment |
| Unit 11         | Structure of Banking System                                    | 14            | Tutor- Marked Assignment |
| Unit 12         | The Nigerian Financial System                                  | 15            | Tutor- Marked Assignment |

|                 |                                                            |    |                          |
|-----------------|------------------------------------------------------------|----|--------------------------|
| Unit 13         | Credit Instruments and Credit Creation by Commercial Banks | 16 | Tutor- Marked Assignment |
|                 |                                                            |    |                          |
| <b>Module 4</b> |                                                            |    |                          |
| Unit 14         | The Role of Central Bank in a Developing Economy           | 17 | Tutor- Marked Assignment |
| Unit 15         | Development of Banking in Nigeria                          | 18 | Tutor- Marked Assignment |
| Unit 16         | Money and Capital Markets                                  | 19 | Tutor- Marked Assignment |
| Unit 17         | Non-Bank Financial Intermediaries (NBFIs)                  | 20 | Tutor- Marked Assignment |
| Unit 18         | Monetary Policy                                            | 21 | Tutor- Marked Assignment |

|  |              |    |            |
|--|--------------|----|------------|
|  | Revision     | 22 | Assignment |
|  | Examination  | 23 |            |
|  | <b>Total</b> |    |            |

### References/Further Readings

Although the course material is the main text for this course, you are however encourage to consult other sources as provided in the list of references and further readings below;

Anonymous (2010). “Abolition of Universal Banking”. Retrieved May 30, 2012  
from <http://www.tribune.ng/index.php/editorial>.

Abrami R., Malesky E. and Zheng Y. (2008). “Accountability and Inequality in

Single-Party Regimes: A Comparative Analysis of Vietnam and China”. Harvard Business School Working Paper 08-099.

Acemoglu D., and Robinson, J.A. (2012). *Why Nations Fail. The Origins of Power, Prosperity and Poverty*. London: Profile Books.

Aglietta, M., and Bai, G. (2012). *China Development. Capitalism and Empire*.



London & New York: Routledge.

Albrecht, D., Hocquart, H., and Papin, P. (2010). *Urban Development in Vietnam:*

*the Rise of Local Authorities. Resources, limits and evolution of local governance.* Paris: AFD Editions.

Femi, A. (1986). "The Elements of Banking in Nigeria" F & A Publishers Ltd  
Lagos

Federal Reserve Bank of Chicago, *Assessing a Decade of Interstate Bank Branching*, April 2007.

Imala, O.I. (2000). 'Arguments for and against universal Banking': Abuja, CBN  
Bullion, Vol.24, No.4, Oct/Dec.

International Monetary Fund (1991). *Banking Crises: Cases and Issues.* Washington D.C. IMF  
Publication Services.

Jhinghan, M.L.(2004). *Money, Banking, International Trade and Public Finance.* Delhi; Vrinda  
Publishers (P) Ltd.

Jimoh, A. (2010). "Still on Universal Banking System". Retrieved March 23, 2012  
from <http://economicconfidential.net>.

Kroszner, Randall. S. (1996). "An Analysis of Bank Privatization," working paper,  
Graduate School of Business, University of Chicago, 1996.

Kroszner, Randall. S. (1997). "The Political Economy of Banking and Financial  
Regulation in the U.S." pp. 200-13 in George M. von Furstenberg, ed., *The Banking and  
Financial Structure in the NAFTA Countries and Chile*, Boston: Kluwer Academic  
Publishers.

Magaji, S. (1995). "Teach your Self the ABCD of Banking" Gargajiya Printers,  
Kano, Vol. 1

Nwankwo, G.O. (1972). "Indigenization of Nigerian Banking" Bankers Magazine.  
July. Nigerian Agricultural Corporate and Rural Development Bank Ltd. Customers  
Guide

Ogiemwonyi, V. (2010). "The trouble with Universal banking in Nigeria".  
Retrieved May 30, 2012 from <http://www.businessday.com.ng/index.php/editorial>.

Oni, B. (2001). "Capacity Building for Universal Banking – The Challenge of

Human Capital Management”. Retrieved March 24, 2012 from <http://openwells.org>.  
Rajan, Raghuram., and Luigi, Zingales. (1999). “Politics, Law, and Financial  
Development”. A Study Prepared for the Government Official Inquiry on the  
Competitiveness of the Swedish Financial Sector.

Stock Analyst (2008). Is It Time To Embrace The Universal Banking Model?.

Unamka, P.C., and Ewurum, U.J.F (1995). Business Administration. Precision  
Printers and Publishers Enugu Nigeria.

## **5.0. HOW TO GET THE MOST FROM THIS COURSE**

In distance learning, the study units replace the lecturer. There is the advantage of reading and working through the course material at the pace that suits the learner best. You are advised to think of it as reading the lecture as against listening to the lecturer. The study units provide exercises for you to do at appropriate periods instead of receiving exercises in the class.

Each unit has common features which are designed purposefully to facilitate your reading. The first feature being an introduction to the unit, the manner in which each unit is integrated with other units and the entire course. The second feature is a set of learning objectives which let the learner to know what should be done by the time the unit is completed. These objectives should guide your study. After completing the unit, you should go back and check whether you have achieved the objectives or not. The next feature is self assessment exercises, study questions which are found throughout each unit. The exercises are designed basically to help you recall what you have studied and to assess your learning by yourself. You should do each self assessment exercise and the study question as you come to each in the study unit. The next features are conclusion and summary at the end of each unit. These help you to recall all the main topics discussed in the main content of each unit. There are also tutor-marked assignments at the end of appropriate units. Working on these questions will help you to achieve the objectives of the unit and to prepare for the assignments which you will submit and the final examination.

It should take you between three to four hours (3-4 hrs) to complete a study unit including the exercises and assignments. Upon the completion of the first unit, you are advised to note the

length of period it took you and use this information to draw up a timetable to guide your study of the remaining units. The margins on either sides of each page are meant for you to make notes on main ideas or key points for your usage when revising the course. These features are for your usage to significantly increase your chances of passing the course.

### **Course Delivery**

There are many ways of learning as an open distant learner. You learn when you interact with the content in your course material just as a student interacts with the teacher in a conventional institution. You also learn when you are guided through the course. Though you are not taught the course, your course material is however your teacher and as such you will not be able to get answers to any questions which may arise from your study of the material. For this reason, apart from the course material which you have received, the delivery of this course is aided by tutorial, facilitation and counselling support services. These services are not compulsory but you are encouraged to maximally take advantage of them.

### **Tutorial Sessions**

A total of eight (8) hours are set aside for this course and they form a part of your learning process as you have an opportunity to receive face-to-face interaction with your informal facilitator and to receive answers to questions or classifications which you may have. Also, you may contact your tutorial facilitator by telephone or e-mail.

As an open and distant learner, you are expected to prepare ahead of time by studying the relevant study units, write your questions so as to gain maximum benefit from tutorial sessions. Information about the location and time schedule for facilitation will be available at your study centre.

Note that tutorial sessions are flexible arrangements between you and your tutorial facilitator. You will need to contact your study centre to arrange the time schedule for the sessions. You will also need to obtain your tutorial facilitator's phone number and e-mail address.

Tutorial sessions are optional however; participating in them provides tremendous benefits because they provide a forum for interaction and group discussions which will maximise the isolation you may experience as an open and distant learner.

### **Facilitation**

This is a learning process that takes place both within and outside of tutorial sessions. Your tutorial facilitator guides your learning by doing the following things.

- 1.0. Providing answers to your questions during tutorial sessions on phone or by e-mail
- 2.0. Coordinating group discussions
- 3.0. Providing feedback on your assignments
- 4.0. Posing questions to confirm learning outcomes
- 5.0. Coordinating, marking and recording your assignments/examination score(s)
- 6.0. Monitoring your progress.

English language is the language of instruction for this course. The course material is available both in print and in CD. It is also on the National Open University of Nigeria website. However, on your part, you are to prepare ahead of time by studying and writing your questions so as to maximally benefit from facilitation. Information about the location and time of facilitation will be available at your study course.

This is a flexible arrangement between you and your tutorial facilitator. You should contact your tutorial facilitator whenever:

- 1.0. You do not understand any part of the study unit
- 2.0. You have difficulty with the self assessment exercises
- 3.0. You have a question or a problem with an assignment, with your tutorial facilitator's comments on an assignment or with the grading of an assignment.

### **Counselling**

Counselling is your part of learning which helps to facilitate the learning process. This service is available to you at two levels-academic and personal. At the study centre, student counsellors are available to provide guidance for personal issues that may affect your studies. In addition, your tutorial facilitators and study centre manager can assist you with questions on academic matters such as course materials, grades, facilitation, etc. Endeavour to have the telephone numbers and e-mail addresses of your study centre and these different individuals who provide counseling services to you at an open and distant learning study centre.

### **Assessment**

The self assessment exercise assignments at the end of each unit, the tutor-marked assignments and the final written examination form three components of assessment for this course. In doing these assignments, you are required to use the information gathered during your study of the course. Find below detailed explanations on how to do each assignment.

### **Self Assessment Exercises (SAEs)**

These are several self assessment exercises spread through your course material; you are expected to attempt each immediately after reading the section that precedes it. Possible answers to the exercises are sometimes given at the end of the course book. Nevertheless, you are advised to refer to them only after you must have attempted the exercises. This is because the exercises are meant to evaluate your learning. They are not to be submitted. These are also study questions spread through the study units. You are expected to attempt these questions after reading a study unit. These questions are to aid you assess knowledge of the contents of the unit only. You are not required to submit the answers to them too.

### **6.0. Tutor-Marked Assignments (TMAs)**

There are fifteen tutor-marked assignments for this course. One TMA for each unit. These TMAs are designed to cover areas treated in the course. You will be assessed on all fifteen, but only the best three will constitute your continuous assessment. Each of these three carries 10% and altogether will count for 30% of your total score for the course. You will be given these assignments and the dates for submitting them at the study centre. The assignments must be submitted to your tutorial facilitator for formal assessment on or before the stipulated dates for submission.

#### **Guidelines for Writing Tutor Marked Assignments**

1. The cover page of your tutor marked assignment, should work like this:

Course code \_\_\_\_\_

Course title \_\_\_\_\_

Tutor marked assignment number \_\_\_\_\_

Name \_\_\_\_\_

Date of submission \_\_\_\_\_

Matriculation number \_\_\_\_\_

2. You should ensure to be brief and straight to the point in your answers. Such answers should be based on your course material, further readings and experiences. However, you are **NOT** to copy from any of these materials. In the event you do so, you will be penalised. You are to give relevant examples and illustrations.

3. Use ruled foolscap-sized paper for writing your answers. Remember to make and keep a copy of your assignments
4. Your answers are to be hand written by you and using a margin of about 1.5 inches of the left side and about 5 lines before the answer to the next question for your tutorial facilitator's comments.
5. Upon the completion of each assignment, ensure it reaches your tutorial facilitator on or before the deadline.

You are to contact your study centre manager and tutorial facilitator if for any reason you cannot complete your work on time before the assignment is due to discuss the possibility of any extension. Remember that no extension will be granted after the due date unless under exceptional circumstances.

### **7.0. Final Examination and Grading**

The final examination for BFN 306 will be for 3 hours duration and will carry 70% of to the total course grade. The examination will be made up of questions which reflect the kinds of self assessment exercises, study questions and tutor marked assignments which you have previously encountered. Remember that all areas of the course will be assessed. The period between finishing the last unit and taking the examination should be used to revise the entire course. You are advised to review your answers to the self assessment exercises and the tutor marked assignments before the commencement of the examination. You are to note that the following determine your eligibility to sit for the final examination.

1.0. Your submission of all the tutor-marked assignments

2.0. Your registration to sit for the examination. The dateline for this registration will be provided at your study centre. Where you sit for the examination without having met these conditions means you will not have a score for the course.

### Course Marking Scheme

The marks that make up the total score for this course are as shown in the table below:

| Assessment                                                          | Marks                                                 |
|---------------------------------------------------------------------|-------------------------------------------------------|
| Assignments (fifteen submitted but the best three will be selected) | 10% of the selected marked assignments, totalling 30% |
| Final examination                                                   | Examination score 70%                                 |
| <b>Total</b>                                                        | Overall course score 100%.                            |

### 8.0. CONCLUSION

All the features of this course guide have been designed to facilitate your learning process in order that you achieve the aims and objectives of this course. Their features include the aims, objectives, course summary, course overview, self assessment exercises and study questions. You should endeavour to make maximum use of them in your study to achieve maximum results.

I wish you success in the course and hope that you will find BFN306- Comparative Banking not only interesting but useful and rewarding.

**Course Code:** **BFN306**

**Course Title:** **COMPARATIVE BANKING**

**Course Writers:** **DR. CHARLES JEGEDE**  
**Department of Banking and Finance**  
Lagos State University

**&**

**SUFIAN JELILI BABATUNDE**  
**Dept of Financial Studies, NOUN**

**Content Editor:** **Professor Patrick Eriki**  
**Department of Banking and Finance**  
University of Benin

**Course Coordinator:** **Mrs Olakunbi Lawal**  
**Dept of Financial Studies, NOUN**

**HEAD OF DEPT:** **Dr. (Mrs.) Ofe I. Inua**  
**Dept of Financial Studies.**



## **CONTENTS**

## **PAGES**

### **MODULE 1:**

**UNIT 1:** Definition and Characteristics of Political Economy of Banking

**UNIT 2:** Evolution of Political Economy of Banking

**UNIT 3:** Principles of Money and Banking

**UNIT 4:** Merchant Bank and Development Bank

### **MODULE TWO:**

**UNIT 1:** Universal Banking

**UNIT 2:** Branch Banking

**UNIT 3:** Unit Banking

**UNIT 4:** Islamic Banking

**UNIT 5:** Inter-Country Comparison of regulations and conduct of banks

**UNIT 6:** Inter-temporal comparison of banking in Nigeria

### **MODULE 3:**

**UNIT 1:** Origin, Growth and Development of Banking

**UNIT 2:** Functions of Banks

**UNIT 3:** Structure of Banking System

**UNIT 4:** The Nigerian Financial System

**UNIT 5:** Credit Instruments and Credit Creation by Commercial Banks

**MODULE 4:**

**UNIT 1:** The Role of Central Bank in a Developing Economy

**UNIT 2:** Development of Banking in Nigeria

**UNIT 3:** Money and Capital Markets

**UNIT 4:** Non-Bank Financial Intermediaries (NBFIs)

**UNIT 5:** Monetary Policy

## **MODULE 1:**

**UNIT 1:** Definition and Characteristics of Political Economy of Banking

**UNIT 2:** Evolution of Political Economy of Banking

**UNIT 3:** Bank under Capitalism

**UNIT 4:** Merchant Bank and Development Bank

## **UNIT 1: POLITICAL ECONOMY OF BANKING – DEFINITION AND DISCUSSION OF CONCEPT**

### **TABLE OF CONTENTS**

1.0 Introduction

2.0 Objectives

3.0 Main Content

3.1 Definition of Political Economy of Banking

3.2 Characteristics of political Economy of Banking

3.2.1 Structure of Banking

3.2.2 Financial Development and the Banking Industry

3.2.3 Ownership of Banking

3.3 Roles and Crises in the Political Economy of Regulatory Reform

### 3.3.1 Perspective on the Political Economy on Banking and financial

#### Regulation

#### 4.0 Conclusion

#### 5.0 Summary

#### 6.0 Tutor Marked Assignment

#### 7.0 References/Further Reading

## **1.0 INTRODUCTION**

This unit will take a look at definition, characteristics and crises in the Political Economy of Banking.

## **2.0 OBJECTIVES**

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

- i. Define political Economy of Banking
- ii. Identify the characteristics of Political Economy of Banking
- iii. Discuss Structure of Banking

## **3.0 MAIN CONTENT**

### **3.1 MEANING OF POLITICAL ECONOMY OF BANKING**

The structure and regulation of a country's financial markets and institutions are the focus of much policy attention for a number of economic and political reasons. Banks and other financial institutions encourage and collect savings that finance a

country's economic growth. By allocating the savings to enterprises and monitoring the use of the funds, these institutions and markets play an integral part of the corporate governance system that ultimately affects the productivity of resources throughout the economy. Banks and other financial institutions also play a key role in transmitting the government's monetary and credit policies to the rest of the economy. Parts of the financial sector are effectively regulated as means to provide subsidized credit or services to targeted groups (including the government itself) and to protect particular groups (from, for example, competition, hostile takeovers, or expropriation).

Political economy is the interplay between economics, law and politics, and how institutions develop in different social and economic systems, such as capitalism, socialism and communism. Political economy analyzes how public policy is created and implemented.

Political economy was the original term used for studying production and trade, and their relations with law, custom, and government, as well as with the distribution of national income and wealth. Political economy originated in moral philosophy. It was developed in the 18th century as the study of the economies of states, or polities, hence the term political economy.

In the late 19th century, the term economics came to replace political economy, coinciding with the publication of an influential textbook by Alfred Marshall in 1890. Earlier, William Stanley Jevons, a proponent of mathematical methods applied to the subject, advocated economics for brevity and with the hope of the term becoming "the recognised name of a science."

Today, political economy, where it is not used as a synonym for economics, may refer to very different things, including Marxian analysis, applied public-choice

approaches emanating from the Chicago school and the Virginia school, or simply the advice given by economists to the government or public on general economic policy or on specific proposal.

### **3.2 CHARACTERISTICS OF POLITICAL ECONOMY OF BANKING**

Few would argue with the proposition that national policy makers, businesses, and analysts in countries everywhere must deepen their understanding and sharpen their awareness of foreign financial systems. The increased globalization and interconnectedness of business and finance provides one set of motives for this effort. In addition, there have been numerous banking and financial crises in the past two decades, and the effects of such crises have had wide-ranging repercussions around the world. Further, national policy discussion on banking and finance can benefit from an international perspective. International comparisons can reveal trends and norms that might be useful in debates about national banking and financial policies, and an awareness of banking and financial systems in other countries can promote the realization that national financial policies are likely to have an impact across borders.

Focus on bank systems in particular flows from several considerations. Recent research has established that the development of the financial system is crucial for the development of the economy as a whole. For all countries, the banking system is an important component of the financial system; for many countries, especially developing countries, the banking system is the dominant component of the financial system. In addition, many have pointed to the special nature of banks as financial intermediaries that simultaneously extend credit and administer the payments system, and are the conduit for monetary policy. Further, researchers and

national and international policy makers have focused on the banking industry as a key actor in causing, and preventing, financial and economic crises.

### **3.2.1 Structure of Banking**

The financial development of the banking industry, the degree of government and foreign ownership of banks, and the concentration of economic power in the banking industry are all key dimensions of the structure of banking. Since the development of several large cross-country comparative data sets in the past decade, researchers have investigated possible links among significant aspects of banking industry structure and economic growth, development, and stability. This section summarizes recent representative cross-country studies on financial development and the banking industry, government and foreign ownership of banking, and the competitiveness of banking industries.

### **3.2.2 Financial Development and the Banking Industry**

Prior to the 1990s, relatively little research was directed to the issues of whether and how the financial system fostered economic growth.

The prevailing view was that economic growth leads financial sector growth, which responded to the wider and deeper development of markets for goods and services. However, within the last decade, a growing body of research has focused on the possible positive causal connection between the development of the financial system and overall economic development. This outlines several key ways in which financial systems contribute to economic growth:

- i. Financial systems mobilize savings by offering savers a range of savings vehicles.

- ii. Financial systems allocate savings by using expertise individual savers do not possess to ascertain potential borrower creditworthiness.
- iii. Financial systems reduce risk to individual savers by diversifying pooled assets across many investment opportunities.
- iv. Financial systems generate liquidity by allowing savers to readily access savings while at the same time financial intermediaries fund long-term projects.

### **3.2.3 Ownership of Banking**

The ownership of banks is a key structural characteristic of banking on which some of the emergent cross-country banking literature has focused. Two facets in particular have received attention: the degree of government vs. private sector ownership of banks and foreign vs. domestic ownership of banks. Following the international banking crises of the mid-to-late 1990s, analysts and policy-makers developed a keen interest in the degree to which the government is involved in a banking system. In general, government ownership of banks is likely to short-circuit market pressures on banks to make credit extension and investment decisions based on economic assessments of risk and return.

## **3.3 ROLES AND CRISES IN THE POLITICAL ECONOMY OF BANKING REGULATORY REFORM**

Reforms are often associated with banking and economic crises, and the “crisis” hypothesis provides an alternative to the political-economy approach. Developing as well as developed countries experiencing major bank insolvencies have subsequently undertaken some reform and restructuring of their banking regulatory and supervisory systems (Caprio and Klingebiel 1996), and Sweden is no exception. First on the list of sixteen hypotheses about reform drawn up by John Williamson (1994), distilled from the experiences of top policy-makers presented



at a conference on “The Political Economy of Policy Reform,” is that “policy reforms emerge in response to crisis.”

Are crises an independent factor which can be said to “cause” reform to occur? Rodrik (1996) has been critical of the crisis hypothesis because it is almost non-falsifiable if reform does not occur, proponents of this view will say that the crisis was not sufficiently severe and because reforms responding to similar crises take very different forms (e.g., Caprio and Klingebiel 1996). The U.S., for example, responded to the banking and economic crisis of the early 1930s by fragmenting the financial system (Kroszner 1996). The Glass-Steagall Act of 1933 narrowed the range of activities permissible for commercial banks, and a series of Acts starting with the Federal Home Loan Bank Act of 1932 created modern Savings & Loan institutions which narrowly focused on the financing of residential mortgages. In continental Europe, however, a number of countries responded in the opposite way by increasing the diversification of their financial institutions, by introducing or broadening powers.

From a political-economy perspective, crises are associated with reform because crises are likely to upset the old political-economy equilibrium. There are four reasons for this. First, crises rarely affect all parties similarly and tend to have important distributional consequences. Since the relative position of competing interests is one of the key elements to political-economy equilibrium, it is thus not surprising that reforms often occur following crises. Powerful groups or coalitions may fragment as their interests diverge during economic trouble, and new constituencies may be created. Although smaller, less diversified banks tended to support federal deposit insurance, for example, they became politically powerful

enough to enact it only in 1933 (Hubbard et al. 1996, but also see Calomiris and White 1994).

Second, economic upheaval can change the relative costs and benefits of particular regulations. An interest rate ceiling, which may act like a price-fixing arrangement among banks to enhance their profits during normal times, for example, could lead to large outflows of funds and liquidity problems during high-interest crisis periods (see Barth 1991 and Kroszner and Strahan 1996). Hyper-inflation crises turn many of the regulations that had protected banks from competition into obstacles in the new circumstances. Innovations in financial technology may create new markets and institutions, and new constituencies with them.

Third, crisis can also affect bureaucratic incentives for regulatory change. Deposit insurance, for example, commits the government to bail-out banks that have liquidity and solvency problems. During times of crisis, deposit insurance funds typically are bankrupt so an explicit taxpayer-financed bail-out would be necessary. To postpone such actions, politicians and regulators may have incentives to reduce various regulatory barriers as a quid pro quo for a financial institution using its private funds to bail out a troubled institution. Special dispensations to cross geographic or product lines have occurred in the U.S., particularly during the Savings & Loan crisis (Kroszner and Strahan 1996), Mexico, where Citicorp recently took a large stake in a troubled local Mexican bank, dramatically easing the expansion of its operations in Mexico, and in Japan, where “arranged” mergers have helped some banks expand into new activities.

Finally, the enormous costs of a financial crisis may serve an important educational role for the public (see Kane 1996). During normal times, individual voters may not know the full value of the implicit or explicit guarantees that the government,

that is, the taxpayer, is making. After a crisis, however, the government is likely to have to raise taxes and sell bonds in order to pay for the bail-out. This more explicit accounting will reveal the costs of policies that the public may not have known were so costly. Bank failures thus may heighten the public's awareness of the costs of regulation and may make it more difficult, that is, more costly in terms of votes, to maintain the old regulatory regime. The banks now would have to provide more support to politicians, for example, through greater campaign contributions, in order to offset the greater popular opposition. Since the banks are experiencing financial distress, they may not be in a strong position to provide the additional funds, so the likelihood of reform increases.

The reform and repeal of the Argentine deposit insurance system follows this pattern. During the 1980s, Argentina experienced two major banking crises. The first in 1980-1982 has been estimated to have required more than 50 percent of GDP to resolve and the second crisis in 1989-90 roughly 13 percent of GDP to resolve (Rojas-Suarez and Weisbrod 1996 and Lindgren, Garcia, and Saal 1996). With such large costs to the bail-outs, the public was now acutely aware of the costs of government guarantees of deposits. Due to the hyperinflation, there were relatively few deposits left in the bank system to be insured by 1990, so there were fewer depositors demanding insurance. Also, the banks were in a rather weak position. In other words, the crisis involved a dramatic shift in the relative strength of the groups supporting and opposing deposit insurance. In these circumstances, it became politically feasible to eliminate deposit insurance and Argentina did so.

### **3.3.1 Perspective on the Political Economy on Banking and financial Regulation**

The term ‘political economy’ has become an increasingly popular part of the vernacular at the World Bank and other development agencies. In parallel, interest in the political economy aspects of development has also seen resurgence in academia, within both economics and political science departments, and even in leading business programs. However, there still exists much skepticism about the value such a perspective can add to development effectiveness.

A chain of insights drives the growing interest in political economy analysis: First, there is the fact that reforms often fail even when solutions that would improve public welfare are available. Abolishing fuel subsidies in Nigeria is proving hard, even though the subsidy regime is both inefficient and unfair for the vast majority of poorer citizens.

Second, in order to improve the likelihood of adopting good policies—be it reforming subsidy regimes, improving road maintenance and school management, or better regulating the financial sectors—better governance is needed. This requires that politicians should become less self-serving and more focused on the provision of public goods.

A third insight that has become increasingly apparent over the past decade—is that improvements in governance are difficult to achieve. Turkey does not vote for Thanksgiving and most politicians do not wish to, or simply cannot, change the systems that bring them to power. In many places, these political systems require constant greasing, while also offering opportunities for significant private gain.

So what can political economy analysis possibly contribute to addressing such deep-seated challenges? In a nutshell, political economy perspectives can help us develop greater clarity about the forces promoting and impeding better development outcomes and to focus on what smart contributions could be made to strengthen existing or potential drivers of progress—in short, to adopt more of a ‘jiu-jitsu approach’ to change.

The World Bank today faces a set of challenges. In a majority of countries, the relative importance of our lending is shrinking. We are looking for renewed relevance as a provider of knowledge and an institution with substantial convening power. At the same time, the development challenges that our client countries face continue to be significant, while changing in nature and scope.

Governments—and the political and economic elite that sustain them—need to generate more and better employment and prepare for more severe impacts of climate change. Long-standing problems such as poverty, rural underdevelopment, or limited progress in education and health continue to exist. Hence, there is an urgent need for an effective World Bank—but our financial firepower is diminishing relative to other flows.

What we need to rise to this challenge is a \_approach that implies working in smart ways with existing political economy dynamics. We must focus on reinforcing the positive ‘drivers of change’ that exist. Can we leverage the desire for politicians to show progress ahead of the next election? Can we help citizens monitor whether politicians keep their own promises after elections? Are we able to broker compromises between vested interests and upstart entrepreneurs to improve regulatory environments and infrastructure bit by bit? Can we become more

serious about taking public opinion and citizens' concerns into account in calibrating and communicating reforms so that we are able to reinforce the demand for change, rather than triggering anti-reform protests?

Political economy perspectives enable us to scan country and sector environments for opportunities to leverage existing positive drivers of change **as** well as to make realistic estimations of the risks and challenges involved. **This** implies taking the incentives of individuals and of groups more seriously—rather than thinking about reforms predominantly from a public welfare perspective.

The implications of political economy work may not always be comfortable, and the analytic understanding of political economy drivers must be followed up by actually doing things differently. But such a perspective is precisely the crucial first step in making aid provided by the Bank as well as by other international development agencies—more effective in an increasingly challenging and complex environment.

Political economy perspectives can help to calibrate where best to apply the Bank's strengths technical knowledge, convening power, and financing and identify how to work towards strengthening both the supply of and the demand for better governance and governments. Over the past few years, we have started to learn how to use political economy analysis in an operationally targeted way to improve development effectiveness. During this time, the Bank's Philippines and Zambia country teams have made some of the strongest uses of political economy analysis to inform their programming, operations, and policy dialogue. Given the significant global and local challenges that we are up against, we should continue honing and deploying this skill

## **4.0 CONCLUSION**

The thrust of the arguments above focus on interest group competition and how the battle among the interests will be a key determinant of the regulatory outcomes. Are careful scholarly analyses of regulations and their reforms then of little relevance for policy so academics should retreat to the Ivory Tower? An organized interest group, money, and/or votes may be necessary for a view to prevail in the political marketplace but it is not sufficient, due to the rivalry among interest groups. Theory and facts, not only money and power, are relevant to the debates.

Without an interest group to champion a position, however, an argument may have little effect. (Television, radio, and the internet, however, have been reducing the costs for both information to be disseminated and for groups to organize.)

## **5.0 SUMMARY**

Finally, foreign entry can generate a virtuous circle because foreign institutions tend to be less politically connected domestically and less likely to be able to capture the regulatory authorities. Foreign institutions also are less likely to succumb to pressure for directed lending by the government. With capture less likely and fewer direct benefits to the politicians of regulation (e.g., through quid pro quos for directed lending), regulatory reform becomes more likely.

## **6.0 TUTOR MARKED ASSIGNMENT**

1. Discuss Political Economic of Banking and its characteristics
2. Discuss Perspective on the Political Economy on Banking and financial Regulation

## **7.0 REFERENCES/FURTHER READING**

Kroszner, Randall. S. (1996). "An Analysis of Bank Privatization," working paper,

Graduate School of Business, University of Chicago, 1996.

Kroszner, R.S. (1997). "The Political Economy of Banking and Financial

Regulation in the U.S."pp. 200-13 in George M. von Furstenberg, ed., the  
Banking and Financial Structure in the NAFTA Countries and Chile, Boston  
Kluwer Academic Publishers.

Rajan, R., & Luigi, Z. (1999). "Politics, Law, and Financial Development". A

Study Prepared for the Government Official Inquiry on the Competitiveness of  
the Swedish Financial Sector.



## **UNIT 2: EVOLUTION OF POLITICAL ECONOMY OF BANKING**

### **TABLE OF CONTENTS**

1.0 Introduction

2.0 Objectives

3.0 Main Content

3.1 Bank under Capitalism

3.2 The Capitalist Monopolies and the Banks.

3.2.1 Role of Credit under Capitalism

3.3 What is Socialism?

3.3.1 The banks and socialism

4.0 Conclusion

5.0 Summary

6.0 Tutor Marked Assignment

7.0 References/Further Reading

### **1.0 INTRODUCTION**

In the last unit, we gave an overview of the concept ‘political Economy of Banking. We defined the Political Economy of Banking and characteristics of Political Economy of Banking. We also identified the structure of Banking and Ownership of Banking. Finally, we listed and briefly explained.

In this unit, we shall trace the evolution of political Economy of Banking.

Shahid Yusuf's essay on 30 years of World Development Reports (WDRs) is a masterful overview of what has at the same time been 30 years of development economics at the World Bank. I will first focus on one key aspect of the overview: the evolution of the political economy of development economics at the World Bank, influenced, of course, by my own perceptions of the 1980s and 1990s, two decades I spent at the World Bank. I will then turn to the future and to one key dimension that I think has been missing in the WDRs.

There is no doubt that development economics at the World Bank, and with it the WDRs, have been and will continue to be influenced by the political and intellectual environment of the times. The Executive Board does influence the management and the staff, not only because it has some "decision powers" over policies and strategies but also, and perhaps even more, because positive recognition by the board is a sought-after prize, and criticism is perceived as a big setback. Positive recognition by the president of the institution and by the chief economist is also something very valuable, influencing careers and promotions. The ideological and intellectual orientations of the president and of the chief economist clearly influence the work of economists at the World Bank.

Shahid Yusuf stresses these influences in his overview, showing how development economics at the World Bank and the content of the WDRs moved from strong faith in planning and in the role of the state, along with the quantitative models championed by Hollis Chenery and his colleagues in the late 1970s, to the structural adjustment approach of the 1980s and early 1990s. This period coincides broadly with what are often called the Reagan-Thatcher years, marked by much greater emphasis on the market, on "getting prices right," and on both

liberalization (particularly trade liberalization) and privatization. The second half of the 1990s saw renewed emphasis on poverty reduction and on the need for proactive poverty-reducing social policies, particularly after James Wolfensohn took over as president in 1996.

## **2.0 OBJECTIVES**

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

- i. Discuss Evolution of political Economy of Banking
- ii. Discuss bank under capitalism

## **3.0 MAIN CONTENT**

### **3.1 BANK UNDER CAPITALISM**

The **history of capitalism** can be traced back to early forms of merchant capitalism practiced in Western Europe during the Middle Ages. It began to develop into its modern form during the Early Modern period in the Protestant countries of North-Western Europe, especially the Netherlands and England. Traders in Amsterdam and London created the first chartered joint-stock companies driving up commerce and trade, and the first stock exchanges and banking and insurance institutions were established.

Over the course of the past five hundred years, capital has been accumulated by a variety of different methods, in a variety of scales, and associated with a great deal of variation in the concentration of economic power and wealth. Much of the history of the past five hundred years is concerned with the development of capitalism in its various forms.

Since 2000 the new scholarly field of "History of Capitalism" has appeared, with courses in history departments. It includes topics such as insurance, banking and regulation, the political dimension, and the impact on the middle classes, the poor and women and minorities.

### **3.2 THE CAPITALIST MONOPOLIES AND THE BANKS.**

The development of capitalist industry produces concentration of banking, and this concentrated banking system is itself an important force in attaining the highest stage of capitalist concentration in cartels and trusts. How do the latter then react upon the banking system? The cartel or trust is an enterprise of very great financial capacity. In the relations of mutual dependence between capitalist enterprises it is the amount of capital that principally decides which enterprise shall become dependent upon the other. From the outset the effect of advanced cartelization is that the banks also amalgamate and expand in order not to become dependent upon the cartel or trust. In this way cartelization itself requires the amalgamation of the banks, and, conversely, amalgamation of the banks requires cartelization. For example, a number of banks have an interest in the amalgamation of steel concerns, and they work together to bring about this amalgamation even against the will of individual manufacturers.

Conversely, a consortium established in the first place by manufacturers can have the consequence that two previously competing banks develop common interests and proceed to act in concert in a particular sphere. In a similar fashion, industrial combinations may influence the expansion of the industrial activities of a bank, which was perhaps previously concerned only with the raw materials sector of an industry, and is now obliged to extend its activities to the processing sector as well.

The cartel itself presupposes a large bank which is in a position to provide, on a regular basis, the vast credits needed for current payments and productive investment in a whole industrial sector. But the cartel also brings about a still closer relationship between banking and industry. When competition in an industry is eliminated there is, first of all, an increase in the rate of profit, which plays an important role. When the elimination of competition is achieved by a merger, a new undertaking is created which can count upon higher profits, and these profits can be capitalized and constitute promoter's profit. With the development of trusts this process becomes important in two respects. First, its realization constitutes a very important motive for the banks to encourage monopolization; and second, a part of the promoter's profits can be used to induce reluctant but significant producers to sell their factories, by offering a higher purchase price, thus facilitating the establishment of the cartel. This can perhaps be expressed in the following way: the cartel exerts a demand on the enterprises in a particular branch of industry; this demand increases to a certain degree the price of the enterprises and this higher price is then paid in part out of the promoter's profit.

Cartelization also means greater security and uniformity in the earnings of the cartelized enterprises. The dangers of competition, which often threatened the existence of the individual enterprise, are eliminated and this leads to an increase in the share prices of these enterprises, which involves further promoter's profit when new shares are issued. Furthermore, the security of the capital invested in these enterprises is significantly increased. This permits a further expansion of industrial credit by the banks, which can then acquire a larger share in industrial profits. As a result of cartelization, therefore, the relations between the banks and industry become still closer, and at the same time the banks acquire an increasing control over the capital invested in industry.

We have seen that in the early stages of capitalist production, the money available to the banks is derived from two sources: on one side, from the resources of the non-productive classes, and on the other side, from the capital reserves of industrial and commercial capitalists. We have also seen how credit develops in such a way as to place at the disposal of industry not only the whole capital reserves of the capitalist class but also the major part of the funds of the non-productive classes. In other words, present-day industry is carried on with an amount of capital far exceeding that which is owned by the industrial capitalists. With the development of capitalism there is also a continual increase in the amount of money which the non-productive classes place at the disposal of the banks, who in turn convey it to the industrialists. The control of these funds which are indispensable to industry rests with the banks, and consequently, with the development of capitalism and of the machinery of credit, the dependence of industry upon the banks increases. On the other side, the banks can only attract the funds of the non-productive classes, and retain their continually growing capital over the long term, by paying interest on them. They could do this in the past, so long as the volume of money was not too great, by employing it in the form of credit for speculation and circulation. With the increase in the available funds on one side, and the diminishing importance of speculation and trade on the other, they were bound to be transformed more and more into industrial capital. Without the continuous expansion of credit for production, the availability of funds for deposit would have declined long ago, as would the rate of interest on bank deposits. In fact, this is to some extent the case in England, where the deposit banks only furnish credit for commerce, and consequently the rate of interest on deposits is minimal. Hence deposits are continually withdrawn for investment in industry by the purchase of shares, and in this case the public does directly what is

done by the bank where industrial and deposit banks are closely linked. For the public the result is the same, because in neither case does it receive any of the promoter's profits from the merger, but so far as industry is concerned it involves less dependence on bank capital in England as compared with Germany.

