COURSE GUIDE

BFN 407
INVESTMENT BANKING

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INTRODUCTION

The course BFN 407, Investment Banking is a three credit unit course prepared for 400 level students in B.Sc. Banking and Finance of the National Open University of Nigeria.

It is an introduction to the study of Investment Banking. The course has eighteen units with appropriate local content for the learner. However it will be very useful to other readers who want to have understanding of the general concepts of the course.

The primary aim of this course is to equip you with the basic fundamental principles, theories and practices of banking. The course will also provide you with a good and sound foundation upon which you will develop the full potentials and understanding of the concept of banks, functions and their operations.

Upon the completion of this course, you should be able to understand the principles, theories, basic concepts and functions of banks, the role of both banking and non-bank financial institutions in the economic development of Nigeria.

This course guide tells you briefly what the course is about, relevant materials that you require to make your study very successful.

COURSE AIMS

This course is geared towards equipping you the student with the basic concepts, theories of banking and a general overview of banking business. This will enable you take important financial decisions. This aim will be achieved in the following ways:

- Introducing you to the Banking Laws and Regulations
- Explaining the functions merchant banks and other regulatory authorities in Nigeria
- Explaining the general overview of banking business and practices

COURSE OBJECTIVES

On the successful completion of this course, you will be able to:

- explain the evolution, theories and growth of banks

- State and explain the functions of banking Institutions and discuss their roles in economic development of Nigeria.
- explain the theories and principles of banking
- discuss the functions of regulatory bodies in the banking sector
- explain the role of the money and capital markets in the development of the Nigerian economy
- Identify and discuss the role of non-bank financial institutions in economic development of Nigeria.
- list the various categories of institutions operating within the banking and sub-banking sectors in Nigeria.
- explain the legal framework within which banks and other financial institutions in Nigeria carry out their operations.

I wish you success in the course and hope that you will find BFN 407-Investment Banking not only interesting but useful and rewarding.

COURSE MATERIALS

The National Open University of Nigeria provides you with the following items:

- Course Guide
- Study Units
- Textbooks and Reference
- Assignment file
- Presentation Schedule

STUDY UNITS

There are 21 units under 4 modules in this course which should be studied carefully:

Module1

Unit 1	Meaning and Evolution of Banking
Unit 2	Theories of Banking
Unit 3	The Central Bank
Unit 4	Evolution of Merchant and Development Banks
Unit 5	Commercial Bank and Investment Banks

Module 2

Module 3

Module 4

REFERENCES AND TEXTBOOKS

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ASSESSMENT

Self-Assessment Exercises are incorporated in the main text. You are to do them carefully to test your understanding of the materials as you go on.

TUTOR-MARKED ASSIGNMENT

The NOUN will direct further on the TMAQ you will do and submit. They will account for 30 per cent of the total course marks

FINAL EXAMINATION AND GRADING

At the end of the semester, you will write an examination that will count for the remaining 70 per cent of the course marks, you are to expect that all the areas of the course will be assessed during the examination.

SUMMARY

On the successful completion of the course, you would have been equipped to take important decisions relating to Investment Banking and Bank practices.

MAIN COURSE

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MODULE 1

UNIT 1 MEANING AND EVOLUTION OF BANKING

CONTENTS

1.0 INTRODUCTION

Various attempts have been made to define the term bank or banker. In this first unit we shall commence with the meaning and evolution of banking. We shall refresh your memory on the definitions and meaning of banking, bank and banker. We will trace the origin of banking. We shall also look at the origin and growth of banks the world over and particularly, briefly consider the growth of banks in our country-Nigeria.

2.0 OBJECTIVES

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

- explain the meaning of a bank, banking or banker
- trace the evolution of banking in Nigeria.
- explain the growth of banks in Nigeria

3.0 MAIN CONTENT

3.1 Meaning of a Bank, Banking and Banker

What is banking? To many people, a bank refers to an institution which accepts deposits from the public and in turn advances loans by creating credit. It is different from other financial institutions in that they cannot create credit though they may be accepting deposits and making advances. Economists on their part have defined a bank in various capacities, some emphasising its various functions.

However, a bank has been defined broadly as any financial institution that accepts, collects, transfers, pays, exchanges, lends, invests, or safe- guard's money for its customers. This broader definition includes many other financial institutions that are not usually thought of as banks but which nevertheless provide one or more of these broadly defined banking services. Summarising these definitions a bank is simply an institution which accepts deposits from the public and in turns advances loans by creating credit.

We shall therefore consider the definition of banking under three viewpoints:

a) Definitions of bank or banker by Text-Book Writers
b) Definitions of bank or banker by Status
c) Definitions of bank or banker as expressed by the Courts

a) Definitions of bank or banker by Text-Book Writers

A bank has been defined by Dr. Hart as " a person or company carrying on the business of receiving moneys, and collecting drafts, for customers subject to the obligation of honoring cheques drawn upon them from time to time by the customers to the extent of the amounts available on the current accounts".

In his 8th edition, published in 1972 Paget defined "a bank or banker as a corporation or person (or group of persons) who accept moneys on current accounts, pay cheques drawn upon such account on demand and collect cheques for customers, that if such minimum services are afforded to all and sundry without restriction of any kind, the business is a banking business, whether or not other business is undertaken at the same time; that providing the banking business as so understood is not a mere for other business, the person or corporation is a banker or bank for the purposes of statutes relating to banking, other than those where the sole criterion is the satisfaction of some government department".

Chamber's 20th Century Dictionary defines a bank as an "institution for the keeping, lending and exchanging, etc of money. Economists have also defined a bank highlighting its various functions. According to Crowther, "The banker's business is to take the debts of other people to offer his own in exchange, and there by create money." A similar definition has been given by Kent who defines a bank as "an organisationl whose principal operations are concerned with the accumulation of the temporarily idle money of the general public for the purpose of advancing to others for expenditure." Sayets, on the other hand, gives a still more detailed definition of a bank thus: "Ordinary banking business consists of changing cash for bank deposits and band deposits for cash; transferring bank deposits from one person or corporation (one 'depositor') to another; giving bank deposit in exchange for bills of exchange, government bonds, the secured or unsecured promises of businessmen to repay, etc. Thus a bank is an institution, which accepts deposits from the public and in turn advances loans by creating credit. It is different from other financial institutions in that they cannot create credit though they may be accepting deposits and making advances.

b) Definitions by Statutes

There are no definitions by statute that are of more value. All we can see from the statutes are that both the Bills of Exchange Act 1882 and the Stamp Act, 1891 attempted to define a banker as any person carrying on the business of banking. In fact, section 2 of the Bills of Exchange Act, 1882 provides that "in this Act, unless the context otherwise requires. A 'banker' includes a body of persons, whether incorporated or not, who carry on the business of banking". A Bank is "a company which carries on as its principal business the accepting of deposits of money on current account or otherwise, subject to withdrawal by cheque, draft or order" .The 1958 Banking Ordinance defined banking as "the business of receiving money on current account, of paying and collecting cheques drawn by or paid in by customers, and of making advances to customer".

Section 2 of the bills of exchange Act 1958 defines a banker as follows: Banker includes a body of persons whether incorporated or not who carry on the business of banking. But section 2 of the Coins Act 1958 state that bankers means any corporation carrying on the business of banker or financial agents. Again section 2.1 of the Nigerian Evidence Act 1958 provides that a bank and banker means any persons, partnership or company carrying on the business of bankers and also include any savings established under the savings bank ordinance and also any banking company incorporated under any ordinance hereto or hereinafter passed relating to such incorporation. Also under section 4.1 of the banking Act 1969 the term bank is defined as follows: Bank means any person who carries on banking business and include a commercial bank, an acceptance house, a discount house and financial institution.

c) Definitions as expressed by the Courts:

There are a number of decided cases where the definition of a banker has been made. For example, there was a traditionally expressed view that no one may be considered a banker unless he pays cheques drawn on self. This was re-affirmed by Justice J. Mocatta (1965) and was supported by the Court of Appeal in the celebrated case of United Dominions Trust Ltd. Versus Kirwood (1966).

SELF-ASSESSMENT EXERCISE

What do you understand by banking?

3.2 Evolution of Banking

Banking is generally known to have started by the Italian goldsmiths who settled down into business in London in about the seventeenth century. They began by accepting deposits of gold coins and other valuables from their customers for safekeeping As the volume of this business grew they had to build large strong rooms where these customers' valuable items were kept until demands were made on them by the depositors. But from empirical observations, they found out that not all that were deposited were needed at any particular time. They began giving out part of the money deposited to interested borrowers by way of loans. They charged some amount of interest. The acceptance of deposits and granting of loans are still some of the basic banking functions all over the world today.

It must be borne in mind that the forerunner of the modern banking started and performed virtually all the present functions of modern banking. The acceptance of their customers' letter of instruction to transfer funds from his or her holding to another represents the present day cheque system. After all a cheque is merely an instruction on a legalised paper from one customer to the banker requesting him (the banker) to pay money written on the cheque to a named beneficiary. The Goldsmiths' receipts to their clients became the first known issue of notes, though they were not legal tender. These receipts later became transferable instruments.

As the individual goldsmith's business expanded, it became necessary for them to organise themselves into groups to form Merchant and Private banks. As a result of the fast expanding activities of these goldsmiths and the huge financial involvement by individual citizens, it became necessary to protect both the depositors and the goldsmiths. In consequence, therefore, the British Government in 1694 established the Bank of England to regulate and control these merchant and private banks amongst other functions.

In Nigeria, banking came with the advent of colonial masters the British colonists. The introduction of the first modern banking dated back to 1892, when the African Banking Corporation was established in Lagos at the invitation of Elder Dempster and Company. African Banking Corporation was based in South Africa but merely opened a branch office in Lagos to finance the shipping business of Elder Dempster and Company who was operating steamship services between Liverpool and the West Coast of Africa. Probably as a result of the good performances of the African banking Corporation, another bank opened its branch office in Lagos in 1894.

The bank was the Bank of British West Africa (now known as First Bank of Nig. Plc), which was registered in London in 1892 with an authorised capital of £100,000 (or N200,000). This bank enjoyed the monopoly over banking business in Nigeria until 1916. Until this date, however, the bank (B.B.W.A.) was the sole agent for the custody and distribution of British silver currency in West Africa as issued by the West African Currency Board, which was established in 1912. The Bank of British West Africa remained dominant in the field until 1916 when the Colonial Bank, which was established. As a result of its dynamism, the bank opened fifteen branches within four years it was established in West Africa.

In 1925, the assets and liabilities of this bank were taken over by a consortium of banks comprising Barclays Bank, Anglo-Egyptian Bank and the National Bank of South Africa to form a new bank named

Barclays Banks, D.C.O. (Dominion, Colonial and Overseas). This new bank had to change its name to Barclays Bank of Nigeria Ltd., and later to Union Bank of Nigeria Limited. The acceptance of their customers' letter of instruction to transfer funds from his or her holding to another represents the present day cheque system. After all a cheque is merely an instruction on a legalised paper from one customer to the banker requesting him (the banker) to pay money written on the cheque to a named beneficiary. The Goldsmiths' receipts to their clients became the first known issue of notes, though they were not legal tender. These receipts later became transferable instruments.

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Other expatriate banks such as United Bank for Africa, Arab Bank, International Bank for West Africa, Bank of India, Bank of America later Savannah Bank and Chase Manhattan Bank were later introduced into Nigeria. These banks were established by the colonial government and businessmen and as such they were mainly catering for the interest of expatriates. The indigenous men and women and their enterprises were severally discriminated against. This discriminatory attitude of these foreign banks led to the first known protest by the Nigerian business community in 1892. This was followed by an appeal from the native traders of Lagos to the Financiers from Great Britain when they visited Lagos in 1912. The height of these protests was the establishment in Lagos of the first indigenous financial institution known as the Industrial and Commercial bank in 1929. This protest "motivated" bank which was established primarily to moderate the effects of the discriminatory credit and investment policies of the expatriate banks against the indigenous enterprises went into liquidation 1930.

In 1931 another indigenous banking institution; the Nigerian Mercantile Bank was formed with an initial paid-up capital of N3,400. Its total deposits did not exceed N5,000 before it voluntarily liquidated in 1936. This bank had the same Managing Director with first indigenous bank (the Industrial and Commercial bank) that liquidated in 1930. The failures of these banks were largely due to inadequate capital, inexperience management and inefficient and crude accounting method, as well as the prevailing depressed economic conditions at the time. In spite of these woeful failures the determination of Nigerians to own, control and manage their own banks continued. However, successful indigenous banking efforts in Nigeria thus began with the establishment of the National Bank of Nigeria Ltd., in 1933. The bank started with a nominal capital of N20,000 and the paid-up capital grew from N2,046 in 1936 to N29,108 in 1946. The deposits liabilities grew from N7,830 in 1936 to N345,930 in 1946 and Loans/Advances grew from N9,486 to N220,000 during the same period.

The favorable outcome of the effort the then Western Region of Nigeria Government in establishing the National Bank of Nigeria; the continuing need to provide banking credits to the indigenous enterprises and the buoyancy of the economic conditions during the post-world war years encouraged others to establish indigenous banks. In any case, between 1945 and 1960 a total of twenty three indigenous banks were established and twenty of them had either failed or surrendered their licenses and three survived. The historical development of commercial banking in Nigeria is well documented. Detailed analysis can be found in various books.

Nigeria appears to be unique among the African Colonial territories in having an early experience of active indigenous commercial banking, although this sector had constantly been dwarfed by the expatriate sector in terms of percentage and absolute shares of assets and liabilities. Indeed, the development of the commercial banking system in Nigeria has been along oligopolistic lines in which a few expatriate banks control the market. This is to be expected, given the fact that banking services were established to serve the needs of the nascent modern sectors (that is, the government, foreign trade, commerce and industries), which were entirely dominated by the expatriates. For the experiences of other developing economies, see E. Nevin.

Between 1951 and 1954 many indigenous banks tottered, faltered, limped and died. In fact these failures were of great magnitude. Various governments in Nigeria have come up with different measures in order to tackle the problem of bank failure. Some of these measures have contributed to strengthening the banking sector of the economy. We shall discuss some of these measures in a latter unit under banking regulation. Nigeria as at today (2007) has twenty-five commercial banks as a result of the recapitalization policy introduced by the Central Bank of Nigeria.

3.3 The 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 Barclays 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 per cent of the aggregate bank deposits at that time.

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 capitalisation 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 lassies – faire phase (1930-59), during which several poorly capitalised and unsupervised indigenous banks failed before their 10th 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 prudentialprinciples. 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, Sierra 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.

SELF-ASSESSMENT EXERCISE

Carefully describe the growth of banks in Nigeria.

4.0 CONCLUSION

In conclusion, there are various definitions of banker or banking. You have seen that both banker and, bank means one and the same thing. The above analyses shows that banking business is an old business which started some centuries ago and has continued to grow over time. The growth and development of banking activities inthe countries of the world differ from country to country depending on the level of economic andtechnological development of each country.

5.0 SUMMARY

In this unit, we have discussed the meaning of a Bank or Banker wherein we explained that they all mean one and the same thing. You have learned about the evolution, origin and growth of banks. The unit has also explained the concept of banking and has also thrown light on the growth and development of banks in the Nigerian economy.

6.0 TUTOR-MARKED ASSIGNMENT

Banking has been defined in various ways. Give some of these definitions.

7.0 REFERENCES/FURTHER READING

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UNIT 2 THEORIES OF BANKING

CONTENTS

1.0 INTRODUCTION

In this unit you are going to learn about the various theories of banking. These theories which are propounded by scholars who, bearing in mind the banks unique type of business, sought to provide solutions on how can the unique business survive. These theories include theReal Bills Doctrine, the shiftability theory, the anticipated income theory, and the liability management theory.

2.0 OBJECTIVES

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

- list and explain all the theories of banking
- differentiate between all the theories of banking
- identify and explain the weaknesses of the banking theories.

3.0 MAIN CONTENT

3.1 Theories of Banking

3.1.1 The Real Bills Doctrine

The Real Bills Doctrine or the commercial loan theory states that a commercial bank shouldadvance only short-term self-liquidating loans to business firms. In other words, this theory holds that banks should lend only on “short-term, self-liquidating commercial papers. This is for thesimple reason that a bank has liabilities payable on demand, and it cannot meet these obligationsif its assets are tied up for long periods of time. Rather, a bank needs a continual and substantialflow of cash moving through it in order to maintain its own liquidity, and this cash flow can beachieved only if the bank limits its lending activities to short-term maturities. Self-liquidating loans are those which are meant to finance the production, and movement ofgoods through the successive stages of production, storage, transportation and distribution. Whensuch goods are ultimately sold, the loans are considered to liquidate themselves automatically.

The theory states that when commercial banks make only short-term self-liquidating productiveloans, the central bank, in turn should only lend to the banks on the security of such short-termloans. This principle would ensure the proper degree of liquidity of each bank and the propermoney supply for the whole economy. This in essence, aims at the stabilisation of the banking system. The weakness of this theory stems from the failure to realise that the loans are made, given thevalue of the goods and not the good itself; and also the value of goods itself is subject tovariations, given the state of the economy.

3.1.2 The Shiftability Theory

The Central thesis of this theory holds that the liquidity of a bank depends on its ability to shiftits assets to someone else without any material or capital loss when the need for liquidity arises.This theory asserted that if the commercial banks maintain a substantial amount of assets that canbe shifted on to the other banks for cash without material loss in case of necessity, then there isno need to rely on maturities. According to this view, an asset to be perfectly shiftable must be immediately transferable without capital loss when the need for liquidity arises. This is particularly applicable to short-term markets investments, such as treasury bills and bills of exchange which can be immediately sold whenever it is necessary to raise funds by banks. For example, it is quite acceptable for a bank to hold short-term open market investments in its portfolio of assets, and if a large number of depositors decide to withdraw their money, the bank need only sell these investments, take the money thus required and pay off its depositors.

Therefore, the theory tried to broaden the list of assets demand legitimate for bank ownership, and hence redirected the attention of banks and the banking authorities from loans to investmentsas a source of bank liquidity that is; the fundamental source of liquidity is the banks secondary resources.The flaw of this theory does not lie on the theory itself, but on the bank management practices towhich the theory led. One bank could obtain the needed liquidity by shifting its assets but not sopossible when all members of the bank behave the same way (Fallacy of composition). Hence, the problem of liquidity of the whole banking system is simply not solvable by commercialbanks alone. This is where a central bank that is prepared to act quickly and decisively is anabsolute necessity.

SELF-ASSESSMENT EXERCISE

What do you understand by the Real Bill Doctrine?

3.1.3 The Anticipated Income Theory

According to this theory, regardless of the nature and character of a borrower's business, the bank plans the liquidation of the loan from the anticipated income of the borrower. This theory opines that a bank should make long-term and non-business loans since even a "real bill" is repaid out of the future earnings of the borrower; i.e. out of anticipated income. At the time ofgranting a loan, the banks take into consideration not only the security, but the anticipated earnings of the borrower. Thus a loan by the bank gets repaid out of the future income of the borrower in installments, instead of in lump sum at the maturity of the loan.

SELF-ASSESSMENT EXERCISE

Differentiate between the Real Bill Doctrine and the Anticipated Income Theory.

3.1.4 The Liability Management Theory

According to this theory, there is no need for banks to grant self-liquidating loans and keep liquid assets because they can borrow reserve money in the money market in case of need. A bank can acquire reserves by creating additional liabilities against itself from different sources.

These sources include the issuing of time certificates of deposits, borrowing from other commercial banks, borrowing from the central bank, raising of capital funds by issuing shares, and by ploughing back of profits.

Arguing that a bank can use its liabilities for liquidity purposes, the theory opines that it canmanage its liabilities so that they actually become a source of liquidity by going out to by money when it needs it (for paying its demand deposits and meeting loan requests). That is, liability management suggests that the bank borrow the funds it needs by means of various bank-relatedmoney market instruments.

4.0 CONCLUSION

The unit discusses four theories of banking which explains how the banks try to survive in aneconomy as a business entity.

5.0 SUMMARY

In this unit, we have discussed about;

- The Real Bill Doctrine
- The Shiftability Theory
- The Anticipated Income Theory
- The Liability Management Theory

6.0 TUTOR-MARKED ASSIGNMENT

What do you understand by Shiftability Theory? What are its flaws?

7.0 REFERENCES/FURTHER READING

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UNIT 3 THE CENTRAL BANK

CONTENTS

1.0 INTRODUCTION

In this unit, we shall explain the meaning of a Central Bank and trace its origin in Nigeria. We shall in addition discuss the functions of the Central Bank, credit control by the CBN and the differences between CBN and Commercial banks.

2.0 OBJECTIVES

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

- explain what is meant by the central bank
- trace its origin in Nigeria
- discuss the functions of the central bank.

3.0 MAIN CONTENT

3.1 The Central Bank

The central bank is the apex bank in a country. Central Bank is a government owned bank and each country owns only one Central Bank. A Central Bank is therefore government's representative in the banking system and acts mainly as a banker to the government. It is the apex bank in a country which controls its monetary and banking structures.

It regulates and issues currency, performs banking and agency services for the country, keeps cash reserves of commercial banks, keeps and manages international currency, acts as the lender of the last resort to commercial banks in the country, acts as clearing house, and controls of credit.

Therefore, a Central Bank can be briefly and functionally defined as “a national (financial) institution that traditionally possess the monopoly of issuance of legal tender money in a country, is entrusted with the custody of the cash reserves of the banking system (that is function as a banker to banks), and acts as lender of last resort”. It usually acts as banker and financial adviserto government, and the custodian and manager of the nation’s foreign exchange reserves.

A Central bank is very different in both its organisation and functions compared to other types of banking institutions. Since it is said to be at the apex of any banking system, the law or charter that establishes a central bank is normally very different from those other laws or legislations establishing other types of banks. The Central Bank of Nigeria (CBN) was established on March 17th, 1958 by the Central Bank Ordinance of 1958. The bank effectively came into existence and fully operational on 1st July, 1959. A Central Bank has been defined in terms of its functions. According to Vera Smith, "The primary definition of central bank is a banking system in which a single bank has either complete control or a residuary monopoly of note issue." W. A. Shaw defines central bank as a bank which controls credit. To Hawtrey, a central bank is the lender of the last resort. According to A. C. L. Day, a central bank is "to help control and stabilise the monetary and banking system"-according to Sayers.

The Central Bank "is the organ of government that undertakes the major financial operations of the government and by its conduct of these operations and by other means, influences the behavior of financial institutions so as to support the economic policy of the Government." Sayers refers only to the nature of the central bank as the government's bank. All these definitions are narrow because they refer only to one particular function of a central bank. The Central Bank is called by different names in different countries. It is the Reserve Bank of India in India, the Bank of England in England, the Federal Reserve System in USA, the Bank of France in France in Nigeria it is called the Central Bank of Nigeria.

3.2 Functions of Central Bank

Some of the functions of the CBN are:

Issuance of Legal Tender Currency

The CBN is the sole authority vested with the power to issue legal tender currency in the country. Because of the primary importance of legal tender currency (Notes and Coins) in the smooth functioning and development of the economy, the issuance of legal tender money is the foremost responsibility of all central banks the world over. Also, it is the central banks' responsibility to safeguard the internal and international values of that currency. So as to service the economy with legal tender currency, the central bank organises not only its production, but also its distribution and the periodic replacement of old or damaged ones.

It is also the sole responsibility of the central bank to withdraw notes. By this function, it is ableto maintain the financial stability of the economy.

Banker to the Government

The central bank serves as banker and financial adviser to the Federal Government and other state Governments. In its capacity as Banker to Government, the bank receives deposits and makes payments on behalf of the Federal Government. It also provides banking services to State Government – owned institutions.

Bankers' Bank

The Central Bank acts as banker to commercial, merchant, development banks and other financial institutions in that they keep part of their deposit with the Central Bank of Nigeria. Every bank in Nigeria is therefore required by law to keep an account with the Central Bank of Nigeria, not only as a statutory requirement, but rather also as a necessity in order to meet interbank transactions best handled through the CBN; for example, through the clearing system. To this end, the CBN established a number of clearing houses in the country to facilitate the clearing of cheques among commercial banks and further improve the payment system in theeconomy.

Banks Control and Supervision

The Central Bank controls, supervises and assists the activities of commercial, merchant banks and other financial institutions in the economy. The CBN exercise surveillance over the operations of the banks with a view to ensuring sound banking practices. For instance, the CBN prescribes periodically the proportion of deposit liabilitieswhich banks must hold in the form of liquid assets so as to foster public confidence in their ability to meet their customers' cash demand.

Lender of Last Resort

Commercial banks in financial difficulties have the central bank as the last place to run to, to borrow or to discount bill of exchange. This function helps to prevent a banking crisis which may have been disastrous. By granting accommodation in the form of re-discounts and collateral advances to commercial banks and other financial institutions, the CBN acts as a lender of last resort. The CBN lends to such institutions in order to help them in times of financial stress so as to save the financial structure of the country from collapse.

Formulation and Implementation of Monetary Policy

A major responsibility of a modern Central Bank is the formulation and implementation of monetary policy in the economy. By this function, the CBN seeks to promote monetary stability with a view to ensuring a stable internal and external value of the national currency. It is important that the supply of credit and money are adequate to support desirable and sustainable growth without generating inflationary pressures and undue instability in the naira exchange rate. Thus, monetary policy is applied to influence the availability and cost of credit in order to regulate money supply.