The dependence of industry on the banks is therefore a consequence of property relationships. An ever-increasing part of the capital of industry does not belong to the industrialists who use it. They are able to dispose over capital only through the banks, which represent the owners. On the other side, the banks have to invest an ever-increasing part of their capital in industry and in this way they become to a greater and greater extent industrial capitalists. I call bank capital, that is, capital in money form which is actually transformed in this way into industrial capital, finance capital. So far as its owners are concerned, it always retains the money form; it is invested by them in the form of money capital, interest-bearing capital, and can always be withdrawn by them as money capital. But in reality the greater part of the capital so invested with the banks is transformed into industrial, productive capital (means of production and labour power) and is invested in the productive process. An ever-increasing proportion of the capital used in industry is finance capital, capital at the disposition of the banks which is used by the industrialists.

Finance capital develops with the development of the joint-stock company and reaches its peak with the monopolization of industry. Industrial earnings acquire a more secure and regular character, and so the possibilities for investing bank capital in industry are extended. But the bank disposes of bank capital, and the owners of the majority of the shares in the bank dominate the bank. It is clear that with the increasing concentration of property, the owners of the fictitious capital

which gives power over the banks, and the owners of the capital which gives power over industry, become increasingly the same people. As we have seen, this is all the more so as the large banks increasingly acquire the power to dispose over fictitious capital.

We have seen how industry becomes increasingly dependent upon bank capital, but this does not mean that the magnates of industry also become dependent on banking magnates. As capital itself at the highest stage of its development becomes finance capital, so the magnate of capital, the finance capitalist, increasingly concentrates his control over the whole national capital by means of his domination of bank capital. Personal connections also play an important role here.

With cartelization and trustification finance capital attains its greatest power while merchant capital experiences its deepest degradation. A cycle in the development of capitalism is completed. At the outset of capitalist production money capital, in the form of usurers' and merchants' capital, plays a significant role in the accumulation of capital as well as in the transformation of handicraft production into capitalism. But there then arises a resistance of 'productive' capital, i.e. of the profit-earning capitalists - that is, of commerce and industry against the interest-earning capitalists. Usurer's capital becomes subordinated to industrial capital. As money-dealing capital it performs the functions of money which industry and commerce would otherwise have had to carry out themselves in the process of transformation of their commodities. As bank capital it arranges credit operations among the productive capitalists. The mobilization of capital and the continual expansion of credit gradually brings about a complete change in the position of the money capitalists. The power of the banks increases and they become founders and eventually rulers of industry, whose profits they seize for themselves as finance



capital, just as formerly the old usurer seized, in the form of 'interest', the produce of the peasants and the ground rent of the lord of the manor. The Hegelians spoke of the negation of the negation: bank capital was the negation of usurer's capital and is itself negated by finance capital. The latter is the synthesis of usurer's and bank capital, and it appropriates to itself the fruits of social production at an infinitely higher stage of economic development.

The development of commercial capital, however, is quite different. The development of industry gradually excluded it from the ruling position over production which it had occupied during the period of manufacture. This decline is definitive, and the development of finance capital reduces the significance of trade both absolutely and relatively, transforming the once proud merchant into a mere agent of industry which is monopolized by finance capital.

### **3.2.1 Role of credit under Capitalism**

#### **Economy Class**

When the credit crunch hit in 2008 and governments bailed out banks with trillions of pounds so they didn't collapse many people recognised that this was because of the huge amounts of debt in the system. Banks had loaned money to people and companies with no idea if they'd be able to pay it back, and these debts had then been sold on and bets taken on their future value.

So if the crash was caused by credit and debt, is it the fault of the banks for lending money, or people for borrowing? And couldn't we just regulate the system to get rid of this toxic aspect?

The system of credit and debt is not just something added on to capitalism that could be removed. It is an important part of the system that allows it to expand beyond its own limits, but ultimately contributes to its instability.

During a boom there is a frantic scramble for capitalists to invest and grab a bigger share of the market from their rivals. But sometimes an individual capitalist or company might not have the capital up front which they need to invest to keep ahead, whereas other capitalists may have surplus value from past rounds of production that they need an outlet for. Banks play an important role in mediating between these two possibilities, lending the profits of one capitalist as capital for another to invest.

This allows capitalists to accumulate more rapidly, driving capitalism forward. However, it relies on the confidence that the money lent can be repaid. And as the boom reaches its peak and people realise all that has been produced cannot be sold, and that therefore profit might not be made, the debts are called in. In this way the system of credit and debt that fuelled the boom also accelerates the crash and ultimately adds to its destruction.

So the credit system lubricates the accumulation process. Capitalists do not have to wait for one round of production to be finished before they can begin another, and have an outlet for surplus value they have accumulated that they do not wish to invest directly in production.

Through this process capital also appears to generate profit as banks pay interest on surplus value they hold, and charge interest on money they lend.

The rate of interest is irrational, depending on the supply of and demand for credit, not actual production. But it is still important for the capitalist. The rate of interest still needs to "make" more money for the capitalist sat in a bank account than it would invested in production. This leads capitalists to see money itself as self-expanding rather than value coming from the exploitation of workers. Sometimes as well as borrowing capital from banks, a capitalist who needs money to invest might sell bonds in a company. The people who buy bonds are promised a share of the money that the company makes - providing a profit is made. These bonds that promise a share of future surplus value can be traded at a price way above their original value if traders believe it will guarantee them an income in the future. But it also means they can become worthless as the market crashes and people no longer believe the company will make enough surplus value to pay out.

These shares and bonds are described by Marx as "fictitious capital" because they are not capital themselves but merely the promise of future earnings. If they lose their value no capital has been destroyed - money has simply been transferred from the shareholder to the company.

It is not just capitalists who borrow money. Increasingly over the last 30 years workers have been encouraged to buy on credit, resulting in huge amounts of personal debt. This allowed capitalists to raise the rate of exploitation of workers, without affecting the number of goods and services a worker could buy, thus helping to maintain their profit rates.

These debts too can be traded and gambled on in the belief that they will be repaid in the future. This further ties the workers into the system and exposes them to the disorder of the financial system. As Marx put it, "Banking and credit thus become

the most potent means of driving capitalist production beyond its own limits - and one of the most effective vehicles of crises and swindle."

So despite major economic crises invariably involving crashes of the banks and financial institutions it is wrong to blame finance, the banks or money itself for the crisis. These are essential elements of the capitalist production process and it is capitalism itself that is prone to crisis by its chaotic and unplanned nature. Credit and debt intensify both the boom and the slump, but do not ultimately cause either.

### **3.3 WHAT IS SOCIALISM**

Socialism is an economic system characterized by public ownership and centralized planning of all major industries (manufacturing, services, and energy), banks and insurance companies, agribusiness, transportation, the media, and medical facilities. Under capitalism, these giant enterprises dominate the economy but are privately owned and operated for the purpose of generating wealth for their owners by extracting it from working people who are paid only a small fraction of what their labor produces. Socialism turns this around so that the class that produces the wealth can collectively decide how it will be used for the benefit of all.

#### **3.3.1 The Banks and Socialism**

In the midst of the greatest economic and social crisis since the Great Depression, the major US banks are about to announce multi-million dollar year-end bonuses for their top executives and traders. Bankers are able to resume full tilt their mad pursuit of personal enrichment due to the plundering of the treasury carried out for the sole purpose of bailing out the "financial wizards" whose speculative practices precipitated the crisis.

This is a global phenomenon. In all the major centers of world capitalism, the financial elites are emerging from the economic wreckage stronger and more powerful than ever, and are dictating the terms of their own enrichment to servile governments.

In the US, Goldman Sachs is expected to announce bonuses totaling more than \$20 billion, about the same amount as California's state budget deficit. One analyst estimates that the average Goldman bonus will approach \$600,000, and that some executives may take home more than \$10 million. It is anticipated that Goldman Sachs, Bank of America, Citibank, JPMorgan Chase and Morgan Stanley will together pay out \$90 billion in 2009 executive compensation, with more than half in the form of bonuses.

In a transparent attempt to preemptively divert and contain public outrage, President Obama will announce on Thursday a proposal to put in place a surtax on 20 banks that received funds through the Troubled Asset Relief Program (TARP). According to the administration, this would raise \$120 billion over ten years not much more than the five biggest banks will pay their executives for 2009 alone.

The surtax proposal comes together with another public relations stunt the hearings held this week by the Financial Crisis Inquiry Commission, the toothless body set up for the purpose of whitewashing the criminal activities of the bankers.

Whatever the precise details of "Obama's gentle bank tax," as the *Wall Street Journal* calls the measure, it can be said with certainty that it will result in no significant penalty for Wall Street. The proposal will be blocked or watered down to the point of irrelevance by a Congress comprised of politicians who depend on campaign contributions and other bribes from the very banks they purport to

regulate. Such has been the fate of the much-vaunted proposals for pay restrictions, the bank regulatory overhaul, credit card “reform,” and Obama’s so-called housing rescue.

The response of the princes of Wall Street to even the slightest encroachment on their right to salaries hundreds of times greater than those of mere mortals is to bristle with indignation.

Much like the powdered wig-bedecked aristocrats of the French Ancien Regime, these modern-day lords and ladies insist on their unchallengeable right to unlimited personal enrichment. “I am a little tired of the constant vilification of these people,” an indignant JPMorgan CEO Jamie Dimon said this week of the furor over bonuses. “I don’t think it’s just whining,” another unnamed executive said of the bankers’ protestations. “There are legitimate liquidity issues that people have.”

These are people who produce nothing of value. Unlike the captains of industry of an earlier period associated with names such as Carnegie, Rockefeller, Edison and Ford whose enormous personal wealth was bound up with the creation of vast industrial empires, today’s robber barons have made their fortunes through parasitic financial operations bound up with the destruction of industry and a relentless attack on the living standards of the working class.

In the midst of soaring foreclosures and growing hunger and poverty, the financial elite flaunts its wealth. “As traders and investment bankers near the finish line of what looks like a boom year for pay, some are spending money like the financial crisis never happened,” the Wall Street Journal recently reported. “From \$15,000-a-week Caribbean getaways to art auctions to \$200,000 platinum wrist watches signs of the good life are returning.” New York’s elite real estate brokers are

“outright giddy” over the bonuses, which will “boost sales, particularly in the \$2 million to \$5 million range.”

More than a year after the near-collapse of the US and world economy at the hands of the bankers, nothing has been done to reform the financial system. Nobody has been held accountable. On the contrary, the banks have exploited the crisis of their own making to make more money than ever, and the government, the courts and the media have revealed themselves as mere handmaidens of what can rightly be called a financial aristocracy.

This demonstrates that the concentration of wealth in the hands of a tiny elite and its unbounded pursuit of personal enrichment are not mere excesses or aberrations of an otherwise rational and healthy system. These characteristics are rooted in the very nature of capitalism as it limps into the 21<sup>st</sup> century.

It is not a question of “reforming” the US and global banking system. The death grip of the banking elite over the wealth of society must be smashed. The answer to the plundering of society by the financial aristocracy is the expropriation of the bankers, the nationalization of the banks and finance houses, and their transformation into public trusts under the democratic control of the working population.

The alternative to the tyranny of the bankers is socialism, i.e., the abolition of private ownership of the banks and the major industries and the replacement of the capitalist market with rational planning and democratic control, geared to social need, not private profit.

The books of the banks must be opened to public inspection, and all predatory and illegal activities prosecuted. The ill-gotten wealth of the financial elite should be seized and used to meet pressing social needs health care, education, housing, jobs.

This requires the independent political mobilization of the working class in the US and internationally, a struggle against the Obama administration and the two parties of US big business, and the formation of a workers' government.

#### **4.0 CONCLUSION**

The Bank fulfils its three-pronged mission in Vietnam: its financial role (granting loans), its development agency role (assistance to poverty reduction policies, to implement reforms and infrastructure projects), and its knowledge production role (providing analyses in liaison with research bodies).

As we have seen, the Bank may well play a prominent role among the donors in terms of both funds and economic policy advice. And it has piled on the economic policy advice at key moments (WTO accession and 2008 crisis). Yet its influence over Vietnam's overall growth path is limited. Firstly, the sum of public and private funds from other sources, especially Japan (ODA, commercial loans and FDI), is infinitely higher. Secondly and more importantly, Vietnam does not have an exclusive tête-à-tête relationship with the Bank on the economic policy front, unlike many other developing countries. For historical, political and economic reasons, the Chinese model is inordinately more important to Vietnam than the Bank's advice, often drawn from the experience of third countries.



## **5.0 SUMMARY**

Nevertheless, economic injustice continues to abound. The corporate scandals of Enron and World.Com that devastated the pensions of myriads of Americans, the mergers and acquisitions that destroy the dreams and hopes of many in one fell swoop, the housing bubble created by government and banking collusion that put many hard working citizens out in the streets, and many other corrupt and selfish economic practices continue to evoke outcries of immorality and injustice.

Humanizing the economy is an ongoing quest, and various forms of religious morality and socialist ideals will continue to promote reform of unjust economic practices. However, economic justice will not be found in a simplistic zero-sum model of dividing the economic pie like communists tried. Rather, it will more likely be based on a positive-sum economic system involving checks and balances on large concentrations of wealth, regulation of corporate behavior, and laws against the collusion of politics and money. The efficiency of the market, the personal fulfillment that can be derived from ownership and entrepreneurship, and the possibilities resident in the mass production of goods and services, can all be integrated into an economic engine for human betterment.

## **6.0 TUTOR MARKED ASSIGNMENT**

1. What is Bank and Socialism?
2. Discuss Socialism

## **7.0 REFERENCES/FURTHER READING**

Abrami R., Malesky E. and Zheng Y. (2008). “Accountability and Inequality in

Single-Party Regimes: A Comparative Analysis of Vietnam and China”.  
Harvard Business School Working Paper 08-099.

Acemoglu D., and Robinson J.A. (2012). *Why Nations Fail. The Origins of Power, Prosperity and Poverty*. London: Profile Books.

Aglietta, M., and Bai, G. (2012). *China Development. Capitalism and Empire*.  
London & New York: Routledge.

Albrecht, D., Hocquart, H., and Papin, P. (2010). *Urban Development in Vietnam: the Rise of Local Authorities. Resources, limits and evolution of local governance*. Paris: AFD Editions.

## **UNIT 3: PRINCIPLES OF MONEY AND BANKING**

### **Content**

1.0. Introduction

2.0. Objectives

3.0. Main Content

3.1. The Principle of time (time has value)

3.2. The principle of Risk Compensation

3.3. The principle of decision making on the basis of adequate information

3.4. The principle of efficient Resources allocation by markets

3.5. The principle of Stability

4.0. Conclusion

5.0. Summary

6.0. Tutor-Marked Assignment

7.0. References/ Further Readings

### **1.0. INTRODUCTION**

Understanding these principles of money and banking does not only helps you understand how the financial system works today in Nigeria, but also gives you an insight into why things go wrong, and what the consequences might be for future events in the economy.

The simple Principles of money and banking you shall learn in this unit include the principle of time (time has value), the principle of risk compensation, the principle of decision making on the basis of adequate information, the principle of efficient resource allocation by markets, and the principle of stability.

### **2.0. OBJECTIVES**

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

- Describe the importance of timing of payments in banking transactions
- Explain why risks in banking transaction needs compensation
- Describe the implication of a decision taken on the basis of an adequate information
- Describe how markets are an efficient way of resources allocation
- Explain the Principle of Stability in banking transaction.

### **3.0. PRINCIPLES OF MONEY AND BANKING**

#### **3.1. THE PRINCIPLE OF TIME; (TIME HAS VALUE)**

The timing of payments is an important part of any transaction. Lenders will demand compensation for parting with their money and getting it back slowly overtime. Borrowers are willing to give this compensation in return for getting the funds today. This is the basis for an interest rate. Furthermore, how long payments are stretched out, and how frequently they occur will be important in determining the value of any financial investment. Value is based on both the SIZE and the TIMING of promised payments.

#### **3.2. THE PRINCIPLE OF RISK COMPENSATION**

Risk is pretty much unavoidable, and no one like it. Putting these two realities together means that people are willing to pay to avoid risk and those who assume certain risks will demand compensation. This is the whole basis of the insurance industry. Therefore, the value of a financial instrument is based on the SIZE, TIMING, and CERTAINTY of payments associated with instruments.

#### **3.3. THE PRINCIPLE OF DECISION-MAKING ON THE BASIS OF ADEQUATE INFORMATION**

At the core of microeconomics is the assumption of rational decision - making. Rational decisions are partly based on using all available information to make a

decision. Some decisions are more important than others, e.g. buying a car vs buying your lunch. Some information are harder to gather than other types.

Problems can arise especially when one party to a transaction has more / better information than the other party. This asymmetric information problem is a big motivation for financial intermediation by banks, insurance companies and other institutions. One role of financial institutions is to gather and disseminate information so that financial markets run smoothly.

### **3.4. THE PRINCIPLE OF EFFICIENT RESOURCES ALLOCATION BY MARKETS**

In economics, we learn about the fundamental problem of scarcity and that most of the time markets are an efficient way to allocate scarce resources. A market sets a price that rations scarce resources to those willing and able to pay. In the financial sector markets will determine what investment projects get funded and what capital stock is built.

### **3.5. THE PRINCIPLE OF STABILITY**

This principle is closely related to the core principle of risks compensation. People prefer the known to the unknown, all things being equal. Therefore when financial institutions offer instruments with stable payments or insurance against variability, and central banks work to create a stable financial system, individuals tend to be better off. That is, stability improves welfare.

### **4.0. CONCLUSION**

This unit throws light on the time value of money, principles of risk compensation and the principle of decision making. It also sheds light on the principles of efficient resources allocation and stability.

### **5.0. SUMMARY**

In this unit, we have learned about;

- i. The principle of time in banking business,
- ii. The principle of risk management,
- iii. The principle of decision-taking on the basis of adequate information,
- iv. The principle of efficient resources allocation by markets, and
- v. The principle of stability banking business.

#### **6.0. TUTOR-MARKED ASSIGNMENT**

- 1. Identify and discuss the principles of money and banking you know.
- 2. Explain the assertion that the principle of Risk is the basis of the Insurance Industry.
- 3. Discuss the principle of time (Time has value) in banking Business.

#### **7.0. REFERENCES/ FURTHER READINGS**

- Goshit, G.G. (2009). 'Money and Finance. Unpublished Lecture Guide;  
Department of Economics, University of Jos, Nigeria.
- Jhinghan, M.L. (2004). Money, Banking, International Trade and Public  
Finance. Delhi; Vrinda Publishers (P) Ltd.
- Vaish, M.C. (2000). Monetary Theory. Fifteenth Edition. New Delhi. Vikas  
Publishing House LTD.

## **UNIT 4: MERCHANT AND DEVELOPMENT BANKS**

### **CONTENTS**

1.0 Introduction

2.0 Objectives

3.0 Main Content

3.1 The Merchant Bank

3.2 Functions of Merchant Banks

3.3 Development Banks

3.4 Rationale or Basis for Establishing Development Banks

3.5 The Nigerian Industrial Development Bank (NIDB)

3.6 Nigerian Bank for Commerce and Industry (NBCI)

3.7 Nigerian Agricultural Corporative and Rural Development Bank (NACRDB)

4.0 Conclusion

5.0 Summary

6.0 Tutor Marked Assignment

7.0 References/Further Readings

### **1.0 INTRODUCTION**

In this unit, we shall discuss the merchant banks and their functions We shall also discuss development banks and their functions.

### **2.0 OBJECTIVES**

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

- i. Discuss the meaning of merchant banks and their functions.
- ii. Discuss the meaning of development banks in Nigeria.

### **3.0 MAIN CONTENT**

#### **3.1 THE MERCHANT BANK**

In contrast to a commercial bank which operate on retail Merchant Bank is a wholesale Bank, accepting deposits only in large blocks and providing mainly medium and long term loans, with public and private corporations being its customers (Magaji 1995). Merchant Banks, otherwise known as acceptance Houses or Investment banks, began operation in Nigeria in 1960 when the Philip Hill (Nig) Ltd and the Nigerian Acceptances Limited (NAL) were registered. These two Banks merged in 1969 to form NAL. In 1974, first National Bank of Chicago (Nig) Ltd, first National City Bank of New York (Nig) Ltd, and Chase Merchant Bank Ltd. were established. In 1975, ICON Ltd. Merchant Bankers began operation. The Nigerian American Merchant Bank Ltd was established in 1979, and in 1982 both the Merchant Banking Corporation Nigeria Ltd and the Indo Nigeria Merchant Bank Ltd were established. Now the number of Merchant Bank is large.

#### **3.2 FUNCTIONS OF MERCHANT BANKS**

**a) Corporate Finance Services:** These include management of public and private equity shares and debt securities issues, company floatation, mergers and reconstruction, financial planning and portfolio management.

**i. Issuing House Services:** Merchant Banks undertakes the sales of shares to their client. They act as issuing Houses in the capital market by, among other things, offering financial services to corporate entities desiring to raise long-term finance for their operations, given advices on type of capital structure, appropriate time of issues, and advise on relevant government regulations. Merchant Banks also gives backing to an issue in the form underwriting.



**ii. Project Financing:** This term is used to describe how Merchant Banks in particular finance new project on the agreement that repayment is expected from the revenues or cash flow to be generated by the project.

**iii. Advisory Services:** These include advice on project financing and joint ownership, arrangement of mergers and acquisitions, advices on corporate financial structure, etc.

**b) Banking Services:** These services include loans and advances, deposits, acceptances, foreign exchange transactions, international trade service and equipment leasing.

**i. Loans and Advances:** These are provided by Merchant Banks mainly to industry and commerce. CBN stipulates the percentage of loans and advances of these types of Banks to be made to various sectors of the economy at the beginning of each financial year. Although Merchant Banks also do lend on short term for working capital requirement, plant expansion, agricultural development, trade finance, etc., but they mainly championed the course of medium and long term loans disbursements.

**ii. Acceptance of Deposit:** Deposits in Merchant Banks are made in the form of fixed term, usually by corporate and non corporate customers, in large amount,

**iii. Acceptances:** Acceptance business is mainly used for the finance of international trade. A customer or client can draw a bill on his merchant Bank. By accepting this bill, his Merchant Bank becomes responsible for its payment at due date.

**iv. Foreign Exchange Service:** Upon authorization by CBN for a Merchant Bank to provide foreign exchange services, the later can act as a correspondent Bank to assist international trade settlement and to act as intermediary between CBN and its clients in obtaining foreign exchange.

**(c) Equipment Leasing:** Most Merchant Banks are members of equipment leasing. They execute leasing in return for fee. Leasing is the hiring of an asset for the duration of its economic life or up to a specific time (Adekanye 1986).

**(d) Portfolio Management:** Merchant Banks manages their clients' portfolios through Investment Departments. Portfolio Management includes "arranging purchases and sales of securities and offering advice on when and what to buy and sell, as well as attending to right or bonus issues and registrations" (Adekanye 1986).

**(e) Money Market Services:** Merchant Banks mobilises deposits on time and call from commercial banks, larger corporations, institutions, etc. at very attractive interest rates. They are also authorised dealers and users of Negotiable Certificates

### **3.3 DEVELOPMENT BANKS**

This category of banking institutions sprang up in response to our establishment of specialized financial institutions for the interests of investors in need for medium and long term finance for accelerated development of the Nigerian economy. Okigbo (1981) recognizes the need to create institutions that could undertake or promote investment where the private sector inspired by private gain, might for the moment be reluctant to go. He finds the answer in the creation of development institutions to provide funds for direct investment on medium and long term basis, or for assisting initiative or providing technical assistance and supporting services in any sector of the economy.

In Nigeria, a number of financial institutions have been set up based on these principles. We shall briefly examine some of them, notably NIDB, NBCI, and NACRDB.

### **3.4 RATIONALE OR BASIS FOR ESTABLISHING DEVELOPMENT BANKS**

- a) To plug the gaps in the financial system of inadequacy of commercial banks services that rarely concerns with long term capital financing, and the determination or involvement of CBN to bridge this gap through establishment of Development banks.
- b) As a recognition at the domestic level, the importance of International Development banks, such as World Bank and International Development Association. Development Banks at National level are therefore, established to investigate, undertake or finance projects which required more local knowledge and patronage than international finance.
- c) As a catalyst to development by financing small, independent manufacturing and industrial enterprises etc. in order to promote speedy industrial expansion (Nwankwo 1980). Development Banks are creature of government and do not emerge on their own. They are finance by government through CBN, but also do obtain loans from institutional lenders such as Banks and Insurance companies.

### **3.5 THE NIGERIAN INDUSTRIAL DEVELOPMENT BANK (NIDB)**

NIDB was established in 1964 in place of the investment corporation of Nigeria established since 1959. This Bank is owned by the Federal Government and the Central Bank.

#### **FUNCTIONS**

- a) It provides medium and long term finance to industrial establishments both in private and public sectors and to render technical, financial and managerial assistance to industry.
- b) Identifies investment bottlenecks in the economy with a view to determine investment priorities

- c) Promotes project developments.
- d) Provides technical, financial and managerial advices to indigenous enterprises.
- e) Supervises the implementation of projects financed by it through requesting project reports and visiting project sites.
- f) Nominates technical and managerial advisers to industrial organizations.
- g) Fosters the development of capital market in Nigeria by encouraging borrowers to list their shares in the stock exchange
- h) Serves as channel for bringing into Nigeria investible funds from international organizations.

### **3.6 THE NIGERIAN BANK FOR COMMERCE AND INDUSTRY (NBCI)**

Partly in reaction to the criticism against NIDB for favouring foreign dominated enterprises in its loan policy and partly for cater for needs of the newly indigenized business for medium and long term funds, the NBCI came on board by the decree No 22 of 1973. Unlike the NIDB which started off with foreign and Nigerian equity interests, the NBCI too off as a wholly owned Nigerian public sector organization to attend chiefly to the interests of Nigerian indigenous investors.

The principal functions and powers of the bank as defined by section 2 of the NIDB decree are follows:

- i. To provide equity and funds by way of loans to indigenous persons, organizations, institutions for medium and long term investment in industry and commerce at such rates and upon such terms as may be determined by the Board in accordance with the policy directed by the Federal Executive Council.
- ii. To engage in all aspects of merchant banking, particularly confirmation of bills and obligation to third parties, acceptance and discounting bills.
- iii. To underwrite stocks, shares and debentures issued in furtherance of the policy of the government.

- iv. To purchase and sell stocks quoted on the Lagos Stock Exchange.
- v. To provide guarantees including letters of credit.
- vi. To accept term deposits from the public, financial institutions, trust funds, post office and other bodies.
- vii. To provide chequing facilities for its customers. With time, the scope of the bank's functions was widened to take on in addition to those outlined above the provision of venture capital and funds for acquisition and investment in basic development (shopping centres, warehouses, grain silos etc).

As with NIDB, to attract NBCI financing, there must be evidence of viability, sound management, good prospects for profit, among other.

### **3.7 THE NIGERIAN AGRICULTURAL COOPERATIVE AND RURAL DEVELOPMENT BANK (NACRDB) LTD**

The birth of the Nigerian Agricultural, Cooperative and Rural Development Bank (NACRDB) Limited as the single largest development finance institution in Nigeria followed the successful merger of the former People's Bank of Nigeria (PBN), the defunct Nigerian Agricultural and Co-operative Bank (NACB) Ltd. and the risk assets of the Family Economic Advancement programme (FEAP) in October, 2000. Thus, NACRDB is dedicated primarily to agricultural financing at both the micro and macro levels, as well as micro financing of small and medium scale enterprises. The Bank is a registered limited liability company that is wholly owned by the Government of the Federal Republic of Nigeria with the share capital fully subscribed by the Federal ministry of Finance Incorporated 60% and the Central Bank of Nigeria 40%. The Bank's broad mandate encompasses savings mobilization and the timely delivery of affordable credit to meet the funding requirements of the teeming Nigerian population in the agricultural sectors of the national economy.

## **FUNCTIONS OF NACRDB**

- Providing all classes of agricultural loans for fanning, livestock, poultry and fisheries etc;
- Developing the economic base of the low income groups through the provision of loans to small scale enterprises, such as bakers, hair dressers, petty traders etc;
- Accepting savings from individuals and co-operative societies and make repayment of such savings together with appropriate interest;
- Encourage the formation of co-operatives;
- Engendering good banking habits amongst Nigerians, especially the target group,
- Encouraging capacity building through the training of beneficiaries on proper loan utilization, repayment, savings and the formulation of strategies for the profitable marketing of products.

## **4.0 CONCLUSION**

We conclude that a merchant bank is a whole sale bank , accept deposit only in large blocks and providing mainly medium and long term loans with public and private corporations being its Development banks are established specifically to aid the development of some specific sectors of the economy such as agriculture, industry etc.

## **5.0 SUMMARY**

In this unit, we have learnt the meaning of merchant and development banks. We have also learnt the functions of merchant banks and also the functions of some development banks in

## **6.0 TUTOR-MARKED ASSIGNMENT**

Define the term merchant bank.

## **7.0 REFERENCES/FURTHER READINGS**

Femi, A. (1986). "The Elements of Banking in Nigeria" F & A Publishers Ltd  
Lagos

Magaji, S. (1995). "Teach your Self the ABCD of Banking" Gargajiya Printers,  
Kano, Vol. 1

Nwankwo, G.O. (1972). "Indigenization of Nigerian Banking" Bankers Magazine.  
July. Nigerian Agricultural Corporative and Rural Development Bank Ltd.

Unamka, P.C., and Ewurum, U.J.F (1995). Business Administration. Precision  
Printers and Publishers Enugu Nigeria.

## **UNIT 5: BANKING UNDER CAPITALISM**

### **CONTENTS**

1.0 Introduction

2.0 Objectives

3.0 Main Content

3.1 .1 Definition of Capitalism

3.1.2 Characteristics of Finance Capitalism

3.1.3 Banking under Capitalism

3.1.4 Role of Credit under Capitalism

3.1.5 Capitalism and Private Property

3.1.6 Capitalism, Profits and Losses

3.1.7 Difference between Free Enterprise and Capitalism

4.0 Conclusion

5.0 Summary

6.0 Tutor-Marked Assignment

7.0 References/Further Readings



## **1.0 INTRODUCTION**

Finance capitalism or financial capitalism is the subordination of processes of production to the accumulation of money profits in a financial system.

Financial capitalism is thus a form of capitalism where the intermediation of saving to investment becomes a dominant function in the economy, with wider implications for the political process and social evolution. Since the late 20th century it has become the predominant force in the global economy, whether in neoliberal or other form.

The meaning of the term financial capitalism goes beyond the importance of financial intermediation in the modern capitalist economy. It also encompasses the significant influence of the wealth holders on the political process and the aims of economic policy. Thomas Palley has argued that the 21st century predominance of finance capital has led to a preference for speculation – Casino Capitalism – over investment for entrepreneurial growth in the global economy.

## **2.0 OBJECTIVES**

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

- i. Explain Banking under capitalism
- ii. Describe the finance capitalism and characteristics of finance capitalism

### **3.0 MAIN CONTENT**

#### **3.1.1 Definition of Capitalism**

Capitalism is an economic system in which capital goods are owned by private individuals or businesses. The production of goods and services is based on supply and demand in the general market (market economy), rather than through central planning (planned economy or command economy). The purest form of capitalism is free market or laissez-faire capitalism, in which private individuals are completely free to determine where to invest, what to produce or sell, and at which prices to exchange goods and services, without check or controls. Most modern countries practice a mixed capitalist system of some sort that includes government regulation of business and industry.

Capitalism is the social system which now exists in all countries of the world. Under this system, the means for producing and distributing goods (the land, factories, technology, transport system etc) are owned by a small minority of people. We refer to this group of people as the capitalist class. The majority of people must sell their ability to work in return for a wage or salary (who we refer to as the working class.)

The working classes are paid to produce goods and services which are then sold for a profit. The profit is gained by the capitalist class because they can make more money selling what we have produced than we cost to buy on the labour market. In this sense, the working classes are exploited by the capitalist class. The capitalists live off the profits they obtain from exploiting the working class whilst reinvesting some of their profits for the further accumulation of wealth.

In capitalism, the motive for producing goods and services is to sell them for a profit, not to satisfy people's needs. The products of capitalist production have to find a buyer, of course, but this is only incidental to the main aim of making a profit, of ending up with more money than was originally invested. This is not a theory that we have thought up but a fact you can easily confirm for yourself by reading the financial press. Production is started not by what consumers are prepared to pay for to satisfy their needs but by what the capitalists calculate can be sold at a profit. Those goods may satisfy human needs but those needs will not be met if people do not have sufficient money.

The profit motive is not just the result of greed on behalf of individual capitalists. They do not have a choice about it. The need to make a profit is imposed on capitalists as a condition for not losing their investments and their position as capitalists. Competition with other capitalists forces them to reinvest as much of their profits as they can afford to keep their means and methods of production up to date.

As you will see, we hold that it is the class division and profit motive of capitalism that is at the root of most of the world's problems today, from starvation to war, to alienation and crime. Every aspect of our lives is subordinated to the worst excesses of the drive to make profit. In capitalist society, our real needs will only ever come a poor second to the requirements of profit.

### **3.1.2 Characteristics of Finance Capitalism**

Finance capitalism is characterized by a predominance of the pursuit of profit from the purchase and sale of, or investment in, currencies and financial products such as bonds, stocks, futures and other derivatives. It also includes the lending of

money at interest; and is seen by Marxist analysts (from whom the term finance capitalism originally derived) as being exploitative by supplying income to non-laborers. Academic defenders of the economic concept of capitalism, such as Eugen von Böhm-Bawerk, see such profits as part of the roundabout process by which it grows and hedges against inevitable risks.

In financial capitalism, financial intermediaries become large concerns, ranging from banks to investment firms. Where deposit banks attract savings and lend out money, while investment banks obtain funds on the interbank market to re-lend for investment purposes, investment firms, by comparison, act on behalf of other concerns, by selling their equities or securities to investors, for investment purposes.

### **3.1.3 Banking under capitalism**

The development of capitalist industry produces concentration of banking, and this concentrated banking system is itself an important force in attaining the highest stage of capitalist concentration in cartels and trusts. How do the latter then react upon the banking system? The cartel or trust is an enterprise of very great financial capacity. In the relations of mutual dependence between capitalist enterprises it is the amount of capital that principally decides which enterprise shall become dependent upon the other. From the outset the effect of advanced cartelization is that the banks also amalgamate and expand in order not to become dependent upon the cartel or trust. In this way cartelization itself requires the amalgamation of the banks, and, conversely, amalgamation of the banks requires cartelization. For example, a number of banks have an interest in the amalgamation of steel

concerns, and they work together to bring about this amalgamation even against the will of individual manufacturers.

Conversely, a consortium established in the first place by manufacturers can have the consequence that two previously competing banks develop common interests and proceed to act in concert in a particular sphere. In a similar fashion, industrial combinations may influence the expansion of the industrial activities of a bank, which was perhaps previously concerned only with the raw materials sector of an industry, and is now obliged to extend its activities to the processing sector as well.

The cartel itself presupposes a large bank which is in a position to provide, on a regular basis, the vast credits needed for current payments and productive investment in a whole industrial sector. But the cartel also brings about a still closer relationship between banking and industry. When competition in an industry is eliminated there is, first of all, an increase in the rate of profit, which plays an important role. When the elimination of competition is achieved by a merger, a new undertaking is created which can count upon higher profits, and these profits can be capitalized and constitute promoter's profit. With the development of trusts this process becomes important in two respects. First, its realization constitutes a very important motive for the banks to encourage monopolization; and second, a part of the promoter's profits can be used to induce reluctant but significant producers to sell their factories, by offering a higher purchase price, thus facilitating the establishment of the cartel. This can perhaps be expressed in the following way: the cartel exerts a demand on the enterprises in a particular branch of industry; this demand increases to a certain degree the price of the enterprises and this higher price is then paid in part out of the promoter's profit.

Cartelization also means greater security and uniformity in the earnings of the cartelized enterprises. The dangers of competition, which often threatened the existence of the individual enterprise, are eliminated and this leads to an increase in the share prices of these enterprises, which involves further promoter's profit when new shares are issued. Furthermore, the security of the capital invested in these enterprises is significantly increased. This permits a further expansion of industrial credit by the banks, which can then acquire a larger share in industrial profits. As a result of cartelization, therefore, the relations between the banks and industry become still closer, and at the same time the banks acquire an increasing control over the capital invested in industry.