Maintenance of External Reserve

To safe-guard the internal value of our legal tender currency, the CBN maintains the management of the country's debt and its foreign exchange. It manages the national debts, controls the foreign exchange as well as deals with the central banks of other nations. In managing the nation's external reserves as required, the central bank seeks to maintain an adequate volume of external reserves to preserve the international value of its domestic (the naira). To achieve this aim, the CBN therefore has the responsibility of managing the country's foreign exchange reserves. The bank not only manages external reserves but also manages the exchange rate.

In Nigeria, the major objectives of exchange rate policy in support of stable economic growth and development including deriving an appropriate exchange rate for the naira and ensuring stability of naira exchange rate. A viable and realistic exchange rate ensures efficient use of resources widens the scope of legitimate foreign exchange transactions and facilitates the achievement of internal and external balance. Also, stability of the exchange rate ensures that economic agents can plan ahead without fear of escalating costs.

Foreign Exchange Management

The foreign exchange management activities of the central bank involve the acquisition and development of foreign exchange resources in order to reduce the destabilising effects of short term capital inflows. The CBN monitors the use of scarce foreign exchange resources to ensure that foreign exchange disbursement and utilisation are in line with economic priorities and within the annual foreign exchange budget and thereby ensure a viable balance of payments position as well as the stability of the naira. The CBN also conducts routine examinations into the foreign exchange operations of the authorised dealers. The activities of some “Bureau De change” are also investigated to ensure compliance with foreign exchange market (FEM) regulations.

SELF-ASSESSMENT EXERCISE

Discuss the functions of the central bank.

3.3 Credit Control by the Central Bank

Credit control is the means to control the leading policy of commercial banks by the central bank.

3.3.1 Objectives of Credit Control

The Central Bank controls credit to achieve the following:

i. Maintenance of relative stability in domestic prices: One of the major objectives of controlling credit in the economy is to stabilise the price level in the country.

   Frequent changes in prices adversely affect the economy. This is because excessive increases or decreases in prices make it difficult for economic planning and decisionmaking as a result of the uncertainty in the economy. Inflationary or deflationary trends can be prevented by judicious credit control policy in the economy.

ii. To stabilise the rate of foreign exchange: with the change in the internal price level, exports and imports of the country are affected when prices fall, export increase and decrease. Consequently, the demand for domestic currency increase in the foreignmarket and its exchange rate rises. On the contrary, a rise in domestic currency, increases in the foreign market and its exchange rate rises. On the contrary, a rise indomestic prices leads to a decline in export and an increase in imports. As a result, the demand for foreign currency increases and that of domestic currency increases and that of domestic currency falls, thereby lowering the exchange rate of the domestic currency. It is the volume of credit money that affects prices, the central bank can stabilise the value of foreign exchange by controlling bank credit.

iii. To protect the outflow of Gold: The Central Bank holds the gold reserves of thecountry in its values. Expansion of bank credit leads to rise in prices which reduceexports and increase imports, thereby creating an unfavourable balance of payments. This necessitates the export of gold to other countries. Central bank has to controlcredit in order to prevent such outflows of gold to other countries.

iv. To control business cycles: Business cycles is a common phenomenon of market economies which lead to periodic fluctuations in production, employment, and prices. They are characterised by alternating periods of prosperity and depression. During prosperity, there is large expansion in the volume of credit, and production, employment and prices rise. During depression, credit contracts, and production, employment and prices fall. The central bank can counteract such cyclical fluctuations through contraction of bank credit during boom periods, and expansion of bank credit during depression.

v. To achieve growth with stability: In recent years, the principal objective of credit control is to achieve growth with stability. The other objectives, such as price stability, foreign exchange stability, etc, are regarded as secondary. The aim of credit control is to help in achieving full employment and accelerated growth with stability in the economy without inflationary pressures and balance of payments deficit.

3.3.2 Methods of Credit Control

The Central Bank of Nigeria adopts two methods of credit control. They are the quantitative and qualitative methods. Quantitative aim at controlling the cost and quantity of credit by adopting such techniques as variations in the bank rate, open market operations (OMO) and variation in the reserve ratios of commercial banks. On the other hand, qualitative methods control the use and direction of credit. These involve selective credit controls and direct action.

The methods of credit control by the Central Bank of Nigeria (CBN) are discussed as below:

Bank Rate or Discount Rate Policy

The bank rate or discount rate is the rate fixed by the Central Bank at which it rediscounts first class bills of exchange and government securities held by the commercial banks. The bank rate is interest charged by the Central Bank of which it provides rediscount to banks through the discount widow. The Central Bank controls credit by making variations in the bank rate. If the need of the economy is to expand credit, the Central Bank lowers the bank rate. By this, borrowing from the Central Bank becomes cheap and easy. So the Commercial Banks will borrow more from the CBN. The Commercial Banks in turn, will loan to customers at a lower rate. The market rate of interest will then be reduced. This therefore encourages business activities, and expansion of credit follows which encourages the rise in price.

The opposite happens when credit is to be contracted in the economy. The Central Bank raises the bank rate which makes borrowing costly from it. So the banks borrow less. They in turn raise their lending rate to customers. The market rate of interest also rises because of the tight money market. This discourages fresh loans. This also discourages business activities. There will also be a contraction of credit which depresses the rise in price. Thus lowering the bank rate offsets deflationary tendency and raises the bank rate which controls inflation.

Open Market Operations (OMO)

Open Market Operations (OMO) is another method of quantitative credit control used by the Central Bank of Nigeria (CBN). This method refers to the sale and purchase of securities, bills and bonds of government as well as private financial institutions by the Central Bank. There are two principal motives of Open Market Operations. One, to influence the reserves of commercial banks in order to control their power of credit creation. Two, to affect the market rates of interest as so to control the commercial bank credit.The effect is that when the central bank sells securities to the market, the commercial bank's reserves is reduced. In this way, open market operations reduce or enhance, respectively the banking system's ability to create credit and hence money supply.

The Required Reserve Ratio

Every commercial bank is required by law to maintain a minimum percentage of its deposits with the central bank. The minimum amount of reserve with central bank may be either a percentage of its time and demand deposits separately or of total deposit. Whatever the amount of money remains with the commercial bank over and above these minimum reserves is known as excess reserves. It is on the basis of this excess reserves that the commercial bank is able o create credit. The larger the size of the excess reserves, the greater is the power of a bank to create credit, and vice versa. When the central bank raises the reserve ratio of commercial banks, it means that the latter are required to keep more money with the former. Consequently, the excess reserves with the commercial banks are reduced and they can lend less than before. On the contrary, if the central bank wants to expand credit, it lowers the reserve ratio so as to increase the credit creation power of commercial banks. Thus, by varying the reserve ratio of commercial banks, the CBN influences their power of credit creation and thereby controls credit in the economy.

Selective credit control

Selective or qualitative methods of credit control are meant to regulate and control the supply of credit among its possible suppliers and uses. They are different from quantitative or general methods which aim at controlling the cost and quantity of credit. Unlike the general instruments, selective instruments do not affect the total amount of credit but the amount that is put to use in a particular sector of the economy. This confers on the CBN the power to regulate the terms on which credit is granted in specific sectors. These powers or controls seek typically to regulate the demand for credit for specific uses and the period of time over which the loan is to be paid. This involves official interference with the volume and directions of credit into those sectors of the economy which planners believe are of crucial importance to economic development. These tools include Moral suasion and selective credit controls or guidelines.

Moral suasion

This involves the employment of persuasions or friendly persuasive statements, public pronouncements or outright appeal on the part of the CBN to the banks requesting them to operate in a particular direction for the realisation of specified government objectives. For examples, the CBN may appeal to the banks to exercise restraint on credit expansion by explaining to them how excess expansion of credit might involve serious consequences for both banking system and the economy as a whole.

Selective credit controls or guidelines

Selective credit controls or guidelines involves administrative orders whereby the CBN uses guidelines, instructs banks on the cost of and volume of credit to specified sectors depending on the degree of priority of each sector.

SELF-ASSESSMENT EXERCISE

Enumerate and explain the major ways in which the central bank of Nigeria controls credit supply in the economy.

3.4 Differences between Central Bank and Commercial Bank

1. The central bank is the apex institution of the monetary and banking structure of the country. The commercial bank is one of the organs of the money market.
2. The central bank is a no-profit institution which implements the economic policies of the government. But the commercial bank is a profit-making institution.
3. The central bank is owned by the government, whereas the commercial bank is owned by shareholders.
4. The central bank is a banker to the government and does not engage itself in ordinary banking activities. The commercial is a banker to the general public.
5. The central bank has the monopoly of notes issue. They are legal tender while the commercial bank can issue only cheques. But the cheques are in the nature of near-money.
6. The central bank is the banker's bank. As such, it grants accommodations to other banks in the form of rediscount facilities, keeps their cash reserves, and clears their balances. On the other hand, the commercial bank advances loans to and accepts deposits from the public.
7. The central bank controls credit in accordance with the needs of business and economy. The commercial bank creates credit to meet the requirements of business. 8. The central bank helps in establishing financial institutions so as to strengthen money and capital markets in a country. On the other hand, the commercial bank helps industry by underwriting shares and debentures, and agriculture by meeting its financial requirements through cooperatives or individually.
9. Every country has only one central bank with its offices at important centers of the country. On the other hand, there are many commercial banks with hundreds of branches within and outside the country.
10. The central bank is the custodian of the foreign currency reserves of the country. While the commercial bank is the dealer of foreign currencies.

11. The chief executive of the central bank is designated as "Governor", whereas the chief executive of the commercial bank is called 'Chairman'.

4.0 CONCLUSION

The above analyses show that a Central bank is very important in the live wire of the financial sector of an economy. Therefore, government needs to accord the Central Bank of Nigeria (CBN) the necessary support and backing to be able to discharge its functions adequately and efficiently in an economy.

5.0 SUMMARY

In this unit, we have discussed about;

- The concept of Central Bank,
- The functions of the Central bank,
- Credit control by Central bank,
- Objectives of credit control,
- Methods of credit control, and
- The differences between Central bank and Commercial Bank

6.0 TUTOR-MARKED ASSIGNMENT

How does the Central Bank of any Country control its credit supply?

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UNIT 4 EVOLUTION OF MERCHANT AND DEVELOPMENT BANKS

CONTENTS

1.0 INTRODUCTION

In this unit, we shall learn about the concept and meaning of Merchant and Development Banks as a provider of long-term funds for development. The evolution of merchant and development banks in Nigeria economy and other countries will also be discussed.

2.0 OBJECTIVES

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

- discuss the evolution of Merchant and Development Banks
- explain the rationale for establishing Merchant and Development banks.

3.0 MAIN CONTENT

3.1 Evolution and Development of Merchant Banks in Nigeria

The beginning of merchant bank industry in Nigeria cannot be clearly traced to a specific timeline in exiting books. Up till now, very little is known of the beginning of merchant banking industry in Nigeria existing textbooks and write ups about the industry have been rather short in this regard, an attempt will be made here to probe into the early days of the industry. The two institutions that commenced merchant business in Nigeria were both registered in 1960.

The Nigeria acceptance limited (NAL) was registered on 25th November, while Philip Hill (Nigeria) limited was registered on 14th September, 1960 NAL and Phil hill held their statutory meeting on 28th December 1960, and 13th December 1960, respectively. The two firms were, prior to merger in 1969 engaged in identical set of activities these includes:

a. Financing of commodity exports by granting credits to the marketing boards.
b. Acceptance of deposits from institution.
c. Provision of loans and advances.
d. Provision of issuing housing services.(e.g.) acting as issuing houses for the debenture issue to raise funds for building of Niger house Philip Hills was specially permitted by the ministry of finance to accept deposit up to a stipulated maximum.

3.2 Evolution and Development of Merchant Banks Outside Nigeria

3.2.1 Role of Lombardy Grain Merchants

The original banks were merchant banks as engaged in by the Italian grain merchants which first evolved in the Middle Ages. The growth of the Lombardy merchants and bankers in importance based on the strength of the Lombardy plains cereal crops, many displaced Jews fleeing Spanish persecution were attracted to the trade. They brought with them ancient practices from the Middle and Far East Silk Routes. They were originally intended to finance long trading journeys; nevertheless, they applied these methods to finance grain production and trading.

Traditionally, Jews could not hold land in Italy, so they entered the great trading piazzas and halls of Lombardy, alongside local traders, and set up their benches to trade in crops. Since they were strategically placed, they had one great advantage over the locals because of the issue of usury. Christians were strictly forbidden the sin of taking usury, defined as lending at interest and Islam too makes similar condemnations of usury.

The Jewish newcomers, on the other hand, could lend to farmers against crops in the field, a high-risk loan at what would have been considered usurious rates by the Church; but the Jews were not subject to the Church's dictates.

In this scenario, the Jews could secure the grain-sale rights against the eventual harvest. They then began to advance payment against the future delivery of grain shipped to distant ports. In both cases they made their profit from the present discount against the future price. This two-handed trade was time-consuming and soon there arose a class of merchants who were trading grain debt instead of grain.

Consequently, the Jewish trader performed both financing (credit) and underwriting (insurance) functions. Financing took the form of a crop loan at the beginning of the growing season, which allowed a farmer to develop and manufacture (through seeding, growing, weeding, and harvesting) his annual crop. Underwriting in the form of a crop, or commodity, insurance guaranteed the delivery of the crop to its buyer, typically a merchant wholesaler. In addition, traders performed the merchant function by making arrangements to supply the buyer of the crop through alternative sources such as grain stores or alternate markets, in the event of crop failure. The arrangement could also keep the farmer or other commodity producer in business during the time drought or other crop failure, through the issuance of a crop or commodity insurance against the hazard of failure of his crop.

Merchant banking progressed from financing trade on one's own behalf to settling trades for others and then to holding deposits for settlement of "billette", or the notes written by the people who were still brokering the actual grain. And so the merchant's "benches" (*bank* is derived from the Italian word for bench, *banca*, as in a counter) in the great grain markets became centers for holding money against a bill (*billette*, a note, a letter of formal exchange, later a bill of exchange and later still a cheque).

In the intervening period of time, the deposited funds by the grain merchants were intended to be held for the settlement of grain trades, but often were used for the banca's own trades. The term bankrupt is a corruption of the Italian *bancarotta*, or broken bench, which is what, happened when someone lost his traders' deposits. Being "broke" has the same connotation as bankrupt.

3.2.2 Role of Moneychangers in Medieval Trade Fairs in Europe

A strategic manner in discounting interest to the depositors against what could be earned by employing their money in the trade of the bench soon developed; in short, selling an "interest" to them in a specific trade, thus overcoming the usury objection. Once again this merely developed what was an ancient method of financing long-distance transport of goods.

Medieval trade fairs, such as the one in Hamburg, contributed to the growth of banking in a curious way: moneychangers issued documents redeemable at other fairs, in exchange for hard currency. These documents could be cashed at another fair in a different country or at a future fair in the same location. If redeemable at a future date, they would often be discounted by an amount comparable to a rate of interest. Eventually, these documents evolved into bills of exchange, which could be redeemed at any office of the issuing banker. These bills made it possible to transfer large sums of money without the complications of hauling large chests of gold and hiring armed guards to protect the gold from thieves.

3.3 Development Banks

This category of banking institutions sprang up in response to the clamour for establishment of specialised financial institutions for the interests of investors in need for medium and long term finance for accelerated development of the Nigerian economy. Okigbo (1981:129) recognises 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 private 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.

3.3.1 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.

4.0 CONCLUSION

We discussed the evolution of Merchant Banks looking at the roles played by Lombardy Grain Merchants and Money changers in Medieval Trade Fairs in Europe. Over the years Merchant banking has progressed from financing trade on one's own behalf to settling trades for others and then to holding deposits for settlement of "billette", or the notes written by the people who were still brokering the actual grain. Thus Merchant Banks play a lot of roles in the development of the financial economy.

5.0 SUMMARY

In this unit we have discussed the evolution of Merchant Banks. We have also discussed briefly on Development Banks and some of the rationales or basis for establishing such.

6.0 TUTOR-MARKED ASSIGNMENT

1. What are development banks?
2. What are the rationale or basis for establishing development banks?
3. Discuss the evolution of Merchant Banking citing the roles played by Lombardy Grain Merchants.
4. Discuss the evolution of Merchant Banking in Nigeria.

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UNIT 5 COMMERCIAL BANKS AND INVESTMENT BANKS

CONTENTS

1.0 INTRODUCTION

In the last unit, you read through importance and evolution of Merchant banks. In this unit, you are going to learn about what a commercial bank is, their function in the economy, and the role it performs in the development of an economy. Besides, you shall also learn about how money or credit is created in an economy, the limitations of the power of banks to create credit.

2.0 OBJECTIVES

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

- explain the meaning of Commercial Bank, Investment Bank and its functions in the economy
- discuss the roles Commercial Banks perform in an economy and how banks create credit.
- explain the major differences between commercial banks and central banks

3.0 MAIN CONTENT

3.1 What are Commercial Banks?

Commercial banks are those banks which perform all kinds of banking functions such as accepting deposits, advancing loans, credit creation, and agency functions. They are also called joint stock banks because they are organised in the same manner as joint stock companies. They usually advance short-term loans to customers. Of late, they have also started giving medium term and long-term loans in Nigeria. At the expiration of the date for all commercial banks in Nigeria to meet-up with the N25billion minimum capital requirement, the total of 25 commercial banks were able to meet up with the N25billion minimum capital requirement at December 31, 2005.

3.2 Functions of Commercial Banks

The Commercial banks perform very important functions in any economy. These include;

Accepting Deposit
Commercial banks accept deposits from their customers on current and / or deposit accounts. Commercial banks perform this very important function to all sectors of the economy by making available the facilities for the pooling of savings through the acceptance of deposits from the public and then making these funds available for economically and socially desirable purposes.

Advancing Loans
Commercial banks give advances to customers in the form of loans, overdrafts, discounting bills of exchange and promissory notes. A commercial bank lends a certain percentage of the cash laying in deposit on higher interest rate than it pays on such deposits. The difference between the lending rate, and deposit rate gives the bank its profits. In making credit available, commercial banks are rendering great social services; through their actions production is increased, capital investments are expanded, and a higher standard of living is realised. The provision of credit facilities by commercial banks is very important to the economy, for it makes possible the financing of the agricultural, commercial and industrial activities of the nation.

Payments Mechanism

Commercial banks make payments on behalf of their clients and in fact, exercise agency services on behalf of their clients. That is, periodic payments like insurance premiums and hire purchase installments, collection of cheques, stock and shares transactions, dividend payments etc. This function becomes increasingly important as more and more Nigerians place greater reliance on the use of cheques and credit cards.

Safe- keeping of Valuables

Commercial banks safe-guard customers' important documents, certificates, jewels, ornaments, deed, bills etc. This function evolved during thegold smith banking era when gold smiths head the strongest safe or vaults that were difficult to enter even by the best of burglars. The safe-keeping of valuables is therefore, one of the oldest functions performed by commercial banks.

Credit Creation

Credit or money creation is one of the most important functions of the commercial banks in an economy. It is this function that distinguishes commercial banks from other institutions. The creation of credit is accomplished by the lending and investing activities of commercial banks in cooperation with the central bank of the nation. Like other financial institutions, they aim at earning profits. For this purpose, they accept deposits and advance loans by keeping small cash in reserve for day-to- day transactions. When a bank advances a loan, it opens an account in the name of the customer and does not pay in cash but allows him to draw the money by cheque according to his needs. By granting a loan, the bank creates credit or deposit.

Commercial Banks Make the Use of Cheques

This eliminates the risks of money being stolen as well as other risks of carrying huge sums of money about.

Acting as Referees

Commercial banks act as referees as to the integrity and standing of their customers.

Accelerating Economic Development

Their activities accelerate the economic development of a nation since they act as intermediaries between large number of depositors and borrowers.

Financing ForeignTrade
A commercial bank finances foreign trade of its customers by accepting foreign bills of exchange and collecting them from foreign banks. It also transacts other foreign exchange business and buys and sells foreign currency. We can thus conclude that the financing of foreign trade by commercial banks contributes to a free flow of trade between nations than if these services were not in existence.

SELF-ASSESSMENT EXERCISE

Discuss the functions of commercial banks in Nigeria.

3.3 Roles of Commercial Banks in Economic Development

Apart from performing the usual commercial banking functions, banks in developing countries plays an effective role in their economic development. The majority of people in such counties are poor, unemployed and engaged in traditional agriculture. There is usually acute shortage of capital, underdeveloped transport and industrial sector. The commercial banks help in overcoming these obstacles and promote economic development. The role commercial banks plays in developing economy include;

- **Commercial Banks encourage savings**

Since investments are made out of savings, the establishment of commercial banks, especially, in the rural areas makes savings possible.

- **Commercial Banks help in mobilising savings through a network of branch banking**

They include the low income earners to save by introducing variety of deposit schemes to suit the needs of individual depositors. They also mobilise idle savings of the few rich by mobilising savings, the banks channeled them into productive investments, hence economic development isenhanced.

- **Commercial Banks providecapital needed for development**

Businessmen and / or entrepreneurs obtain both short – term and medium loans and overdrafts from commercial banks to start off new industries or engage in other development efforts.

- **Commercial Banks enhance domestic trade**

Commercial banks encourage trading activities within the country through making the use of cheques possible. This is more so, when they provide facilities for clearing these cheques possible.

- **Commercial Banks enhance the Development of International Trade**

These include acting as referees to importers, providing travelers' cheques, opening letters of credit as well as providing credit for exports, all these helps to promote international trade.

- **Commercial Banks encourage investment**

They provide direct loans to the government and individuals for investment purposes. They also buy government treasury bills or shares and thus provide money for investment or development purposes.

- **Commercial Banks provideManagerial and Financial advice in the economy**

They provide managerial advice to small scale industrialists who do not engage the services of specialists.They also render financial advice to their customers which include the viability of projects,loans, as well as the nature of business to invest in to the avoid bankruptcy.

- **Commercial Banks help in Monetary Policy Implementation**

The commercial banks help the economic development of a country by faithfully following the monetary policy of the central bank. As a matter of fact, the central bank depends upon the commercial banks for the success of its policy of monetary management in keeping with the requirement of a developing economy

3.4 Investment Banks and Commercial Banks

Early investment banks in USA differed from commercial banks, which accepted deposits and made commercial loans. Commercial banks were chartered exclusively to issue bank notes and make short-term business loans.

On the other hand, early investment banks were partnerships and were not subject to regulations that apply to corporations. Investment banks were referred to as private banks and engaged in any business they liked and could locate their offices anywhere. While investment banks could not issue notes, they could accept deposits as well as underwrite and trade in securities.

The distinction between commercial banking and investment banking is unique and confined to the United States, where legislation separates them.

In countries where there is no legislated separation, banks provide investment-banking services as part of their normal range of business activities. Countries where investment banking and commercial banking are combined have 'universal banking' system. European countries have universal banking system, which accept deposits, make loans, underwrite securities, engage in brokerage activities and offer financial services.

3.4.1 Functions of Investment Banks

Mergers and Acquisitions (M & A)
For investment bankers M&A encompasses anything that affects the fundamental structure of the companies, the business of acquisitions, disposals, and the shape of the balance sheet in terms of long-term debt and equity. It is essentially what used to be called 'Corporate Finance'.

The M&A wave in middle nineties, which has hit the markets around the globe is fortunately based on fundamentals with greater focus by companies on strategic restructuring and the urge to earn global stature. Corporate mergers around the globe numbering 22,000 during 1996 were propelled by record stock prices and low interest rates. The value of mergers in 1996 at a record $1.04 trillion surpassed by 25 per cent the record of $866 billion in 1995. Regulatory changes and the threat of increased global competition are expected to encourage in 1997 telecommunication companies, broadcasters, utilities and financial service companies among others to merge in order to reduce costs and increase revenue. Further, interest rates are expected to stay at a relatively low level to enable companies to borrow to buy other companies.

To realise economies of scale in technology and cut costs in administration, banks, fund companies and insurers resorted to mergers. Three of the top five mergers in Europe in 1996 were of financial services companies. In USA, telecommunications industry accounted for $120 billion in mergers. Radio and Television mergers, totaling $37 billion were the second largest.

Merger activity in utilities industry on account to deregulation allowing electric companies to join natural gas providers at $32 billion was the third largest. Merger mania has struck the investment banks to leading to removal of barriers between investment banking and other financial services. Investment banks have been traditionally wholesale banks and avoided dealing with public.

The mergers have, however, involved the adoption of a retail approach. Apart from mergers of investment banks with others, investment banks and brokers are teaming up. After merger, giant investment banks are emerging with fund management, securities trading and credit card business. The changes in the activities of investment banks are influenced by the need to diversify the source of their earnings to compete in share and bond underwriting which is quite lucrative with securities market firms. Further, fund management business is a regular source of income and is more highly valued by the market than trading and underwriting which is quite volatile. Investment banks have also adopted a retail approach to exploit the boom in mutual funds and retirement assets controlled by individuals sweeping across America and Europe in the nineties.