We have seen that in the early stages of capitalist production, the money available to the banks is derived from two sources: on one side, from the resources of the non-productive classes, and on the other side, from the capital reserves of industrial and commercial capitalists. We have also seen how credit develops in such a way as to place at the disposal of industry not only the whole capital reserves of the capitalist class but also the major part of the funds of the non-productive classes. In other words, present-day industry is carried on with an amount of capital far exceeding that which is owned by the industrial capitalists. With the development of capitalism there is also a continual increase in the amount of money which the non-productive classes place at the disposal of the banks, who in turn convey it to the industrialists. The control of these funds which are indispensable to industry rests with the banks, and consequently, with the development of capitalism and of the machinery of credit, the dependence of industry upon the banks increases. On the other side, the banks can only attract the funds of the non-productive classes, and retain their continually growing capital over the long term, by paying interest on them. They could do this in the past, so

long as the volume of money was not too great, by employing it in the form of credit for speculation and circulation. With the increase in the available funds on one side, and the diminishing importance of speculation and trade on the other, they were bound to be transformed more and more into industrial capital. Without the continuous expansion of credit for production, the availability of funds for deposit would have declined long ago, as would the rate of interest on bank deposits. In fact, this is to some extent the case in England, where the deposit banks only furnish credit for commerce, and consequently the rate of interest on deposits is minimal. Hence deposits are continually withdrawn for investment in industry by the purchase of shares, and in this case the public does directly what is done by the bank where industrial and deposit banks are closely linked. For the public the result is the same, because in neither case does it receive any of the promoter's profits from the merger, but so far as industry is concerned it involves less dependence on bank capital in England as compared with Germany.

The dependence of industry on the banks is therefore a consequence of property relationships. An ever-increasing part of the capital of industry does not belong to the industrialists who use it. They are able to dispose over capital only through the banks, which represent the owners. On the other side, the banks have to invest an ever-increasing part of their capital in industry and in this way they become to a greater and greater extent industrial capitalists. I call bank capital, that is, capital in money form which is actually transformed in this way into industrial capital, finance capital. So far as its owners are concerned, it always retains the money form; it is invested by them in the form of money capital, interest-bearing capital, and can always be withdrawn by them as money capital. But in reality the greater part of the capital so invested with the banks is transformed into industrial, productive capital (means of production and labour power) and is invested in the

productive process. An ever-increasing proportion of the capital used in industry is finance capital, capital at the disposition of the banks which is used by the industrialists.

Finance capital develops with the development of the joint-stock company and reaches its peak with the monopolization of industry. Industrial earnings acquire a more secure and regular character, and so the possibilities for investing bank capital in industry are extended. But the bank disposes of bank capital, and the owners of the majority of the shares in the bank dominate the bank. It is clear that with the increasing concentration of property, the owners of the fictitious capital which gives power over the banks, and the owners of the capital which gives power over industry, become increasingly the same people. As we have seen, this is all the more so as the large banks increasingly acquire the power to dispose over fictitious capital.

We have seen how industry becomes increasingly dependent upon bank capital, but this does not mean that the magnates of industry also become dependent on banking magnates. As capital itself at the highest stage of its development becomes finance capital, so the magnate of capital, the finance capitalist, increasingly concentrates his control over the whole national capital by means of his domination of bank capital. Personal connections also play an important role here.

With cartelization and trustification finance capital attains its greatest power while merchant capital experiences its deepest degradation. A cycle in the development of capitalism is completed. At the outset of capitalist production money capital, in the form of usurers' and merchants' capital, plays a significant role in the accumulation of capital as well as in the transformation of handicraft production



into capitalism. But there then arises a resistance of 'productive' capital, i.e. of the profit-earning capitalists - that is, of commerce and industry - against the interest-earning capitalists. Usurer's capital becomes subordinated to industrial capital. As money-dealing capital it performs the functions of money which industry and commerce would otherwise have had to carry out themselves in the process of transformation of their commodities. As bank capital it arranges credit operations among the productive capitalists.

### **3.1.4 Role of credit under capitalism**

#### Economy Class

When the credit crunch hit in 2008 and governments bailed out banks with trillions of pounds so they didn't collapse many people recognized that this was because of the huge amounts of debt in the system. Banks had loaned money to people and companies with no idea if they'd be able to pay it back, and these debts had then been sold on and bets taken on their future value.

So if the crash was caused by credit and debt, is it the fault of the banks for lending money, or people for borrowing? And couldn't we just regulate the system to get rid of this toxic aspect?

The system of credit and debt is not just something added on to capitalism that could be removed. It is an important part of the system that allows it to expand beyond its own limits, but ultimately contributes to its instability.

During a boom there is a frantic scramble for capitalists to invest and grab a bigger share of the market from their rivals. But sometimes an individual capitalist or company might not have the capital up front which they need to invest to keep

ahead, whereas other capitalists may have surplus value from past rounds of production that they need an outlet for. Banks play an important role in mediating between these two possibilities, lending the profits of one capitalist as capital for another to invest.

This allows capitalists to accumulate more rapidly, driving capitalism forward. However, it relies on the confidence that the money lent can be repaid. And as the boom reaches its peak and people realize all that has been produced cannot be sold, and that therefore profit might not be made, the debts are called in. In this way the system of credit and debt that fuelled the boom also accelerates the crash and ultimately adds to its destruction. So the credit system lubricates the accumulation process. Capitalists do not have to wait for one round of production to be finished before they can begin another, and have an outlet for surplus value they have accumulated that they do not wish to invest directly in production. Through this process capital also appears to generate profit as banks pay interest on surplus value they hold, and charge interest on money they lend. The rate of interest is irrational, depending on the supply of and demand for credit, not actual production. But it is still important for the capitalist. The rate of interest still needs to "make" more money for the capitalist sat in a bank account than it would invested in production. This leads capitalists to see money itself as self-expanding rather than value coming from the exploitation of workers. Sometimes as well as borrowing capital from banks, a capitalist who needs money to invest might sell bonds in a company. The people who buy bonds are promised a share of the money that the company makes - providing a profit is made.

These bonds that promise a share of future surplus value can be traded at a price way above their original value if traders believe it will guarantee them an income

in the future. But it also means they can become worthless as the market crashes and people no longer believe the company will make enough surplus value to pay out. These shares and bonds are described by Marx as "fictitious capital" because they are not capital themselves but merely the promise of future earnings. If they lose their value no capital has been destroyed - money has simply been transferred from the shareholder to the company.

It is not just capitalists who borrow money. Increasingly over the last 30 years workers have been encouraged to buy on credit, resulting in huge amounts of personal debt. This allowed capitalists to raise the rate of exploitation of workers, without affecting the number of goods and services a worker could buy, thus helping to maintain their profit rates. These debts too can be traded and gambled on in the belief that they will be repaid in the future. This further ties the workers into the system and exposes them to the disorder of the financial system. As Marx put it, "Banking and credit thus become the most potent means of driving capitalist production beyond its own limits - and one of the most effective vehicles of crises and swindle." So despite major economic crises invariably involving crashes of the banks and financial institutions it is wrong to blame finance, the banks or money itself for the crisis. These are essential elements of the capitalist production process and it is capitalism itself that is prone to crisis by its chaotic and unplanned nature. Credit and debt intensify both the boom and the slump, but do not ultimately cause either.

### **3.1.5 Capitalism and Private Property**

Private property rights are very important in capitalism. Most modern concepts of private property stem from John Locke's theory of homesteading, in which human beings claim ownership through mixing their labor with unclaimed resources. Once

owned, the only legitimate means of transferring property are through trade, gifts, inheritance or wagers.

Private property promotes efficiency by giving the owner of resources an incentive to maximize its value. The more valuable a resource, the more trading power it provides the owner of the resource. In a capitalist system, the person who owns property is entitled to any value associated with the property.

When property is not privately owned, but rather shared by the public, a market failure can emerge known as the Tragedy of the Commons. The fruit of any labor performed with a public asset does not belong to the laborer but is diffused among many people. There is a disconnect between labour and value, creating a disincentive to increase value or production. People are incentivized to wait for someone else to do the hard work and then swoop in to reap the benefits without much personal expense.

For individuals or businesses to deploy their capital goods confidently, a system must exist that protects their legal right to own or transfer private property. To facilitate and enforce private property rights, capitalist societies tend to rely on contracts, fair dealing and tort law.

### **3.1.6 Capitalism, Profits and Losses**

Profits are closely associated with the concept of private property. By definition, an individual only enters into a voluntary exchange of private property when he believes the exchange benefits him in some psychic or material way. In such trades, each party gains extra subjective value, or profit, from the transaction.

Voluntary trade is the mechanism that drives activity in a capitalist system. The owners of resources compete with one another over consumers, who in turn compete with other consumers over goods and services. All of this activity is built into the price system, which balances supply and demand to coordinate the distribution of resources.

A capitalist earns the highest profit by using capital goods most efficiently while producing the highest value good or service. In this system, value is transmitted through those prices at which another individual voluntarily purchases the capitalist's good or service. Profits are an indication that less valuable inputs have been transformed into more valuable outputs. By contrast, the capitalist suffers losses when capital resources are not used efficiently and instead create less valuable outputs.

### **3.1.7 Difference between Free Enterprise and Capitalism**

Capitalism and free enterprise are often seen as synonymous. In truth, they are closely related yet distinct terms with overlapping features. It is possible to have a capitalist economy without complete free enterprise, and possible to have a free market without capitalism. Any economy is capitalist as long as the factors of production are controlled by private individuals. However, a capitalist system can still be regulated by government laws and the profits of capitalist endeavors can still be taxed heavily.

"Free enterprise" can roughly be translated to mean economic exchanges free of coercive government influence. Although unlikely, it is possible to conceive of a system where voluntary individuals always trade in a way that is not capitalistic. Private property rights still exist in a free enterprise system, although private

property may be voluntarily treated as communal without government mandate. Many Native American tribes existed with elements of these arrangements. If accumulation, ownership and profiting from capital is the central principle of capitalism, then freedom from state coercion is the central principle of free enterprise.

#### **4.0 CONCLUSION**

The development of commercial capital, however, is quite different. The development of industry gradually excluded it from the ruling position over production which it had occupied during the period of manufacture. This decline is definitive, and the development of finance capital reduces the significance of trade both absolutely and relatively, transforming the once proud merchant into a mere agent of industry which is monopolized by finance capital.

#### **5.0 SUMMARY**

The mobilization of capital and the continual expansion of credit gradually brings about a complete change in the position of the money capitalists. The power of the banks increases and they become founders and eventually rulers of industry, whose profits they seize for themselves as finance capital, just as formerly the old usurer seized, in the form of 'interest', the produce of the peasants and the ground rent of the lord of the manor. The Hegelians spoke of the negation of the negation: bank capital was the negation of usurer's capital and is itself negated by finance capital. The latter is the synthesis of usurer's and bank capital, and it appropriates to itself the fruits of social production at an infinitely higher stage of economic development.

## **6.0 TUTOR-MARKED ASSIGNMENT**

- i. Differences between Free Enterprise and Capitalism
- ii. Discuss the role of credit under capitalism

## **7.0 REFERENCES/FURTHER READINGS**

Inside Money and Outside Money, Lagos (2006).

Repeat after Me: Banks Cannot and Do Not “Lend Out” Reserves, Standard and  
Poors, (2013)

Money, Reserves, and the Transmission of Monetary Policy: Does the Money  
Multiplier Exist?, Federal Reserve, (2012).

Banks are not intermediaries of loanable funds and why this matters, Bank of  
England, (2015).

Understanding the Modern Monetary System, Roche C. (2011).

## **MODULE TWO: UNIVERSAL BANKING**

Unit 1: Universal Banking

Unit 2: Branch Banking

Unit 3: Unit Banking

Unit 4: Islamic Banking

### **UNIT 1: UNIVERSAL BANKING**

#### **CONTENTS**

1.0 Introduction

2.0 Objectives

3.0 Main Content

3.1 Definition of Universal Banking

3.1.1 Advantages of Universal Banking

3.1.2 Disadvantages of Universal Banking

3.2 Objectives of Universal Banking

3.3 The fall of the universal banking

4.0 Conclusion

5.0 Summary



## 6.0 Tutor Marked Assignment

## 7.0 References/Further Reading

### **1.0 INTRODUCTION**

The banking system in Nigeria has been undergoing tremendous reforms. These reforms relate to the capital base, number of institutions, ownership structure and the depth and breadth of operations. These changes were occasioned largely by the challenges posed by deregulation of the financial sector, globalization of operations, technological innovations and adoption of supervisory and prudential requirements that conformed to international standards.

The sector has shifted focus from the traditional borrower and lender to a more differentiated and customized product or service provider. It has moved from regulation to liberalization and from planned economy to a market driven economy. This transformation results from economic reforms and liberalization which allowed banks to explore new business opportunities rather than generating revenues through the conventional borrowing and lending. The change in the financial sector created the platform for universal banking in Nigeria.

The adoption of universal banking in several countries may be attributed to changes in laws and regulations. These changes were responses to the pressure mounted by banking institutions to be allowed to expand their activities. In France, a number of legislative changes in the 1960s prepared the ground for universal banking. In the USA, following the rapid changes in the financial structure, including the initiatives taken by some financial institutions to expand their scope of services, the Depository Institutions Deregulation and Monetary Control Act

of 1989 was passed. The Act sought to improve monetary control and also to remove impediments to competition and equalize the cost of monetary control among deposit institutions.

## **2.0 OBJECTIVES**

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

- i. Define Universal Banking
- ii. Advantages and Disadvantages of Universal Banking
- iii. Objectives of Universal Banking

## **3.0 MAIN CONTENT**

### **3.1 DEFINITION OF UNIVERSAL BANKING**

A banking system in which banks provide a wide variety of financial services, including both commercial and investment services. Universal banking is common in some European countries, including Switzerland. In the United States, however, banks are required to separate their commercial and investment banking services. Proponents of universal banking argue that it helps banks better diversify risk. Detractors think dividing up banks' operations is a less risky strategy.

Universal banking is a combination of Commercial banking, Investment banking, Development banking, Insurance and many other financial activities. It is a place where all financial products are available under one roof. So, a universal bank is a bank which offers commercial bank functions plus other functions such as

Merchant Banking, Mutual Funds, Factoring, Credit cards, Housing Finance, Auto loans, Retail loans, Insurance, etc.

Universal banking is done by very large banks. These banks provide a lot of finance to many companies. So, they take part in the Corporate Governance (management) of these companies. These banks have a large network of branches all over the country and all over the world. They provide many different financial services to their clients.

In India, two reports in 1998 mentioned the concept of universal banking. They are the Narasimham Committee Report and the S.H. Khan Committee Report. Both these reports advised to consolidate (bring together) the banking industry through mergers and integration of financial activities. That is, they advised a combination of all banking and financial activities. That is, they suggested a Universal banking.

The word universal banking is a new concept in the banking industry and therefore has no definition on what it tends to achieve by adopting universal banking. Definitions given to universal banking have therefore ranged from what can be termed multipurpose banking, financial conglomeration to a single product in a bank's stable.

The Governor of the Central Bank of Nigeria. Sanusi the guideline he released for the implementation of the universal banking in Nigeria as the business of receive deposit on current, savings or other account paying or collecting cheques drawn or paid by customers, provision of finance, consultancy and advisory services relating to corporate and investment matters, making or managing investment on behalf of any person and the provision of insurance marketing services and capital market

business or such other services as the governor of the Central Bank may be gazette designated as banking business.

On the other hand, the managing director of Magnum Trust Bank plc. Mr. Babatunde Dabiri defined universal banking as ‘a form of banking which allows a single financial institution to perform the function of merchant and commercial banks, participate in the clearing of cheques and other instruments and at the same time render insurance and capital market services’.

On its own the banking supervision department of the CBN referred to universal banking as “a financial system where banks in addition to offering traditional banking services are not barred from holding equity interested in commercial and industrial undertakings or engage in capital market activities such as securities. It also encompasses”. Equipment leasing, discount houses services, insurance brokerage, trusteeship and administration of estate etc. All carried out by the same bank or each of its branches and subsidiaries.

Modern banking in Nigeria started with the advent of the British colonial rule with the advent of the government in Nigeria came a need for modern day banking in the country to care for the government and the business community and to replace the barter system that had been prevalent. The structure of the banking industry then even now is tailored towards that prevailing in the United Kingdom. This is characterized by a single banking company engaging in business in one or more branches.

The first sets of banks to open in the country were expatriate banks. This is because Nigeria business class was not conversant with the modern day banking and the multinational firms then dominated the respective counties. For six decades

expatriate banking dominated the Nigerian banking industries notable among these banks were the bank of British West African (now first bank) of 1894, Barclays bank (Union Bank) and the British French Bank (U.B.A) of 1949. Between then, they control about 90% of aggregate bank deposits.

Many of the indigenous banks established during this period could not survive because “the absence of local money or capital market and Central Bank meant that any bank without a “Godfather” in London, new York or Paris was doomed to failure because it can neither raise money from outside to loan out nor attract deposit from customers”. (Osubor, 1984). Through their headquarters situated in Europe the expatriate banks had adequate terms of fund generation for customers in Nigeria. The foreign banking domination was checked for the first time in 1969 banking decree, which repealed the earlier banking legislation in the country.

It required all banks to be locally incorporated. During the indigenization decree of 1973, the federal government acquired 40% equity shares in the first three and biggest expatriates’ banks first bank, union bank and U.B.A. This was increased to all expatriate banks. Thus we can safely say that today there is no foreign bank in Nigeria.

Universal banking has been adopted by many countries to remove restrictions and allow free flow of transactions for efficient allocation of resources to boost economic development. With increasing deregulation of economic activities across the world, the practice of universal banking is gaining global spread. It has been embraced in Germany, U.S.A, United Kingdom, South Africa, Zambia, Canada, Japan and Congo.

In the United Kingdom the big banks have steadily taken on multipurpose functions through the acquisition and take-over of institutions already established in the specialized areas of their interest. Following the “big bang” of 1986 banks have become broad-based institutions. British banks may engage in almost any type of financial activity.

Indeed the clearing banks are permitted to develop into diversified financial services grown that engage in universal banking. The case of the U.S. is instructive in the banking Act of 1933 (the famous Glass Steagal Act) impose significant restrictions on banks in respect of investment bank ties. This prohibition was as a result of the 1929 stock market crash and the indictment of some banks and their securities affiliate’s owners and their role in the collapse of the market.

However in recent years, banks and bank holding companies have been allowed to expand their investment banking activities into areas such as brokerage and financial advisory services, mutual fund services and securities underwriting. In Africa counties that have introduced universal banking, full banking licenses are issued without functional or class delimitation.

### **3.1.1 Advantages of Universal Banking**

The benefits or advantages of universal banking are:-

**Investors' Trust:** Universal banks hold stakes (equity shares) of many companies. These companies can easily get other investors to invest in their business. This is because other investors have full confidence and faith in the Universal banks. They know that the Universal banks will closely watch all the activities of the companies in which they hold a stake.

**Economics of Scale:** Universal banking results in economic efficiency. That is, it results in lower costs, higher output and better products and services. In India, RBI is in favour of universal banking because it results in economies of scale.

**Resource Utilisation:** Universal banks use their client's resources as per the client's ability to take a risk. If the client has a high risk taking capacity then the universal bank will advise him to make risky investments and not safe investments. Similarly, clients with a low risk taking capacity are advised to make safe investments. Today, universal banks invest their client's money in different types of Mutual funds and also directly into the share market. They also do equity research. So, they can also manage their client's portfolios (different investments) profitably.

**Profitable Diversification:** Universal banks diversify their activities. So, they can use the same financial experts to provide different financial services. This saves cost for the universal bank. Even the day-to-day expenses will be saved because all financial services are provided under one roof, i.e. in the same office.

**Easy Marketing:** The universal banks can easily market (sell) all their financial products and services through their many branches. They can ask their existing clients to buy their other products and services. This requires less marketing efforts because of their well-established brand name. For e.g. ICICI may ask their existing bank account holders in all their branches, to take house loans, insurance, to buy their Mutual funds, etc. This is done very easily because they use one brand name (ICICI) for all their financial products and services.

**One-stop Shopping:** Universal banking offers all financial products and services under one roof. One-stop shopping saves a lot of time and transaction costs. It also

increases the speed or flow of work. So, one-stop shopping gives benefits to both banks and their clients.

### **3.1.2 Disadvantages of Universal Banking**

The limitations or disadvantages of universal banking are:-

**Different Rules and Regulations:** Universal banking offers all financial products and services under one roof. However, all these products and services have to follow different rules and regulations. This creates many problems. For e.g. Mutual Funds, Insurance, Home Loans, etc. have to follow different sets of rules and regulations, but they are provided by the same bank.

**Effect of failure on Banking System:** Universal banking is done by very large banks. If these huge banks fail, then it will have a very big and bad effect on the banking system and the confidence of the public. For e.g. Recently, Lehman Brothers a very large universal bank failed. It had very bad effects in the USA, Europe and even in India.

**Monopoly:** Universal banks are very large. So, they can easily get monopoly power in the market. This will have many harmful effects on the other banks and the public. This is also harmful to economic development of the country.

**Conflict of Interest:** Combining commercial and investment banking can result in conflict of interest. That is, Commercial banking versus Investment banking. Some banks may give more importance to one type of banking and give less importance to the other type of banking. However, this does not make commercial sense.



## **3.2 OBJECTIVES OF UNIVERSAL BANKING**

Universal banking is a term related to banks providing both investment services and savings and loan options to their customers. Many of the banks in Europe function on the basis of the universal banking model. The main objectives of such a model are an increased participation in investment strategies, securing clients through saving and loan schemes, development of private sectors and cutting costs for financial services.

### **1. Participation in Investments**

Universal banking focuses on performance of private firms by directly investing into such entities. By participating on the investment market, such banks can directly exercise decision-making power in the governance of corporations. This objective of universal banking aims to secure the financial interests of companies that have received direct investment and to protect the future development of such institutions. For example, Swiss economist Georg Rich indicates that by aiming to directly participate on the investment market, universal banks in Switzerland want to ensure that the companies that have received investment funds would deal with them properly and will not undertake unreasonable financial decisions.

### **2. Savings and Loans**

By delivering multiple financial services, universal banking aims to deliver immediate benefits for their clients. This makes such entities quite attractive for people who want to take care of their all financial needs at one place -- they can both apply for an investment scheme and require credit for business development. By providing their clients with saving and loan options, universal banks aim to

diversify their range of services and have larger influence on the financial markets. German economist Ralf Elsas from Frankfurt University emphasizes on the fact that by aiming to promote saving and loan programs, universal banks can benefit from different types of clients and obtain more working capital to invest in the future.

### **3. Development of Private Sector**

Among the main objectives of universal banking is the development of the private sector. As such, banking institutions are highly unlikely to cooperate with governmental funds because of their urgent need to invest money, universal banks target the private sector as a main source of clients. But to have such clients, universal banks need to develop the sector and ensure its stable run and economic growth. This has been revealed by economist Gary Gorton who states that universal banks in Germany are the main contributors for the rapidly expanding private sector in the country.

### **4. Cutting the Costs**

Since many of the European continental banks are adopting the universal banking approach, it is essential for them to be more competitive on the global market where American and Asian banks offer better prices for providing financial services. The idea of the universal banks is to reduce the costs of their financial services by enlargement being able to expand their areas of expertise would empower European banks to engage in more serious price reduction strategies. The European Central Bank has already partially achieved this objective by providing low interest loans to European Union economies.

### **3.3 THE FALL OF THE UNIVERSAL BANKING**

Before the great crash of 2008, the universal banks swaggered around London, Hong Kong and New York. Barclays, Citigroup, Credit Suisse, Deutsche and UBS imagined they could be all things to investors in (almost) all corners of the globe. Five years on, in 2013, such ambitions will seem quaint as the American and European banks find themselves either shrinking further or increasingly marginalised.

Far from competing in every category from asset management to equity derivatives and fixed income, the universal banks will abandon businesses and locations, through forced disposals or severe cost-cutting. From the ruins, a new order will emerge: one with different capital structures, new credit channels and a continued shift in power towards Asian institutions, some of which will be either partly or wholly government-owned.

The decline of the universal bank will pass unlamented. The promise of the cross-selling financial supermarket has long been eclipsed by the destruction of shareholder value after the crash. Sandy Weill, universal banking's evangelist-in-chief when at the helm of Citigroup, recanted publicly in 2012. In 2013, combining stolid utility banking and bonus hungry investment banking under one roof will look even more questionable. As one City of London veteran says: "It's like putting Tesco together with Harrods it doesn't work."

The new banking order in 2013 will not be fashioned by a son-of-Glass Steagall, the Depression-era act which separated commercial lending and investment banking. There will be little appetite for a giant legislative overhaul, coming on top of America's Dodd-Frank act and Britain's Vickers commission. Instead, the

power of universal banks will be eroded by market forces driven by the new Basel 3 rules on capital ratios as well as a more intangible but vital factor: culture.

In 2012 universal bankers and, more importantly, their clients at last realised that financial capitalism had moved too far towards transaction banking at the expense of “relationship banking”. Politicians and regulators won the argument. Bankers came to understand that in a world of lower leverage using money borrowed on the wholesale markets to invest the old turbo charged transaction model no longer worked. The liberate-fixing scandal was the final straw.

In 2013 the rock-star banking CEO typified by Bob Diamond at Barclays will be consigned temporarily to the Hall of Infamy. Power will either be shared (at Deutsche, Anshu Jain, a high flying Indian investment banker, serves as CEO alongside Jurgen Fitschen, an older German) or invested in a low profile CEO like Antony Jenkins, a sober retail banker who has succeeded the abrasive Mr. Diamond at Barclays, or like Michael Corbat, who has succeeded Vikram Pandit at Citigroup. Expect further moves at the universal banks, with Brady Dougan at Credit Suisse among the vulnerable.

#### **4.0 CONCLUSION**

Universal banking, as a global system of banking, is a major innovation in the banking sector in Nigeria. The scheme was introduced by the CBN in Nigeria to guarantee the safety of depositors’ and investors’ funds, protect the interests of stakeholders and ensure that banks in Nigeria meet international standards. It was designed to ensure a diversified, strong and reliable banking that would stimulate the economic growth of the nation. The adoption and implementation of universal banking system and other reforms that accompany it would herald rapid and sustainable development and economic growth in the country. Universal banking

has many prospects as well as challenges confronting it. Though the experience with universal banking in Nigeria has not been beneficial, efforts should be made to maximize the prospects and minimize the challenges.

## **5.0 SUMMARY**

The CBN and other regulatory agencies should invest in the upgrade of both human and non-human capacities to be able to manage the ever changing and complex financial systems. Consolidated and integrated supervision is also needed for a continuous operation of universal banking. It must be noted that the recent reforms in the banking sector appeared to be too hasty considering the fissure between them. Though reforms are necessary, they should be predicated on needs and sufficient period be allowed for adjustments and workability.

## **6.0 TUTOR MARKED ASSIGNMENT**

1. Define Universal Banking
2. Discuss the objectives of Universal Banking

## **7.0 REFERENCES/FURTHER READING**

Anonymous (2010). “Abolition of Universal Banking”. Retrieved May 30, 2012 from <http://www.tribune.ng/index.php/editorial>.

Jimoh, A. (2010). “Still on Universal Banking System”. Retrieved March 23, 2012 from <http://economicconfidential.net>.

Ogiemwonyi, V. (2010). “The trouble with Universal banking in Nigeria”. Retrieved May 30, 2012 from <http://www.businessday.com.ng/index.php/editorial>.

Oni, B. (2001). “Capacity Building for Universal Banking – The Challenge of

Human Capital Management”. Retrieved March 24, 2012 from  
<http://openwells.org>.

Stock Analyst (2008). Is It Time To Embrace The Universal Banking Model?.

Cato Journal (1993). The Future of Universal Banking; Georg Rich et al.

## **UNIT 2: BRANCH BANKING**

### 1.0 Introduction

### 2.0 Objectives

### 3.0 Main Content

#### 3.1 Definition of Branch Banking

##### 3.1.1 Advantages of Branch Banking

##### 3.1.2 Disadvantages of Branch Banking

##### 3.1.3 Legal restrictions in the United States

##### 3.1.4 Types of Branches

#### 3.2 The Importance of the local Branch Bank

### 4.0 Conclusion

### 5.0 Summary

### 6.0 Tutor Marked Assignment

### 7.0 References/Further Reading

## **1.0 INTRODUCTION**

Historically, branch banks were part of a larger building, often found in strip malls or even in grocery stores or discount stores, sharing the location with another business. Today, however, branch banking can take place at a number of different locations, and many banks build individual branch locations that are independent of other businesses. Each type of location is still considered a branch bank.

In general, most of the services offered at a large bank can be completed at a branch banking location. Locations found in grocery and discount stores often do not have as many options as other branch services; it is often not possible to "drive-through" at these locations, because the bank is located inside the store. In addition, though deposits can be made at this type of bank branch, safe deposit boxes are typically never available, because the security is simply not high enough. Otherwise, these locations typically offer all other services, and generally include an automated teller machine (ATM).

## **2.0 OBJECTIVES**

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

- i. Definition of Branch Banking
- ii. Advantages and disadvantages of Branch Banking
- iii. Types of Branches

## **3.0 MAIN CONTENT**

### **3.1 DEFINITION OF BRANCH BANKING**

Engaging in banking activities such as accepting deposits or making loans at facilities away from a bank's home office. Branch banking has gone through significant changes since the 1980s in response to a more competitive nationwide financial services market. Financial innovation such as internet banking will greatly influence the future of branch banking by potentially reducing the need to maintain extensive branch networks to service consumers.



## **Investopedia explains 'Branch Banking'**

The Riegle-Neal Interstate Banking & Branching Efficiency Act of 1994 authorized well-capitalized banks to acquire branch offices, or open new ones, anywhere in the United States outside their 1997. Most states passed laws enabling interstate branching prior to that date. Branch banking networks are gradually evolving into multistate financial services networks where depositors can access their accounts from any banking office.

For many people, the only business they will ever do with their bank home states after June 1, is through branch banking. The central location of the bank may be too far away to visit, and the branches of the bank will provide all the necessary services one may need. It is also possible to apply for loans, such as personal loans, vehicle loans, or even mortgages, through branch locations. With all of these options, branch banking has made banking much more convenient for many people, in addition to the large numbers of people who simply do all their banking online.

### **3.1.1 Advantages of Banking**

Rapid growth and wide popularity of branch banking system in the 20th century are due to various advantages as discussed below.

#### **1. Economies of Large Scale Operations**

Under the branch banking system, the bank with a number of branches possesses huge financial resources and enjoys the benefits of large-scale operations,

(a) Highly trained and experienced staff is appointed which increases the efficiency of management,

(b) Division of labour is introduced in the banking operations which ensures greater economy in the working of the bank. Right persons are appointed at the right place and specialisation increases,

(c) Funds are made available liberally and at cheaper rates,

(d) Foreign exchange business is done economically,

(e) Large financial resources and wider geographical coverage increases public confidence in the banking system.

## **2. Spreading of Risk**

Another advantage of the branch banking system is the lesser risk and greater capacity to meet risks,

(a) Since there is geographical spreading and diversification of risks, the possibility of the failure of the of the bank is remote,

(b) The losses incurred by some branches may be offset by the profits earned by other branches,

(c) Large resources of branch banks increase their ability to face any crisis.

## **3. Economy in Cash Reserves**

Under the branch banking system, a particular branch can operate without keeping large amounts of idle reserves. In time of the need, resources can be transferred from one branch to another.

#### **4. Diversification on Deposits and Assets**

There is greater diversification of both deposits and assets under branch banking system because of wider geographical coverage,

(a) Deposits are received from the areas where savings are in plenty,

(b) Loans are extended in those areas where funds are scarce and interest rates are high. The choice of securities and investments is larger in this system which increases the safety and liquidity of funds.

#### **5. Cheap Remittance Facilities**

Since bank branches are spread over the whole country, it is easier and cheaper to transfer funds from one place to another. Inter-branch indebtedness is more easily adjusted than inter-bank indebtedness.

#### **6. Uniform Interest Rates**

Under branch banking system, mobility of capital increases, which in turn, brings about equality in interest rates. Funds are transferred from areas with excessive demand for money to areas with deficit demand for money. As a result, the uniform rate of interest prevails in the whole area; it is prevented from rising in the excessive demand area and from falling in the deficit demand area.

#### **7. Proper Use of Capital**

There is proper use of capital under the branch banking system. If a branch has excess reserves, but no opportunities for investment, it can transfer the resources to other branches which can make most profitable use of these resources.

## **8. Better Facilities to Customers**

The customers get better and greater facilities under the branch banking system. It is because of the small number of customers per branch and the increased efficiency achieved through large scale operations.

## **9. Banking Facilities in Backward Areas**

Under the branch banking system, the banking facilities are not restricted to big cities. They can be extended to small towns and rural as well as underdeveloped areas,. Thus, this system helps in the development of backward regions of the country.

## **10. Effective Control**

Under the branch banking system, The Central bank than have a more efficient control over the banks because it has to deal only with few big banks and nor with each individual branch. This ensures better implementation of monetary policy.

### **3.1.2 Disadvantages of Branch Banking**

Following are the main disadvantages and limitations of branch banking system:

#### **1. Problem of Management**

Under the branch banking system a number of difficulties as regards management, supervision and control arise:

(a) Since the management of the bank gets concentrated at the head office, the managers can afford to be lax and indulgent in their duties and are often involved in serious irregularities while using the funds.

(b) Since the branch manager has to seek permission from the head office on each and every matter, this results in unnecessary delay and red- tapism in the banking business.

## **2. Lack of Initiative**

Branch managers generally lack initiative on all-important matters; they cannot take independent decisions and have to wait for. The clearance signal from the head office.

## **3. Monopolistic Tendencies**

Branch banking encourages monopolistic tendencies in the banking system. A few big banks dominate and control the whole banking system of the country through their branches. This can lead to the concentration of resources into a few hands.

## **4. Regional Imbalances**

Under branch banking system, the financial resources collected in the smaller and backward regions are transferred to the bigger industrial centres. This encourages regional imbalances in the country.

## **5. Adverse Linkage Effect**

Under branch banking system, the losses and weaknesses of some branches also have their effect on other branches of the bank.

## **6. Inefficient Branches**

In this system, the weak and unprofitable branches continue to operate under the protection cover of the large and more profitable branches.

## **7. Other Defects**

Other defects of branch banking system are as follows:

- (a) Preferential treatment is given to the branches near the head office,
- (b) Higher interest rates are charged in the developed area to compensate for the lower rates charged in the backward areas,
- (c) There is concentration and unhealthy competition among the branches of different banks in big cities,
- (d) Many difficulties are faced when a bank opens branches in foreign countries.

### **3.1.3 Legal restrictions in the United States**

Historically, branch banking in the United States - especially interstate branch banking - was viewed unfavorably by regulatory authorities, and this was codified with the enactment of the McFadden Act of 1927, which specifically prohibited interstate banking. Over the next few decades, some banks attempted to circumvent McFadden's provisions by establishing bank holding companies that operated so-called independent banks in multiple states. To address this, The Bank Holding Company Act of 1956 prohibited bank holding companies headquartered in one state from having branches in any other state.

Most interstate banking prohibitions were repealed by the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. Research has also found that anticompetitive state provisions restricted out-of-state growth when those provisions were more restrictive than the provisions set by the Interstate Banking and Branching Efficiency Act or by neighboring states. Some states have also had restrictive bank branch laws; for example, Illinois outlawed branches (other than the main office) until 1967, and did not allow an unlimited number until 1993.

### **3.1.4 Types of branches**

#### **Traditional or brick-and-mortar**

These are typically stand alone branches of a financial institution that often are contained in its own building. These branches typically offer full service banking including safe deposit boxes. They may include access to a drive-through teller windows.

#### **In-store**

These are typically branches located in a retail space such as a grocery, shopping malls or discount store. They may be full service branches or limited service branches. They generally do not include a drive-through teller windows or safe deposit boxes. These branches may have limited staff and typically include technology as a means to deliver banking services such as the use of automated teller machines, videoconferencing, and video banking systems.

## **Foreign Bank Branch**

A type of foreign bank that is obligated to follow the regulations of both the home and host countries. For example, Canada has 24 foreign bank branches operating in the country, regulated by the Office of the Superintendent of Financial Institutions.

### **3.4 THE IMPORTANCE OF THE LOCAL BRANCH BANK**

A major development in international banking is the increased importance of retail banking; retail business contributes more than 60 percent of the total revenue for many large banking groups. Compared with other international markets, Chinese retail banking has seen little development yet there is a big opportunity for retail business. Because the retail business features high margin transactions, a low non-performing loan ratio, risk diversification, and a low risk of default it has become an important development direction for domestic commercial banks.

Although self-service banking (automated teller machines) and internet banking offer customers convenient real-time access, branch banks provide more convenient and people-friendly service. This local customer service is good for handling high-value and complex transactions and services, and is the mode preferred by customers of different ages. While branch banks are important tools for developing comprehensive and effective customer relationships, they are also the most effective sales channels. In the U.S., commercial banks enhance their competitiveness against non-bank financial institutions by selling financial advice products through branch banks. Considering the rapid development of financial consulting products in China, branch banks that develop customer relationships will become increasingly important.



## **The key drivers for China's branch bank transformation**

The key drivers to transforming Chinese branch banks are increasingly fierce competition in the banking industry, high customer expectations for (and current dissatisfaction with) existing branch banks, and the low efficiency of the branch banks. To keep up with leading international banks, the Chinese banking industry urgently needs to change huge numbers of traditionally low-value network transactions into high-value network and personal service transactions. They need to provide more segmented and personalized products and services for customers in order to promote operational efficiency, increase customer satisfaction, increase sales, and boost banking profits.

### **Driver 1: The increasingly fierce competition in the banking industry**

As the banking market opens up in China, foreign capital banks have sped up the pace of expansion. The number of branch banks is increasing, and foreign capital banks are rapidly adding to their assets. According to a PricewaterhouseCoopers Survey, from 2005 to 2008, the assets of 30 foreign banks increased by 134 percent. The foreign banks are targeting the high-end market in the economically developed regions, and the local banks face the threat of losing high-end customers. According to one survey of 11 foreign banks, from 2005 to 2008, the number of retail customers increased tenfold.

During this expansion of foreign banks, many small and medium-sized joint-stock banks added branch banks and increased their efforts to transform the existing branch banks. In the past five years, the number of branches of small and medium-sized joint-stock banks grew by an average annual rate of 13.7 percent. The four largest banks are fully aware of the importance of transforming their branch banks

and are actively upgrading. Whether these banks can complete their transformations will determine their shares of the retail business and resulting profit.

### **Driver 2: To meet customer expectations**

Raising domestic customer demand and satisfaction with the branch banks also requires branch bank transformation. Increasing customer expectations includes offering a variety of products, high-quality service, and convenient access to services. If branch banks do not satisfy customers, customer loyalty will decrease, the banks will lose customers and, therefore, banks will suffer huge losses.

The domestic customers show more dissatisfaction with branch banks than with internet banking, telephone banking, and other banking channels. Meeting customer expectations is a great challenge for domestic banks. One customer survey for a domestic bank shows that customers hope banks can improve business processing speed, simplify business processing, and optimize the arrangement of the branch bank. At the same time, high-end customers also hope the banks can provide services in a special area to protect their privacy, and provide a qualified financial adviser in the branch bank.

### **Driver 3: To increase the operational efficiency of the branch banks**

There is a gap between the profit margin of China banks and the advanced foreign banks. As the banking business has gradually moved toward more publicly-listed banks, domestic banks must meet the expectations of investors to get a bigger piece of public financing. As for branch bank operations, domestic banks must use the branch bank to expand the number of customers, deepen customer relationships

to increase sales, simplify the back office processes, optimize the layout of the branch bank, and reduce costs.

Currently, domestic branch banks spend less time on valuable marketing because the transaction processing and back office efficiency is very slow. Operating personnel spend most of their time on customer service, transactions, back office processes, and office administration, which are all lower value. Unless branch banks improve their process and operational efficiencies, the profitability and market value of Chinese banking will be impacted strongly for a long time.

These three key drivers are pushing the Chinese branch bank transformation. Specifically, this transformation includes four strategic objectives:

1. Expand the retail business
2. Improve customer satisfaction
3. Improve operational efficiency
4. Reduce operating costs

## **4.0 CONCLUSION**

Banking systems have been with us for as long as people have been using money. Banks and other financial institutions provide security for individuals, businesses and governments, alike. Let's recap what has been learned with this tutorial: In general, what banks do is pretty easy to figure out. For the average person banks accept deposits, make loans, provide a safe place for money and valuables, and act as payment agents between merchants and banks.

Banks are quite important to the economy and are involved in such economic activities as issuing money, settling payments, credit intermediation, maturity transformation and money creation in the form of fractional reserve banking.

## **5.0 SUMMARY**

In this unit, we have learned about;

- i. The definition of Branch Banking
- ii. Advantages and Disadvantages of Branch Banking

## **6.0 TUTOR MARKED ASSIGNMENT**

1. Definition, Advantages & Disadvantages of Branch Banking
2. Discuss Legal restrictions in the United States

## **7.0 REFERENCES/FURTHER READING**

Carl Nolte (2008). "Grand buildings celebrate centennials". *San Francisco Chronicle*.

Federal Reserve Bank of Chicago, *Assessing a Decade of Interstate Bank Branching*, April (2007).

## **UNIT 3: UNIT BANKING**

### **CONTENTS**

1.0 Introduction

2.0 Objectives

3.0 Main Content

3.1 Definition of Unit Banking

3.1.1 Advantages of Unit Banking

3.1.2 Disadvantages of Unit Banking

3.2 Operational Classification of Banks

3.3 Functional Classification of Banks

4.0 Conclusion

5.0 Summary

6.0 Tutor Marked Assignment

7.0 References/Further Reading

### **1.0 INTRODUCTION**

Unit Banking means a system of banking under which banking services are provided by a single banking organisation. Such a bank has single office of place of work. It has its own governing body or board of directors. It functions

independently and is not controlled by any other individual, firm or body corporate. It also does not control any other bank. Such banks can become member of the clearing house and also of the Banker's Association. Unit banking system originated and grew in the USA. Different unit banks in the USA are linked with each other and with other financial centres in the country through 'correspondent banks.'

## **2.0 OBJECTIVES**

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

- i. Define Unit Banking
- ii. Advantages and Disadvantages of Unit Banking
- iii. Discuss operational classification of banks

## **3.0 MAIN CONTENT**

### **3.1 DEFINITION OF UNIT BANKING**

Unit banking is a way of offering bank services and assistance from bank branches distributed in different regions. Unit banking is operated without branches or corporate relationship.

Unit banking has one office. Generally, limited banking services are offered to customers by unit banking organization. Although unit banking organization has one banking office, it can spread cash counters in market place such as walk-in windows, automated teller machines, retail store point-of-sale terminals that are linked to the bank's computer system. Unit banking is the oldest kind of banking organization most common in the world banking today. One reason for the

comparatively large number of unit banks is the rapid formation of new banks. It can be established easily even in an age of electronic banking and mega mergers among industry leaders. Many customers still seem to prefer small banks, which get to know their customers well and often provide personalized services. Most new banks start out as unit organization, because their capital, management and staffs are severely limited until the bank can grow and attract additional resources and professional staff. Later, they try to convert them into branch banking organization. However, economic and legal barriers to banks expanding geographically into new territory still exist in some places. Yet, most banks desire to create multiple service facilities-branch offices, electronic networks, and other service outlets. In competitive banking market, it is essential to open new markets and diversify geographically in order to lower risk and cost of banking services. If the surrounding economy weakens and people move away to other market areas, it becomes very risky in relying on a single office location, from which to receive customers and income.

### **3.1.1 Advantages of Unit Banking**

Unit banking system has the following advantages:

#### **1. Local Development**

Unit banking is localized banking. The unit bank has the specialised knowledge of the local problems and serves the requirements of the local people in a better manner than branch banking. The funds of the locality are utilised for the local development and are not transferred to other areas

## **2. Promotes Regional Balance**

Under unit banking system, there is no transfer of resources from rural and backward areas to the big industrial commercial centres. This tends to reduce regional imbalance.

## **3. Easy Management**

The management and supervision of a unit bank is much easier and more effective than that under branch banking system. There are less chances of fraud and irregularities in the financial management of the unit banks.

## **4. Initiative in Banking Business**

Unit banks have full knowledge of and greater involvement in the local problems. They are in a position to take initiative to tackle these problems through financial help.

## **5. No Monopolistic Tendencies**

Unit banks are generally of small size. Thus, there is no possibility of generating monopolistic tendencies under unit banking system.

## **6. No Inefficient Branches**

Under unit banking system, weak and inefficient branches are automatically eliminated. No protection is provided to such banks.



## **7. No diseconomies of Large Scale Operations**

Unit banking is free from the diseconomies and problems of large-scale operations which are generally experienced by the branch banks.

### **3.1.2 Disadvantages of Branch Banking**

The following are the disadvantages of unit banking system:

#### **1. No. Distribution of Risks**

Under unit banking, the bank operations are highly localised. Therefore, there is little possibility of distribution and diversification of risks in various areas and industries.

#### **2. Inability to Face Crisis**

Limited resources of the unit banks also restrict their ability to face financial crisis. These banks are not in a position to stand a sudden rush of withdrawals.

#### **3. No Banking Development in Backward Areas**

Unit banks, because of their limited resources, cannot afford to open uneconomic banking business in smaller towns and rural areas. As such, these areas remain unbanked.

#### **4. Lack of Specialization**

Unit banks, because of their small size, are not able to introduce, and get advantages of, division of labor and specialization. Such banks cannot afford to employ highly trained and specialized staff.

## **5. Costly Remittance of Funds**

A unit bank has no branches at other place. As a result, it has to depend upon the correspondent banks for transfer of funds which is very expensive.

## **6. Disparity in Interest Rates**

Since easy and cheap movement of does not exist under the unit banking system, interest rates vary considerably at different places.

## **7. Local Pressures**

Since unit banks are highly localised in their business, local pressures and interferences generally disrupt their normal functioning.

## **8. Undesirable Competition**

Unit banks are independently run by different managements. This results in undesirable competition among different unit banks.

## **3.2. OPERATIONAL CLASSIFICATION OF BANKS**

On the basis of nature of operation, banks can be classified into the following two categories.

### **(a) Correspondent Banks**

The unit banks, having no branch are linked together by correspondent bank system. Under this system, a unit bank of a village or small town deposits a portion of its cash reserve with another bank in the nearest city. And this superior bank of city also deposits with another greater bank of big city. These unit banks are linked

through correspondence. Remittances of funds of home and foreign trade transactions are made through these correspondent banks. The unit banks are completely independent of each other no doubt, but these are connected with one another through correspondent system.

### **(b) Specialized Banks**

The bank which performs one or more special functions is known as specialized bank. As for example an agricultural bank takes up the special responsibility of financing agricultural activities. Industrial banks specially finance the industrial undertakings. Japan is the home of specialized banks where different types of specialized banks are working with their special functions.

The specialized banks have a great role in the economic development of a country, specially of a developing country like Pakistan.

In our country, Agricultural Development Bank of Pakistan is helping financially in the development of agricultural sector of our economy. The Industrial Development Bank of Pakistan is another specialized bank who is financing large scale industries in Pakistan.

### **3.3. FUNCTIONAL CLASSIFICATION OF BANKS**

Banks may be classified according to their functions. Different kinds of banks, with different functions may be summarized as follows:

### **(a) Central Bank**

A central bank is the most important institution in the banking system of a country established with the objective of regulating the banking and monetary system of the country. It issues notes and currencies within the country and is entrusted with responsibility of maintaining the price level in the country stable. It acts as banker to the Government and it directly or indirectly controls the activities of all other banks. State Bank of Pakistan is Central Bank of our country.

### **(b) Commercial Bank**

Such type of bank is cheerfully engaged in financing internal trade. It deals in short term credit. It takes deposit from public through different type of deposit accounts and invests that collected fund in advances and loan of short period to the trading and commercial undertaking. This type of bank is familiar in most of the world. In our country, for example, National Bank of Pakistan, Habib Bank Limited, United Bank Limited, Muslim Commercial Bank Limited and Allied Bank Limited are the commercial banks.

### **(c) Industrial Bank**

Such institution specialises in financing industry. It provides long term credit to people who carry on industrial enterprises. Industrial Development Bank of Pakistan (IDBP) and Pakistan Industrial Credit and Investment Corporation (PICIC) are the examples of industrial banks.

#### **(d) Agricultural Bank**

Such bank provides long and short term finance to agriculturists for their agricultural purposes. Long term capital is required for acquisition and improvement of land and purchase of heavy machinery and equipments. Short period capital is required by the farmers for current expenditure on seed, manures, wages etc. Agricultural Development Bank of Pakistan (ADBP) is the best example of agricultural bank in our country who provides long term, medium term and short term loans to the agriculturists.

#### **(e) Exchange Bank**

Exchange bank deals mainly in the finance of the foreign trade of the country. It deals in foreign exchange. On otherwords, the main function of such bank is to buy and sell foreign currencies, rather titles to foreign currencies in the form of bills of exchange, drafts, telegraphic transfers etc. It purchases the bills of exchange which arise in connection with the import and export trade of the country and they deal in exchange. The exchange banks liquidate the international indebtiness by exporting and importing precious metals and securities, if necessary; they purchase bills in the international money market and deposit them with their banking agents in big commercial centres like London, Paris, New York etc. They draw and sell their own drafts on these deposit accounts.

#### **(f) Cooperative Bank**

This type of bank is organised mutually by the persons of similar occupations within the objectives of providing banking and credit facilities to the members.

Government patronises co-operative banks in order to encourage the cultivators, fisherman, workers in the factories etc.

#### **(g) Mortgage Bank**

Mortgage bank advances long term credits against securities of immovable properties like, agricultural lands, buildings and machinaries etc. Generally, credit is give to the agriculturist, small industries or house builders. This type of bank is essential in an under developed country where capital supply is very limited. In our country, House Building Finance Corporation is functioning as mortgage bank providing long term loans to house builders against securities of building and land property.

#### **(h) Savings Bank**

Such banks provide facilities to people to save money. This type of bank is established with the objective of promoting the thrift or saving habits among the people of small incomes. It takes deposits from the public and lands the collected funds to traders. Depositors are allowed to withdraw money from their deposits twice in a week. Post offices in Pakistan carry on functions of saving bank. Of course commercial and other bank also accept saving deposits.

### **4.0 CONCLUSION**

Banking systems have been with us for as long as people have been using money. Banks and other financial institutions provide security for individuals, businesses and governments, alike. Let's recap what has been learned with this tutorial: In general, what banks do is pretty easy to figure out. For the average person banks

accept deposits, make loans, provide a safe place for money and valuables, and act as payment agents between merchants and banks.

Banks are quite important to the economy and are involved in such economic activities as issuing money, settling payments, credit intermediation, maturity transformation and money creation in the form of fractional reserve banking.

## **5.0 SUMMARY**

In this unit, we have learned about;

- i. The definition of Unit Banking
- ii. Advantages and Disadvantages of Unit Banking
- iii. Functional Classification of Banks

## **6.0 TUTOR MARKED ASSIGNMENT**

- 1. Definition, Advantages & Disadvantages of Unit Banking
- 2. Discuss Operational Classification of Unit Banking

## **7.0 REFERENCES/FURTHER READING**

Carl Nolte (2008). "Grand buildings celebrate centennials". *San Francisco Chronicle*.

Federal Reserve Bank of Chicago, *Assessing a Decade of Interstate Bank Branching*, April (2007).

## **UNIT 4: ISLAMIC BANKING**

### **1.0 Introduction**

### **2.0 Objectives**

### **3.0 Main Content**

#### **3.1 The Origin, History and Evolution of Islamic Banking**

#### **3.2 Major Models of Islamic Banking System**

#### **3.3 The concept of Islamic Banking**

#### **3.4 Islamic vs. Conventional Banking**

### **4.0 Conclusion**

### **5.0 Summary**

### **6.0 Tutor-Marked Assignment**

### **7.0 References/Further Reading**

## **1.0 INTRODUCTION**

The term Islamic banking refers to a banking activity or a system of banking that is in consonance with the basic principles of Islamic Shraiah (rules and values set by Islam). Islamic banking is also known as interest free banking system as the Shariah disallows the acceptance of “Riba” or interest rate for the accepting and lending of money. In Islamic banking system, a business that offers good interest rates or services is strictly prohibited and it is in fact considered Haraam (forbidden). Islamic banking offers the same facilities as conventional banking system except that it strictly follows the rules of Shariah or Fiqh al- Muamlat.

## **3.0 OBJECTIVES**

After completing this unit, you would be able to:

- i. Discuss concept of Islamic Banking



- ii. Know the history and evolution of Islamic Banking
- iii. Differentiate between Islamic vs. Conventional Banking

### **3.0 MAIN CONTENT**

#### **3.1 THE ORIGIN, HISTORY AND EVOLUTION OF ISLAMIC BANKING**

The origin of Islamic banking system can be traced back to the advent of Islam when the Prophet himself carried out trading operations for his wife. The “Mudarbah” or Islamic partnerships has been widely appreciated by the Muslim business community for centuries but the concept of “Riba” or interest has gained very little diligence in regular or day-to-day transactions.

The first model of Islamic banking system came into picture in 1963 in Egypt. Ahmad Al Najjar was the chief founder of this bank and the key features are profit sharing on the non interest based philosophy of the Islamic Shariah. These banks were actually more than financial institutions rather than commercial banks as they pay or charge interest on transactions. In 1974, the Organization of Islamic Countries (OIC) had established the first Islamic bank called the Islamic Development Bank or IDB. The basic business model of this bank was to provide financial assistance and support on profit sharing.

By the end of 1970, several Islamic banking systems have been established throughout the Muslim world, including the first private commercial bank in Dubai(1975), the Bahrain Islamic bank(1979) and the Faisal Islamic bank of Sudan (1977).

#### **3.2 MAJOR MODELS OF ISLAMIC BANKING SYSTEM**

The main and important models of Islamic banking system are as follows:

##### **MURABAHA**

Murabaha is the sale on the profit which is mutually agreed by both parties. Islamic banking system has adopted this term as a primary mode or technique of financing. Murabaha is actually a request which is set by the client to the Islamic bank to leverage certain services or goods for him and in return, the bank provides a definite profit to the client over the cost of the services or goods.

## **IJARAH**

It is the contract or the legal right against a lawful or a specified return for the effort or work which is proposed to be expended and for the benefits that are proposed to be taken.

## **MUSAWAMAH**

It is the regular or general sales of goods in which the price of the goods or commodity is bargained between the buyer and the seller.

Islamic banking has the same purpose as conventional banking except that it operates in accordance with the rules of Sharia, known as Fiqh al-Muamalat (Islamic rules on transactions). The basic principle of Islamic banking is the sharing of profit and loss and the prohibition of riba' (interest). Amongst the common Islamic concepts used in Islamic banking are profit sharing (Mudharabah), safekeeping (Wadiah), joint venture (Musharakah), cost plus (Murabahah), and leasing (Ijarah).

In an Islamic mortgage transaction, instead of loaning the buyer money to purchase the item, a bank might buy the item itself from the seller, and re-sell it to the buyer at a profit, while allowing the buyer to pay the bank in installments. However, the fact that it is profit cannot be made explicit and therefore there are no additional penalties for late payment. In order to protect itself against default, the bank asks

for strict collateral. The goods or land is registered to the name of the buyer from the start of the transaction. This arrangement is called Murabaha.

Another approach is Ijara wa Iqtina, which is similar to real-estate leasing. Islamic banks handle loans for vehicles in a similar way (selling the vehicle at a higher-than-market price to the debtor and then retaining ownership of the vehicle until the loan is paid). There are several other approaches used in business deals. Islamic banks lend their money to companies by issuing floating rate interest loans. The floating rate of interest is pegged to the company's individual rate of return. Thus the bank's profit on the loan is equal to a certain percentage of the company's profits. Once the principal amount of the loan is repaid, the profit-sharing arrangement is concluded. This practice is called Musharaka. Further, Mudaraba is venture capital funding of an entrepreneur who provides labor while financing is provided by the bank so that both profit and risk are shared. Such participatory arrangements between capital and labor reflect the Islamic view that the borrower must not bear all the risk/cost of a failure, resulting in a balanced distribution of income and not allowing lender to monopolize the economy. And finally, Islamic banking is restricted to islamically acceptable deals, which exclude those involving alcohol, pork, gambling, etc. Thus ethical investing is the only acceptable form of investment, and moral purchasing is encouraged. JAIZ International is trying to see that it has established an Islamic bank in this country; however with the review of Capital adequacy in Nigerian banks, the Islamic bank is delayed. Although the N25B Capital base is one condition for the establishment of an Islamic bank in Nigeria, but we see that there is more to meeting this CBN condition. The most important required conditions are: Managerial commitment, sharia supervisory board, safeguarding Muslim investor's fund and compliance with standards. Managerial commitment: The management must be fully convinced of the concept

and fully committed and dedicated to it. Unless the entire management is committed and convinced, the business activities and the enterprise will not be free or will not escape irregularities and deviation. Regardless of how strict and stringent fatwa and contracts are, this will not ensure sound practices if there is no one sufficiently sincere and committed to implement the principles.

**Sharia Supervisory Board:** There should be a sharia supervisory board for any Islamic bank, and that board should consist of trustworthy scholars who are highly qualified to issue fatawa on financial transactions.

Giving our present situation within the muslims today how do we constitute the members of the board? Another issue is trust from the customers who may use the banks fund, when it comes to profit sharing. Last but not the least is enlightenment, many people even within the Muslim are not aware of how Islamic banks operate. Therefore there is urgent need for a serious enlightenment to the public on operational modalities and requirement of an Islamic bank. Other options that may be considered by Jaiz or even states like Sokoto, Kano Borno, Katsina etc is to establish an islamic micro finance at local government level. The recently approved micro finance banks can be converted to an Islamic one. In a symposium held at Harvard University on financing the poor: Towards Islamic Microfinance some time last year, Nazim Ali has pointed out that Microfinance is not reaching the poorest of the poor, even though this is its purpose, and loans are going to activities unrelated to entrepreneurship. Islamic finance could, in principle and in practice, correct these defects. Robert Annibale, global director of microfinance for Citigroup, shared his insights into both Islamic finance and microfinance. He described microfinance institutions as self-styled “bankers of the poor, originally rooted in domestic, local markets but increasingly expanding into larger markets and

offering a broader range of services. He noted that the high operating costs, passed on to the customer in the form of high interest rates, are a hurdle for the poor. He felt that this was where there is potential for Islamic finance to make a difference. Under conventional microfinance, risk is borne by borrowers and rarely held by the institutions. Islamic finance focuses on interest-free methods of providing capital, because the shariah holds lending to be a purely charitable exercise, rather than a means of making a profit, Islamic finance is also accustomed to methods of risk-reward sharing between the institution and the borrower. Islamic microfinance banks have grown significantly in countries like Pakistan, Indonesia, Malaysia, and Bangladesh. In fact, Islamic microfinance institutions enjoy greater penetration than traditional commercial banks in Bangladesh. It is high time for us here in Nigeria (particularly in the north because the south have started) to start introducing Islamic microfinance banks which will graduate to a full bank in future.

### **3.3 THE CONCEPT OF ISLAMIC BANKING**

One of the many dilemmas faced by me, a young Islamic banking practitioner, is having to defend the concept of Islamic banking. Critics often argue (rather passionately) that there is no difference between Islamic and conventional banking. To them, the former is simply the latter in an Islamic facade. This is the most contentious issue with regards to Islamic banking and finance and whether the whole concept is in line altogether with Islam.

Critics often site the example that Islamic banking practices the use of interest rates (or profit rates in my sphere) in the calculations of the banks' selling price. The only difference I have identified is that the rates (be it fixed or variable) is still couched in terms that are halal (or permissible by Shariah-Islamic Law). These are

essentially lending contracts' with interest rates nonetheless and still an integral part of them. And conclude that this -in substance at least- is unIslamic.

On the other end, defenders of Islamic banking say that a halal transaction is mutually exclusive to haram, for if the deal is halal, therefore it is not haram. One seasoned Islamic banking practitioner has even told me that while all Riba' (usury) is interest, not all interest is riba'. It is in this light that the defenders argue that Islamic banking contracts are halal even if the determination of the contract price involves interest rates calculations. What is important here is the 'aqad' or contractual terms of the transaction.

Critics argue that many Islamic banks (particularly in Malaysia) operate as a subsidiary of a larger, riba'-based conventional bank. And that the Shariah Advisory Committee who is usually comprised of scholars or experts in Fiqh (Islamic jurisprudence) are deemed as collaborators of these riba'-based banks disqualify themselves for being true propagators of Islam and Islam's brand of financial solutions.

Defenders of Islamic banking on the other hand spend much attention and energy trying to attack the many deficiencies of riba-based conventional banking. To put it simply, while the two factions disagree on a array of ideas, they do agree that riba-based is 'unfair' and a viable financial solution must be presented to the consumers and widen their options. Why then are they focusing their efforts on attacking each other instead of trying to find a solution to solve or reduce the 'selling price' of Islamic banking products.

### **3.4 ISLAMIC VS. CONVENTIONAL BANKING**

Since Islamic banking had grown owing to the global financial crunch, it would be important to establish the difference of both Islamic banking and conventional banking.

Very few people who know the real difference between Islamic and conventional banking, as apparently both seem the same as in conventional banking interest is charged on its transactions and on the other hand Islamic banking is based on interest free banking but they also charge some fees for their transactions. Many employees even in the Islamic banks do not know the basic concept or rationale behind Islamic modes of financing.

Islamic banking is asset based banking which means that its transactions must be backed by some assets. Interest or Riba is prohibited in Islam therefore it is also prohibited in Islamic banking operations.

We cannot earn money out of money in Islamic banking. On the other hand conventional banking is totally based on interest they charge interest on their transactions and take out profit from that.

In conventional banking only the profit is shared whereas in Islamic banking, profit and loss both are shared.

Islamic banking must stay within the limits of Islamic law and Shariah in all actions and transactions. Islamic banking is done by laws and regulations which are defined in the Quran and Sunnah in which the product or services are not introduced by the Islamic banks which contradicts the Islamic values. These banks also introduced tax and Zakat system according to the Islamic values. Profit sharing is fixed in Islamic banking based on real profit. Islamic banks based on the

buyer-seller relationship, whereas conventional banking based on the debtor-creditor relationship.

The regulations, laws, rules and transactions of conventional banking system are fully manmade. Investors are encouraged by maximum interest rate. The aim of conventional banking system is to earn profit. In case of any default by the investors it charges extra amount of money, whereas in Islamic banking is case of defaults the extra amount charged to customer will go for charity not in the bank's income. Conventional banks always encourage providing loans with fixed interest rate to its customer which is against our Islamic values.

The accounting and auditing of both banking system is to some extent similar but the documentation in Islamic banking is different as compared to conventional banking.

If a person wants to start his business he will take a loan on interest basis from a conventional bank and pay the principle amount plus the interest on that, on the other hand if the same person goes to an Islamic bank the Islamic bank asks him about the type of business he wants to start and provides all resources or material to him to start his business instead of giving him only cash and charge some fees on that.

Now many conventional banks also open Islamic banking window or moves towards Islamic banking due to change in the trend of banking. So Islamic banking is relatively better from conventional banking because it follows all the Islamic values and conditions which are given in the Quran and Sunnah.



## **4.0 CONCLUSION**

The countries of the world practice different banking systems and the soundness of the banking sector of the countries varies from country to country. This highlights systems of banking system in Nigeria, Branch banking etc to electronic banking. It also discusses essentials of a sound banking system.

## **4.0 SUMMARY**

In this unit, you have learned about,

- i. Islamic banking
- ii. Islamic vs. Conventional Banking
- iii. Major Models of Islamic Banking System
- iv. Evolution of Islamic Banking

## **6.0 TUTOR-MARKED ASSIGNMENT**

- Discuss Major Models of Islamic Banking System
- Discuss concept of Islamic Banking

## **7.0 REFERENCES/FURTHER READING**

Imala, O.I. (2000). 'Arguments for and against universal Banking': Abuja, CBN Bullion, Vol.24, No.4, Oct/Dec.

International Monetary Fund (1991). Banking Crises: Cases and Issues. Washington D.C. IMF Publication Services.

Jhinghan, M.L.(2004). Money, Banking, International Trade and Public Finance. Delhi; Vrinda Publishers (P) Ltd.

## **UNIT 5: INTER-COUNTRY COMPARISON OF REGULATIONS AND CONDUCT OF BANKS**

### **CONTENTS**

1.0 Introduction

2.0 Objectives

3.0 Main Content

3.1 .1 Definition of Banks, Banking and Socialism

3.1.2 Characteristics / Features of a Bank

3.1.3 Seven (7) Steps to Open Bank Account

3.1.4 The Advantages of Opening Bank Account

3.1.5 Types of Bank Account

3.1.6 What is a Cheque? Definition:- Kinds and types of Cheques

3.1.6.1 What are the Features of and Characteristics of Cheque

3.1.7 Inter-country comparison of regulations and conduct of Banks

3.1.8 Inter-temporal comparison of banking in Nigeria

3.1.9 The Banks and Socialism

4.0 Conclusion

5.0 Summary

6.0 Tutor-Marked Assignment

## 7.0 References/Further Readings

### 1.0 INTRODUCTION

Finance is the life blood of trade, commerce and industry. Now-a-days, banking sector acts as the backbone of modern business. Development of any country mainly depends upon the banking system.

The term bank is either derived from old Italian word *banca* or from a French word *banque* both mean a Bench or money exchange table. In olden days, European money lenders or money changers used to display (show) coins of different countries in big heaps (quantity) on benches or tables for the purpose of lending or exchanging

### 2.0 OBJECTIVES

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

- i. Definition of Banks, Banking and Socialism
- ii. Characteristics / Features of a Bank
- iii. Discuss Current Account in Bank:- Meaning, Features and Advantages
- iv. What are the advantages of Opening Bank Account

### **3.0 MAIN CONTENT**

#### **3.1 .1 Definition of Banks, Banking and Socialism**

##### **Banks**

An institution that provides a great variety of financial services. At their most basic, banks hold money on behalf of customers, which is payable to the customer on demand, either by appearing at the bank for a withdrawal or by writing a check to a third party. Banks use the money they hold to finance loans, which they make to businesses and individuals to pay for operations, mortgages, education expenses, and any number of other things. Many banks also perform other services for a fee; for instance they offer certified checks to customers guaranteeing payment to third parties. In some countries they may provide investment and insurance services. With the exception of Islamic banks, they pay interest on deposits and receive interest on their loans. Banks are regulated by the laws and central banks of their home countries; normally they must receive a charter to engage in business. Banks are usually organized as corporations.

Bank is a deposit-taking institution which is licensed by the monetary authorities of a country (the Bank of England in the UK) to act as a repository for money deposited by persons, companies and institutions, and which undertakes to repay such deposits either immediately on demand or subject to due notice being given. Banks perform various services for their customers (money transmission, investment advice, etc.) and lend out money deposited with them in the form of loans and overdrafts or use their funds to purchase financial securities, in order to operate at a profit. There are many types of banks, including Commercial Banks, Merchant Banks, Savings Banks and Investment Banks.

## **Banking**

Banking is an industry that handles cash, credit and other financial transactions. Banking provides a safe place to store extra cash and credit. It offers savings accounts, certificates of deposit and checking accounts. It uses these deposit to make loans. These loans include home mortgages, business loans and car loans. Banking is one of the key drivers of the U.S. economy. It provides the liquidity needed for families and businesses to invest for the future.

## **Socialism**

Is a range of economic and social systems characterized by social ownership and democratic control of the means of production; as well as the political ideologies, theories, and movements that aim to establish them. Social ownership may refer to forms of public, collective, or cooperative ownership; to citizen ownership of equity; or to any combination of these. Although there are many varieties of socialism and there is no single definition encapsulating all of them, social ownership is the common element shared by its various forms.

Socialist economic systems can be divided into both non-market and market forms. Non-market socialism involves the substitution of factor markets and money with engineering and technical criteria based on calculation performed in-kind, thereby producing an economic mechanism that functions according to different economic laws from those of capitalism. Non-market socialism aims to circumvent the inefficiencies and crises traditionally associated with capital accumulation and the profit system. By contrast, market socialism retains the use of monetary prices, factor markets, and, in some cases, the profit motive with respect to the operation of socially owned enterprises and the allocation of capital goods between them.

Profits generated by these firms would be controlled directly by the workforce of each firm or accrue to society at large in the form of a social dividend. The feasibility and exact methods of resource allocation and calculation for a socialist system are the subjects of the socialist calculation debate.

### **3.1.2 Characteristics/Features of a Bank**

#### **1. Dealing in Money**

Bank is a financial institution which deals with other people's money i.e. money given by depositors.

#### **2. Individual / Firm / Company**

A bank may be a person, firm or a company. A banking company means a company which is in the business of banking.

#### **3. Acceptance of Deposit**

A bank accepts money from the people in the form of deposits which are usually repayable on demand or after the expiry of a fixed period. It gives safety to the deposits of its customers. It also acts as a custodian of funds of its customers.

#### **4. Giving Advances**

A bank lends out money in the form of loans to those who require it for different purposes.

## **5. Payment and Withdrawal**

A bank provides easy payment and withdrawal facility to its customers in the form of cheques and drafts, It also brings bank money in circulation. This money is in the form of cheques, drafts, etc.

## **6. Agency and Utility Services**

A bank provides various banking facilities to its customers. They include general utility services and agency services.

## **7. Profit and Service Orientation**

A bank is a profit seeking institution having service oriented approach.

## **8. Ever increasing Functions**

Banking is an evolutionary concept. There is continuous expansion and diversification as regards the functions, services and activities of a bank.

## **9. Connecting Link**

A bank acts as a connecting link between borrowers and lenders of money. Banks collect money from those who have surplus money and give the same to those who are in need of money.

## **10. Banking Business**

A bank's main activity should be to do business of banking which should not be subsidiary to any other business.

## **11. Name Identity**

A bank should always add the word "bank" to its name to enable people to know that it is a bank and that it is dealing in money.

### **3.1.3 Seven (7) Steps to Open Bank Account**

**i. Decide the type of Bank Account you want to open:** There are several types of bank accounts such as Saving Account, Recurring Account, Fixed Deposit Account and Current Account. So, a decision regarding the type of account to be opened must be taken.

**ii. Approach any Bank of choice & meet its Bank Officer:** Once the type of account is decided, the person should approach a convenient bank. He has to meet the bank officer regarding the opening of the account. The bank officer will provide a proposal form (Account Opening Form) to open bank account.

**iii. Fill up Bank Account Opening Form - Proposal Form:** The proposal form must be duly filled in all respects. Necessary details regarding name, address, occupation and other details must be filled in wherever required. Two or three specimen signatures are required on the specimen signature card. If the account is opened in joint names, then the form must be signed jointly. Nowadays the banks ask the applicant to submit copies of his latest photograph for the purpose of his identification.

**iv. Give References for Opening your Bank Account:** The bank normally required references or introduction of the prospective account holder by any of the existing account holders for that type of account. The introducer introduces by



signing his specimen signature in the column meant for the purpose. The reference or introduction is required to safeguard the interest of the bank.

**v. Submit Bank Account Opening Form and Documents:** The duly filled in proposal form must be submitted to the bank along with necessary documents. For e.g. in case of a joint stock company, the application form must accompany with the Board's resolution to open the account. Also certified copies of articles and memorandum of association must be produced.

**vi. Officer will verify your Bank Account Opening Form:** The bank officer verifies the proposal form. He checks whether the form is complete in all respects or not. The accompanying documents are verified. If the officer is satisfied, then he clears the proposal form.

**vii. Deposit initial amount in newly opened Bank Account:** After getting the proposal form cleared, the necessary amount is deposited in the bank. After depositing the initial money, the bank provides a pass book, a cheque book and pay in slip book in the case of savings account. In the case of fixed deposits, a fixed deposit receipt is issued. In the case of current account, a cheque book and a pay in slip book is issued. For recurring account, the pass book and a pay in slip book is issued.

### **3.1.4 The Advantages of Opening Bank Account**

**1. Bank account facilitates a safe custody of money:** The bank is the custodian of cash. As and when the account holders needs the money can withdraw the same depending upon the type of account.

**2. Bank account helps in making payments:** The bank account holder can make payment to third parties through the savings and current account. The payment may be regarding electricity bills, insurance premium, etc. The bank also makes direct payment on the standing instructions of the customer.

**3. Bank account helps in collection of money:** The bank can directly collect money of the customer in respect of dividend, salary pension or from debtors. The collected money is then deposited in customer's bank account.

**4. Bank account holders get advances and loans:** The current account holder can obtain an overdraft facility from his bank. The recurring and fixed deposit account holders can get a loan upto 75% of the amount to their credit. The savings account holders can also obtain loans to purchase computers and such other equipments.

**5. Bank account helps in smooth transactions:** The bank account makes it possible for the businessmen to conduct their business operations smoothly not only in the domestic trade but also in the foreign markets.

**6. Bank account holders get a safe deposit locker:** The bank provides safe deposit locker facility to its account holders to keep their valuables like gold jewellery, share certificates, property documents, etc.

### **3.1.5 Types of Bank Account**

The four different types of bank accounts are:

#### **i. Saving Account in Bank:- Meaning, Features, Advantages**

The 'saving account' is generally opened in bank by salaried persons or by the persons who have a fixed regular income. This facility is also given to students,

senior citizens, pensioners, and so on. Saving accounts are opened to encourage the people to save money and collect their savings. In Nigeria, saving account can be opened by depositing ₦5,000. The saving account holder is allowed to withdraw money from the account as and when required. The interest which is given on saving accounts is sometime attractive, but often nominal. At present the rate of interest ranges between 4% and 6% per annum in Nigeria. The interest rates vary as per the amount of money deposited (lying) in the saving bank account, scheme opted, and its maturity range. It is also subject to current trend of banking policies in a country.

#### **a. Features of Saving Account**

The main features of saving account in bank are as follows:

- i. The main objective of saving account is to promote savings.
- ii. There is no restriction on the number and amount of deposits
- iii. Withdrawals are allowed subject to certain restrictions.
- iv. The money can be withdrawn either by cheque or withdrawal slip of the respective bank.
- v. The rate of interest payable is very nominal on saving accounts.
- vi. Saving account is of continuing nature. There is no maximum period of holding.
- vii. A minimum amount has to be kept on saving account to keep it functioning.
- viii. No loan facility is provided against saving account.
- ix. Electronic clearing System (ECS) or E-Banking are available to pay electricity bill, telephone bill and other routine household expenses.