With the ideology of M&A, most organisation in Nigeria has adopted the ideology for a simple reason, which is that, it serves as an avenue of revenue generation, market capitalisation, market expansion, market penetration. This method has successfully been adopted in the Nigeria society.

Global Custody

Global custody is a service provided by investment banks to local fund managers for cross border settlement and administration. It involves receipt of dividends and interest, subscribing to rights, issues and adjusting portfolios.

Custody is the unglamorous aspect of investment banking, the prosaic back office work of settling trades, making payments, keeping records and such related tasks. Investment banks provide this service for a fee to large investors such as mutual funds, pension funds and insurance companies, enabling fund managers to buy and sell securities at home and abroad. It is a hi-tech, hi-volume, low margin business, revolutionised by advances in computer technology and information exchange.

Global custody is growing at the rate of 15–20 per cent a year and exceeds $3 trillion of the $17 trillion of international securities investment. The primary reason for such growth is the growing need to diversify beyond domestic markets to reduce risk and boost returns.

Custody fees are based on the value of assets under consideration. With increased competition, bank fees are falling to levels insufficient to cover operating expenses. This is forcing a shakeout in the industry with big names such as J.P. Morgan, Bank of America and the US Trust Corporation throwing in the towel on their custody business and deploying their energy and capital elsewhere.

Proprietary Trading and Market Making

The big changes in investment banking in the 90's have increased competition, the advent of new technology and globalisation of capital markets. Increased competition and new technology have set the margins to be earned from traditional financial mediation and compelled many investment banks to undertake proprietary trading. Several of the world's largest investment banks have $5–6 billion of equity, which enables them to undertake proprietary trading. Globalisation demands large worldwide network to service governments and large firms.

Some investment banks have proprietary trading desks which make straight forward wagers on financial markets by buying and selling securities.

Secondly, market makers who buy and sell securities on behalf of customers often hold an inventory of securities. If investment banks expect markets to rise, they can take a bet by holding bigger inventories and by not hedging them against falling prices.

Shareholders have put pressure on investment banks to mend their ways by discounting the risks, since proprietary trading leads to wild swings in profits from quarter to quarter and from year to year.

Some investment banks, such as Goldman Sachs and Salomon Brothers who want to stay in proprietary trading have invested heavily in complex risk management systems that should aid their understanding and control of trading risks. Others are taking risks of a different sort by moving into loan business, underwriting huge chunks of debt for companies to finance acquisitions and selling them later to other banks.

Some investment banks are using their capital to buy long-term stakes in companies to sell them later at a profit. Securitisation consisting of buying such assets as mortgages and consumer loans, repacking them as bonds and selling them at a profit is another activity. But securitisation has landed some banks, among them Bear Stearns, Lehman Brothers, and Salomon in losses when the prices of their inventories and of mortgages fell in 1994. In 1980's some banks such as First Boston (since renamed CS First Boston) came unstuck when the values of its portfolio of bridge loans to finance leveraged buyouts collapsed.

Niche Business
Some investment banks have a clutch on niche business such as trading in gold bullion (Rothchild has a franchise since the early 19th century), financing mining houses in America and Australia (again Rothchild), advising governments on privatisation (Schroders and Rothchild), and trading in bonds denominated in Australian and New Zealand dollars (Hombros).

Fund Management
Investment banks provide fund management services. Funds under management of Schroders have swollen five-fold to 74 billion pounds in the ten years to the end of 1995. Fund management contributes to nearly half of Schroders annual profits. Flemings manages 60 billion pounds, Rothchild 17 billion pounds and Hombros, 8 billion pounds.

Advisory Services
Several investment banks have long standing relationships with governments and firms. Their advise is sought because these banks are not big traders and distributors of securities (Hombros) or do not have a commercial bank parent (e.g. Schroders and Flemings).

Extension of Credit
After the stock market crash and consequent drop in M&A and equities transactions since 2000 the extension of credit through loans; bonds and commercial paper has returned to the centre stage of the investment banking business.

A fallout of the credit crisis in 2007 and 2008 and the collapse of the securitised debt and housing mortgages was the implosion of investment banking model. There are no investment banks on Wall Street. Two universal banks have taken the place of the two survivors, Goldman Sachs and Morgan Stanley. After the infusion of government capital they have become banks.

3.4.2 Credit Creation by Commercial Banks

The creation of credit or deposits is one of the most important functions of commercial banks. Like other corporations, banks aim at earning profits. For this purpose, they accept cash indemand deposits and advance loans on credit to customers. When a bank advances a loan, it does not pay the amount in cash. But it opens a current account in his name and allows him to withdraw the required sum by cheques. In this way, the bank creates credit or deposits. Thus, the principal process by which the banking system creates deposits is the granting of loans and overdrafts. Every loan and overdraft approved by a bank creates a new deposit. Upon the granting of a bank facility, the customer can draw cheques to effect a payment. Usually, the cheque is paid to another bank account. After the cheque has been cleared, there is an increase in the total deposits in the banking system as a new deposit has been created. To illustrate the process of deposit creation, let us show an initial cash deposit of N10,000 can yield total bank deposit of 100,000. To do this, we make the following assumptions:

i. The banking system is comprised of several banks.
ii. The statutory reserve ratio (i.e. cash to be retained) is 10%.
iii. Banks have made loans up to the limit set by the reserve requirement before thereceipt of the additional cash.
iv. All bank loans are withdrawn by borrowers in currency which is spent and redeposited by the ultimate recipients of the money in the same or another bank.
v. One of the banks receive N10,000 in cash.
vi. There is no cash or leakage in the banking system.
vii. There are credit-worthy customers of banks willing to borrow as much as banks areable and willing to lend.

3.4.3 Limitation of the Power of Banks to Create Credit

Although banks have the ability to create credit in the economy, their ability to do this is constrained by a number of factors. The following are some of the limitations of the power of commercial banks to create credit.

Availability of Cash
The credit creation power of banks depends upon the amount of cash they possess. The larger the cash, the large the amount of credit that can be created by banks. The amount of cash that a bank has in its vaults cannot be determined by it. It depends upon the primary it possesses.

Minimum Reserve Ratio (MRR)
The minimum legal reserve ratio of cash to deposit fixed by the central bank is an important factor which determines the power of banks to create credit, the higher this ratio (MRR), the lower the power of banks to create credit, and the lower the ratio, the higher the power of banks to create credit.

Availability of Collateral Securities

An important factor that limits the power of a bank to create credit is the availability of collateral securities. If securities are not available with the public, a bank cannot create credit. Therefore the more available collateral securities with the public, the more loans will be granted and vice versa. Hence, credit creation depends on the availability of securities.

Banking Habit of the People

The banking habit of the people also governs the power of credit creation on the part of banks. If people are not in the habit of using cheques, the grant of loans will lead to the withdrawal of cash from the credit creation stream of the banking system. This reduces the power of banks to create credit to desired level.

Leakages

If there are leakages in the credit creation stream of the banking system, credit expansion will not reach the required level, given the legal reserve ratio. It is possible that some persons who receive cheques do not deposit them in their bank account, but withdraw the money in cash for spending or for hoarding at home. The extent to which the amount of cash is withdrawn from the chain of credit expansion, the power of the banking system to create credit is limited.

Credit Control policy of the Central Bank

The power of commercial banks to create credit is also limited by the credit control policy of the central bank. The central bank influences the amount of cash reserves with banks by open market operations, discount rate policy, etc. accordingly, it affects the credit expansion or contraction by commercial banks.

Economic Climate

Banks ability to create credit is also limited by the economic climate prevailing in an economy. In other words, their power to create credit depends upon the economic climate in the country. In boom periods, investment opportunities increase and businessmen take more loans from banks, therefore credit expands. But in depression period when business activity is at a low level, banks cannot force business community to take loans from them. Thus the economic climate in a country determines the power of banks to create credit.

Behaviour of other Banks

The power of credit creation is further limited by the behaviour of other banks. If some banks do not advance loans to the extent required of the banking system, the banking system will not be “loaned up”.

3.4.4 Restrictions on Commercial Banks

In Nigeria, commercial banks are restricted from buying and selling securities beyond five per cent of their net incremental deposits of the previous year.

They can subscribe to securities in the primary market and trade in shares and debentures in the secondary market. Issue management activities which are not fund based are managed by wholly owned subsidiaries and distinct from the banks' operations. Further, acceptance of deposits is limited to commercial banks. Non-bank financial intermediaries accept deposits for fixed term and are restricted to financing leasing/hire purchase, investment and loan activities and housing finance. They cannot act as issue managers or merchant banks. Only merchant bankers registered with Securities and Exchange Board of Nigeria can undertake issue management and underwriting, arrange mergers and offer portfolio services. Merchant banking in Nigeria is non-fund based except underwriting.

SELF-ASSESSMENT EXERCISE

Discuss the limitations of the power of commercial banks to create credit.

4.0 CONCLUSION

In this unit, we discussed about;

i. What a commercial bank is and an Investment bank,
ii. The functions of commercial banks and Investment banks,
iii. The role of commercial banks in economic development of a country
iv. The concept of credit creation by commercial banks
v. The limitations of the power of banks to create credit

5.0 SUMMARY

It is important as an administrator and business individual to understand the idea behind investment banking, its advantages and disadvantages, and how it has led to successful financial globalisation and resources generation. The investment banking, M&A have generally become an aspect of revenue generation for both individual and government. The investment banking helps to determine which market to source for fund and what's the best means of capital generation is.

The foregone analyses indicate that commercial 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.

6.0 TUTOR-MARKED ASSIGNMENT

1. Discuss the functions of commercial banks in Nigeria.
2. Briefly explain the term investment banking and how investment banking helps an economy.
3. What is the relationship between niche market and investment banking?

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MODULE 2

UNIT 1 MERCHANT BANKING

CONTENTS

1.0 INTRODUCTION

In the last unit (3), we have learned about the commercial bank and its functions in an economy. It was very clear that the commercial bank is primarily concerned about advancing short-term loans to its customers. The question therefore is who meets the needs of those who are in need of long-term loans? In this unit, you shall learn about the Merchant Bank and at the end of the unit, you shall appreciate its role in the economy as a provider of long-term funds for development.

2.0 OBJECTIVES

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

- explain the concept of merchant bank
- state and explain the functions of a merchant bank
- differentiate between the banking services and the corporate services of the merchant bank
- differentiate between merchant bank and commercial bank

3.0 MAIN CONTENT

3.1 Meaning of Merchant Banks

Merchant banks could be defined in terms of the functions they perform in an economy. Merchant banks in different countries perform various functions but there are some activities that are basic to all of these functions. These are “deposit banking, underwriting, and the management of clients”. Talking of “deposit- banking”, the merchant banks do not mean the same thing as did the commercial banks. Merchant banks are involved in wholesale banking whereas commercial banking is simply involved in retail banking.

A Merchant Bank is a financial institution specialised in the provision of certain services such as acceptance of bills of exchange, corporate finance, portfolio, management, equipment leasing, etc. Merchant Banks, unlike commercial banks, concentrate on wholesale banking. They carter for the need of corporate institutional customers and as such, accept only relatively large deposits of N25, 000 and above. Since commercial banks concentrate more on short – term lending, merchant banks are expected to bridge this gap by providing medium and long- term loans. In other words, the principal function of a merchant bank is the provision of medium and long –term lending as against short – term lending which is regarded as the sacred domain of commercial banking.

In Nigeria, the Bank and other financial institutions Decree No. 25 of 1991, legally defines a merchant bank as “a bank whose business includes receiving deposits on deposit account, provision of finance, consultancy and advisory services relating to corporate and investment matters, making or managing investments on behalf of any person”. Merchant Banks are best known in the U. K as “acceptance houses” and as “investment banks in the U.S.A”.

3.2 Functions of Merchant Banks

Merchant banking services comprise primarily corporate finance services and banking services. Corporate finance services range from the management of the issue of private and public equity shares to corporate debt securities. Merchant banks provide expertise in the arrangement of syndicated loans for the financing of large-scale industrial projects, general financial and investment advisory services, company floatation, mergers and reconstructions, financial planning and portfolio management. Banking services are essentially loans and advances, deposits, acceptances, foreign exchange transactions, international trade and equipment leasing.

3.2.1 Banking Services

Loans and Advances

Merchant banks provide loans and advances to industry and commerce. The merchant banks like commercial banks, provides loans and advances of short-medium and long-term nature. The central bank directs that a minimum of 4% of merchant banks' total loans and advances shall be of a medium and long-term nature while a maximum of 20% shall be of short-term nature.

Thus Merchant banks also help their clients in the management of interest on debentures and loans, and dividends on shares in terms of negotiation on such interest payments, timing, rate and frequency of payments of dividends.