- x. Generally, equated monthly installments (EMI) for housing loan, personal loan, car loan, etc., are paid (routed) through saving bank account.

#### **b. Advantages of Saving Account**

The advantages of saving account are as follows:

- i. Saving account encourages savings habit among salary earners and others who have fixed income.
- ii. It enables the depositor to earn income by way of saving bank interest.
- iii. Saving account helps the depositor to make payment by way of issuing cheques.
- iv. It shows income of a salaried and other person earned during the year.
- v. Saving account passbook acts as an identity and residential proof of the account holder.
- vi. It provides a facility such as Electronic fund transfer (EFT) to other people's accounts.
- vii. It helps to do online shopping via facility like internet banking.
- viii. It aids to keep records of all online transactions carried on by the account holder.
- ix. It provides immediate funds as and when required through ATM. The bank offers number of services to the saving account holders.

#### **ii. Current Account in Bank:- Meaning, Features and Advantages**

Current bank account is opened by businessmen who have a number of regular transactions with the bank, both deposits and withdrawals. It is also known as Demand Deposit.

Current account can be opened in co-operative bank and commercial bank. In current account, amount can be deposited and withdrawn at any time without

giving any notice. It is also suitable for making payments to creditors by using cheques. Cheques received from customers can be deposited in this account for collection.

#### **a. Features of Current Account**

The main features of current account are as follows:-

- i. The main objective of current bank account is to enable the businessmen to conduct their business transactions smoothly.
- ii. There is no restriction on the number and amount of deposits. There is also no restriction on the withdrawals.
- iii. Generally bank does not pay any interest on current account. Nowadays, some banks do pay interest on current accounts.
- iv. Current account is of continuing nature and as such there is no fixed period.

#### **b. Advantages of Current Bank Account**

The advantages of current account are as follows:-

- i. Current account enables businessmen to conduct his business transactions smoothly.
- ii. The businessmen can withdraw any amount at any time from their current accounts. There are also no restrictions on withdrawals.
- iii. The businessmen can make direct payment to their creditors with the help of cheques.
- iv. The bank collects money on behalf of its customers and credits the same to their accounts.
- v. Current account enables the account holder to obtain overdraft facility.

- vi. The creditors of the account holder can get credit-worthiness information of the account holder through interbank connection.
- vii. Current account facilitates the industrial progress of the country. Without the help of this account, businessmen would have difficulties in running their business.

### **iii. Fixed Deposit Account of Bank:- Meaning, Features, Advantages**

The account which is opened for a particular fixed period (time) by depositing particular amount (money) is known as Fixed (Term) Deposit Account.

The term 'fixed deposit' means that the deposit is fixed and is repayable only after a specific period is over.

Under fixed deposit account, money is deposited for a fixed period say six months, one year, five years or even ten years. The money deposited in this account cannot be withdrawn before the expiry of period. The rate of interest paid for fixed deposit vary (changes) according to amount, period and from bank to bank.

#### **a. Features of Fixed Deposit Account**

The main features of fixed deposit account are as follows:-

- i. The main purpose of fixed deposit account is to enable the individuals to earn a higher rate of interest on their surplus funds (extra money).
- ii. The amount can be deposited only once. For further such deposits, separate accounts need to be opened.
- iii. The period of fixed deposits range between 15 days to 10 years.
- iv. A high interest rate is paid on fixed deposits. The rate of interest may vary as per amount, period and from bank to bank.
- v. Withdrawals are not allowed. However, in case of emergency, banks allow to close the fixed account prior to maturity date. In such cases,

the bank deducts 1% (deduction percentage may vary) from the interest payable as on that date.

- vi. The depositor is given a fixed deposit receipt, which depositor has to produce at the time of maturity. The deposit can be renewed for a further period.

#### **b. Advantages of Fixed Deposit Account**

The advantages of fixed deposit account are as follows:-

- i. Fixed deposit encourages savings habit for a longer period of time.
- ii. Fixed deposit account enables the depositor to earn a high interest rate.
- iii. The depositor can get loan facility from the bank.
- iv. On maturity the amount can be used to make purchases of assets.
- v. The bank can get the funds for a longer period of time.
- vi. The bank can lend such funds for short term loans to businessmen.
- vii. Fixed deposits indirectly boost economic development of the country.
- viii. The bank can also invest such funds in profitable areas.

#### **iv. Recurring Deposit Account of Bank:- Meaning, Features, Advantages**

Under a Recurring Deposit account (RD account), a specific amount is invested in bank on monthly basis for a fixed rate of return. The deposit has a fixed tenure, at the end of which the principal sum as well as the interest earned during that period is returned to the investor. Recurring Bank Account provides the element of compulsion to save at high rates of interest applicable to Term Deposits along with liquidity to access those savings anytime. Since a recurring deposit offers a fixed rate of return, it does not provide protection against inflation.

##### **a. Features of Recurring Deposit account:**

The main features of Recurring deposit account are as follows:-

- i. This type of account is the latest innovation with most of the banks. Banks have introduced this scheme with the object of affording convenience and incentive to small depositors for savings.
- ii. The rate of interest given on recurring account stands favourably as compared with the savings bank account because the former partly resembles the fixed deposit account.
- iii. As in savings bank account, the customer is furnished a passbook. The passbook ordinarily is to accompany each installment as and when it falls due. The account holder can give a standing order to deduct installments from his savings bank account in the bank.
- iv. At the expiry of the period, the depositor gets a lump sum representing the installments and handsome interest on his savings.
- v. In case depositor needs money before the due date he may borrow up to 90% of the amount in the account at the prevailing rate of interest.
- vi. Recurring deposit accounts are transferable from one branch to another without charge.
- vii. The recurring deposit account can be opened by any person, more than one person jointly or severally, by a guardian in the name of a minor and even by a minor.

### **3.1.6 What is a Cheque? Definition:- Kinds and types of Cheques**

Cheque is an important negotiable instrument which can be transferred by mere hand delivery. Cheque is used to make safe and convenient payment. It is less risky and the danger of loss is minimized.

"Cheque is an instrument in writing containing an unconditional order, addressed to a banker, sign by the person who has deposited money with the banker,



requiring him to pay on demand a certain sum of money only to or to the order of certain person or to the bearer of instrument."

### **Different Kinds / Types of Cheques**

i. **Bearer Cheque:** When the word "bearer" appearing on the face of the cheque is not cancelled, the cheque is called a bearer cheque. The bearer cheque is payable to the person specified therein or to any other else who presents it to the bank for payment. However, such cheques are risky; this is because if such cheques are lost, the finder of the cheque can collect payment from the bank.

ii. **Order Cheque:** When the word "bearer" appearing on the face of a cheque is cancelled and when in its place the word "or order" is written on the face of the cheque, the cheque is called an order cheque. Such a cheque is payable to the person specified therein as the payee, or to any one else to whom it is endorsed (transferred).

iii. **Uncrossed / Open Cheque:** When a cheque is not crossed, it is known as an "Open Cheque" or an "Uncrossed Cheque". The payment of such a cheque can be obtained at the counter of the bank. An open cheque may be a bearer cheque or an order one.

iv. **Crossed Cheque:** Crossing of cheque means drawing two parallel lines on the face of the cheque with or without additional words like "& CO." or "Account Payee" or "Not Negotiable". A crossed cheque cannot be cashed at the cash counter of a bank but it can only be credited to the payee's account.

v. **Anti-Dated Cheque:** If a cheque bears a date earlier than the date on which it is presented to the bank, it is called as "anti-dated cheque". Such a cheque is valid upto six months from the date of the cheque.

vi. **Post-Dated Cheque:** If a cheque bears a date which is yet to come (future date) then it is known as post-dated cheque. A post-dated cheque cannot be honoured earlier than the date on the cheque.

vii. **Stale Cheque:** If a cheque is presented for payment after six months from the date of the cheque it is called stale cheque. A stale cheque is not honoured by the bank.

### **3.1.6.1 What are the Features of and Characteristics of Cheque**

i. Cheque is an instrument in writing: A cheque must be in writing. It can be written in ink pen, ball point pen, typed or even printed. Oral orders are not considered as cheques.

ii. Cheque contains an unconditional order: Every cheque contains an unconditional order issued by the customer to his bank. It does not contain a request for payment. A cheque containing conditional orders is dishonoured by the bank.

iii. Cheque is drawn by a customer on his bank: A cheque is always drawn on a specific bank mentioned therein. Cheque drawn by stranger is of no meaning. Cheque book facility is made available only to account holder who are supposed to maintain certain minimum balance in the account.

iv. Cheque must be signed by customer: A cheque must be signed by customer (Account holder). Unsigned cheques or signed by persons other than customers are not regarded as cheque.

v. Cheque must be payable on demand: A cheque when presented for payment must be paid on demand. If cheque is made payable after the expiry of certain period of time then it will not be a cheque.

- vi. Cheque must mention exact amount to be paid: Cheque must be for money only. The amount to be paid by the banker must be certain. It must be written in words and figures.
- vii. Payee must be certain to whom payment is made: The payee of the cheque should be certain whom the payment of a cheque is to be made i.e. either real person or artificial person like joint stock company. The name of the payee must be written on the cheque or it can be made payable to bearer.
- viii. Cheque must be duly dated by customer of bank: A cheque must be duly dated by the customer of bank. The cheque must indicate clearly the date, month and the year. A cheque is valid for a period of six months from the date of issue.
- ix. Cheque has 3 parties: Drawer, Drawee & Payee
  - a. **Drawer:** A drawer is a person, who draws a cheque.
  - b. **Drawee:** A drawee is a bank on whom a cheque is drawn.
  - c. **Payee:** A payee is a person in whose favour a cheque is drawn.

### **3.1.7 Inter-country comparison of regulations and conduct of Banks**

A large body of research suggests that banks matter for human welfare. Most noticeably, banks matter when they fail. Indeed, the fiscal costs of banking crises in developing countries since 1980 have exceeded \$1 trillion, and some estimates put the cost of Japan's banking problems alone over this threshold. Recent research also finds that banks matter for economic growth. Banks that mobilize and allocate savings efficiently, allocate capital to endeavors with the highest expected social returns, and exert sound governance over funded firms foster innovation and growth. Banks that instead funnel credit to connected parties and the politically powerful discourage entrepreneurship and impede economic development. Recent work further shows that banks matter for poverty and income distribution. Well-functioning banks that extend credit to those with the best projects, rather than to

the wealthy or to those with familial, political, or corrupt connections, exert an equalizing effect on the distribution of income and a disproportionately positive impact on the poor by de-linking good ideas and ability from past accumulation of wealth and associations.

The important relationship between banks and economic welfare has led researchers and international institutions to develop policy recommendations concerning bank regulation and supervision. The International Monetary Fund, World Bank, and other international agencies have developed extensive checklists of "best practice" recommendations that they urge all countries to adopt. Most influentially, the Basel Committee on Bank Supervision recently revised and extended the 1988 Basel Capital Accord. The first pillar of these new recommendations develops more extensive procedures for computing minimum bank capital requirements. The second pillar focuses on enhancing official supervisory practices and ensuring that supervisory agencies have the power to scrutinize and discipline banks. The third pillar envisions greater market discipline of banks through policies that force banks to disclose accurate, transparent information. Although considerable debate surrounds the validity of these pillars, over 100 countries have already stated that they will eventually adopt Basel II.

Consistent with research on the political economy of banking policies, the patterns we observe in the data suggest that countries do not choose individual regulations in isolation; rather, individual choices reflect broad approaches to the role of government in the economy. Some governments choose an active, hands-on approach, where the government owns much of the banking industry, restricts banks from engaging in non-lending activities such securities underwriting, insurance, real estate, and non-financial services, limits the entry of new banks, and creates a powerful supervisory agency that directly oversees and disciplines

banks. Other countries rely substantially less on direct government control of banks. These countries place comparatively greater emphasis on forcing banks to disclose accurate information to the public as a mechanism for facilitating private sector governance of banks. Thus, some of my research can be viewed as using the laboratory of bank regulation and supervision to assess the historic debate about the proper role of government in the economy.

Given these observations, my coauthors and I have framed our initial international investigations of bank regulation and supervision within the context of two views of government. The public interest approach stresses that market failures - information and contract enforcement costs -interfere with the incentives and abilities of private agents to monitor and discipline banks effectively. From this perspective, a powerful supervisory agency that directly monitors and disciplines banks can improve bank operations. The public interest approach assumes that there are market failures and official supervisors have the incentives and capabilities to ameliorate those market failures by directly overseeing, regulating, and disciplining banks.

The private interest view, however, questions whether official supervisory agencies have the incentives and ability to fix market failures and enhance the socially efficient operation of banks. The private interest view holds that politicians and government supervisors do not maximize social welfare; they maximize their own welfare. Thus, if bank supervisory agencies have substantial influence over bank decisions, then politicians and supervisors may abuse this power to force banks to divert the flow of credit to ends that satisfy the private interests of politicians and supervisors, not the interests of the broader public. Thus, strengthening official

oversight of banks might reduce bank efficiency and intensify corruption in lending.

According to the private interest view, most countries do not have political and legal systems that induce politicians and government officials to act in the best interests of society. Thus heavy regulation of bank activities and direct, hands-on influence over banks is unlikely to promote sound banking. Rather, the private interest view holds that the most efficacious approach to bank supervision relies on using government regulations and institutions to empower private monitoring of banks. Specifically, the private interest approach advocates effective information disclosure rules and sound contract enforcement systems so that private investors can use this information to exert sound corporate governance over banks with positive ramifications on bank operations. This is not a laissez-faire approach. To the contrary, the private interest approach stresses that strong legal and regulatory institutions are necessary for reducing information and contract enforcement costs. My research is beginning to provide cross-country empirical evidence on these different approaches to bank regulation and supervision, including analyses of the role of legal and political institutions in determining the effectiveness of different banking sector policies.

### **3.1.8 Inter-temporal comparison of banking in Nigeria**

The trend of bank profits in Nigeria since the liberalization of the financial sector in the Structural Adjustment Programme (SAP) era led to the thinking in many circles that investment was most worthwhile in the banking industry. The increase in the number of new entrants to the industry in the late 1980s and 1990s lent credence to this view. However, there are no available statistics either for inter-temporal or group comparisons within the banking industry and much more so for

comparison between returns on investment in the banking and the other industries. Some past attempts to assess the performance of the Nigerian banking industry either had the mark of incomplete coverage or were limited in scope in terms of the number of metrics used. Moreover, there is no study that used the actual balance sheet and income statements (audited accounts) data; the micro data. A few studies on performance of banks in Nigeria, for example, Okafor (2012) used aggregate data from Central Bank of Nigeria (CBN) and the Nigeria Deposit Insurance Corporation (NDIC). These are largely call data for offsite examination purposes which, to all intents and purposes, are interim. Indeed, there is no study yet based on the gospel according to the banks.

Traditionally, Return on Assets (ROA) and Return on Capital Employed (ROCE) are the most popular standard metrics of bank performance. However, these are no longer adequate for the assessment of bank performance since they do not satisfactorily meet the needs of interest groups other than shareholders and prospective investors. In recent times, margin measurement and other ratio analysis have become very important tools to banks' management, regulatory authorities and the general public.

In view of the role that the banking industry plays in the economy, the regulatory authorities, policy makers, banks' management, investors and other stakeholders cannot be less interested in the growth and performance statistics of the industry. There is, therefore, a need to have a comprehensive study on the performance of the banking industry, using the framework of financial ratio analysis (FRA) and in the process, build a statistical database.

Babalola (1989) noted that profitability and asset base are the two traditional measures of bank performance in Nigeria. While profitability pleases shareholders, asset base pleases the board of directors. He further stated that, quantity as well as

quality of service rendered by banks could also be used to assess the performance of banks. Various factors which affect performance indices include monetary policy measures, rates of interest, exchange rate, provisioning for bad and doubtful loans, prudential requirements, liquidity ratio and open market operations. The two traditional profitability measures are return on assets and return on capital employed. However, these measures, alone, are no longer adequate in measuring bank profitability performance assessment since they do not satisfactorily meet the needs of stakeholders other than the shareholders. Of increasing importance in the assessment of bank profitability performance is margin analysis. While the net interest margin measures the profitability of employment of interest bearing assets and liabilities, the net non-interest margin specifically measures the profitability of pricing and marketing decisions (Lynn,1989).

Bank Managements and owners of capital are not the only parties interested in the performance of banks. Regulatory authorities are also interested in so far as they have the statutory responsibility for protecting depositors against losses that may result from possible mismanagement or bank runs. Meanwhile, a current controversy has been raging between bank Managements and the regulatory authorities over bank capital. While bank Managements would want to reduce capital ratios to please the owners of banks, the regulatory authorities, concerned with the stability and soundness of the system would want relatively high capital ratios as cushion against unexpected and other contingent liabilities. Also controversial is the issue of who specifies the level of capital (Oraler and Wolkowite, 1976). In this connection, while bank Managements argue that the market should be allowed to set the level, the regulatory authorities insist that they have that responsibility.



Quantitative measurement of bank performance usually focuses on net income, capital and liquid assets, among others, depending on the purpose of such an exercise. However, measuring the absolute quantities of balance sheet or income variables in themselves is not very meaningful unless such measurements relate to other balance sheet items, such as bank portfolios.

Absolute measurement is also associated with scale problem resulting from size. For example, large banks with large absolute values of such variables may, in fact, not be operating efficiently or profitably, or may even be undercapitalized; hence bank performance measures are usually stated as ratios. The basis for the judgment of the adequacy of these ratios is the comparison with the industry-wide averages. These averages are not regarded as optimal, maxima or minima but as a guide and, may in fact, be an oversimplification of performance in the light of the factors that affect the operations of banks and their environment.

The concept of competition in the banking industry has remained a subject of many scholarly inquiry and empirical research. The motivation stems from the realization that, competitiveness of the banking sector represents a socially optimal target as it reduces the cost of financial intermediation and improves delivery of high quality services (Simpasa, 2013). The concept of competition has evolved over time and assumed different meanings. After the initial classical notions of competition, some of the other approaches to explain the concept include Neuberger (1998), Toolsema (2003) and Northcott (2004), among others. Notably, each approach introduces various aspects of industry dynamics and growth. However, a general definition as given by Stigler (1987) described competition as rivalry between two individuals (or groups or nations) and noted that it arises whenever two or more parties strive for something that all cannot obtain. Vickers (1995) pointed out the following characteristics of this definition:

- The breadth of the definition encompasses all forms, instruments and objects of rivalry.
- It is a behavioral definition of competition as opposed to the analytical concept of perfect competition.
- Identification of competition with rivalry does not mean more competition is an end in itself.

In a similar expose, McNulty (1968) described competition either as a seemingly tranquil equilibrium state in which informed agents treat price parametrically (perfect competition) or as a force, which assures efficiency in resource allocation within the system through equating prices with marginal costs.

Competition among banks improves firms' access to external financing thereby enhancing economic growth and improving social welfare. While Petersen and Ranjan (1995) showed theoretically that banks having market power usually lend to new firms with opaque credit records, hence leading to high lending rates, Cetorelli and Gamberra (2001) found strong evidence of a general depressing effect on growth associated with banks' exercise of market power and this impacts all sectors and firms. However, ensuring competition in the banking industry continues to be at the centre of policy to ensure efficient delivery of financial services.

Nevertheless, competition in the banking industry is also needed for efficiency and maximization of social welfare. However, banking industry has specific features that make it of particular importance to an economy and indeed possesses certain properties that distinguish it from other industries. Banks contribute greatly to economic growth by playing an intermediating role between borrowers and lenders and providing financial resources to other industries, thus facilitating production. The banking system is also important since any instability therein could lead to

financial instability and economic crisis. Hence, a well-functioning banking system is regarded as a cornerstone of a market economy. Consequently, policymakers try to ensure that the banking system is stable, besides ensuring that it is competitive and efficient.

Typical structure variables include measures of concentration and the number of sellers. Market power is measured using accounting data on profits and costs. As well, in order to measure a structural variable such as concentration, one must define the relevant product and geographical markets.

The outcome of the traditional Industrial Organisation (IO) approach that competition requires many small banks assumes a unitary banking system, which has small independent banks without branches. The inclusion of branch banking can change this result. In a seminal work, Allen and Gale (2000a) showed that a few large banks with extensive branch networks can provide a more competitive outcome than a unitary banking system in an environment with switching costs: a large-branch bank has less of an incentive to exploit the “locked-in” value of clients, because it is always competing for the clients’ future business in another product or location.

### **3.1.9 The Banks and Socialism**

In the midst of the greatest economic and social crisis since the Great Depression, the major US banks are about to announce multi-million dollar year-end bonuses for their top executives and traders. Bankers are able to resume full tilt their mad pursuit of personal enrichment due to the plundering of the treasury carried out for the sole purpose of bailing out the “financial wizards” whose speculative practices precipitated the crisis.

This is a global phenomenon. In all the major centers of world capitalism, the financial elites are emerging from the economic wreckage stronger and more

powerful than ever, and are dictating the terms of their own enrichment to servile governments.

In the US, Goldman Sachs is expected to announce bonuses totaling more than \$20 billion, about the same amount as California's state budget deficit. One analyst estimates that the average Goldman bonus will approach \$600,000, and that some executives may take home more than \$10 million. It is anticipated that Goldman Sachs, Bank of America, Citibank, JPMorgan Chase and Morgan Stanley will together pay out \$90 billion in 2009 executive compensation, with more than half in the form of bonuses.

Banks cannot be "socialised." They are part of capitalism and will end with the coming of Socialism. Under Socialism the functions performed by the banks will not have to be performed at all. The provision of the needs of life will be simplified once the means of production and distribution are made the common property of Society as a whole. At present the workers may not go to work producing and distributing food, clothing, and so on, without obtaining the permission of the owners of the land, factories and railways. Under capitalism we have to enter into a complicated and wasteful system of negotiating wages between workers and employers, negotiating for the purchase of raw materials, and then organising for the sale of the goods, and the allocation of the proceeds as rent, interest, profit and taxes. Underneath it all is the essential feature of capitalism that the capitalists own the means of production and the goods produced by the workers they employ. The banks exist because of the monetary system by means of which capitalism carries on all these complex relationships between the individual owners of property, between them and the workers, and between both and the State. Money and banks only exist because of the private property system. Socialism will cut out all these intermediate steps. There will be no private ownership and control of the means of

production and distribution. Society through its appropriate organisations will handle the much-simplified problem of producing goods in the quantities and in the places required, and of transporting them to the places where they are needed. There will be no wages system, no rent, interest or profit hence no monetary system and no banks. That is why Socialists oppose schemes put forward by Lord Beaverbrook on the one hand and by the Labour Party on the other for making privately owned banks into State banks. Socialists want no banks, neither better banks nor Government banks.

#### **4.0 CONCLUSION**

Banks provide a safe environment and help us manage our financial transactions. To avail professional banking service it is mandatory for every individual to open a bank account. Opening a bank account is not a difficult task. It takes only seven easy steps to open a bank account. It cannot be safely and conveniently stated, with this study, that the banking industry is more attractive for investments than other segments of the economy unless similar studies are done for the other sectors or comparative studies across sectors and across countries are done. Perhaps, such studies are the future agenda that this work has set.

#### **5.0 SUMMARY**

In this unit you learnt the seven steps to opening a bank account, the advantages of opening bank account as well as the different types of bank account. You also learnt the meaning, features and advantages of saving account, current account, fixed deposit account and the banks and socialism.

#### **6.0 TUTOR-MARKED ASSIGNMENT**

- Discuss types of Bank Account

- What are the Features of and Characteristics of Cheque
- Features of Fixed Deposit Account

## **7.0 REFERENCES/FURTHER READINGS**

Jhingan, M.L. (2004). *Monetary Economics*: 6<sup>th</sup> Ed. Delhi: Vrinda Publications (P)  
Ltd. The Nigerian Banking Amendment Decree (No.88) of 1979.

McKinnon, R.I. (1973). *Money and Capital in Economic Development*  
Washington DC, The Brookings Institution.

## **MODULE 3: INTRODUCTION TO BANKING**

Unit 1: Origin, Growth and Development of Banking

Unit 2: Functions of Banks

Unit 3: Structure of Banking System

Unit 4: The Nigerian Financial System

Unit 5: Credit Instruments and Credit Creation by Commercial Banks

### **Unit 1: Origin and Development of Banking**

1.0 Introduction

2.0 Objectives

3.0 Main Content

3.1 Origin and Development of Banking

3.2 Meaning and Definition of Banking

3.3 Types of Banks

3.4 Types of Banking

3.5 Growth of Banks in Nigeria

4.0 Conclusion

5.0 Summary

6.0 Tutor-Marked Assignment

7.0 References/Further Reading

### **1.0 INTRODUCTION**

Modern commercial banking, in its present form, is of recent origin. Though bank is considered to be an ancient institution just like money. Its evolution can be traced in the functions of money lender, the goldsmiths and the merchants.

A bank has been often described as an institution engaged in accepting of deposits and granting loans. It can also be described as an institution which borrows idle resources, makes funds available to. It does not refer only to a place of tending and depositing money, but looks after the financial problems of its consumers. This era is the age of specialization with the changing situation in the world economy, banking functions have broadened. Financial institutions which are shaped by the general economic structures of the country concerned vary from one country to another. Hence, a rigid classification of banks is bound to be unrealistic.

## **2.0 OBJECTIVES**

After completing this unit, you would be able to:

- i. State the origin and development of banking.
- ii. Understand the meaning and definition of bank.
- iii. Identify the different types of banks.
- iv. Know about various banking system in India.

## **3.0 MAIN CONTENT**

### **3.1 ORIGIN AND DEVELOPMENT OF BANKING**

There seem to be no uniformity amongst the economists about the origin of the word 'Bank'. It has been believed that the word 'Bank' has been derived from the German word 'Bank' which means joint stock of firm or from the Italian word 'Banco' which means a heap or mound. In India the ancient Hindu scriptures refer to the money - lending activities in the Vedic period. They performed most of those functions which banks perform in modern times. During the Ramayana and Mahabharata eras also banking had become a full-fledged business activity. In other words the development of commercial banking in ancient times was closely associated with the business of money changing.



In simple words, bank refers to an institution that deals in money. This institution accepts deposits from the people and gives loans to those who are in need. Besides dealing in money, bank these days perform various other functions, such as credit creation, agency job and general service. Bank, therefore is such an institution which accepts deposits from the people, gives loans, creates credit and undertakes agency work.

## **3.2 MEANING AND DEFINITION OF BANKING**

### **Meaning of Banking**

You know people earn money to meet their day to day expenses on food, clothing, education of children, having etc. They also need money to meet future expenses on marriage, higher education of children housing building and social functions. These are heavy expenses, which can be met if some money is saved out of the present income. With this practice, savings were available for use whenever needed, but it also involved the risk of loss by theft, robbery and other accidents.

Thus, people were in need of a place where money could be saved safely and would be available when required. Banks are such places where people can deposit their savings with the assurance that they will be able to withdraw money from the deposits whenever required. Bank is a lawful organization which accepts deposits that can be withdrawn on demand. It also lends money to individuals and business houses that need it.

### **Definitions of Bank**

**1. Indian Banking Companies Act** - “Banking Company is one which transacts the business of banking which means the accepting for the purpose of lending or investment of deposits money from the public repayable on demand or otherwise and withdrawable by cheque, draft, order or otherwise”.

**2. Dictionary meaning of the Word ‘Bank’:** The oxford dictionary defines a bank as “an establishment for custody of money received from or on behalf of its customers. Its essential duty is to pay their drafts on it. its profits arises from the use of the money left employed by them”.

**3. The Webster’s Dictionary Defines:** A bank as “an institution which trades in money, establishment for the deposit, custody and issue of money, as also for making loans and discounts and facilitating the transmission of remittances from one place to another”.

**4. According to Prof. Kinley:** “A bank is an establishment which makes to individuals such advances of money as may be required and safely made, and to which individuals entrust money when it required by them for use”.

The above definitions of bank reveal that bank is an Business institution which deal in money and use of money. Thus a proper and scientific definition of the bank should include various functions performed by a bank in a proper manner. We can say that any person, institution, company or enterprise can be a bank. The business of a bank consists of acceptance of deposits, withdrawals of deposits, Making loans and advances, investments on account of which credit is exacted by banks.

### **3.3 TYPES OF BANKS**

There are various types of banks which operate in our country to meet the financial requirements of different categories of people engaged in agriculture, business, profession etc. on the basis of functions, the banking institution may be divided into following types:

#### **1. Central Bank**

A central bank functions as the apex controlling institution in the banking and financial system of the country. It functions as the controller of credit, banker’s

bank and also enjoys the monopoly of issuing currency on behalf of the government. A central bank is usually control and quite often owned, by the government of a country. The Reserve Bank of India (RBI) is such a bank within an India.

## **2. Commercial Banks**

It operates for profit. It accepts deposits from the general public and extends loans to the households, the firms and the government. The essential characteristics of commercial banking are as follows:

- Acceptance of deposits from public
- For the purpose of lending or investment
- Repayable on demand or lending or investment.
- Withdrawal by means of an instrument, whether a cheque or otherwise.

Another distinguish feature of commercial bank is that a large part of their deposits are demand deposits withdrawable and transferable by cheque.

## **3. Development Banks**

It is considered as a hybrid institution which combines in itself the functions of a finance corporation and a development corporation. They also act as a catalytic agent in promoting balanced and viable development by assuming promotional role of discovering project ideas, undertaking feasibility studies and also provide technical, financial and managerial assistance for the implementation of project.

In India 'Industrial Development Bank on India' (IDBI) is the unique example of development bank. It has been designated as the principal institution of the country for co-ordinating the working of the institutions engaged in financing, promoting or development of industry.

#### **4. Co-operative Banks**

The main business of co-operative banks is to provide finance to agriculture. They aim at developing a system of credit. Agriculture finance is a special field. The co-operative banks play a useful role in providing cheap credit facilities to the farmers. In India there are three wings of co-operative credit system namely: –

(i) Short term, (ii) Medium-term, (iii) Long term credit. The former has a three tier structure consisting of state co-operative banks at the state level. At the intermediate level (district level) these are central co-operative banks, which are generally established for each district.

At the base of the pyramid there are primary agricultural societies at the village level. The long term credit is provided by the central land development Bank established at the state level. Initially, these banks used to advance loans on mortgage of land for the purpose of securing repayment of loans.

#### **5. Specialized Banks**

These banks are established and controlled under the special act of parliament. These banks have got the special status. One of the major bank is ‘National Bank for Agricultural and Rural development’ (NABARD) established in 1982, as an apex institution in the field of agricultural and other economic activities in rural areas. In 1990 a special bank named small industries development Bank of India (SIDBI) was established.

It was the subsidiary of Industrial development Bank of India. This bank was established for providing loan facilities, discounting and rediscounting of bills, direct assistance and leasing facility.

#### **6. Indigenous Bankers**

That unorganised unit which provides productive, unproductive, long term, medium term and short term loan at the higher interest rate are known as

indigenous bankers. These banks can be found everywhere in cities, towns, mandis and villages.

### **7. Rural Banking**

A set of financial institution engaged in financing of rural sector is termed as 'Rural Banking'. The policies of financing of these banks have been designed in such a way so that these institutions can play catalyst role in the process of rural development.

### **8. Saving Banks**

These banks perform the useful services of collecting small savings commercial banks also run "saving bank" to mobilize the savings of men of small means. Different countries have different types of savings bank viz. Mutual savings bank, Post office saving, commercial saving banks etc.

### **9. Export - Import Bank**

These banks have been established for the purpose of financing foreign trade. They concentrate their working on medium and long-term financing. The Export-Import Bank of India (EXIM Bank) was established on January 1, 1982 as a statutory corporation wholly owned by the central government.

### **10. Foreign Exchange Banks**

These banks finance mostly to the foreign trade of a country. Their main function is to discount, accept and collect foreign bills of exchange. They also buy and sell foreign currencies and help businessmen to convert their money into any foreign currency they need. Over a dozen foreign exchange banks branches are working in India have their head offices in foreign countries.

## **3.4 TYPES OF BANKING**

Banking is described as the business carried on by an individual at a bank. Today, several forms of banking exist, giving consumers a choice in the way they manage

their money most people do a combination of at least two banking types. However, the type of banking a consumer uses normally based on convenience.

These are different types of banking through which consumer can attach to it:

### **(A) Walk-in-Banking**

It is still a popular type of banking. As, in the past, it still involves bank tellers and specialized bank officers. Consumers must walk into a bank to use this service normally, in order to withdraw money or deposit it, a person must fill out a slip of paper with the account and specific monetary amount and show a form of identification to a bank letter. The advantage of walk in Banking is the face to face connection between the banker and a letter. Also unlike drive thru and ATM banking, a person can apply for a loan and invest money during a walk in.

### **(B) Drive thru Banking**

It is probably the least popular form of banking today, but is still used enough by consumers to create a need for it. It allows consumers to stay in their while and drive up to a machine equipped with container, chute and intercom. This machine is connected to a bank and is run by one or two bank letters. A person can withdraw or deposit money at a drive thru. He must fill out a slip with his account and specific monetary amount and put it in the container. The container travels through the chute to the bank letter, who will complete the banker's request. This is where the intercom comes into play. The bank teller and banker use it to communicate and discuss the specific banking request.

### **(C) ATM Banking**

It is very popular because it gives a person 24 hour access to his bank account. Walk in and drive thru banking does not offer this perk. In order to use an ATM, a person must have an ATM card with personal identification number (PIN) and access to an ATM machine. Any ATM machine can be used, but charges apply if

the ATM machine is not affiliated with the bank listed on the ATM card. By sliding an ATM card into an ATM machine, it is activated and then through touching buttons on the machine, a consumer is able to withdraw or deposit money.

#### **(D) Online Banking**

It allows a person to get on the internet and sign into their bank. This process is achieved with the use of a PIN, different from the one used for the ATM card. By going website of a bank and entering it, a consumer can get into his account, withdraw money, deposit money, pay bills, request loans and invest money. Online banking is growing in popularity because of its convenience.

These different types of banking give a consumer the power of choice and also give them a comfortable banking system that gives them a convenient choice.

#### **Activity B:**

1 According to you why banks differ from the early banks concept within India and do you think that commercialization of banks can develop the economic structure of India.

### **3.5 GROWTH OF BANKS**

Shortly after the fall of Rome in AD 476, banking decline in Europe. The increase of trade in 13th century in Italy prompted the revival of banking. The money exchangers of the Italian states developed facilities for exchanging local and foreign currency. Soon merchants demanded other services, such as lending money, and gradually bank services were expanded. The first bank called the “Bank of Venice” was established in Venice, Italy in 1157 to finance the monarch in his war. The bankers of Lombardy were famous in England. But modern banking began with English gold smiths only after 1640.

### **3.3.1. Growth of Banks in Nigeria**

In Nigeria, commercial banking pre - dates central banking and laid the foundation of the Nigerian financial system as far back as the late nineteenth century. The first commercial bank in Nigeria was the African Banking Corporation which opened its first branch in Lagos in 1892. The bank experienced some initial difficulties and eventually decided to transfer its interest to Elder Dempster and Co. in 1893. This led to the formation of a new bank known as the British Bank of West Africa (BBWA) in 1893 which is today known as the First Bank Nigeria PLC. Another bank known as the Bar Clays Bank DCO (Dominion, Colonial and overseas) opened its first branch in Lagos in 1917. This bank is known today in Nigeria as the Union Bank Nigeria Plc. British and French Bank, now called United Bank for Africa Plc was established in 1949 making it the third expatriate bank to dominate early Nigeria's commercial banking. The foreign banks came principally to render services in connection with international trade, so their relations at that time were chiefly with the expatriate companies and with the government. They largely ignored the development of local African entrepreneurship.

These three banks controlled almost about 90% of the aggregate bank deposits as at then. From 1914 to the early part of 1930s, several abortive attempts were made to establish locally owned and managed banks to break the foreign monopoly. This was as a result of the weakness of those indigenous banks in such areas as capitalization and management; and given the total absence of regulation by any government agency, the indigenous banks could not survive the hostile and unfair competition posed by the foreign banks. It was therefore not surprising that by 1954, a total of 21 out of 25 indigenous banks had failed and went into self – liquidation.



In a nutshell, historically, the Nigerian banking industry had evolved in four stages. The first stage can be best described as the unguided *laissez-faire* phase (1930-59), during which several poorly capitalized and unsupervised indigenous banks failed before their tenth anniversary. The second stage was the controlled regime (1960-1985), during which the Central Bank of Nigeria (CBN) ensured that only “fit and proper” persons were granted banking license, subject to a minimum paid – up capital.

The third stage was the post Structural Adjustment Programme (SAP) or decontrolled regime (1986-2004), during which the Neo – liberal philosophy of “free entry” was over stretched and political authorities on the bases of patronage dispensed banking licenses.

The emerging fourth stage is the era of consolidation (2004-to a foreseeable future), with major emphasis on recapitalization and proactive regulation based on prudential principles.

In the area of Central Banking, the West African Currency Board (WACB) carried out banking operations in the former British colonies in West Africa before independence. The problems of the WACB led to the establishment of Central Banks in these colonies. In Ghana, it came into being in 1957, in Nigeria 1959, Sierre-Leon in 1964, and in the Gambia 1964. The Central Bank of Nigeria (CBN) was established by the Central Bank Act of 1958. It was to replace the West African Currency Board (WACB) of the colonial government as part of the preparation for independent Nigeria.

## **5.0 SUMMARY**

Thus, a bank can play a useful role in promoting the economic development of any country’ economy. Banks tending and investment activities lead to changes in the

quantity of money in circulation which in turn influence the nature and quality of production.

Therefore, banks have been rightly crowned as ‘the nerve’ centre of all economic activity. And also play important role in day to day life of every consumer who consumes the banking sector activities.

## **6.0 SELF ASSESSMENT QUESTIONS**

1. What is a bank? Discuss the various types of bank giving their main functions only.
2. Discuss the branches of banking system which of the system or branch would be more suitable for India.
3. Define bank and discuss how banks can contribute to the economic development of a country.
4. Discuss merits and demerits of unit and branch banking. Which of the two systems would be more suitable for India?

## **7.0 BOOKS FOR FURTHER READINGS**

- Jhingan, M.L. (2004). *Monetary Economics*: 6<sup>th</sup> Ed. Delhi: Vrinda Publications (P) Ltd. The Nigerian Banking Amendment Decree (No.88) of 1979.
- McKinnon, R.I. (1973). *Money and Capital in Economic Development* Washington DC, The Brookings Institution.

## **UNIT 2: FUNCTIONS OF BANKS**

1.0 Introduction

2.0 Objectives

3.0 Main Content

3.1 Functions of Banks

3.2 Importance of Banks

4.0 Conclusion

5.0 Summary

6.0 Tutor-Marked Assignment

7.0 References/Further Reading

### **1.0 INTRODUCTION**

A bank is an institution which accepts deposits from the general public and extends loans to the households, the firms and the government. Banks are that institutions which operates in money. Thus, they are money traders. With the process of development, functions of banks are also increasing and diversifying. Now, the banks are not nearly the traders of money, they also create credit. Their activities are increasing and diversifying.

Banks, therefore, is such an institution which accepts deposits from the people, given loans creates credit and undertakes agency work.

### **2.0 OBJECTIVES**

After completing this unit, you will be able to:

- i. Know about introduction of Banks
- ii. Identify different functions of Banks
- iii. Understand the importance of Banks

### **3.0 MAIN CONTENT**

#### **3.1 FUNCTIONS OF BANKS**

Modern banks not only deal in money and credit creation, other useful functions management of foreign trade, finance etc. The meaning of modern banks is used in narrow sense of the term as commercial banks.

The various functions of banks can be seen from the following:

#### **FUNCTIONS OF BANKS**

1. Accepting Deposits
2. Advancing of Loans
3. Agency Services
4. Other Services

#### **I. ACCEPTING DEPOSITS**

The most important function of commercial banks is to accept deposits from public. This is the primary functions of a commercial bank. Banks receives the idle savings of people in the form of deposits and finances the temporary needs of commercial and industrial firms.

A commercial bank accepts deposit from public on various account, important deposit account generally kept by bank are:

**(i) Saving Bank Deposits:** This type of deposits suit to those who just want to keep their small savings in a bank and might need to withdraw them occasionally. One or two withdrawals up to a certain limit of total deposits are allowed in a week. The rate of interest allowed on saving bank deposits is less than that on fixed deposits. Depositor is given a pass book and a cheque book. Withdrawals are allowed by cheques and withdrawal form.

**(ii) Current Deposits:** These type of account are generally kept by businessmen and industrialists and those people who meet a large number of monetary transactions in their routine. These deposits are known as short term deposits or demand deposits. They are payable demand without notice. Usually no interest is paid on these deposits because the bank cannot utilize these deposits and keep almost per cent reserve against them. Overdraft facilities are also available on current account.

**(iii) Fixed Deposits:** These are also known as time deposits. In this account a fixed amount is deposited for a fixed period of time. Deposits are payable after the expiry of the stipulated period. Customers keep their money in fixed deposits with the bank in order of earn interest. The banks pay higher interest on fixed deposits. The rates depend upon the length of the period and state of money market.

Normally the withdrawals are not allowed from fixed deposits before the stipulated date. If it happens, the depositor entails an interest penalty.

**(iv) Other Deposits:** Banks also provide deposit facilities to different type of customers by opening different account. They also open. ‘Home Safe Account’ for housewife or very small savers. The other accounts are: ‘Indefinite Period Deposit a/c’; ‘Recurring Deposit’ a/c; ‘Retirement Scheme’ etc.

## **II. ADVANCING OF LOANS**

The second main function of the commercial bank is to advance loans. Money is lent to businessmen and trade for short period only. These banks cannot lend money for long period because they must keep themselves ready to meet the short term deposits. The bank advances money in any one of the following forms:

**(i) Overdrafts:** Customers of good standings are allowed to overdraw from their current account. But they have to pay interest on the extra amount they have withdrawn. The banks allow ‘overdrafts’ to their customers just to provide

temporary accommodation save the extra amount withdrawn is payable within a period. The amount allowed in 'overdraft' varies from customer to customer depending on this financial condition.

**(ii) Loans:** Loans are granted by the banks on securities which can be easily disposed off in the market, e.g. Government securities or shares of approved concerns. When the bank has satisfied itself regarding the soundness of the party, the loan is advanced. A borrower seldom wants the whole amount of his loan in cash, so he opens the current account with the bank (and the loan amount) and thus a 'deposit is created' in the books of the name in the bank.

**(iii) Cash Credit:** It is an arrangement by which a bank allows his customers to borrow money upto a certain limit against certain tangible securities as Government securities or shares of approved concerns etc. In this case interest is charged on the actual amount withdrawn by the customer and not on the limit allowed to him.

**(iv) Discounting Bills:** It is another important way of giving loans. The banks purchase bills and immediately pay cash for these bills after deducting the discount (interest). After the maturity of the bills, the banks get back its full value. Thus these bills are good liquid assets and moreover this investment is also very safe.

### **III. AGENCY SERVICES**

Modern Banks render service to the individual or to the business institutions as an agent. Banks usually charge little commission for doing these services. These services are as follows-

- (i) A bank collects cheques, bills and promissory notes and receives their payments.
- (ii) A bank collects dividend or interest on stock and shares. It also collects subscriptions and insurance premium.

(iii) A bank also buys and sells securities on behalf of its customers. It also not charges anything from the customers for this but gets some commission from the stock broker.

(iv) A bank acts as trustee or an executor on behalf of its customers in the administration of a will or of settlement.

(v) Lastly a bank helps in the transfer of funds from one bank or branch to another.

#### **IV. OTHER SERVICES**

A modern bank nowadays serves its customers in many other ways:

(i) A bank issues personal and commercial letters of credit. Through these letters of credit customers are able to benefit themselves out of the superior credit of the bank.

(ii) A bank also helps in the transaction of foreign exchange business.

(iii) A bank has 'Safe Deposit Vaults'. It undertakes the safe custody of valuables and important documents. The bank acts as bailee of these goods or documents.

(iv) A few banks also undertake to underwrite loans raised by Government, public or trading corporation.

#### **3.2 IMPORTANCE OF BANKS**

Banks play an important role in the economic growth of a country. In the modern set up, banks are not to be considered dealers in money but as the leaders of development. The importance of bank for a country's economy can be explained in following ways:

- Banks by playing attractive interest rate on deposits try to promote thrift and savings in an economy.

The investment of these savings in productive channel results in capital formation.

- The scattered small savings in the country can be put to optimum use by commercial banks. Banks utilize this amount by giving loans to industrial

houses and the government. By providing funds to the entrepreneurs, bank help in increasing productivity of capital.

- Banks help in remitting money from one place to another. The cheque, bank draft, letter of credit, bills, hundies enable traders to transfer large sums of money from one place to another.
- By their ability to create credit, the banks have placed at the disposal of the nation a large amount of money. The bank can increase the supply of money through credit creation.
- With the growth of banking activity, employment opportunity in the country has increased to a considerable extent.
- The banks help in capital formation in the country. A high rate of saving and investment promote capital formation.
- Money deposited in the bank and other precious items are now absolutely safe. For keeping valuables, banks are providing locker facilities. Now people are free from any type of risks.

#### **4.0 CONCLUSION**

The unit discusses functions and Importance of banks which explains how the banks try to survive in an economy as a business entity.

#### **5.0 SUMMARY**

Bank act as payment agents by conducting checking or current accounts for customer, paying cheque drawn by customers on the bank, and collecting cheque deposited to customers current accounts. Banks also enable customer payments via other payment methods such as automated teller machine (ATM), Telegraphic Transfer etc.

Banks borrow money by accepting funds deposited on current accounts, by accepting term deposits, and by issuing debt securities such as banknotes and



bonds. Banks lend money by making advances to customers on current accounts, by making installment loans and by investing in marketable debt securities and other forms of money lending.

Banks also provide almost all payment services and a bank account is considered indispensable by most businesses, individuals and governments.

## **6.0 SELF ASSESSMENT QUESTIONS**

1. Describe the main function of Banks. How can banks contribute to economic development of a country?
2. Define bank and discuss various functions of a bank?
3. Describe the different types of banks and their functions.
4. What is a bank? Discuss the various types of banks giving their main functions only.
5. What do you understand by bank? What functions are executed by banks in modern world?

## **7.0 BOOKS FOR FURTHER READINGS**

- Jhingan, M.L. (2004). *Monetary Economics*: 6<sup>th</sup> Ed. Delhi: Vrinda Publications (P) Ltd. The Nigerian Banking Amendment Decree (No.88) of 1979.
- McKinnon, R.I. (1973). *Money and Capital in Economic Development* Washington DC, The Brookings Institution.

## **UNIT 3: STRUCTURE OF BANKING SYSTEM**

1.0 Introduction

2.0 Objectives

3.0 Main Content

3.1 Indian Banking System

3.1.1 Reserve Bank of India (RBI)

3.1.2 Industrial Development Bank of India (IDBI)

3.1.3 Small Industries Development Bank of India (SIDBI)

3.1.4 National Bank for Agriculture and Rural Development (NABARD)

3.1.5 Export Import Bank of India (EXIM)

3.1.6 National Housing Bank (NHB)

3.2 Structure of Indian Banking Industry

3.2.1 Phase I

3.2.2 Phase II

3.2.3 Phase III

3.3 Present Structure of Indian Banking Industry

3.3.1 Commercial Banks

3.3.2 Public Sector Banks

3.3.3 Private Sector Banks

3.3.4 Local Area Banks

3.3.5 Indian Banks

3.3.6 Foreign Banks

3.3.7 Regional Rural Banks

3.3.8 Cooperative Banks

4.0 Conclusion

5.0 Summary

6.0 Tutor-Marked Assignment

7.0 References/Further Reading

## **1.0 INTRODUCTION**

The structure of banking varies widely from country to country. Often a country's banking structure is a consequence of the regulatory regime to which it is subjected. The banking system in India works under the constraints that go with social control and public ownership. Nationalization, for instance, was a structural change in the functioning of commercial banks which was considered essential to better serve the needs of development of the economy in conformity with national policy and objectives. Similarly to meet the major objectives of banking sector reforms, government stake was reduced to 51 percent in public sector banks.

New private sector banks were allowed and foreign banks were permitted additional branches.

## **2.0 OBJECTIVES**

After going through this unit you would be able to:

- i. Understand the structure of the banking system in India
- ii. Understand the recent developments taking place in Indian banking industry
- iii. Describe the role and functions of Reserve Bank of India
- iv. Describe the Scheduled, Non-scheduled and Licensed bank
- v. Understand the components that took place in Indian Banking Sector
- vi. Get overview about the Public Sector Banks, Private Sector Banks, Regional Rural Banks, Local Area Banks, Indian Banks, Foreign Banks and Cooperative Banks

### **3.1 INDIAN BANKING SYSTEM**

The banking system of a country plays an important role in the economic development of any country. Banking system comprises of the banking institutions functioning in the country. Banking system comprises from the central bank to all banking institutions which are functioning and providing financial facilities to any developmental sector like agriculture, industries, trade, housing etc. Under the Indian banking structure central bank in the name of the Reserve Bank of India which regulates, directs and controls the banking institutions. Separate institutions are functioning to meet the financial requirement of the different sectors of the economy. Indigenous bankers and moneylenders do dominant in the unorganized sector. Regional Rural Banks are meeting the requirement of the rural population. Cooperatives are working to meet the requirement of medium, short and long-term credit for agriculture sector. Development banks are meeting the business and industrial requirements. Thus, we can say that the structure of Indian banking system has an international level banking system which can meet the economic requirements of globalized world.

The Indian banking structure has a wide and comprehensive form. Apex institutions in the form of banking institutions are playing important role in the country. The chief regulator of banking system in our country is the Reserve bank of India. Industrial Development Bank of India (IDBI) is an apex body in the industrial sector. National Bank of Agriculture and Rural Development (NABARD) has been working as an apex institution for the agriculture and rural development. Import-Export Bank of India (EXIM) is an Apex body of international trade. National Housing Bank (NHB) is an apex institution in field of housing construction.

Thus these four apex institutions are accelerating the banking system by providing refinance facilities to commercial banks and other financial institutions along with other banking services.

### **3.1.1 Reserve Bank of India (Rbi)**

The Reserve Bank of India (RBI) is India's central banking institution, which controls the monetary policy of the Indian rupee. It was established on 1 April 1935 during the British Raj in accordance with the provisions of the Reserve Bank of India Act, 1934. The share capital was divided into shares of 100 each fully paid, which was entirely owned by private shareholders in the beginning. Following India's independence in 1947, the RBI was nationalized in the year 1949.

The RBI plays an important part in the development strategy of the Government of India. It is a member bank of the Asian Clearing Union. The general superintendence and direction of the RBI is entrusted with the 21-member- Central Board of Directors - the Governor (currently Raghuram Rajan), four Deputy Governors, two Finance Ministry representative, ten government-nominated directors to represent important elements from India's economy, and four directors to represent local boards headquartered at Mumbai, Kolkata, Chennai and New Delhi. Each of these local boards consists of five members who represent regional interests, as well as the interests of co-operative and indigenous banks.

The bank is also active in promoting financial inclusion policy and is a leading member of the Alliance for Financial Inclusion (AFI).

## History

### 1935–1950



#### The old RBI Building in Nagpur

The Reserve Bank of India was founded on 1 April 1935 to respond to economic troubles after the First World War. It began according to the guidelines laid down by Dr. Ambedkar. RBI was conceptualized as per the guidelines, working style and outlook presented by Ambedkar in front of the Hilton Young Commission. When this commission came to India under the name of “Royal Commission on Indian Currency & Finance”, each and every member of this commission were holding Ambedkar’s book titled *The Problem of the Rupee – It’s origin and it’s solution*. The bank was set up based on the recommendations of the 1926 Royal Commission on Indian Currency and Finance, also known as the Hilton–Young Commission. The original choice for the seal of RBI was The East India Company Double Mohur, with the sketch of the Lion and Palm Tree. However it was decided to replace the lion with the tiger, the national animal of India. The Preamble of the RBI describes its basic functions to regulate the issue of bank notes, keep reserves to secure monetary stability in India, and generally to operate the currency and credit system in the best interests of the country. The Central Office of the RBI

initially established in Calcutta (now Kolkata), but was permanently moved to Bombay (now Mumbai) in 1937. The RBI also acted as Burma's central bank, except during the years of the Japanese occupation of Burma (1942–45), until April 1947, even though Burma seceded from the Indian Union in 1937. After the Partition of India in 1947, the Bank served as the central bank for Pakistan until June 1948 when the State Bank of Pakistan commenced operations. Though originally set up as a shareholders' bank, the RBI has been fully owned by the Government of India since its nationalization in 1949.

### **1950–1960**

In the 1950s the Indian government, under its first Prime Minister Jawaharlal Nehru, developed a centrally planned economic policy that focused on the agricultural sector. The administration nationalized commercial banks and established, based on the Banking Companies Act of 1949 (later called the Banking Regulation Act), a central bank regulation as part of the RBI. Furthermore, the central bank was ordered to support the economic plan with loans.

### **1960–1969**

As a result of bank crashes, the RBI was requested to establish and monitor a deposit insurance system. It should restore the trust in the national bank system and was initialized on 7 December 1961. The Indian government founded funds to promote the economy and used the slogan "Developing Banking". The government of India restructured the national bank market and nationalized a lot of institutes. As a result, the RBI had to play the central part of control and support of this public banking sector.

## **1969–1985**

In 1969, the Indira Gandhi-headed government nationalized 14 major commercial banks. Upon Gandhi's return to power in 1980, a further six banks were nationalized. The regulation of the economy and especially the financial sector was reinforced by the Government of India in the 1970s and 1980s. The central bank became the central player and increased its policies for a lot of tasks like interests, reserve ratio and visible deposits. These measures aimed at better economic development and had a huge effect on the company policy of the institutes. The banks lent money in selected sectors, like agri-business and small trade companies.

The branch was forced to establish two new offices in the country for every newly established office in a town. The oil crises in 1973 resulted in increasing inflation, and the RBI restricted monetary policy to reduce the effects.

## **1985–1991**

A lot of committees analysed the Indian economy between 1985 and 1991. Their results had an effect on the RBI. The Board for Industrial and Financial Reconstruction, the Indira Gandhi Institute of Development Research and the Security & Exchange Board of India investigated the national economy as a whole, and the security and exchange board proposed better methods for more effective markets and the protection of investor interests. The Indian financial market was a leading example for so-called "financial repression" (Mackinnon and Shaw). The Discount and Finance House of India began its operations on the monetary market in April 1988; the National Housing Bank, founded in July 1988, was forced to invest in the property market and a new financial law improved the versatility of direct deposit by more security measures and liberalisation.



## **1991–2000**

The national economy came down in July 1991 and the Indian rupee was devalued. The currency lost 18% relative to the US dollar, and the Narsimham Committee advised restructuring the financial sector by a temporal reduced reserve ratio as well as the statutory liquidity ratio. New guidelines were published in 1993 to establish a private banking sector. This turning point should reinforce the market and was often called neo-liberal. The central bank deregulated bank interests and some sectors of the financial market like the trust and property markets.<sup>[19]</sup> This first phase was a success and the central government forced a diversity liberalization to diversify owner structures in 1998.

The National Stock Exchange of India took the trade on in June 1994 and the RBI allowed nationalized banks in July to interact with the capital market to reinforce their capital base. The central bank founded a subsidiary company - the Bharatiya Reserve Bank Note Mudran Limited in February 1995 to produce banknotes.

## **Since 2000**

The *Foreign Exchange Management Act* from 1999 came into force in June 2000. It should improve the item in 2004–2005 (National Electronic Fund Transfer). The Security Printing & Minting Corporation of India Ltd., a merger of nine institutions, was founded in 2006 and produces banknotes and coins.

The national economy's growth rate came down to 5.8% in the last quarter of 2008–2009 and the central bank promotes the economic development.

## **OBJECTIVES OF RBI**

The following were the objectives of RBI when it was set up:

1. To manage adequate money and credit in the country
2. To maintain the stability of rupee internally and externally
3. Balanced and well managed banking development in the country
4. To develop well organized money market
5. To provide adequate agriculture credit
6. To manage public debt
7. To seek international monetary co-operation
8. Centralization of cash reserves of commercial banks
9. To set up Government banks
10. To set up Government banks
11. Publication of data

### **FUNCTIONS OF RBI**

RBI is an apex banking institution of the country. It carries on several functions as a central bank. According to RBI Act, 1934, “the principal function of RBI is to issue notes and maintain reserves, currency and credit to maintain monetary stability in the general interest of the nation.”

As a central banking authority RBI carries on the following functions:

**Bank of Issue:** Under Section 22 of the Reserve Bank of India Act, the Bank has the sole right to issue bank notes of all denominations. (except one rupee note and coin, which are issued by Ministry of finance).

The distribution of two rupee notes and coins and small coins all over the country is undertaken by the Reserve Bank as agent of the government. The Reserve Bank has a separate Issue Department which is entrusted with the issue of currency notes. The assets and liabilities of the Issue Department are kept separate from those of the Banking Department.

**Monetary authority:** The Reserve Bank of India is the main monetary authority of the country and beside that the central bank acts as the bank of the national and state governments. It formulates, implements and monitors the monetary policy as well as it has to ensure an adequate flow of credit to productive sectors.

**Regulator and supervisor of the financial system:** The institution is also the regulator and supervisor of the financial system and prescribes broad parameters of banking operations within which the country's banking and financial system functions. Its objectives are to maintain public confidence in the system, protect depositors' interest and provide cost-effective banking services to the public. The Banking Ombudsman Scheme has been formulated by the Reserve Bank of India (RBI) for effective addressing of complaints by bank customers. The RBI controls the monetary supply, monitors economic indicators like the gross domestic product and has to decide the design of the rupee banknotes as well as coins.

**Managerial of exchange control:** The central bank manages to reach the goals of the Foreign Exchange Management Act, 1999. Objective: to facilitate external trade and payment and promote orderly development and maintenance of foreign exchange market in India.

**Issuer of currency:** The bank issues and exchanges or destroys currency notes and coins that are not fit for circulation. The objectives are giving the public adequate supply of currency of good quality and to provide loans to commercial banks to maintain or improve the GDP. The basic objectives of RBI are to issue bank notes, to maintain the currency and credit system of the country to utilize it in its best advantage, and to maintain the reserves. RBI maintains the economic structure of

the country so that it can achieve the objective of price stability as well as economic development, because both objectives are diverse in themselves.

### **Banker of Banks**



Nagpur branch holds most of India's gold deposits

RBI also works as a central bank where commercial banks are account holders and can deposit money. RBI maintains banking accounts of all scheduled banks. Commercial banks create credit. It is the duty of the RBI to control the credit through the CRR, bank rate and open market operations. As banker's bank, the RBI facilitates the clearing of cheques between the commercial banks and helps inter-bank transfer of funds. It can grant financial accommodation to scheduled banks. It acts as the lender of the last resort by providing emergency advances to the banks. It supervises the functioning of the commercial banks and take action against it if need arises.

**Detection of Fake currency:** In order to curb the fake currency menace, RBI has launched a website to raise awareness among masses about fake notes in the market. [www.paisaboltahai.rbi.org.in](http://www.paisaboltahai.rbi.org.in) provides information about identifying fake currency.

On January 22, 2014; RBI gave a press release stating that after March 31, 2014, it will completely withdraw from circulation all banknotes issued prior to 2005. From April 1, 2014, the public will be required to approach banks for exchanging these notes. Banks will provide exchange facility for these notes until further communication. The Reserve Bank has also clarified that the notes issued before 2005 will continue to be legal tender. This would mean that banks are required to exchange the notes for their customers as well as for non-customers. From July 01, 2014, however, to exchange more than 10 pieces of `500 and `1000 notes, non customers will have to furnish proof of identity and residence to the bank branch in which she/he wants to exchange the notes. This move from the Reserve Bank is expected to unearth black money held in cash. As the new currency notes have added security features, they would help in curbing the menace of fake currency.

### **3.1.2 Industrial Development Bank of India (IDBI)**

This is an apex institution providing long-term finance to industrial sector. It was set up as a subsidiary of the RBI in 1964. In February, 1976 it was segregated from the RBI. At present its whole of the share capital is owned by the Government of India. IDBI provides financial assistance to industrial concerns by way of variety of products and services which include project finance, equipment finance, asset credit, equipment lease, technology up gradation fund scheme, refinance for medium scale industries and bill finance. It provides as well as for expansion, diversification and modernization of existing industrial enterprises. In response to the changing financial needs of industries, IDBI has also designed other products to meet the short term funding, core working capital and other short term requirements of industrial units. It also offers fee-based services in the area of merchant banking, corporate advisory services, foreign exchange services etc. IDBI has also set up subsidiaries and associates to offer banking products &

services, capital market and trusteeship services, as also registrar and transfer services structured to meet customized client requirements. For meeting fund requirements thereof as well as towards its various other business operations, IDBI raises resources directly from the market (at market-related interest rates) from retail as well as institutional investors – both within India and abroad, through a variety of investor-friendly instruments. IDBI's resources raising efforts have brought it closer to all sections of society.

### **3.1.3 Small Industries Development Bank of India (SIDBI)**

Small Industries Development Bank of India (SIDBI) was established in April 1990 under an Indian Parliament wholly-owned subsidiary of Industrial Development Bank of India (IDBI).

SIDBI's stature provides that it should serve as the principal financial institution for:

- Promotion
- Financing
- Development of industry in the small scale sector and
- Coordinating the functions of other institutions engaged in similar activities

The Small Scale industry (SSI) sector, which is vibrant and dynamic sub-sector of the India's industrial economy, comprises the area of SIDBI's business. The contribution of the SSI's in term of production, employment and export earnings has been significant. The objectives of Government policy have been to impact vitality and growth impetus to the sector by removing bottlenecks that affect the growth potential. In the liberalized era and emerging economic scenario, the sector is assured of continued support.

### **3.1.4 National Bank for Agriculture And Rural Development (NABARD)**

In order to meet the credit requirement of agriculture and rural development the NABARD was set up in 1982 with the merger of 'Agriculture Credit Department' and Agriculture \Refinance and development Corporation' of the RBI. The bank provides short term and long term credit to agriculture and non agriculture activities namely hand weaving, artisans etc. and coordinate the activities. It provides refinance facilities on the loan given by commercial banks and cooperative for the agriculture and rural development.

#### **Main Function of NABARD**

- Refinancing to Cooperative Banks
- Financing to Rural Banks
- Loan facilities for purchase of Shares
- Refinance of Rural Development loans
- Long term Loan Facilities
- Technical Assistance and Advice

### **3.1.5 Export-Import Bank of India (EXIM)**

The Export-Import Bank of India (EXIM Bank) was set in January, 1982 with its headquarters in Mumbai.

It Perform the normal banking functions connected with import and export of goods, and several other functions. These major functions include financing of exports from and imports to India, financing joint ventures in foreign countries and financing the export and import of machinery and equipment on lease basis. It also undertakes purchasing, discounting and negotiating of exports bills and thus encourages the exporters.

### **3.1.6 National Housing Bank (NHB)**

The National Housing Bank (NHB) was established on 9th July 1988 under an Act of the Parliament viz. the National Housing Bank Act, 1987 to function as a principal agency to promote Housing Finance Institutions and to provide financial and other support to such institutions. The Act, inter alia, empowers NHB to:

- Issue Directions to housing finance institutions to ensure their growth on sound lines
- Make a loan and advances and render any other form of financial assistance to scheduled banks and housing finance institutions or to any authority established by or under any Central, State or Provincial Act and engaged in slum improvement and
- Formulate schemes for the purpose of mobilization of resource and extension of credit for housing

### **3.2 STRUCTURE OF INDIAN BANKING INDUSTRY**

The Banking industry in India has grown in a specific kind of environment and with some defined objectives.

This historicity of this environment and the objectives has a strong bearing on the operations and management of present day. To appreciate any economic dimension of the banking industry in India in a proper perspective, understanding of the path of evolution of the industry must. The origin of banking industry may be traced back to establishment of Bank of Bengal in Calcutta in 1786. Since then the industry has witnessed substantial growth and radical changes. As on March 2011, Indian banking industry consisted of the 234 Commercial Banks.

**Phase 1:** Early phase from 1786 to 1969 of Indian banks.

**Phase 2:** Nationalization of Indian banks up to 1991 prior to the Indian banking sector reforms.



**Phase 3:** New phase of Indian banking system with the advent of Indian Financial and Banking Sector Reforms after 1991.

We shall now discuss these three phase briefly.

### **3.2.1 PHASE I**

The General Bank of India was set up in 1786. Next came the Bank of Hindustan and Bengal Bank. The East India Company established Bank of Bengal (1809), Bank of Bombay (1840) and Bank of Madras (1843) as independent units and called them presidency Banks. These three banks were amalgamated in 1920 and the Imperial Bank of India, which started as private shareholders banks, was established with mostly European shareholders.

In 1865, the Allahbad Bank was established, and, for the first time, exclusively by Indians, Punjab National Bank Ltd. was set up in 1894 with headquarters at Lahore. Between 1906 and 1923, Banks of India, Central Bank of India, Bank of Baroda, Canara Bank, Indian Bank and Bank of Mysore were set up. The Reserve Bank of India (RBI) was established in 1935. During the first phase, the growth was very slow and banks also experienced periodic failures between 1923 and 1948. There were approximately 1100 banks, mostly small. As per the Reserve Bank India Act of 1934, the Reserve Bank of India (RBI) was constituted as an apex bank without major government ownership. To streamline the functioning and activities of commercial banks, the Government of India came up the Banking Companies Act, 1949 which was later changed to Banking Regulation Act, 1949. As per the Banking Regulation (Amendment) Act of 1965 (Act No. 23 of 1965), RBI was vested with extensive powers for the supervision of banking in Indian as the Central Banking Authority. During those days, the public confidence in banks was somewhat low and, so, deposit mobilization was slow. Abreast of it the

savings banks facility provided by the postal department was comparatively safer. Moreover, funds were largely given to traders.

### **3.2.2 PHASE II**

The government took major steps in the Indian Banking Sector Reforms after independence. In 1955, it nationalized the Imperial Bank of India (the State Bank of India Act) with extensive banking facilities on a large scale, especially in rural and semi-urban areas as the first phase of nationalization. It formed the State Bank of India (SBI) to as the principal agent of RBI and to handle banking transactions of the Union and the State Governments of the Country.

In 1969, seven subsidiary banks of the State Bank of India were nationalized as a major process of nationalization due to the effort of then Prime Minister Mrs. Indira Gandhi, Later in 1969, 14 Major Private Commercial Banks in the country were nationalized. The list of 14 banks nationalized in 1969 was;

1. Central Bank of India
2. Bank of Maharashtra
3. Dena Bank
4. Punjab National Bank
5. Syndicate Bank
6. Canara Bank
7. Indian Bank
8. Indian Overseas Bank
9. Bank of Baroda
10. Union Bank
11. Allahabad Bank
12. United Bank of India
13. UCO Bank

#### 14. Bank of India

The second phase of nationalization of Indian banks was carried out in 1980, with seven more banks being nationalized. This step brought 80 percent of the banking segment in India under government ownership. The Government of India has taken the following steps to regulate banking institutions in the country:

1949: Enactment of Banking Regulation Act

1955: Nationalization of State Bank of India

1959: Nationalization of SBI subsidiaries

1961: Insurance cover extended to deposits

1969: Nationalization of 14 major banks

1971: Creation of Credit Guarantee Corporation

1975: Creation of regional rural banks

1980: Nationalization of seven more banks with deposits over Rs. 200 crore.

After the nationalization of banks, the branches of the public sector banks in India rose to approximately 800 percent in deposits, and advances took a huge jump by 11,000 percent. Government ownership gave the public implicit faith and immense confidence in the sustainability of public sector banks.

#### **3.2.3 PHASE III**

The third phase of development of Indian banking introduced many more products and facilities in the banking sector in its reform measures. In 1991, under the chairmanship of M. Narsimham, a committee was set up under his name, which worked for the liberalization of banking practices.

The country is flooded with foreign banks and their ATM stations. Efforts are being put in to give a satisfactory service to customers. Phone banking and net banking have been introduced. The entire system has become more convenient and swift. Today, time is given more importance than money.

The financial system of India has shown a great deal of resilience. It is sheltered from any crisis triggered by any external macroeconomic shock as other East Asian countries suffered. This is all due to a flexible exchange rate regime, high foreign reserves, the not yet fully convertible capital account, and limited foreign exchange exposure to banks to their customers.

### **3.3 PRESENT STRUCTURE OF INDIAN BANKING INDUSTRY**

The Indian financial system comprises a large number of commercial and cooperative banks, specialized developmental banks for industry, agriculture, external trade and housing, social security institutions, collective investment institutions, etc. The banking system is at the heart of the financial system.

The Indian banking system has the RBI at the apex. It is the central bank of the country under which there are the commercial banks including public sector and private sector banks, foreign banks and local area banks. It also includes regional rural banks as well as cooperative banks. The structure of the Indian banking system is given in figure

#### **3.3.1 COMMERCIAL BANKS**

In the organized sector of the money market, commercial banks and cooperative banks have been in existence for the past several decades. A commercial bank which is run for the benefit of a group of members of the cooperative body, e.g., housing cooperative society. The commercial banks are spread across the length and breadth of the country, and cater to the short term needs of industry, trade and commerce and agriculture unlike the developmental banks which focus on long term needs. These days the commercial banks also look after other needs of their customers including long term credit requirements.

The Central Bank (Reserve Bank of India)

Old Banks

Local Banks

## **Indian Banking System**

Commercial Banks Regional Rural Banks Cooperative Banks

Public Sector Banks Private Sector Banks

State Cooperative Bank

Nationalized Banks

State Bank

Group Indian Foreign

Central/ district

Cooperative Banks

Public Credit Societies

SBI Subsidiary Banks

New Banks

The banking sector has been undergoing drastic metamorphosis. The rapid progress witnessed in the realm of banking services has been engineered by the trends in globalization, liberalization and privatization. The technological revolution and demographic changes have also helped to change the face of banking in India. More banks are switching over virtual banking for the brick and mortar banks, and are providing a vast array of products through very innovative channels and at highly competitive prices. Banks are now free to quote their own interest rates in loan/advances and term deposits. They now have to manage their investments and loans portfolios based on the international norms and practices of risk management including asset liability management.

Commercial banks operating in India may be categorized into public sector, private sector, and Indian or foreign banks depending upon the ownership, management

and control. They may also be differentiated as scheduled or non-scheduled, licensed or unlicensed.

**Expansion of Bank Offices:** The branch expansion of commercial banks has been very fast after independence in the history of India banking. There were 4115 branches of scheduled commercial banks in 1951 which have increased to 8262 in June, 1969, 60190 on 30th June, 1991 and 93080 in 31st March 2011.

### **3.3.2 Public Sector Banks**

The public sector banks comprise of 20 nationalized banks, the state Banks of India and its 7 associates. Till 1955 they were used to be only private commercial bank- whether scheduled or non-scheduled, licensed or unlicensed, foreign or India, they were all owned and controlled by private entrepreneurs and shareholders.

There were three phases of banks nationalization. The first was in July 1955, when Government of India nationalized the Imperial Bank of India to create the State Bank of India. It was a pioneering attempt in introducing public sector banking in the country. In 1959, eight state banks of erstwhile princely states were also nationalized to form the subsidiaries of the State Bank of India. But now only seven of them are in Scheduled Banks in India

### **3.3.3 Private Sector Banks**

Private sector banks have existed for over a century in India. Prior to the first major nationalization in 1969, private capital called the shots in commercial banking. The Tatas owned the Central Bank of India, the Birlas the United Commercial Bank (UCO Bank now), and so on. Following the recommendations of the Narasimham committee on financial sector (1991), the Reserve Bank of India issued guidelines for the setting up of new private sector banks in India in January 1993. It was hoped that these financially viable, technologically sound and

professionally managed banks will infuse greater competition and propel the entire banking sector to much higher levels of productivity and efficiency. The guidelines of the RBI for the entry of private sector banks are as follows:

**Formation:** Such a bank shall be listed as public limited company under the Companies Act, 1956. It will be governed by the provisions of Reserve Bank of India Act and Banking Regulation Act. The decision regarding licensing and inclusion under second schedule of the RBI shall be final. At the time of granting of licenses preference may be given to those banks which propose to have their headquarters located in a centre, which does not have headquarters of any other bank. The voting rights of an individual shareholder shall be governed by the ceiling of one percent (which was raised to 10 percent in 1994).

**Capital:** The minimum paid-up capital shall be Rs. 100 crore with promoter's contribution being 25 percent. In case the capital is more than Rs. 100 crore, then the promoter's contribution shall be 20 percent. NRI participants can to the extent of 40 percent. The shares of the banks should be listed on stock exchanges.

The bank shall be subject to prudential norms in respect of banking operations norms for income recognition, asset classification and provisioning as well as capital adequacy of 8 percent of the risk weighted average.

**Operations:** The banks shall have to observe priority sector lending targets as applicable to other banks, though some modifications in their composition may be allowed by the RBI in the initial three years. RBI instructions with respect to export credit will also have to be complied with. For at least three years after its establishment they will be allowed to set up a subsidiary or mutual fund.

**Opening of Branches:** Branch licensing shall be governed by the existing policy whereby banks are free to open any branches without prior approval of the RBI, if they satisfy capital adequacy and prudential accounting norms. If the RBI so

directs, they might be required to open branches in rural and semi-urban areas. Revised guidelines issued by the RBI in January 2001 brought in some changes. The major changes are:

- Minimum paid-up capital for a new bank should be Rs. 200 crore which shall be increased to Rs.300 crore in subsequent three years after commencement of business.
- A non-banking financial company (NBFC) may convert into a commercial bank, if it satisfies the prescribed criteria.
- A large industrial house should not promote any new bank
- Preference would be given to promoters with expertise of financing priority area, and in setting up banks specializing in the financing of rural and agro-based industries.