Deposits

Merchant bank's deposits are provided in the forum of fixed term deposits, usually form corporate and non-corporate customers. The deposits are only in large blocks with a minimum of N50, 000 at present. The deposits are not withdrawable with cheques. Certificates of deposits are used for inter-banks transactions.

Acceptances

Merchant banks accept bills of exchange from importers and exporters which are easily re-discountable.

Foreign exchange services

Merchant banks as authorized dealers perform foreign exchange services. This include the provision of service for opening letters of credit and handling direct remittances for both importers and exporters, arrangement of confirming lines for the letter of credit of clients, and liaising with the Central Bank on behalf of client. They also sell foreign exchange to customers obtained from bidding sessions at the Foreign Exchange Market (FEM).

Equipment Leasing

Merchant banks also deal in equipment leasing business by serving to guarantee lease contracts or buying and supplying equipment to companies on leasehold basis. Leasing is a method of financing which enables a company to "rent" industrial equipment instead of buying it out rightly. Leasing involves the purchase of equipment by a bank for a client who is unable to pay for the cost of the equipment at a time, but takes the possession of the equipment in installment basis over a period of time. The equipment becomes that of the client on the completion of the payment for its cost. In this way, merchant banks help to promote the activities of their clients. Merchant banks lease equipment to farmers and industrialist.

Money Market Operation

Merchant banks deal in and underwrite short-term money market instruments such as Government Bonds, Certificate of Deposits issued by large corporate entities and financial institutions, commercial papers issued by large corporate firms, Treasury Bills and Treasury Certificates issued by the apex bank on behalf of the Government.

Portfolio Management

Most merchant banks in Nigeria have investment departments set up to manage the portfolios of customers so as to ensure safety, liquidity, and profitability of the investment. This includes arranging purchases and sales of securities (and offering advice on when and what to buy and sell) as well as attending to registrations, rights or bonus issues. They also offer expert guidance on investment decisions to their clients.

Brokerage Business

Merchant banks participate in stock brokerage business by helping their clients to buy and sell shares. In addition, they engage in conducting research on equity shares and thereby advise their clients on which shares to buy, the amount of funds to invest and appropriate time to sell holdings of shares.Merchant banking services are normally offered by companies such as well-established and large Brokerage Firms, Mutual Funds, Venture Capital firms, and Investment Bankers.

3.2.2 Corporate Finance Services

Issuing House Services

Merchant Bank acts as issuing House in the capital market. In this role they provide financial services to corporate entities including governments, government parastatals and companies seeking to raise long-term or permanent finance for their operations. Merchant banks also perform function of advising and managing public issue of shares for companies particularly in areas of: advising on the timing of the public issue; advising on the size and price of the issue; acting as managers to public issues; helping in accepting applications and allotment of securities; helping in appointing underwriters and brokers to public issues; listing of shares on the stock exchange, among others.

They provide advice on the current type of capital structure and determine the most appropriate time tomake an issue. In addition, they advise on relevant government regulations, legislation and policies and in preparing all the necessary documents (e.g. the prospectus required for an application for quotation on the stock exchange) and give backing to an issue in the form of underwriting.

Handling Government Consent for Industrial Projects

Merchant banks help corporate entities to handle formalities towards securing government permission to start projects as well as for expansion or modernization activities, as the case may be.

Render Advice on Business Opportunities

Merchant banks render assistance to small companies and entrepreneurs about business opportunities, government policies, available incentives and concessions as well as helping them to take advantage of such opportunities.

Project Financing

“Project financing” (or project loans) are terms which describe the method that banks, especially merchant banks and other institutional lenders in Nigeria, use to finance the construction of new projects on a basis whereby repayment is anticipated from the revenue stream generated by the project. Project financing often involves a loan to a new entity formed specifically to own or operate the project. Merchant Banks are deeply involved in the provision of this service to both government and corporate organisations in Nigeria.

Merchant banks help their clients in managing their project investments. This the merchant bank do by advising about location of a project, preparation of project report, conducting feasibility studies, making loans for financing of projects, securing sources for project funding, and advising about concessions and incentives from the government.

Investment and Financial Advisory Services

Merchant banks assist trustees of staff pension, endowment and unit trust funds and institutional fund managers in developing overall investment, strategies; they also provide advisory services with respect to privatisation, mergers and acquisitions; and debt rescheduling.

The merchant banks also perform other functions in the course of their operations in the economy. Such functions (Akrani, 2013) include the following:

1. **Raising Finance for Clients**
   Merchant banks help their clients to raise finance from both domestic and international markets for aiding entrepreneurs in starting new businesses and projects. They also help to raise funds for their clients for expansion or modernisation of business operations.

2. **Provide Services on Corporate Reconstruction**
   Merchant banks do offer advice on expansion and modernisation of business entities. They also give expert advice on mergers and acquisitions, amalgamations and takeovers, diversification of business, foreign collaborations and joint ventures, and technological upgrading in their clients' operations, among others.

3. **Services to Public Companies**
   Merchant banks offer varied services to public-sector companies and public utilities in raising long-term capital, marketing of securities, foreign collaborations and arranging long-term finance lending institutions.

4. **Revival of Sick Industrial Organisations**
   Merchant banks help in reviving failing industrial undertakings and engaging in Board for Industrial and Financial Reconstruction (BIRD). In addition, merchant banks plans and execute full revive package for such failing companies.

5. **Corporate Restructuring**
Merchant banks also help their clients to restructure their operations such as divestment or sale of existing business units (e. g., those classified as Dogs or Question Marks in BCG Matrix), vertical and horizontal combinations, and diversification of business operations, among others.

SELF-ASSESSMENT EXERCISE

Discuss some of the main functions of merchant banks.

3.3 The Concept of Merchant Banks

Merchant Banking involves the operations of a bank that combines banking services and consultancy services. The normal banking services of merchant banks are more into wholesale banking because they do not operate on retail banking. Furthermore, merchant banking borders on wholesale banking operations because it does not accept deposits from the general banking public. In contrast to a commercial bank which operates on retail basis, a 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 the Nigerian Acceptances Limited (NAL) were registered. These two Banks merged Investment banks, began operation in Nigeria in 1960 when the Philip Hill (Nig) Ltd, and 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.

Merchant banks also provide consultancy to their clients in areas such as financial, marketing, managerial and legal matters. Consultancy services are fundamentally on advisory in nature because they provide advice, guidance and service for some fee. In the process of their operations, merchant banks help businessmen to start business enterprises, help to raise finance for their operations, help to expand and modernize the business, also help in restructuring of a business. Merchant banks also help to revive sick business entities, and help companies to register, buy and sell shares at the stock exchange (Akrani, 2011).

Furthermore, according to Knapfel (20130, a merchant bank in the United States is an investment bank that handles financing for corporations and select wealthy individuals. These banks commit their own funds to act as a creditor for, or take an equity interest in, another corporate entity. For instance, a merchant bank could provide financing for a leveraged buyout, acquisition or corporate merger.

3.4 Major Differences between Merchant Banks and Commercial Banks

Some of the major differences between the merchant banks and the commercial banks include the following:-

i. Merchant banks are wholesale bankers accepting deposits only in large blocks with a minimum of N50, 000 while commercial banks act primarily as retail bankers. Thus, while commercial banks do business with individuals and companies, merchant banks concentrate on corporate customers.
ii. Merchant banks operate as wholesale bankers with only a few branches, while commercial banks, as retailers, need a wide network of branches.
iii. Merchant banks provide mainly medium and long-term finance, while commercial banks grant short-term loans and advances.
iv. While commercial banks accept deposits from all and sundry, merchant banks depend on public and private corporations. In their lending activities, commercial banks deal with a wide variety of customers, while merchant banks deal mainly in the acceptance and discounting of commercial bills to finance trade and corporate customers.

4.0 CONCLUSION

Though merchant banks are primarily concerned with the provision of medium and long term loans in the economy, they are not a substitute to commercial banks in any way, but they compliment the efforts of the commercial banks in an economy. This unit highlights the functions of merchant banks. It also shows the difference between merchant banks and commercial banks terms of operations.

5.0 SUMMARY

You have learned that Merchant banking is any person who is engaged in wholesale banking, medium and long-term financing, equipment leasing, debt factoring, investment management, issue and acceptance of bills and the management of unit trust. In this unit, you have also learned about the major differences between the Merchant bank and the commercial bank.

6.0 TUTOR-MARKED ASSIGNMENT

1. What is the meaning of Merchant Banking?
2. Clearly differentiate between a merchant bank and a commercial bank.

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UNIT 2 STRUCTURE AND PERFORMANCE OF MERCHANT/DEVELOPMENT BANKS

CONTENTS

1.0 INTRODUCTION

As seen from the previous unit, the authorities or financial regulators who regulate the financial institution In Nigeria play a vital role in the development, substance and good performance of the players in the financial industry. The structure and development of merchant/ development bank in Nigeria has under gone several changes, which is believed to strengthen the industry and also protect the customers of the service providers. Within the last decade in Nigeria, the structure and development of the sector has come under serious transformation, in other to make these banks reliable and financially autonomous, and to avoid further financial break down.

2.0 OBJECTIVES

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

- discuss merchant bank process and operations
- explain the evolution of merchant banks in Nigeria

3.0 MAIN CONTENT

3.1 Merchant Development Banks International Operations

Commercial and Merchant Banks. Financial intermediation is carried out in Nigeria primarily through 89 commercial and merchant banks. These institutions are deposit-taking institutions offering loans (mostly short term) and providing other services. Commercial banks clearly dominate the banking system, accounting for nearly 80% of total (non-CBN) financial assets in 1998. Merchant banks are designed more as wholesale banks but are increasingly emulating commercial banks in the way they operate. They cater for the needs of corporate and institutional customers, and are encouraged to provide medium and long term financing.

J.E.H Collins, chairman Morgan Gienfell holdings in his 1976, annual report talks of merchant banking thus "I am quite sure that merchant banking is by its very nature a business based primarily on skills, a successful merchant bank is an association of men and women of above average ability who makes available to a variety of clients a wide range of free rewarded financial services" parker page 59. 1977.)

The institutions are difficult to define for various reasons on, until recently, in on country was any attempt made at providing a legal definition of the merchant banks or merchant banking. Attempts were made to define them, in the U.K and Nigeria in 1979 by way of specifying what they can do and cannot do. Another problem is that these institutions vary very widely within the same country and between countries in their size, shapes and permitted functions. As if to compound the problem the extent to which they specialised in one or more major activities varies almost endlessly

3.2 Reasons For Non-establishment of new Merchant Banks

1. Regarding their very poor performance in the provision of specialised services, almost all of the banks interviewed presented one and similar problems as impending their ability to perform as per expectations. They have low creditable that is the reason for not opening new merchant banks.
2. Most Nigerians do not like to make long- term deposit and also a lot of Nigerians have huge sums of money abroad, referring to invest in other economic instead of theirs. The reason has to do with instability in official policies to the extent that one cannot

actually plan for say, six month ahead.

3. That the maturity structure of assets is largely a reflection of the structure of the availabilities used to finance the assets. In other words, those merchant banks in Nigeria by nature obtain their funds from inter-bank and short money. The banker said that the issue of merchant banks providing medium and long term finance is like calling them to give what they don't have.

3.3 Merchant Banks Constraints and Achievements

1. Due to the establishment of merchant banks maintain dominant presence in the capital market. They manage equity and debts issues through the Nigeria stock exchange for companies raising new capital.
2. The corporate finance division of the merchant banks. acts as financial adviser, to corporations in identifying and evaluating merger and acquisition opportunities. and providing tactical and financial advice for achieving particular corporate objectives.
3. Merchant banks provide finance to corporate bodies by way of long term and medium term financing. The loans are used by the corporations for the paying of fixed assets for the firms and in some cases they are used for project expansion.

3.3.1 Constraints

Instability in government policies presented a great problem because when the overall economic outlook becomes more stable and less short-term, merchant banks in Nigeria will respond accordingly, and that horizon thinking and practice will be reduce maturely.

3.3.2 Merchant Banking – Twenty-five Years in Nigeria

Inorder to contribute significantly, meaningfully and "appropriately" to Nigeria economic development. The industry meet more steadily and determinedly out of commercial banking routine reading and deposit mobilization and into the proper merchant banking area where a high proportion of the business consists of free rewarding activity project financing, leasing etc. this will however on the part of the banks call for an intensive marketing of these services. In this regard, the suggests that the older merchant bank should shoulder this responsibility of Educating the public about the industry, generally not so much for the individual gains to be derived but as a contribution to the development of the industry and country.

Under an agreement (more of an understanding) that the CBN would exercise some limited control over its operations. In addition to pure merchant banking activities the two institutions owned stock rocking subsidiaries providing stock booking services as well as subsidiary offering registration services.