### **3.3.4 Local Area Banks**

To meet the long standing need of developing a decentralized banking system, the union budget 1996-97 announced a very important policy measure regarding the development of commercial banking in India, namely, the setting up of local area banks (LABNKs) as commercial banks in the private sector. It was hoped that the large number of problems faced by RRBs and other commercial and cooperative banks would be addressed by the local area banks especially in the rural areas. These banks were thus set up with two objectives of:

- (i) Providing an institutional mechanism for promoting rural and semi-urban savings, and
- (ii) For providing credit for viable economic activities in the local areas. These banks were established as public by either individual, corporate, trusts or societies. The minimum paid-up capital of such banks was Rs.5 crore with promoter's contribution at least Rs. 2 crore. Unlike the RRBs which can operate in many



districts with large number of banks, the local area banks can operate and open branches in maximum of three geographically contiguous districts. The local area banks are governed by the provisions of the RBI Act, 1934, the Banking Regulation Act, 1949 and other relevant statutes. They are to registered as a public limited company under the Companies Act, 1956. The concept of the local areas banks has remained a non-starter.

### **3.3.5 Indian Banks**

Indian banks operate nationally through a colossal network of branches. Since, they have a large and varied clientele with a diverse spectrum of needs, the Indian banks specialized in different geographical region surban, different sectors-industry both large and small, agriculture trade, housing, exports, etc. However, all of them in the organized sector come under the purview of the RBI Act and the Banking Regulation Act.

The main Strength of the Indian banks is their cast number of employees who are well conversant with social and cultural fabric of their customers, the Indian banks by and large focus on core banking operations.

They also strictly comply with the RBI guidelines as to liquidity requirements, interest rates and priority sector lending amongst other provisions.

### **3.3.6 Foreign Banks**

Till the 1950s they were called Exchange Banks because they alone transacted most of the import and export financing business of India. The foreign banks are branches of joint stock companies incorporated abroad, but operating in India. They are foreign in origin, and have their head office located in their parent country. Many foreign banks opened their offices, and expanded branches after the opening up of the Indian economy in the 1990s. These banks created an entirely new plying field in the banking sector through their range of products and services

including ATMs, electronic services, credit cards and portfolio management. They provide foreign currencies for bona fide purpose like trade, travel or for study abroad.

Most foreign banks have a very strong parent bank commitment, superior technology and provide a very high level of customer service. This has resulted in very strong performances of these banks both in the retail sector (home loans, credit cards, distribution of third party products including mutual funds and insurance services) as well as the corporate sector (derivatives, structures products, other risk management products and debt capital markets).

### **3.3.7 Regional Rural Banks**

Regional Rural Banks were established under the provisions of an Ordinance promulgated on the 26<sup>th</sup> September 1975 and the RRB Act, 1976 with an objective to ensure sufficient institutional credit for agriculture and other rural sectors. The RRBs mobilize financial resources from rural / semi-urban areas and grant loans and advances mostly to small and marginal farmers, agricultural laborers and rural artisans. The area of operation of RRBs is limited to the area as notified by Government of India covering one or more districts in the State.

The Regional Rural Banks (RRBs) have been set up to supplement the efforts of cooperative and commercial banks to provide credit to rural sector. The following were the reasons or need set up the RRBs:

1. To free the rural poor, small and marginal farmers from the clutches of money lenders.
2. To provide credit to small farmers, marginal farmers, rural artisans, landless laborers who do not fulfill the criterion of creditworthiness as per the banking principles.

3. To provide banking services to the rural community at a relatively lower cost by adopting a different staffing pattern, wage structure and banking policies.

### **3.3.8 Cooperative Banks**

Cooperative banks are a part of the set of institutions, which are engaged in financing rural and agriculture development. The other institutions in this set include the RBI, NABARD, commercial banks and regional rural banks, cooperative banking is small-scale banking carried on a no profit, no loss basis for mutual cooperation and help. Cooperative banks were assigned the important role of delivering of fruits of economic planning at the grass roots level. Cooperative banking structure is viewed as a vehicle for democratization of the Indian financial system. They were conceived to supplant moneylender and indigenous bankers by providing adequate short-term and long term institutional credit at reasonable rates of interest. Cooperative banks originated with enactment of the Cooperative Credit Societies Act of 1904. A new Act was passed in 1912, which provided for the establishment of the cooperative central banks by a union of primary credit societies, or by a union of primary credit society and individuals. After 1991, a number of reforms have taken place under which licensing of UCBs (Urban Cooperative Banks) has been liberalized greatly, lending and deposit rates of all cooperative banks have been completely freed or deregulated, a cooperative development fund has been set up by NABARD for improvement of managerial systems and skills. UCBs have been allowed to invest in equity/bonds of all India Financial Institutions, PSUs, UTI, and CDs of scheduled commercial banks subject to certain ceilings.

## **4.0 CONCLUSION**

The foregoing analyses indicate that structure of banks are indispensable in the development process of an economy. Therefore, it is very essential for the government to provide the necessary conducive atmosphere for commercial banks to operate in the economy.

## **5.0 SUMMARY**

This unit examines the structure of the banking industry in India. Banks in India are organized as commercial banking institutions and cooperative banking societies. Commercial banks are owned by the public sector, private sector and foreign banks. The public sector banks dominate the banking industry both in terms of volumes and reach of branches. The cooperative banking segment of Indian banking is small in comparison to the commercial banking segment. It is also plagued by poor performance. However, it has an important place as a provider of banking services to smaller sections of the society.

This unit also provides an overview of the statutory framework for banking in India. The Banking Regulation Act, 1949 is the most important legislation for banks in India. This act lays down the definition of banking and allowable banking activities. It also gives the RBI wide-ranging regulatory power to control banks in India starting from their licensing.

## **6.0 SELF ASSESSMENT QUESTIONS**

1. Define the structure of Indian Banking System.
2. Describe the structural and operational changes in Indian Banking System after Independence.
3. What were the reasons to initiate banking sector reforms?
4. Explain the salient feature of reforms during Phase I.

5. Give a detailed account of the different types of banking institutions all of which constitutes for Indian Banking System.

## **7.0 BOOKS FOR FURTHER READINGS**

Pramod Kumar (2006). “Banking Sector Efficiency in Globalized Economy”, *Deep` and Deep Publications Pvt. Ltd, New Delhi*

Trivedi, I.V., Chaudhary, C M. and Kumar S.B. (2008). “Indian Banking System”, *Ramesh Book Depot, Jaipur and Delhi*

Saggar, S. (2005). “Commercial Banks in India”, *Deep and Deep Publications Pvt. Ltd.*

Sethi, J., and Bhatia, N. (2007). “Banking and Insurance”, *PHI Learning Pvt. Ltd , New Delhi*

Rokind Christian (2008). “Banking Sector Liberalization in India”, *Physica-Verlag Heidelber Publication*

Muraleedharan, D (2009); “Modern Banking: Theory and Practices”, *PHI Learning Pvt Ltd, New Delhi*

Reserve Bank of India: Banking Statistics – *Basic Statistical Returns, Various Issues*

Reserve Bank of India, Report on Trend and Progress of Banking in India, *Various Issues*

## **UNIT 4: THE NIGERIAN FINANCIAL SYSTEM**

### **CONTENTS**

1.0 Introduction

2.0 Objectives

3.0 Main Content

3.1 The Structure of the Nigerian Financial System

3.2 The Regulatory Agencies of Financial Institutions

4.0 Conclusion

5.0 Summary

6.0 Tutor-Marked Assignment

7.0 References/Further Reading

### **1.0 INTRODUCTION**

The financial structure of Nigeria is the composite of the instruments and institutions. It consists of the present stock of various financial assets together with the pattern of financial institutions in existence. The institutions differ from one another by the kind of secondary claim they issue and the type of primary claim they buy. We will be looking at the structure of the Nigerian financial system and the various regulatory bodies.

## **2.0 OBJECTIVES**

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

- i. explain the structure of the Nigeria financial system
- ii. identify the regulatory bodies of financial institutions.

## **3.0 MAIN CONTENT**

### **3.1 THE STRUCTURE OF THE NIGERIAN FINANCIAL SYSTEM**

The Nigerian financial system can be broadly divided into two, namely: the formal and the informal sector. The formal sector can be subdivided into money and capital market institutions and these comprises of banks, non-bank and specialised financial institutions.

i. The banking financial institutions are active agents in the money market. They mobilise short-term funds from the surplus sector of the economy to the deficit sector. This comprises of the following:

#### **a. Commercial Banks and Merchant Banks:**

These institutions operate under the legal framework of the banks and other financial institutions decree 25 of 1991 (as amended). The commercial banks perform three major functions, namely: acceptance of deposits, granting of loans and the operation of payment and settlement mechanism. The merchant banks take deposits and cater for the need of corporate and institutional customers by the way of providing medium and long-term financing. They also engage in equipment leasing, debt factoring, etc. However, following the adoption of universal banking policy, most merchant banks were converted to commercial banks.

### **b. Micro Finance Banks (Community Banks):**

A community bank in Nigeria is a self-sustaining financial institution owned and managed by the community to provide financial services to that community. National Board issues provisional license of community banks for Community Banks (NBCB) while the final license is issued by the CBN after operating for two years with the banking reforms, these banks have been transformed to micro finance banks and their capital base has been raised.

ii. The non-banking financials consist of insurance companies, pension funds, mortgage houses, stock broking firms, daily collection bureau de change. They are also of great importance to the Nigerian financial system. Most of them give long-term loans.

iii. The Specialised Banks or Development Finance Institutions (DFIS) was established to contribute to the development of specific sectors of the economy. They consist of the Nigeria

Industrial Development Bank (NIDB), Nigeria Bank for Commerce and Industry (NBCI), Nigerian Agricultural and Co-operative Bank (NACB) and Urban Development Bank (UDB).

## **3.2 THE REGULATORY AGENCIES OF FINANCIAL INSTITUTIONS**

There are several financial institution regulatory agencies in Nigeria, among which are:

The Federal Ministry of Finance (FMF): The FMF advises the Federal Government on its fiscal operations and cooperates with CBN on monetary matters. It was at the top of the financial system until recently, the CBN was under its control. However,



an amendment in 2006 to the laws of the CBN compels the CBN to report to the presidency through the Federal Ministry of Finance.

**The Central Bank of Nigeria:** The CBN is the apex regulatory authority in the financial system. Among its other primary functions, the bank promotes monetary stability and a sound financial system; acts as bank and financial adviser to the Federal Government; and act as banker of the last resort to other banks in the country. Enabling laws made in 1991, gave the CBN more flexibility in regulatory and overseeing the banking sector and licensing finance companies, which hitherto operated outside any regulatory framework.

**The Nigerian Deposit Insurance Cooperation (NDIC):** Although an autonomous entity from the CBN, NDIC complements the regulatory and supervisory role of the CBN. NDIC commenced operations in 1989 with the aim of providing deposit insurance and related services for banks to promote confidence in the banking industry. It examines the books of deposit money and financial institutions.

**The Securities and Exchange Commission (SEC):** Formally known as the Capital Issues Commission, SEC is the apex regulatory organ of the exchange market. Its major objective is to promote an orderly and active capital market by ensuring the adequate protection of securities, registering all securities dealers in order to maintain proper standard of conduct and professionalism, approving and regulating mergers and acquisitions and maintaining surveillance over the market to enhance efficiency.

**National Insurance Commission (NIC):** The NIC is charged with effective administration, supervision, regulation and control of the business of insurance in Nigeria, high technical expertise and judicious fund placement in the insurance industry.

The Federal Mortgage Bank of Nigeria: FMBN is the successor of the Nigerian Building Society. It provides banking and advisory services, and undertakes research activities pertaining to housing. With the adoption of National Housing Policy in 1990, FMBN was empowered to regulate primary mortgage institutions in Nigeria. The financing function of FMBN was carved out and transferred to the federal mortgage finance, while the FMBN retained the regulatory role. FMBN is under the control of the CBN.

Financial Service Coordinating Committee (FSCC): This is a committee established to coordinate the activities of all regulatory institutions in the financial system. The Federal Ministry of Finance chairs the committee.

#### **4.0 CONCLUSION**

The above discussion has shown us that there are many institutions in the Nigerian financial system. These institutions have varying responsibilities, thus, there is need for different regulatory bodies to be set-up to cater and regulate their activities. This is to check abnormalities and ensure the smooth running of the financial system in Nigeria.

#### **5.0 SUMMARY**

This unit has explained to us the financial system of Nigeria. The classification of financial institutions was considered alongside with the regulatory bodies set up by government to monitor the activities of these institutions to keep them in check.

#### **6.0 TUTOR-MARKED ASSIGNMENT**

1a. Distinguish between the role of the Federal Ministry of Finance and the Central Bank of Nigeria.

- b. Explain the activities of the Federal Mortgage Bank of Nigeria.
- 2. Outline the agencies that regulate the various financial institutions in Nigeria.
- 3. Explain the structure of the Nigerian financial system.

## **7.0 REFERENCES/FURTHER READING**

Admin (2009). “Banking and Finance Structure of Nigeria Financial System.”

Posted on Internet in Business, Economy Entrepreneur Nigeria.

## **UNIT 5: CREDIT INSTRUMENTS AND CREDIT CREATION BY COMMERCIAL BANKS**

### **CONTENTS**

1.0 Introduction

2.0 Objectives

3.0 Main Content

3.1 Meaning and features of credit

3.2 Credit instruments

3.3 Credit and the economy

3.4 Credit Instruments

3.5 Factors affecting the volume of credit

3.6 Bank credit creation process

3.7 Bank constraints in credit creation

4.0 Conclusion

5.0 Summary

6.0 Tutor – Marked Assignment

7.0 References/Further Readings

## **1.0 INTRODUCTION**

In the previous unit we saw one of the important functions of the commercial banks in the economy, that of credit creation. The question that quickly comes to mind is what does credit exactly mean?

In economics and commerce, transactions are carried out of which cash payments are not always effected but may be agreed to be effected at a later but fixed date. This transaction is referred to as credit and is of varied types and employ different instruments in accomplishing its purpose.

In this unit, we shall therefore be discussing credits, its instruments and the process of its creation in an economy.

## **2.0 OBJECTIVES**

It is expected that at the end of this unit, you will be able to:

- i. Explain the features and types of credits.
- ii. Explain the role of credit in economic development.
- iii. Identify the various types of credit instruments.
- iv. Explain the process of credit creation by commercial banks and factors militating against this process.

## **3.0 MAIN CONTENT**

### **3.1 MEANING AND FEATURES OF CREDIT**

In general terms, credit, a word that took its origin from Latin meaning “to believe or trust” has been adopted as an economic term. As an economic term, credit

usually refers to “a promise by one party to pay another for money borrowed or goods or services received. It is also a medium of exchange to receive money or goods on demand at some future date. “It can however be referred to, as many economists do, “as the right to receive payments or the obligation to make payment on demand at some future time on account of the immediate transfer of goods.”

As a commerce and finance term, credit denotes transaction involving the transfer of money or other property on promise to repay money usually at a fixed date.

For credit to successfully satisfy its object, the following essential features must be present:

1. Trust and confidence on the part of the borrower or buyer to the lender or seller.
2. Time element, when the money or goods will be paid back or returned.
3. Transfer of goods and services between the seller and buyer.
4. The willingness and ability of the parties concerned, this is hinged on character (honesty), capacity and capital of the parties in the transaction.
5. The purpose of the credit presupposes the credit transaction either production or consumption purpose.
6. Security or collateral which is, in most cases, the base or important element for raising the credit.

### **3.2 TYPES OF CREDIT**

Credit as we have earlier seen as a commerce and finance term, has the following principal classes:

1. Mercantile or Commercial credit: These are credits, merchants extend to one another to finance production and distribution of goods.
2. Investment credit: Those credits used by business firms to finance the acquisition of plant and equipment and represented by corporate bonds, long-term notes, and other proofs of indebtedness.
3. Bank credit: This consists of deposits, loans and discounts of depository institutions.
4. Consumer or Personal credit: Comprises advances made to individuals to enable them meet expenses or to purchase, on a deferred payment basis, goods or services for personal consumption.
5. Real: Estate credit comprises loans secured by land or buildings.
6. Public or government credit: represented by the bond issues of federal, state or local governments.
7. International credit, which is extended to particular government by other governments, by nationals of foreign countries or by agencies, like the International Bank for Reconstruction and Development (the World Bank).

All these types of credit reveal the principal function of credit – that of transferring property from those who own it to those who wish to use it, as in the case of banks granting loans to individuals who plan to initiate or expand a business venture.

### **3.3 CREDIT AND THE ECONOMY**

Credit transactions have been indispensable to the economic development of the modern world. It puts to use property/funds that would otherwise lie idle, thus enabling a country to more fully employ its resources.

One of the most significant differences between some nations of the developing nations and the advanced western nations is the extent to which the use of credit permits them to keep their savings continuously at work. Without credit, the tremendous investment required for the development of the large-scale enterprises on which the high living standards of the West are based would have been impossible. Thus, credit encourages investment and finance development in economy. The performance of some complex modern business operations are made possible by the use of credit, thus minimizing the constant handling of cash. These are in areas of internal and international trades, which it thus makes to be more convenient in operation.

Some economic problems like inflation - changes in general price level are controlled through the adoption of some credit control policies by the central bank. This policy helps in maintaining price stability in the economy. The condition of this credit system gauges the business activities in the economy. Expanding credit availability generally reflects a period of prosperity, whereas contracting credit usually reflect a period of declining economic activity or depression. It can then be seen that fluctuations in the volume of credit affects the level of prices, as credit expands the money supply increases; thus causing prices to rise. The converse is also true. The extension of international credit to developing nations by such institutions as the International Bank for Reconstructing and Development (World Bank) contribute to their economic growth and survival.



Some government exigencies or emergencies are mostly met with credits when it becomes obvious that the usual fiscal measures have failed to fulfill them. This is achieved mostly, through deficit financing for economic development but creating excess credit.

### **3.4 CREDIT INSTRUMENTS**

Credit instruments are these financial or legal documents on which the credit transaction is contracted. They are usually written or printed financial documents that serve as order to pay or promise to pay. These credit instruments enable the parties effect the transaction, which is the transfer of funds from one party to another at a specified time and conditions.

Some well known and widely used credit instruments include:

#### **i. Promissory Note**

This is a written promise by a debtor to pay another or his order a specified amount of money within an agreed date. It is an “I.O.U” (I owe you) which is usually effected between 30 days to one year. Promissory notes may be issued by individuals, corporate bodies and government agencies which have to be acceptable by the debtor’s bank.

The creditor or the holder of the note can discount it before the date of recovery for a fee.

#### **ii. Bill of Exchange**

This is an unconditional order in writing addressed by one person giving it, requiring the person to pay whom it is addressed to pay on demand at affixed or determinable future time a sum certain in money to or to the order of a specified

person or to bearer. The payment period is usually 90 days. For a bill of exchange to be valid, it must be

- a) A definite order or command to pay, thus not an unconditional order;
- b) In writing; oral bills are not valid;
- c) Addressed by one person (drawer) to another (drawee) to be identified at a stated address where the bill is expressed to be paid;
- d) Signed by the drawer as his consent to the bill;
- e) Payable on demand or at sight or on presentation or at a future date;
- f) A sum sufficiently certain in money, even if payable with interest
- g) Payable to a person or to bearer or a holder of an office for the time. The bill of exchange is a negotiable instrument which can be bought or sold by the holder of the bill till the time of its maturity, at the prevailing rate of interest/discount. The holder of the bill presents it only after maturity to the drawee who pays the amount written on the bill. The bill can also be discounted and cashed by the holder before maturity date.

### **iii. Bank Notes**

These are all circulating medium of exchange (currency) of a country issued by her Central Bank. They all carry the promise of the governor of the Central Bank to pay on demand to the bearer of the note an amount mention on it.

### **iv. Credit Cards**

These are credit instruments issued by banks where the holder is allowed some credit facilities by the concerned bank for a specified period of time without any

security. They can be used to effect some payment for purchases made without cash for goods and services from certain establishments. There are national and International credit cards.

## **ii. Cheques**

A Cheque is defined as a bill of exchange drawn on a banker and payable on demand. It is an order on a bank by the drawer, who has his deposit with other bank, to pay on demand the stated sum of money to the person named on the Cheque.

A Cheque may either be;

- (a) “Bearer Cheque” where it can be cashed by the payee/ the person whose name appears on it or any other person holding it,
- (b) “Order Cheque” where the responsibility of payment to the payee is on the bank,
- (c) “Crossed Cheque” where the Cheque is crossed with two parallel lines with the words “payee’s the A/C only” written and amount shown must be credited to the account of the payee in his bank

## **iii. Drafts**

This is also called “bankers Cheques or demand drafts” which constitute an order of a bank to its other branch to pay an amount on it to specified person, firm or organization. The bank charges a commission for preparing the draft to the debtor who then sends it to the payee for presentation and payment.

### **3.5 FACTORS AFFECTING VOLUME OF CREDIT**

The previous section has shown that the quantum of credit available to those in need of it is influenced by some variable in the economic system. These are when credit expands or contracts. The factors that contribute to these conditions are discussed below.

#### **(i) The business cycle or state of business activity**

During periods of prosperity or boom conditions, business are growing and therefore demand for credit will increase with its attendant rise in interest rates. Periods of recession or depression, there is general declining business activity. Though interest rates are low, the entrepreneurs will not be ready to borrow, thus having contracting credit.

#### **(ii) Credit control policy**

The central bank's credit policy affects the volume of credit. A cheap credit policy reduces the cost of credit (interest); this increases in the demand for credit while the quantity of credit is contracted with a dear credit policy leading to a high interest rate.

#### **(iii) The stage or level of economic development of a nation**

In developing economies, the demand and supply of credits are usually high because of the operation of many financial institutions that are ready to provide credits no matter the quantity. The banking development and system also contribute to the volume of credit available to creditor as the level of development of the entire economy, when fully developed; the quantity of credit expands, while the converse is also true.

#### **(iv) The political stability of an economy**

During periods of political stability, credits expand since investment is encouraged hence increase demand for credit. Periods of political instability and insecurity, investment level is low leading to contraction in the quantity of credit.

### **3.6 CREDIT CREATION BY COMMERCIAL BANKS**

Credit creation, a very important function of commercial banks is the process where they (Commercial banks) make available to borrowers in the form of loans and overdrafts deposits in their possession. Bank customers who want to enjoy credit facilities with them usually open and operate current accounts. They therefore make withdrawal of credits granted them from such accounts through the use of cheques, in most case, not cash. Credits are therefore credit by the banks by their making use of cheques and clearing facilities.

Thus, credit creation requires bank opening a deposit every time they make loan available to customers. The customers in turn open chequering account through which payments and withdrawals are made finally effected through the Cheque clearing system. Thus bank loan creates deposits and it is in this sense that credit is credited by commercial banks.

It is worthy to note that banks do not give out all deposit they receive on loans and also depositors do not withdraw their money simultaneously. They therefore keep small cash in reserve for day-to-day transactions, and then advance the excess on this reserve on loans. Also, the banks are legally required to keep a fixed percentage of their deposits in cash, and lend or invest the remaining amount which is called excess reserves. The entire banking system can lend and create credit upon a multiple of its original excess reserves. The deposit multiplier

depends upon the required reserved ratio which is the basis of credit creation process.

#### **4.0 CONCLUSION**

Credits and credit instruments are of utmost importance in an economy. They help in mobilizing savings, increasing investments and the rate of capital formation by raising production and employment. Credit is essential for the overall economic development of the economy since it has been seen that it may be impossible to think of the present-day economies without the use of credit. Thus, credits and credit creation are indispensable lubricants and tools of convenience for the economic progress of a country. It is, however, worthy to note that its uncontrolled use brings untold problems for the economy.

#### **5.0 SUMMARY**

In this unit, we have discussed credit, credit instruments and credit creation process and abilities by commercial banks in an economy. The meaning, features, types and role of credit in an economy were extensively discussed. The various credit instruments used in the economy and the factors affecting their volume were also examined.

The concluding section is on the commercial, banks credit creation process and the constraints that affect this credit creation process. In the next study unit, we shall discuss the central bank functions and credit control.

#### **6.0 TUTOR-MARKED ASSIGNMENTS**

1. What do you mean by credit? Mention at least five types of credit prevalent in the economy.

2. a) Discuss the role of credit in an economy.
- b) What is a credit instrument? Mention at least four well know credit instruments.
3. a) Describe the process of credit creation by commercial bank
- b) Outline the constraints that inhibit commercial banks' power in credit creation.

## **7.0 REFERENCES/FURTHER READINGS**

- Lipsey, R.G. (1980). An Introduction to Positive Economics (5<sup>th</sup> Edition). English Language Book Society & Weidenfeld & Nicolson.
- Jhingan, M.L. (2006). Money, Banking, International Trade and Public Finance. Vrinda Publication Ltd India.
- Orji, J. (1996). Elements of Banking. ROCK Communication Nig Enugu Nigeria.
- Unamka, P.C. et al (1995). Business Administration. Precision Printers and Publishers Enugu Nigeria.

## **MODULE 4: ROLE OF CENTRAL BANK AND NON BANK SYSTEMS**

Unit 1: The Role of Central Bank in a Developing Economy

Unit 2: Development of Banking in Nigeria

Unit 3: Money and Capital Markets

Unit 4: Non-Bank Financial Intermediaries (NBFIs)

Unit 5: Monetary Policy

### **UNIT 1: THE ROLE OF THE CENTRAL BANK IN A DEVELOPING ECONOMY**

#### **CONTENTS**

1.0 Introduction

2.0 Objective

3.0 Main Content

3.1 Creation and expansion of financial system role

3.2 Price level stability role

3.3 Interest rate policy stability role

3.4 Debt management role

3.5 Monetary stability role.

3.6 Foreign exchange management role



## 4.0 Conclusion

## 5.0 Summary

## 6.0 Tutor-Marked Assignment

## 7.0 References/Further Readings

### **1.0 INTRODUCTION**

The position of the central bank in any developing economy is of dual purpose. It performs the normal or traditional central bank functions and at the same time non-traditional functions of stimulating the general economic development of the country by direct participation in key establishments.

The principal traditional functions of the central banks as you have already learnt in unit twelve include – issuance of the nation's legal tender (currency), banker to the government, banker's bank, lender of last resort, maintenance of external reserves and the controller of credit and maintenances of stable foreign dealings.

In developing nations, the central bank helps the economy to develop fast by making money available for rising level of production and distribution, helping the drive to increase exports and keep prices stable. It further through the use of its monetary policy, maintains stability in the supply of money and credit. These functions of the central bank in the economic development of nation are discussed hereunder.

### **2.0 OBJECTIVES**

It is expected that at the end of this unit, you will be able to;

i. identify and explain how the central bank controls and enhances stability in the economic and financial system of a developing nation.

### **3.0 MAIN CONTENT**

#### **3.1 CREATION AND EXPANSION OF THE FINANCIAL SYSTEM**

The commercial banks that have the function of credit creation in the economy are mostly profit oriented institutions. They therefore prefer to be localized in the big cities to provide credit facilities to estates, plantations, big industrial and commercial ventures.

The commercial banks hitherto provide only short-term loans to the aforementioned groups, thus credit facilities in the rural areas to peasant farmers, small business men/women and traders were mostly nonexistent. The central bank in its bid to improve the currency and credit system of the country issues directives to the commercial banks to extend branch banking to rural (i.e. rural banking scheme) areas to make credit available to the rural business operatives. Also they are directed on the provision of credit facilities to marginal farmers on short, medium and long term basis. The central bank also encourages the establishment of community banks and other programmes through which deposit mobilization and investments are encouraged in the rural areas. The central bank also helps in establishing specialized banks and financial corporations in order to finance large and small industries.

#### **3.2 PRICE LEVEL STABILITY ROLE**

In units six, seven and eight where we discussed the demand and supply of money and inflations, you learned about the movement in price level resulting from the imbalance between demand and supply of money. It is a general economic system

that as the economy develops; the demand for money is likely to go up due to increase in production and price.

This if not properly checked may result in inflation. The central bank controls the uses of policy that will prevent price level from rising without affecting investment and production adversely.

### **3.3 INTEREST RATE POLICY STABILITY ROLE**

In developing economies, the existence of high interest rates in different sectors act as an obstacle to the growth of both private and public investment. Since investors borrow from the banks and the capital market for purposes of investment, it therefore, behoves the system to encourage them by ensuring a low interest rate policy. Low interest rate policy is a cheap money policy, making public borrowing cheap, cost of servicing public debt low and finally encouraging and financing economic development. The policy becomes more effective if the central bank operates a discriminatory interest rate, charging high rates for non-essential and unproductive loans and lower rates for productive loans.

### **3.4 DEBT MANAGEMENT ROLE**

In developing economies in particular and every economy in general, the central bank manages the domestic and foreign debts on the instruction of the Federal Ministry of Finance. Debt management involves debt service payments and participation in debt restructuring through rescheduling, debt refinancing, as well as debt conversion to ensure that the debt is reduced to a manageable size. The aim of the bank in this results in areas of proper timing and issuing of government bonds and securities, stabilizing their prices and also minimizing the cost of servicing the public debt.

In order to achieve this role, it becomes essential that the central bank should ensure a low interest rate policy on these bonds to make them more attractive. Thus, for this role of debt management to be successful, the central bank will ensure and encourage the existence of well developed money and capital markets where both short and long-term securities abound.

### **3.5 MONETARY STABILITY**

Monetary policy: The credit control measures adopted by the central bank of a country, is of vital importance in the process of development.

This is important because of how they influence the pattern of investment and production through the conscious action taken by the bank in the control of the supply of money. This mechanism in effect, when the proper mix of the control instrument is adopted effectively, controls inflationary pressures arising in the process of development. These instruments as we saw in the previous unit include open market operations, required reserve, ratio, bank rate or discount rate, among others.

### **3.6 FOREIGN EXCHANGE MANAGEMENT ROLE**

The central bank manages and controls the foreign exchange resources of a nation—its acquisition and allocation in order to reduce destabilizing short-term capital flows. The bank thus monitors the use of scarce foreign exchange resource to ensure that foreign exchange disbursement and utilization are in line with the economic priorities at the same time in line with economic priorities and within the foreign exchange budget. In this regard the central bank further acts as the technical adviser to the government on foreign exchange policy, especially in maintaining a stable foreign exchange rate.

This, the bank still achieves this through exchange controls and variations in the bank rates (discount rates). This role generally helps in achieving a balance of payment equilibrium; a problem prevalent in the developing economies.

#### **4.0 CONCLUSION**

The central bank with its general functions to a nation's financial system in particular and the entire economic system in general cannot be overemphasized. Their role in the general development of an economy in achieving economic growth especially in a developing nation has been discussed and the measures it adopts in this area without losing sight of economic stability. At the pivot of a nation's financial and general economic development, the central banks have been blamed and criticized by the public for having too frequent changes in monetary policies among some other issues. These notwithstanding, the central bank has been seen and adjudged to be of great value and importance in developing economies.

#### **5.0 SUMMARY**

The role of the central bank in a developing economy as we discussed in this unit was seen as the crux of the existence of the bank. It has been revealed that this is mostly hinged on the control, management and quality of credit at the disposal of the investors in the economy. Thus, the creation and expansion of the financial system role of the bank, price and interest rate stability roles topped the list of its major and outstanding ways to enhancing the growth of developing nations. Other roles discussed are debt and foreign exchange management roles.

In the next study unit, we shall discuss monetary policy and fiscal policy.

#### **6.0 TUTOR-MARKED ASSIGNMENTS**

1. Outline the role of the central bank in the economic development of a nation.
2. Discuss extensively three of the roles outlined above.

## **7.0 REFERENCES/FURTHER READINGS**

Microsoft Encarta Encyclopaedia 2005.

Lipsey, R.G. (1980). An Introduction to Positive Economics (5<sup>th</sup> Edition). English Language Book Society & Weidenfeld & Nicolson.

Jhingan, M. L. (2006). Money, Banking, International Trade and Public Finance. Vrinda Publication Ltd India.

Orji, John (1996). Elements of Banking. ROCK Communication Nig Enugu Nigeria.

Unamka, P.C. et al (1995). Business Administration. Precision Printers and Publishers Enugu Nigeria.

## **UNIT 2: MONETARY POLICY AND FISCAL POLICY**

### **CONTENTS**

1.0 Introduction

2.0 Objectives

3.0 Main Content

3.1 Monetary Policy – Meaning and Objectives.

3.2 The CBN and Monetary Policy

3.3 Instruments of Monetary Policy

3.4 Role of Monetary Policy in Economic Development.

3.5 Fiscal Policy – Meaning and Objective.

3.6 Fiscal Policy and Economic Development

4.0 Conclusion

5.0 Summary

6.0 Tutor-Marked Assignments

7.0 References/Further Readings

### **1.0 INTRODUCTION**

In any economy to operate effectively, policies which are codes, guides or general rules that stipulates the referenced procedure to follow in handling recurring

situations or in exercising delegated authorities must be followed. These policies theoretically serve to ensure that decisions support set objectives and describes plans to follow in a coordinated and consistent manner. Policies should however be controlled, monitored and considerably enforced in order to be effective.

Macroeconomic policies are those measures taken by government intended to influence the behaviour of the economic policies, to achieve desired objectives through the manipulation of a set of instrumental variables. The scope for macroeconomic policy depends upon the economic system in operation, and thus the framework of laws and institutions governing it. The most important class of macroeconomic policy is demand management, which seeks to regulate the pressure on the community's resources by operating on the level of spending power and so of demand. This generally takes the form of measures we shall be discussing in this unit – monetary policy and fiscal policy.

## **2.0 OBJECTIVES**

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

- i. Explain the meaning and objectives of monetary policy and fiscal policy
- ii. Explain their respective roles in the economy.
- iii. Identify and explain their respective instruments of operation
- iv. Explain the constraints of monetary policy.



### **3.0 MAIN CONTENT**

#### **3.1 MONETARY POLICY: MEANING AND OBJECTIVES**

Monetary policy is the means by which the Central Bank (i.e. the monetary regulatory authority) manipulates the money supply in order to influence the overall direction of the economy; particularly in the areas of employment, production and prices.

Monetary policy can therefore be seen as any conscious action taken by the Central Bank to change the volume, quantity, availability, cost and direction of money and credit in the economy.

It therefore involves the regulation by the Central Bank of the supply and interest rates in order to control inflation and stabilize currency. Monetary policy is one of the two ways the government through its regulatory agencies can impact on the economy.

The principal objectives of monetary policy include:

##### **1. Full Employment**

This is the economic term used to describe a situation in which everybody who wants to work gets work; thus, the absence of involuntary unemployment. The U.N. experts on National and International measures for full employment define it as ‘a situation which employment cannot be increased by an increase in effective demand and unemployment does not exceed the minimum allowances that must be made for the effects of fractional and seasonal factors’. It further states that full employment stands for 96% to 97% employment. This can be achieved in the economy by following expansionary monetary policy.

## **2. Economic Growth**

The general goal of monetary policy is to promote a stable economy. Thus, one of its objectives is the rapid growth in the economy. Economic growth is the process whereby the real per capita income of a country increases over a long period of time and is measured by the increase in the amount of goods and services produced in that country. Economic growth is therefore a desirable goal of a country since it raises the standard of living of the people and reduces inequalities in income distribution. A good monetary policy influences this by controlling the real interest rate through its effect on the level of investment in the economy at the same time controls hyper-inflation.

## **3. Balance of Payment**

The monetary policy of a country also has as one of its objectives the maintenance of equilibrium in the balance of payments. This follows from the phenomenal world trade growth as against the growth in international liquidity.

### **3.1 THE CENTRAL BANK OF NIGERIA AND MONETARY POLICY**

The Central Bank of Nigeria in its conduct of monetary policy in Nigeria undertakes monetary policy in order to:

- Maintain Nigeria's external reserves to safeguard the international value of the legal currency.
- Promote and maintenance of monetary stability and a sound and efficient financial system in Nigeria.
- Act as banker and financial adviser to the Federal Government; and

- Act as lender of last resort to banks.

The recent CBN economic reforms and monetary policy which focused on structural changes, monetary policy, interest rate administration and exchange management, encompasses both financial and market liberalization and institutional building in the financial sector. The broad objectives of this reform include:

- a) Removal of control on interest rates to increase the level of savings and improve allocative efficiency;
- b) Elimination of non-oil rationing of credit to reduce misdirected credit and increase competition;
- c) Adoption of indirect monetary management in place of the imposition of credit ceiling on individual banks;
- d) Enhancing of industrial structure and supervision;
- e) Strengthening the money and capital markets through policy changes and distress resolution measures; and
- f) Improving the linkages between formal and informal sectors.

### **3.2 INSTRUMENTS OF MONETARY POLICY**

The tools, techniques or instruments of monetary policy in an economy are of two broad groups. First, the general, quantitative or indirect instruments, which are meant to regulate the overall level of credit in the economy through the commercial banks. The second group – selective, qualitative or direct instruments that aims at controlling specific types of credits in the economy. They all affect the

level of aggregate demand through the supply of money, cost of money and availability of credit. Central Bank Functions and Credit Control include:

**1. Open Market Operation (OMO):** This is the sale and purchase of government securities in the market by the Central Bank.

**2. Legal Reserve Ratio (Cash Reserve Requirement) of Banks:** This is the proportion of commercial banks deposits kept with the Central Bank for the purpose of monetary control.