Philip Hill owned Philip hill stock broker and Nal securities. The fact that these two institutions were engaged in the some feed of business was one season why they close to merge in 1969. more importantly they emerge because there wasn't enough business for both and so it made good business sense to come together rather than engage in fiat less competition indeed the volume of business was small that even in these early days. Banking engages in marketing of their service. the NAL merchant bank limited remained the only licensed merchant bank operating in the country until late in 1973 the UDT banking (Nigeria) limited was born out of the reconstruction of the united Dominion corporation (Nigeria) limited a holy owned subsidiary of UDT international, which in turn was a wholly owned subsidiary of united dominion trust limited.

4.0 CONCLUSION

Merchant bank does not provide retail current account and cheque facilities like the commercial banks. They also have no widespread branch net work. They obtain their funds apart from their capital almost entirely from bank and public and private corporations. As at 1079, merchant bank obtain the fund of 56% from public and Private Corporation (nwankwo p. 91. 1979). They provide term deposit facilities usually to depositors' requirement with flexible terms and rates within the central bank regulation. They also specialise in providing short-term finance by means of acceptance credit cover both the exportees and the exporters. Although basis, they are normally and predominantly made available for period of up to three months (Merchant bankers) explanatory memorandum.

5.0 SUMMARY

Nigeria merchant banks are governed by the same statutory and central bank regulations as govern the commercial banks and the 1968 December in particular permits them to engage in all the activities earned on by commercial bank except current account although they can now offer cheque for them big corporate customers.

Nigeria merchant banks, like their counter parts in the United Kingdom are whole sale bankers of N10, 000 are fixed for a period and are all in interest bearing. Similarly, the typical loan is usually large. The merchant banks engage in "made to measure" banking only a small proportion of loans and advance of merchant bank is of the overdraft type common to commercial banking. Little or a reserve of cash are held (Nwankwo 1979).

6.0 TUTOR-MARKED ASSIGNMENT

1. Discuss the major constraints of Merchant Banking.
2. What are the reasons for non-establishment of new Merchant Banks?

7.0 REFERENCES/FURTHER READING

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UNIT 3 DEVELOPMENT AND SPECIALISED BANKS

CONTENTS

1.0 INTRODUCTION

In this unit, you shall be introduced to the concept of Development and Specialised banks. You shall be made to understand that apart from the other types of banks discussed in the previous units, there could be Development and specialised banks that could be established to purposely carter for some specific sectors in an economy. In Nigeria, some of these development banks include the Nigerian Bank for Commerce and Industry (NBCI), the Nigerian Agricultural, Co-operative and Rural Development Bank (NACRDB), the Federal Mortgage Bank of Nigeria (FMBN), and the Nigerian Industrial Development Bank (NIDB). The Specialised banks include the Federal Savings bank (now FSB International), the Peoples Bank, and the Community Banks.

2.0 OBJECTIVES

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

- define a development bank
- enumerate and explain the general functions of development bank
- distinguish between the banking and development functions of a development bank
- differentiate between development banks and specialised banks in nigeria.

3.0 MAIN CONTENT

3.1 What is a Development Bank?

Development banks are specialised financial institutions providing medium and long – term credit for the creation or expansion of agriculture, commercial and industrial enterprises in developing countries such as Nigeria. They are mostly established by government.
The main objective of development banks is the promotion of economic development in the economy. The idea of setting up development banks in Nigeria was mooted after the establishment of the CBN. It became apparent that there was an urgent need for banking institutions capable of providing medium and long-term finances, to fill the gaps in the economy which the merchant banks at that time were not well – equipped to service. The gaps were specifically made up of the priority sectors of the Federal Government such as the development of our agricultural and industrial sectors. Since these areas involve large expenditures which cannot be met by the commercial banks, because of the legal constraints and regulations by the CBN coupled with the rapid development within the economy, the need to establish development banks devoted primarily to stimulate these priority sectors of the economy and concerned with the promotion and finance of enterprises by the provision of long-term and intermediate finance was accepted.
The development banks operating in Nigeria includes the Nigeria Bank for Commerce and Industries (NBCI), the Nigeria Agricultural, Co-operation and Rural Development Bank (NACRDB), the Federal Mortgage Bank of Nigeria (FMBN), and the Nigerian Industrial Development Bank (NIDB).

SELF-ASSESSMENT EXERCISE

What is a Development Bank?

3.2 General Functions of Development Banks

Development Banks are specialised banks which are established for specified purposes in the economy. Their functions are therefore aimed at developing those sectors which they are established for. However, they perform two broad functions which include the banking functions and the development functions.

3.2.1 Banking Functions

i. Development Banks provide long-term and medium-term finance / loans for commerce, industry and agriculture as well as general development projects.
ii. Development Banks make funds available in the form of equity to development projects.
iii. They raise bilateral and multilateral loans from international aid agencies like the United States Agencies for International Development (USAID), from international donor agencies like the World Bank and from their own governments.

3.2.2 Development Functions

i. Development banks provide promotional activities such as identifying and properly articulating investment proposals.
ii. Development bank facilitates the establishment of institutions and enterprises which fill specific gaps in the financial system.
iii. They help to stimulate their nations' capital markets (Market for long-term loans) by selling their own stocks and bonds and / or selling and using the proceeds to invest in new enterprises.
iv. Development banks provide their clients with technical skill and advice at the preparatory and implementation stages of projects.
v. They provide managerial assistance to their clients in project preparation and evaluation.
vi. Development banks ensure that allocations to projects are in line with the defined economic, social and political priorities of the government.
vii. Development banks ensure efficient allocation to scarce financial resources in the development planning projects.
viii. They thus help to quicken the pace of economic development.

3.3 Specialised Banks

Specialised banks are established in Nigeria to carter for the financial needs of some segments of the society. The banks in this category include the Federal Savings Bank (Now FSB International), people's bank of Nigeria (PBN) and Community Banks (CB).

3.3.1 The Federal Savings Bank (FSB International)

The Federal Savings Bank (FSB) evolved from the post office savings banks in 1974, backed by Decree No. 33 of 1973. The objective of setting up a Federal Saving Bank was to encourage the savings habit among the low- income group in the society. It was recognised in 1990, as FSB international Ltd.

3.3.2 Peoples Bank of Nigeria

People's Bank of Nigeria was established in 1989 to encourage savings and provide credit facilities for the underprivileged in both urban and rural areas. The Decree that set up the bank specified its functions as the provision of basic credit requirements normally demanded by banks' customers. The bank was thus set up to facilitate access to credit for those at the grass – roots and thereby increase their self – reliance.

3.3.3 Community Banks

A Community Bank (CB) is defined as a self – sustaining financial institution owned and managed by a community or group of communities to provide financial services to that country. Community Banks were established in Nigeria in 1990 to provide banking facilities for rural dwellers as well as to support micro-enterprises in urban areas.

SELF-ASSESSMENT EXERCISE

Name and explain the purpose of any specialised bank in Nigeria.

3.4 TYPES OF DEVELOPMENT BANKS

3.4.1 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 organisations.
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 organisations.

3.4.2 The Nigerian Bank for Commerce and Industry (NBCI)

Partly in reaction to the criticism against NIDB for favoring 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 organisation 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 as follows:

i. To provide equity and funds by way of loans to indigenous persons, organisations, 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 criteria.

3.4.3 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 per cent and the Central Bank I of Nigeria 40 per cent. The Bank's broad mandate encompasses savings mobilisation 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 utilisation, repayment, savings and the formulation of strategies for the profitable marketing of products.

SELF-ASSESSMENT EXERCISE

Define the term development bank and discuss the functions of NIDB, NBCI and NACRDB.

4.0 CONCLUSION

This unit highlights the concept of development banks, and its functions. The unit also discusses specialised banks in Nigeria and the various types of development banks.

5.0 SUMMARY

In this unit, we have discussed about;

i. The concept of development banks
ii. Functions of development banks
iii. Banking functions of development banks, and
iv. The various specialised banks and their purposes in the Nigerian economy

6.0 TUTOR-MARKED ASSIGNMENT

Discuss the general functions of Development Banks in Nigeria.

7.0 REFERENCES/FURTHER READING

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UNIT 4 LAWS REGULATING THE ESTABLISHMENT OF BANKS IN NIGERIA

CONTENTS

1.0 INTRODUCTION

The conduct of banking business in Nigeria and in other countries is regulated by several laws. These laws are put in place to provide some set of standards and establish Government agencies to be responsible for ensuring that banks comply with the requirements of all relevant laws. Anything that is not governed by law is a free for all affairs and could be done to the detriment of other persons, society and of course the nation. The laws that are put in place for establishment of banks in Nigeria have set standard and requirements to be fulfilled by the operators. The establishment of banks in Nigeria involves several processes which are required by different laws.

The operation of banking includes its internal control system, conduct of business, the process of obtaining banking license, relationship with customers, and other banks, the Central Bank, and dealings in banking instruments. All these are covered by laws such as the Banks and Other Financial Institutions Act which majorly sets criteria for all banks which is finalised by the authority of the Central Bank Governor under the Central Bank Nigeria Act. The CBN Act establishes the CBN as the apex regulatory government agency to oversee the operation of other banks while the Bills of Exchange Act deals with negotiable instruments that are used by banks in their relationship with customers. There is also the process of incorporation, which is regulated by the Companies and Allied Matters Act.

2.0 OBJECTIVES

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

- identify the relevant laws that regulate banking operation in Nigeria.
- distinguish between the requirements of each of the laws.
- identify the regulatory significance of each of the laws.

3.0 MAIN CONTENT

3.1 Laws Regulating the Establishment of Banks in Nigeria.

After the establishment and licensing of a bank in Nigeria, it can legally commence business, however, in doing business it has to operate within the purview of the applicable laws in Nigeria. These laws include principally the Companies and Allied Matters Act, Cap. C. 20 LFN 2004; Banks and Other Financial Institutions Act, Cap. B.3 LFN 2004; and Central Bank of Nigeria Cap C4 LFN 2004 and the Bills of Exchange Act. Cap B8 LFN 2004.

Investment banks in USA are the most important participants in the direct market by bringing financial claims for sale. They specialise in helping businesses and governments sell their new security issues, whether debt or equity in the primary market to finance capital expenditures. Once the securities are sold, investment bankers make secondary markets for the securities as brokers and dealers. In 1990, there were 2500 investment banking firms in USA doing underwriting business. About 100 firms are so large that they dominate the industry. In recent years some investment banking firms have diversified or merged with other financial firms to become full service financial firms.

3.1.1 Companies and Allied Matters Act. (CAMA)

Banks operating in Nigeria are corporate bodies. They must firstly be incorporated as a company under the CAMA by complying with the requirements in respect of registration of such a company. See Sections 18, and 35 CAMA See also Section 2(1) BOFIA. Once a company is incorporated, it becomes a body corporate by the name contained in the memorandum of association to carryout business. See Sections 37 and 38 (1) CAMA.

3.1.2 Banks and other Financial Institutions Act. (BOFIA)

Section 2(1) BOFIA states that no person shall carry on any banking business in Nigeria except if it is a company duly incorporated in Nigeria and holds a valid banking licence issued under the Act. The procedure for application for grant of licence to undertake banking business is contained under section 3(1) (2) of BOFIA. The Central Bank Governor has unfettered discretion as to whether to issue or not to issue licence, however, any licence to be issued shall be with the prior approval of the Minister of Finance. See sections 3 (3) & (5) BOFIA

- The opening and closing of branches requires a written consent of the CBN.
  Section 6 BOFIA likewise the operation of foreign branches. Section 8 BOFIA.
- Every reconstruction, reorganisation, mergers and disposal including acquisitions requires prior approval of the Governor of the CBN.
- Every bank must at all material times maintain the minimum paid-up share capital as may be determined by the C.B.N. Section 9, and 61 BOFIA.
- Every bank is required to maintain a reserve fund which a proportion of the annual profit is transferred into for the purpose of its business and adequacy in relation to its liabilities. Section 16 BOFIA. - The BOFIA restricts certain banking activities except with prior approval of in writing of the CBN. See Section 20
- Every bank is required to keep proper books of account with respect to all the transactions of the bank. Section 24.
- The control and management of failing banks is done by the CBN in conjunction with the Nigerian Deposit Insurance Company (NDIC).See Sections 35, 36 & 38 BOFIA.
- The name which a bank should bear is also regulated, e.g. names that appear Government patronage are restricted or depict religious connotation. Section 43.
- The appointment of directors, chief executives is done with the approval of the CBN. Section 48

3.1.3 Central Bank of Nigeria Act.

The Central Bank of Nigeria is established as a body corporate under S.1. CBN Act. It is constituted by a Board chaired by its Governor. The governor is very significant in the establishment of other banks because he issues them with banking licence. The CBN operates within the Act establishing it. The Act provides for the powers of the Bank to print currency notes and coins and the monopoly of issuing them. See Section 16 & 17 CBN Act. The general operation powers of the CBN are contained elaborately under Section 26 while the activities it is prohibited from undertaking are stipulated under S. 28.19.