**3. Bank Rate Policy or Discount Rate Operation:** This refers to the interest rate at which the CBN lends to the commercial banks or rediscounts first class bill of exchange and government securities to the commercial banks.

**4. Liquidity Ratio:** This is the percentage of a bank's deposit held in form of cash or liquid assets to meet sudden rush on banks by depositors.

### **3.3 THE ROLE OF MONETARY POLICY IN ECONOMIC DEVELOPMENT**

The economists' measure of the effectiveness of a monetary policy is its influence on inflation, employment, and industrial production. This stems from the already mentioned principal objectives of monetary policy, especially in a developing economy. We can restate these objectives again as the major role monetary policy plays in a developing economy thus:

#### **a) Credit Control**

With a view of controlling inflation and inflationary pressures within the economy. This is achieved through the adoption of one or a combination of the instruments of monetary policy discussed above.

## **b) Price Stability**

The adoption of various tools of monetary policy brings a proper adjustment between the demand for and supply of money. In a developing economy, the gradual monetization of the non-monetized sector leads to increase in the demand for money. This also results from increase in agricultural and industrial production. All these will lead to increase in the demand for transactions and speculative motives, which monetary policy reacts to by raising the money supply more than proportionate to the demand for money in order to avoid inflation.

## **c) Exchange Rate and Interest Rate Stability**

Towards bridging the balance of payment deficit, monetary policy in the form of interest rate policy plays an important role. A developing economy must have to increase imports to meet their respective development needs. On the other hand, exports in such economies are almost stagnant, thus leading to imbalance in balance of payments. This could be narrowed through the adoption of a high interest rate policy which will in turn attract the inflow of foreign investments. The policy will also have a positive effect on the exchange rate favourable to the development of the economy.

In Nigeria, the implication of the monetary policy reforms highlighted in section 3.2 has the following implications on the economy:

i) Increase in the number of Banking Institutions resulting from the provision of a liberalised and level playing field for the emergence of effective and efficient institutions that would serve as an engine of growth for the economy.

ii) Improved service delivery through new innovations and new product development like the Automated Teller Machines (ATM), use of debit and credit cards, e-money and e-banking.

iii) Shift in Monetary Policy management from direct to indirect approach to monetary management. This led to a better development of the primary and secondary markets for treasury securities. These took advantage of the liberalization that discount houses, banks and some selected stock brokers are now very active in the primary market for treasury bills.

iv) Between 1987 and 1996, the CBN had adopted different interest rate regimes in 1987 to a total deregulation of interest rates in October 1996.

v) Modernisation in the Nigerian payment system process with the implementation of Magnetic Ink Character Recognition (MICR), ATMs and electronic banking (e-banking). These are all aimed at promoting the automation of the payments system, thus reduce delays in the clearing of payment instruments, reduce cash transactions and enhance transmission mechanism of monetary policy.

The foregoing reveals that monetary policy has a global reach in addition to its domestic effects. This revolves around its main objective of promoting a stable economy. Through its effect in the economy, many economists agree that the central bank of a nation is the most important political tool a government has. This stems from the fact as discussed above that each of a monetary policy's effects influences the everyday financial decisions of the citizens of the economy, whether they should buy a car, save more money, or start a business.

### **3.4 FISCAL POLICY**

Fiscal Policy is a deliberate government policy designed to change the level of government expenditure or varying the level of taxation or both; for the purpose of achieving some desired economic objectives. It is therefore government's decisions relating to taxation and its spending with the goals of full employment, price stability, and economic growth.

Fiscal policy objectives are implemented and achieved through changes in the budget [a financial statement of the sources (revenue) and uses (expenditure) of fund of the government). Government is said to adopt a “loosened fiscal policy” when it reduces taxation or increases public expenditure with the aim of stimulating aggregate demand. On the other hand, “tightened fiscal policy” prevails when taxation is increased or public expenditure is reduced.

Thus, by changing tax laws, the government can effectively modify the amount of disposable income available to its tax payers. For example, during tightened fiscal policy regime, when taxes are increased, consumers would have less money to spend on goods and services.

Also, government could choose to increase her spending by directly purchasing goods and services from private companies. This would increase the flow of money through the economy and would eventually increase disposable income available to consumers.

### **3.5 FISCAL POLICY AND ECONOMIC DEVELOPMENT**

Fiscal policy which has been seen as government policy in relation to taxation and public spending is one of the two most important components of a government's overall economic policy concerned with money supply.

In times of recession and inflation, government can apply fiscal policy to solve the resulting problems. Some of the mechanisms as discussed partly in section 3.5 follow the fiscal policy regime adopted by the government. Either loosened or tightened fiscal policy regimes when adopted aids in achieving the desired objective.

During times of recession, reduction in taxation, increase in government spending and government grants or/and financial assistance to industries will get the economy out of the problems.

Conversely, in periods of inflation, increased taxation, reduction in government expenditure and reduction of grants and/or financial aids to industries will reduce inflationary pressure on the economy.

#### **4.0 CONCLUSION**

We have seen that government influences the behaviour of the economy by adopting some economic policies. The two most important of these economic policies are monetary policy and fiscal policy. In all these measures, the government operates through the market, giving market forces a new direction but not attempting to supervise them. The objectives and purposes of these policies are all geared towards attaining full employment, price stability and general economic growth.

#### **5.0 SUMMARY**

The unit discussed two important policies of government – monetary policy and fiscal policy under their respective meanings and objectives, their instruments of operation and how they affect the economy.



## **6.0 TUTOR-MARKED ASSIGNMENTS**

- 1) Discuss the objectives and principal instruments of monetary policy.
- 2) Distinguish between cheap (or easy or expansionary) and dear (or restrictive) monetary policy.
- 3) Discuss the role and instruments of fiscal policy in a developing economy.

## **7.0 REFERENCES/FURTHER READINGS**

Orjih, John (1996). Elements of Banking. Rock Communication (Nig) Enugu  
Nigeria.

Jhingan, M.L. (2006). Money, Banking, International Trade and Public Finance.  
Vrinda Publications (P) Ltd, Delhi India.

## **UNIT 3: THE NIGERIAN FINANCIAL SYSTEM**

### **CONTENTS**

1.0 Introduction

2.0 Objectives

3.0 Main Content

3.1 Meaning and Features of an Efficient Financial System

3.2 The Structure of the Nigerian Financial System

3.3 The Regulatory Authorities:

3.3.1 The Central Bank of Nigeria

3.3.2 The Nigeria Deposit Insurance Corporation

3.3.3 The Securities and Exchange Commission

3.3.4 The Federal Ministry of Finance

3.3.5 Nigeria Insurance Supervisory Board

3.3.6 The Federal Mortgage Bank of Nigeria

3.4 The Rationale for Regulating the Financial Systems

4.0 Conclusion

5.0 Summary

6.0 Tutor-Marked Assignment

7.0 References/Further Readings

## **1.0 INTRODUCTION**

Finance, a term applied to the purchase and sale of legal instruments that gives owner specified rights to a series of future cash flows. These legal instruments, known as financial assets or securities, are issued by private concerns, such as companies and corporations, and government bodies, and they include bonds, stocks, and shares.

In business generally, finance whose need in the economy is paramount refers to the raising of capital funds and using them for generating returns and paying returns to the suppliers of those funds, which may be equity or borrowed funds.

In this unit and the following two units we shall be introducing you to the system of financial system, features, structure and finally hinging on the regulatory authorities in the system.

## **2.0 OBJECTIVES**

By the end of this unit you should be able to:

- i. Explain the meaning and features of an efficient financial system.
- ii. Understand the structure of the Nigerian Financial System
- iii. Identify the various regulatory bodies in the Nigerian financial system
- iv. Identify and explain the reasons for regulating the Nigerian financial system.

### **3.0 MAIN CONTENT**

#### **3.1 MEANING AND FEATURES OF A FINANCIAL SYSTEM**

The financial system refers to family of rules and regulation, institutions, instruments and operators that interact within an economy in the provision of financial services and the facilities through which they are transferred to various members in the economy. The services they provide may include resources mobilization and allocation, and financial interactions with a view of enhancing international trade.

The foregoing reveals that the financial system plays important role in the process of economic growth and development of a country. These roles could be well achieved if the system is well developed with adequate attention given to the measurement indicator of the system.

These indicators which measure the efficiency of the financial system are:

1. The availability of multiple financial assets of varying characteristics that will meet the need of the operators for effective competition.
2. The awareness of the articles of trade in the system to the participant. This implies the existence of unrestricted access to the traded securities liquidity, safety, current yield, capital gain, etc.
3. Stability of the cost of capital (i.e. interest rate).
4. The availability of infrastructure in the system, most especially in areas of information transmission and communication.

5. The absence of external intervention (by the government or other institutions) in price determination of securities.
6. The availability of sufficient discounting facilities.
7. The availability of experts/qualified personnel that will be able to read the value of the securities.
8. The cultural/general attitudinal behaviour of the participants toward credit facilities.
9. The independence of the productive sector on foreign exchange. It could therefore be seen that a well developed financial system dictates the development of that economy.

### **3.2 THE STRUCTURE AND OBJECTIVES OF THE NIGERIAN FINANCIAL SYSTEM**

The Federal Government of Nigeria in 1976 set up a committee to review the Nigerian financial system that was almost near existing void.

The committee headed by Dr. P.N.C. Okigbo among others recommended the following objectives for the financial system:

- (a) The Nigerian Financial System should be able to facilitate effective management of the economy.
- (b) The system should provide non-inflationary support for the economy.
- (c) The achievement of greater mobilization of savings and its efficient and effective channelling.
- (d) Ensures that no viable project is frustrated simply for lack of funds.

(e) Insulate the economy as much as possible and as much as desirable from vicissitudes of the international economic scene.

(f) Effectively sustain the indigenization of the country.

(g) Assist in achieving significant transformations of the rural area, and

(h) Assist in achieving greater integration and linkages in agricultural, commerce and industry.

These recommendations formed the bedrock on which today's Nigerian financial system has developed though it is still anything but very efficient.

The Nigerian financial system is made up of the regulatory supervisory authorities that provide the rules governing the mode of activities and the system and also the institutions that provide the facilities for exchanging funds in the financial market. The regulatory authorities are the Central Bank of Nigeria (CBN) at the apex, the Nigeria Deposit Insurance Corporation (NDIC), the Securities and Exchange Commission (SEC), the Federal Ministry of Finance (FMF), the Nigerian Insurance Supervisory Board (NISB), and the Federal Mortgage Bank of Nigeria (FMBA).

### **3.3 THE REGULATORY AUTHORITIES**

The regulatory /supervisory authorities in the financial system are very crucial in the functions and orderly development of the system. Highlights of these authorities are provided hereunder.

### **3.3.1 The Central Bank of Nigeria (CBN)**

The CBN established by the CBN Act of 1958 and started operate on 1<sup>st</sup> July, 1959 is the apex regulatory authority of the financial system. As discussed in earlier units, the CBN has among its primary functions the promotion of monetary stability and a sound financial system in addition to acting as banker to last resort to the banks. The bank also encourages the growth and development of the financial institutions.

The CBN was given more flexibility in regulating and supervising the banking sector and licensing finance companies framework by the CBN Decree 24 and BOFID all of 1991.

### **3.3.2 The Nigeria Deposit Insurance Corporation (NDIC)**

The NDIC which complements the regulatory and supervisory role of the CBN was established in 1988 following the promulgation of Decree 22 of 15th June, 1988, but it became effectively operational in February 1989. The NDIC was set up to provide deposit insurance and related services to banks in order to promote confidence in the banking industry. The NDIC is therefore empowered to examine the books and other deposit – taking financial institutions. Licensed banks are therefore mandated to 15/16 of 1% of their total deposit liabilities as insurance premium. The decree also limited to a maximum of N500, 000.00 in event of a bank failure. The NDIC in collaboration with the CBN has intensified its effort to resolve the problem of distress in the banking industry.

### **3.3.3 The Securities and Exchange Commission (SEC)**

The SEC, formerly called Capital Issues Commission was established by the SEC Act of 27th September, 1979 and future strengthened by SEC Decrees of 1988.

Like the CBN, SEC is the apex regulatory organ of the capital market with its major objective of promoting an orderly and active capital market and major function of ensuring adequate protection of the investing public. One of the major functions of the SEC – that of price determination was on the course of the regulation of the capital market transferred to the issuing house. However, the SEC has continued to maintain surveillance over the capital market to enhance efficiency. Other outstanding functions of the SEC worthy of mention include the registering of all securities dealers, investment advisers and market places (such as stock Exchanges and their branches). The Companies and Allied Matters Decrees of 1990 further enlarged the role of the SEC by empowering it to approve and regulate mergers and acquisitions and authorize the establishment of unit trusts.

#### **3.3.4 The Federal Ministry of Finance (FMF)**

The Federal Ministry of Finance as one of the regulatory bodies of the financial system advises the Federal Government on its fiscal operations and interacts with the CBN on monetary matters. The FMF is also charged with the responsibility of licensing bureau de change nationwide.

#### **3.3.5 Nigerian Insurance Supervisory Board (NISB)**

The NISB, established by the Insurance Special Supervision Fund (Amendment) Decree 62 of 1991, is charged with the effective administration, supervision, regulation and control of the business handled by the FMF. It was transferred to NISB to ensure better results and more effective control and reserves, good management, high technical expertise and judicious funds placement.

The NISB therefore is centered on the establishment of standards for the conduct of insurance policy holders and establishment of a bureau to which complaints may



be submitted against insurance companies and their intermediaries by members of the public.

### **3.3.6 The Federal Mortgage Bank of Nigeria (FMBN)**

The FMBN established by Decree 7 of 1977 had its main functions to include the provision of banking and advisory services and research activities pertaining to housing in the country. The FMBN was empowered by the National Housing Policy in 1990 and Decree 3 of January 1991 to license and regulate mortgage institutions in Nigeria and to act as the apex regulatory body for the mortgage. Federal

Mortgage Finance was later carved out of the FMBN. The financing functions of the Federal Mortgage Bank of Nigeria were therefore transferred to the Federal Mortgage Finance while the FMBN retains its regulatory role.

## **3.4 THE RATIONALE FOR REGULATING THE FINANCIAL SYSTEM**

The financial system as already stated consists of institutions engaged in the provision of money and credit or simply financial services both locally (nationally) and internationally. The system cannot be said to be without problems that militates against its efficient operation. Some of these problems which could be managed from within the system become obvious that they should be nipped in the bud. This gave rise to the need for the institutions of the above discussed regulatory bodies in the financial system. These reasons could be summarized as follows:

1. To ensure safety of depositors funds.
2. To control bank charges.

3. To scrutinize entry into the system and thus avoid undercapitalization
4. To control credit expansion in the economy.
5. To control effectively capital distribution.
6. To control the conduct of directors and employees of the institutions.
7. To limit the risk taking by banks and other finance houses.
8. For channelling of funds to productive sections.
9. To ensure healthy competition among banks
10. To ensure sensitivity to macro-economic objectives and social responsiveness by participants.

#### **4.0 CONCLUSION**

The importance of finance in an economy hence financial service cannot be over-emphasized for an effective economic development. The financial system which consists mainly of regulatory authorities and the financial institutions play remarkable role in the economy. The regulatory authorities has at its apex the Central Bank of Nigeria has wide ranging powers to regulate the volume of activities in the economy, with very important consequences for incomes, prices and employment.

#### **5.0 SUMMARY**

This unit has dealt with the Nigeria financial system, the general meaning and features that enhance its efficient operation. The regulatory authorities were highlighted with the major objectives for their establishment that hinged on

regulating the financial system. Some of the regulatory authorities discusses include the CBN, NDIC, SEC, FMF, NISB and FMBN.

## **6.0 TUTOR-MARKED ASSIGNMENTS**

1. Define a financial system, highlighting its measurement indices.
2. The Nigeria financial system developed on the recommendations of the Dr. P.N.C Okigbo's committee in 1976. Discuss the level of achievement of these recommendations by the present day Nigerian financial system.
3. The CBN is at the apex of the regulatory authorities of the Nigerian financial system; discuss the reasons for regulating the system.

## **7.0 REFERENCES/FURTHER READINGS**

CBN Briefs, Research Dept. Series No. 96101 of June 1996.

Emekekwe, P.E (1990). Corporate Financial Management Publication of B.A.S.E  
Kinshasa Zaire.

Unamka, P.C et al (1995). Business Administration Precision Printers and  
Publishers Enugu Nigeria.

Orjih, John (2002). Banking and Finance; Principle, Policies and Institutions.  
Splash Media Organization Enugu.

Microsoft Encarta Encyclopedia 2005: Finance.

Okafor, F.O (1997). Bank Management; (unpublished lecturer notes). UNEC  
Enugu.

## **UNIT 4: THE NIGERIAN MONEY MARKET**

### **CONTENTS**

1.0 Introduction

2.0 Objectives

3.0 Main Content

3.1 Development of Nigerian Money Market

3.2 Composition and Institutions of the Nigerian Money Market

3.3 Nigerian Money Market Instruments

3.4 Role of the Money Market in Economic Development

4.0 Conclusion

5.0 Summary

6.0 Tutor-Marked Assignments

7.0 References/Further Readings

### **1.0 INTRODUCTION**

The place of money in the economy enables us to separate our decisions on how we want to make a going from how we want to live. This therefore enables us to separate our production decisions from consumption decision thus enabling us to improve and facilitate our transaction methods of exchange. Also, money, as seen in earlier units, functioning as a medium of debt transaction gives a time dimension

to it. This function of money necessitates the establishment of financial markets, a market or facilities created by financial institutions for holding and transferring of funds from one economic unit to another. It is a market that is concerned with the flow of funds from savings – surplus to saving – deficit economic units. The organized financial market has two major outstanding segments – the money market and the capital market these are distinguishable mainly on the basis of the maturity structure of the instruments traded in them. While the money market forms the basis of the discussion of this unit capital market shall form the content of the subsequent one.

## **2.0 OBJECTIVES**

By end of this unit, you would have been able to:

- i. Define and explain the reasons for establishment the of money market.
- ii. Identify and explain the institutions that operate in the Nigerian money market.
- iii. Identify and explain the various types of instruments traded in the Nigerian Money Market.
- iv. Explain the functions and role of the money market in developing economy.

## **3.0 MAIN CONTENT**

### **3.1 DEVELOPMENT OF THE NIGERIAN MONEY MARKET**

The money market is the financial market for short-term debt instruments that are close substitutes for money. It therefore provided facilities for the exchange of financial claims and obligations for materials, that vary from one day to one

calendar year. The importance of this market derives from the opportunities which it created for raising short-term funds and/or for investing such funds, thus serving those economic units that require money market facilities for the profitable investment of their temporary excess funds.

The need for local investment outlets became more imperative with the establishment of the CBN in 1959. This led to CBN setting in motion the necessary machinery for the establishment of the Nigerian money market. Consequently, in April, 1960, the CBN launched the CBN first Treasury Bills, a bill that was used for raising short-term finance for the government. This marked the birth of the Nigerian money Market. The reasons for the establishment of this market which stem from the consequences of its absence in the economy can be summarized thus:

- (a) To check the outflow of surplus funds from the Nigerian economy unit investment outlets in the London financial markets.
- (b) To Nigerianize the credit base.
- (c) To enhance an effective monetary management
- (d) To ensure management of commercial banks' portfolio of assets and liabilities.

The foregoing reveal that for the money market to operate effectively, the under listed conditions are obvious.

- (i) The CBN should act as lenders of last resort to enable the banking sector operate at lower level of liquidity, thus making full use of available resources.
- (ii) There must be an integrated structure of financial organization holding a variety of assets with differing liquidity level, and profitability. This will facilitate free movement of money and financial assets from surplus to deficit sectors of the

economy. To prevent limited scope of operation, there must be large number of institutions in operation.

(iii) The regulatory bodies (CBN, etc) must formulate and implement a system of central and classification of market assets to inspire confidence in the system.

### **3.2 COMPOSITION AND INSTITUTIONS OF THE NIGERIAN MONEY**

#### **MARKET**

The Nigerian money market institutions constitute the hub of the financial system. They include the discount houses, merchant banks, low income and rural sector-targeted institutions like the then People's Bank of Nigeria and commercial banks which are special purpose banks and the parallel market.

While the discount houses and the banks, which are financial institutions, deal in bills of exchange by discounting them of less than their respective face values, the parallel money market is where there is horizontal transfer of credit to meet the "tailor –made" requirement of both lenders and borrowers.

It is important to note that the Central Bank of Nigeria (CBN) in collaboration with the Nigeria Deposit Insurance Corporation (NDIC) is the principal regulatory authority in the money market.

A discount house is a special non-bank financial institution which specializes in mobilizing funds from the surplus sectors of the economy for channelling into the deficit sectors. It achieves this by providing discounting or re-discounting facilities in government short-term securities. In the process of shifting from direct to indirect monetary control which place emphasis on OMO, discount house have

been established to serve as financial intermediaries between the CBN, licensed banks and other financial institutions.

### **3.3 INSTRUMENTS IN THE NIGERIAN MONEY MARKET**

The money market instruments introduced by the CBN provide the government with short-term funds in addition to providing financial institutions with opportunities for local investment of idle funds by trading in these short-term instruments. These instruments are highlighted hereunder:

#### **(a) Treasury Bills (TB)**

These are 91-day maturity short-term debt instrument introduced by the CBN first in 1960 to raise finances for the Federal Government weekly.

The TB serves dual purposes for the government viz:

- As an source of short-term fund to cover temporary excess of state expenditure over income, and
- As an instrument of monetary policy of the CBN in the execution of OMO to mop up excess liquidity or the purchasing power in the economy.

#### **(b) Call money (CM)**

The CM was introduced in 1962 as a means used by the commercial banks and other participating financial institutions to keep their temporary surplus cash with the CBN. They are later invested in short-term money market instruments like TB. The CM earned interest at slightly less than TB.



### **(c) Commercial Bills/Trade Bills**

These are instruments issued by commodity boards in respect of export produce. They are rediscounted by the CBN with most of the commercial banks participating as consortium. This bill which was introduced in 1962 crumbled in 1965 and finally abandoned in 1986 when the CBN took over financing of agricultural produce.

### **(d) Treasury Certificates (TC)**

This was introduced in 1986 to fill the gap created by the termination of commercial bills. They have one to two years tenure and are similar to TB's except in tenure, thus referred to sometimes as medium – term security instruments.

### **(e) Certificates of Deposit**

These are inter-bank instruments with maturity dates ranging from 3 to 36 months. The certificates of deposits are mostly used by merchant banks to attract the surplus funds of commercial banks. They are two categories of certificates of deposit

- \* Negotiable Certificates of deposit issued for periods ranging from 3 months to 36 months, and

- \* Non- negotiable certificates of deposit issued for shorter periods ranging from 3 to 28 months.

### **(f) Bankers' Unit Fund**

This was introduced in September, 1975 for banks and other financial institutions to invest part of their excess liquid resources. They were in multiples of N10,

000.00 while the CBN invests the pooled fund in government stocks. They are repayable on demand in whole or part and attract some interest which is dependent on the maturity period.

#### **(g) Eligible Development Stocks (EDS)**

These were government development stock with less than 3 years maturity period and used by the CBN to meet commercial bank's liquidity ratios requirements.

#### **(h) Stabilization Securities**

These introduced in 1976 were used by the CBN to mop up the excess liquidity of the banks. This is an effective monetary policy instrument which empowers the CBN to issue the securities and sell same by allocation to banks and other financial institutions that are compelled by law to take up such, failure leads to imposition of stiff penalties by the CBN.

### **3.4 ROLE OF THE MONEY MARKET IN ECONOMIC DEVELOPMENT**

The money market which mirrors the economic health of a nation's economy is of great importance. Its activities which are influenced by the country's reserves, balance of payments and the state of the economy generally serves the following functions in the economy.

1. Promotion of efficient allocation and utilization of funds by ensuring that no idle fund is in existence.
2. Helping in the indigenization of the credit base of the economy.
3. Helps the commercial banks to hold lower cash reserves through the operation of the call money scheme.

4. Provides an avenue for the implementation of the CBN monetary policy.
5. Acts as an important source of short-term borrowing to the government.
6. Provides opportunity for investment in fairly liquid and riskless assets in the economy.
7. Minimized cash holdings by banks by helping them invest their secondary line of reserves in earning assets.
8. Provides avenue for fund mobilization and allocation in the economy.
9. Its interest rates serve the CBN as a barometer to judge the shortages and surplus of funds in the system.
10. It promotes liquidity and safety of financial assets thereby encouraging saving demand investments.
11. Promotes equilibrium between demand and supply of loanable funds.
12. It helps in economizing the use of cash by dealing in near – money assets and not paper money.

#### **4.0 CONCLUSION**

The money market, one of the components of the financial market has been seen as the market for short-term securities. As a part of the financial market whose function is to make available idle funds in a surplus sector to deficit areas of the economy. By so doing, it links up investors and savers thus facilitating the transfer of these funds (short-term) for use in economic development. In this way, the money market has been seen as very important for rapid economic growth of a nation.

Since the activities of the market are influenced by the nation's reserves, balance of payment and the state of the economy generally it could be deduced that the money market mirrors the economic health of the country.

## **5.0 SUMMARY**

In this unit you have seen the meaning, features and development of the Nigerian Money Market. The reasons for its establishment and the conditions that will enhance its effective operation were also discussed.

The operations of the market together with the various instruments traded were discussed too. Finally, the important roles the money markets play in an economy, especially a developing one concluded the discussion on this unit.

In the last study unit, we shall discuss the Nigerian capital market.

## **6.0 TUTOR-MARKED ASSIGNMENTS**

1. What is a money market? Why was the Nigerian money market established?
2. Who are the operators of the Nigerian money market? Discuss the major role of at least two of such operators/institutions in the market.
3. What are money market instruments? Highlight at least four of such instruments.

## **7.0 REFERENCES/FURTHER READINGS**

- Emekekwe, P.E. (1990). Corporate Financing Management, African Bureau of Educational Science Publication, Kinshasa – Zaire
- Fabozzi, Frank, et al. (1974). Foundations of Financial Market and Institutions, Prentice Hall International Edition.

Okafor, F. O (1983). Investment Decisions: Evaluation of Projects and Securities,  
CASSELL Ltd. London.

Central Bank of Nigeria, CBN Briefs June, 1995: Research Department series No.  
95/01

Central Bank of Nigeria, CBN Briefs June, 1996: Research Department series No.  
96/01

Modebe, J.N (1997). The Nigerian Securities Market: The Money and Capital  
Markets in Nigeria. (Unpublished lecture notes, UNEC).

Okoro Okoro E.U (1990). The Nigerian Money and Capital Markets  
(Unpublished Lecture notes – UNEC).

## **UNIT 5: THE NIGERIAN CAPITAL MARKET**

### **CONTENTS**

1.0 Introduction

2.0 Objectives

3.0 Main Content

3.1 Development of the Nigerian Capital Market

3.2 Reasons for the Establishment of the Nigerian Capital Market

3.3 Instruments of the Nigerian Capital Market

3.4 Institutions of the Nigerian Capital Market

3.4.1 The Nigerian Securities and Exchange Commission

3.4.2 The Nigerian Stock Exchange

3.4.3 The Issuing Houses

3.5 Problems with the Nigerian Capital Market

4.0 Conclusion

5.0 Summary

6.0 Tutor-Marked Assignment

7.0 References/Further Readings

## **1.0 INTRODUCTION**

In our discussion in the previous units, we saw that the financial market is a place where individuals, institutions and instruments which make it possible for the deficit spending units of an economy use the surplus funds of surplus spending units. The Nigerian financial market is grouped into Money Market, Capital Market, Foreign Exchange Market and the Mortgage Market.

The Nigerian Money Market formed the crux of unit sixteen; this unit shall therefore be devoted to the Nigerian Capital Market.

## **2.0 OBJECTIVES**

It is expected that at the end of this unit, you should be able to:

- i. Explain the meaning and reasons for the establishment of the Nigerian Capital Market.
- ii. Identify the institutions in the market and the classes/segments of the markets
- iii. The major instrument traded in the market
- iv. The problems that impair the optimal output of the Nigerian Capital Market

### **3.0 MAIN CONTENT**

#### **3.1 DEVELOPMENT OF THE NIGERIAN CAPITAL MARKET**

One of the segments of the financial market is the capital market. The Nigerian Capital Market is a market for long term financial claims or obligations. It deals with long term funds and procedures for financing long term investments. Interactions in the market facilitates the exchange of long term funds between savings- surplus and saving – deficit economic units. The capital market instruments have maturely periods of the years and above.

The development of the capital market in Nigeria has been induced and fostered by the government. Before the establishments of the stock exchange in Nigeria, there existed some less formal market arrangements for the issue of securities for sale and for their transfer. Government securities were floated in Nigeria as far back as 1946 but the basic institution for the operation of capital market was not provided until 1961 when the Lagos Stock Exchange commenced business as formal and specialist capital market institution.

Following Governments adoption of the recommendations of the Financial System Review Committee of 1976, the Nigerian Stock Exchange (NSE) was set up in 1977. The capital market is classified into two segments, the primary and the secondary segments. While the primary market is market where stocks are issued for the first time to members of the public, the secondary market is same as the stock exchange market. It is a market for stocks which are not being sold for the first time is the primary market. It can be referred to as the market for second hand stocks, though without diminishing value. The mode of offer in the primary market includes offer for subscription, right issues, offer for sale and private placement.



### **3.2 REASONS FOR THE ESTABLISHMENT OF THE NIGERIA CAPITAL MARKET**

The reasons for the establishment of the capital market in Nigeria could be likened to the following:

- a) The provision of local opportunities for borrowing and lending on long-term basis.
- b) To enable the government mobilize funds for long-term economic development.
- c) To provide both the foreign and local companies with the opportunities to offer their shares for the purpose of raising capital.
- d) The provision of opportunities for quotation and marketing of corporate stocks and securities.
- e) To introduce a code of conduct, check abuses and regulate activities of the participants in the capital market.

### **3.3 INSTRUMENTS OF THE NIGERIAN CAPITAL MARKET**

The major instruments used to raise funds in the capital market include equities, debentures, bonds and stocks. These are all long-term finance instruments which supplies investors with the opportunity to borrow and lend money on medium and long-term bases. Brief description of these instruments is given below:

#### **i) Equity**

This is a permanent source of capital for a business organization which confers ownerships right to the individual(s) through subscription to the shares of the company. There are two classes of equity viz – Common/Ordinary shares and

Preferred Share. While common share holders' are not entitled to fixed earnings of the company, preferred shares holders have fixed rate of returns attached to them.

## **ii) Debentures**

These are also long-term debt instruments issued by a limited liability company. They are thus long-term promissory notes issued by a borrower who agrees to pay a fixed rate of interest on a specified amount on loan for a specific period of time and to redeem the loan on a stated future date. They are thus unsecured bonds, backed up only by the credit standing of the company issuing it.

## **iii) Bond**

A bond is like a debenture but secured by some kind of collateral. A bond is generally a promise by a borrower to repay the principal sum and interest to the lender at the expiration of the bond period. A bond issued by an individual is known as private bond while that issued by a company is known as corporate bond.

## **3.4 INSTITUTIONS OF THE NIGERIAN CAPITAL MARKET**

The institutions that operate in the Nigerian capital market can be categorized into two viz: Mediators and Facilitators.

The mediators or financial intermediaries are those institutions that obtain financial resources from a lender and supply them to a borrower. They thus allow serve with small amounts of capital to pool their funds in order to diversify across a large number of investments. They through their expertise in portfolio management and diversification provide a high return for the savers on their investment. These

institutions include commercial banks, building/mortgage societies, insurance companies and pension funds.

On the other hand facilitators help in the process of issuing, sale, registration and orderly transfer of shares in the market. These include the merchant banks, development banks Stock Exchange, issuing houses and stock broking firms.

It could however be seen that the main institutions of the Nigerian Capital Market include the Securities and Exchange Commission (SEC) which is the apex and serves as the regulatory authority, the Nigerian stock Exchange (NSE) which provide a mechanism for mobilizing private and public savings and making such funds available for productive purposes of trading in existing securities, the issuing houses and the stock broking firms. The key institutions are SEC and NSE.

#### **3.4.1 The Nigerian Securities And Exchange Commission (SEC)**

This is the apex institution for the regulations and monitoring of the Nigerian capital market. The SEC superseded the Capital Issues Commission which itself superseded the ad hoc Capital Issue Commission in 1973. The establishment of SEC was however approved in 1977 and started operation in July 1977 with retrospective legislation – SEC Act of 27th September, 1979.

#### **3.4.2 The Nigerian Stock Exchange (NSE)**

A stock exchange is a market which facilitates buying and selling of shares, stocks, bonds, debentures and other securities. It is essentially a secondary market for buying and selling of already existing securities, but some new issues may be traded in the Stock Exchange.

The NSE as earlier stated in section 3.1 above was set up in 1977 on the recommendations of the Financial System Review Committee. The NSE was charged with the major responsibility of providing a mechanism for mobilizing private and public savings and making such funds available for productive purposes.

The NSE in its bid in providing a means for trading in existing new securities, it encourages small and large-scale enterprises to gain access to the public listing. The NSE however operates the main Exchange for relatively large enterprises and the second-Tier securities market, where listing requirements are less stringent, for small and medium scale enterprise.

The overall management of the exchange was vested in a single council and operates from their headquarters in Lagos with trading floors at Abuja, Ibadan, Port-Harcourt, Kano, Kaduna and Onitsha. NSE has four categories of membership viz:

- i) The Foundation Members: These initial members who signed the memorandum of association of the Exchange on 15<sup>th</sup> September, 1960 at incorporation;
- ii) The Council Members: These are the policy making body of the exchange elected from the members;
- iii) Ordinary Membership: This is a precondition to all other categories, open to all individuals and firms whose applications are acceptable to the council and
- iv) Dealing Members: These are persons, firms or corporate bodies who in addition to being ordinary members are licensed by the council to trade in stock, shares and bonds, on the floor of the exchange. Since the NSE operates a double – capital system, dealing members, combine jobbing and brokerage functions. In their

capacity as brokers, they act as agents for their clients, with license to buy and sell securities in the exchange. As jobbers, they do business in their own account.

The dealing members also act as advisers to institutional investors, paddling their clients through the intricacies of security transfer and registrations.

The transactions/dealings in the NSE take any of the following forms:

- a) Direct issue or offer for subscription of securities;
- b) Offer for sale;
- c) Private placing, and
- d) Right issues of Pre-emptive Rights.

#### 3.4.3 The Issuing Houses

These include the Merchant banks and non-bank financial institutions that serve as advisers on new issues. They provide technical assistance to companies which desire to raise capital, undertaking to issue the securities and also assisting in the allotment of shares.

### **3.5 PROBLEMS OF NIGERIAN CAPITAL MARKET**

The capital market plays an important role in mobilizing savings and channelling same into productive investment for the development of commerce and industry in particular and the general economic growth in the country. Despite this important role of the market, its efficient operation for optimal output is impaired by a number of variables. These which are either indigenous or exogenous are highlighted below:

- i) Government Policies: This is in area of income policy and the rigid interest rate structure.
- ii) Over –regulation of the exchange rate by the regulatory authorities who assert much control on the capital market.
- iii) Low savings Attitude: Accumulated funds for investment is lacking in Nigeria because of the low level of savings caused by low income of the people.
- iv) Infrastructure problems: This includes the lack of reliable communication network, electronic data and reliable storage capacity from where reliable information on the market can be called upon when necessary. Also, the unreliable public power supply constitutes a cog in the wheel of progress in the developments of the capital market.
- v) The listing requirements in the market are rather severe and also the restrictive provisions for companies wishing to get listed in the market.

#### **4.0 CONCLUSION**

The capital market which provides industries with fixed and working capital deals in stocks, debentures, bonds and securities of government. The market achieves this by working through the stock exchange a market that facilitates buying and selling in the market. The capital market is related to the supply and demand of new capital. The difficulty encountered by some industries in raising capital for economic and productive activities are ameliorated by the proper operations of a well developed capital market. In this way the capital market encourages economic growth by facilitating the movement of streams of capital to be used more productively and profitably and these increase the national income.

## **5.0 SUMMARY**

The unit has tried to discuss the Nigerian Capital Market, a segment of the Nigeria Financial System. The meaning, segments development and reasons for its establishment were discussed. The instruments traded in the market and the major participants/institutions of the market formed greater part of the unit. Some problems that hinder the attainment of optimal and efficient operation of the market were highlighted with a view that proper attention be given to them because of the important role the capital market plays in the Nigerian economy.

## **6.0 TUTOR-MARKED ASSIGNMENTS**

1. What do you understand by capital market? Why is it important in the economy?
2. Explain the instruments and institutions of the Nigerian Capital Market.
3. The Nigerian capital market is faced with some operational problems, identify and discuss these problems.

## **7.0 REFERENCES/FURTHER READINGS**

Emekekwe, P.E. (1990). Corporate Financing Management, African Bureau of Educational Science Publication, Kinshasa – Zaire

Fabozzi, Frank, et al. (1974). Foundations of Financial Market and Institutions, Prentice Hall International Edition.

Okafor, F. O (1983). Investment Decisions: Evaluation of Projects and Securities, CASSELL Ltd. London.