The CBN is entrusted with certain services which it renders to the Federal Government Section 30. It is also mandated to act as banker to other banks in Nigeria and outside Nigeria, Section 36 and 37. Very importantly, it has power to make and alter rules and regulations for the good order and management of its activities. S. 47.

3.1.4 Bills of Exchange Act. (BEA)

This Act deals with cheques, which is a bill of exchange that is commonly used by commercial banks, ("whose business includes the acceptance of deposits withdrawals by cheques") S. 66 BOFIA. By virtue of Section 73 BEA " A cheque is a bill of exchange drawn on a banker payable on demand" See also UBN Plc V. Okubama (2000) 14 NWLR Pt 688, 573; Trade Bank Plc v. Barilux (Nig.) Ltd (supra). Therefore, the provisions of the BEA apply to a cheque. See Section 73 BEA. There are specific provisions in respect of cheques under the BEA such as presentment of cheque for payment S. 74, crossed cheques. S. 78-84.

In Addition, other provisions of the Bills of Exchange Act (BEA) in respect of bills of exchange generally apply to cheques, so banks are bound by them.

SELF-ASSESSMENT EXERCISE

1. State the statutory backing to the establishment of banks in Nigeria.
2. What are the roles of the CBN and BEA in the regulation of banking operations in Nigeria?

4.0 CONCLUSION

The conduct or operation of banking in Nigeria is regulated by three principal statutes. These laws provide operational standard to be conformed to by banks. They also provide the legal basis for their activities. Consequently, every bank is mandated to operate within the ambit of the laws. Any activity outside the law might be illegal.

5.0 SUMMARY

There are three principal laws that regulate the establishment of banks in Nigeria. The Companies and Allied Matters Act deals with incorporation of a bank as a body corporate, while the Banks and Other Financial Institutions Act are concerned with application and issuance of banking license, and regulates the activities of all banks apart from the Central of Nigeria. The BOFIA regulates banking business and management of banks while the Central Bank of Nigeria Act deals with the authority to issue banking license.

The Banks and other Financial Institutions Act CBN Act establishes the CBN as the apex regulator of the banking sub-sector with functions and powers under the Act. The Bills of Exchange Act deals with the negotiable instruments, which are used by banks in the conduct of their business, especially cheques.

6.0 TUTOR-MARKED ASSIGNMENT

1. Explain the relationship between the under listed statues with regard to theestablishment of Banks in Nigeria.

    (a) Companies and Allied Matters Act
    (b) Banks and Other Financial Institutions Act.
    (c) Central Bank of Nigeria.

2. What is the relevance of Bills of Exchange Act to the conduct of banking business in Nigeria?

7.0 REFERENCES/FURTHER READING

Banks and Other Financial Institutions Act, Cap. B2LFN, 2004.

Bills of Exchange Act, Cap. B8, LFN 2004.

Central Bank of Nigeria Act, Cap. C4 LFN, 2004.

Companies and Allied Matters Act, Cap. C. 20 LFN 2004.

UNIT 5 LOAN SYNDICATION

CONTENTS

1.0 INTRODUCTION

Loan syndications have become an increasingly important part of the financial landscape. A syndicate is a group of banks making a loan jointly to a single borrower. Several factors are responsible for the desire to share a large loan among several lenders, chief among them the banks' need to achieve diversification in their loan portfolios. Limitations on interstate banking closely link the fortunes of small andmid-sized banks to those of their local and regional economies. Participating in syndicated loans can give these banks a chance to lend to borrowers in regions and industries to which they might otherwise haveno convenient access.

Capital constraints also promote loan syndications. Banks that find themselves with capital-asset ratios below or close to regulatory minimums may not want to increase assets by adding large loans to their balance sheets and may choose, instead, to share them with other banks by syndicating them.

2.0 OBJECTIVES

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

- Explain the meaning of Loan syndication
- Discuss elements of syndicated loan

3.0 MAIN CONTENT

3.1 The Meaning of Loan Syndication

Loan syndication is the process of involving several different lenders in providing various portions of a loan. Loan syndication most often occurs in situations where a borrower requires a large sum of capital that may be too much for a single lender to provide or outside the scope of a lender's risk exposure levels. Thus, multiple lenders work together to provide the borrower with the capital needed. Loan syndication is used in corporate borrowing. Companies seek corporate loans for a wide variety of reasons. Loan syndication is commonly needed when companies are borrowing for mergers, acquisitions, buyouts and other capital projects. These types of capital projects often require large loans, thus loan syndication is mainly used in extremely large loan situations.

Loan syndication allows any one lender to provide a large loan while maintaining a more prudent and manageable credit exposure because the lender is not the only creditor on the deal. Large capital projects for corporate borrowers often need very large sums of capital to complete the transaction; therefore, more than one single lender is often relied upon for loan funding. Within the loan syndication process, terms from all of the lenders on the deal are typically the same although they may vary. Collateral requirements by the lenders can often vary considerably. Usually there is only one loan agreement for the entire syndicate.

3.2 Elements of Syndicated Loan

Typically, in cases of syndicated loans, there is a lead bank or underwriter of the loan, known as the arranger, the agent or the lead lender. This lender may put up a proportionally bigger share of the loan, or it may perform duties such as dispersing cash flows among the other syndicate members and administrative tasks.

The main goal of syndicated lending is to spread the risk of a borrower default across multiple lenders such as banks, or institutional investors such as pension funds and hedge funds. Because syndicated loans tend to be much larger than standard bank loans, the risk of even one borrower defaulting could cripple a single lender. Syndicated loans are also used in the leveraged buyout community to fund large corporate takeovers with primarily debt funding.

Syndicated loans can be made on a best-efforts basis, which means that if enough investors can't be found, the amount the borrower receives is lower than originally anticipated. These loans can also be split into dual tranches for banks who fund standard revolvers and institutional investors that fund fixed-rate term loans.

3.2.1 Difference between Loan Syndication and a Consortium

In a very general sense, a consortium is any group of individuals or entities that decides to pool resources toward a given objective. A consortium is usually governed by a legal contract that delegates responsibilities among its members. In the financial world, a consortium refers to several lending institutions that group together to jointly finance a single borrower. These multiple banking arrangements are very similar to aloan syndication, although there are structural and operational differences between the two.

Loan Syndication

While loan syndication also involves multiple lenders and a single borrower, the term is generally reserved for loans that involve international transactions, different currencies and a necessary banking cooperation to guarantee payments and reduce exposure. loan syndication is headed by a managing bank that is approached by the borrower to arrange credit. The managing bank is generally responsible for negotiating conditions and arranging the syndicate. In return, the borrower generally pays the bank a fee.

The managing bank in loan syndication is not necessarily the majority lender, or "lead" bank. Any of the participating banks may act as lead or assume the responsibilities of the managing bank depending on how the credit agreement is drawn up.

Consortium

Like loan syndication, consortium financing occurs for transactions that might not take place with a single lender. Several banks may agree to jointly supervise a single borrower with a common appraisal, documentation and follow-up. Consortiums are not built to handle international transactions such as a syndication loan; instead, a consortium may arise because the size of the project at hand is simply too large or too risky for any single lender to assume. Sometimes the participating banks form a new consortium bank that functions by leveraging assets from each institution and disbands after the project is complete.

3.2.2 Advantages and Disadvantages of Syndicate Loans

Syndicate Loans offer an amalgamation of effort and the opportunity to create new banking contacts. Lenders also prefer syndications, as Fidler and Neymeyer explained, that they permit the lenders to make more loans while limiting individual exposures and spreading their risk within portfolios more widely. Moreover, administration of the loan is extremely efficient, with the agent managing much of the process on behalf of the participants.

Syndicated loans are centered on the creation of an alliance of smaller banking institutions that, because of this union, can meet the credit needs of the borrower. This creation is accelerated by appointment of an agent who manages the account. The arranger will then assemble a group of banks or a syndicate, after consultations with the borrower, with each bank lending portions of the required amount. The loan is sanctioned six to eight weeks after the mandates is awarded, and post the signing; the borrower is free to raise funds. The borrowers are required to pay upfront fees and some annual charges to the participating banks along with interest accruing from the initial drawing date. Along with giving the flexibility of choice and variety to the borrower, they also enable him to raise the loan cheaply than through a series of bilateral loans.

Other Advantages

Also, economists and syndicate executives contend that there are other, less obvious advantages to going with a syndicated loan. These benefits include:

- Syndicated loan facilitates competition for business by insinuating other banks to supply market information to a business in hopes of gaining recognition.
- Borrowers enjoy flexibility in structure and pricing, such that they have a variety of options in structuring their syndicate loans,

including multi-currency options, risk management techniques, and prepayment rights without penalty.

- Syndicated facilities bring to the businesses the best prices in aggregate and spare the companies their time and effort that could have gone waste in individual dealing with each bank.
- Syndicate Lending also increases feedback in the sense how the banks are willing to share viewpoints on contemporary issues about the business that they are otherwise unwilling to share with the borrowing business.
- They also clear visibility in the open market for the borrower. Bunn remarked that rating agencies viewed a multi-year syndicate lending as a much stronger support than several bilateral one-year credit arrangements

Disadvantages of a Syndicate Loans

- Negotiating with one bank can take several days, which is a time-consuming process.
- Managing multiple ban relationships is an ardent task and requires investment both regarding money and time.

3.2.3 Syndicate Formation

A borrower's ability to secure a syndicated loan, though, is predicated on its ability to spur the creation of a syndicate in the first place. "No two syndications are identical," wrote Bunn. "The market changes every day. Many intangibles influence the structure and pricing of a credit, including the experience and depth of a company's management team; trends in the industry and market; and financial trends within a company."

The first thing the company has to do is select an agent to facilitate communications and transactions between the borrower and the banking institutions that will form the syndicate. "The first place to look for an agent is among your existing relationships," said Fidler and Neumeyer. "Certainly you will want a bank that has the necessary syndication capability and experience to obtain market credibility. Although the agent need not always be the largest participant in the syndication, the agent should have sufficient capital strength to be the anchor for the credit. Most important, however, is that you are comfortable with the bank. Because the agent is acting on your behalf, they must fully understand your business and share your attitudes and priorities."

Once an agent has been selected, the process of finding willing banks is undertaken. This phase of the process can vary considerably in terms of complexity. Some agents gauge the interest level of other lenders by simply sending them necessary financial information on the borrower and the intended shape and size of the syndicate group, as well as data on borrower operations, background, management, and marketing. Bunn noted that in other cases, however, this process can be more complex, involving extensive due diligence, the preparation of a complete syndication offering memorandum (including financial projections), and a formal bank presentation.

By and large, the length of time necessary to form a bank group is roughly equivalent to the complexity of the proposed deal. Creation of a syndicate can take place over the course of a few weeks or a few months. Analysts note, however, that the length of time necessary to conclude the deal is usually less if the banks are already familiar with the borrower's operations. Once the membership of the group has been determined, the relationship quickly assumes the character that the borrowing business would expect when dealing with a single lending institution. "This is not to say that the borrower relinquishes control over the process and the participants will still actively call on the borrower," noted Fidler and Neumeyer. "It is merely the interaction between the participating banks that should diminish to your benefit. The agent should educate you about the market and help you navigate the specifics of pricing and structuring the transaction."

Indeed, the agent's responsibilities are many and varied. The agent is charged with administering the syndicated facility itself, as well as all borrowings, repayments, interest settlements, and fee payments. A chief component of the administration function is to make sure that communications between the lending institutions and the borrower remain open so that both sides remain informed about changing business and market realities. In return for providing these services, the agent is compensated with an annual fee.

3.3 Pros and Cons for the Borrower to Enter a Syndicated Loan Agreement

The main reason for a borrower to seek entering a syndicated loan agreement is flexible and efficient funding. Compared to the option of entering various separate loan agreements with different bank, the borrower can have access to multiple facilities that may very well serve all its funding needs, and this involving less documentation, time and resources consumed in the process, in order to comply to conditions precedent or any requests from the syndicate. Also and very important, the borrower benefits of only one set of terms and conditions. It also benefits from the combined experience of different members of the syndicate relating to the different facilities in question (for example, some banks who enter a syndicate may have a particular experience in factoring facilities, compared to others from the same syndicate, whereas if the borrower were to obtain a factoring facility outside the syndicate than maybe the facility would not be administered as well).

The borrower may also benefit from the delegation of the decision making power inside the syndicate because it may have a positive effect on the time of response of the syndicate related to the borrower's requests.

But the borrower may also be negatively impacted by entering a syndicated loan agreement. For example, technical or administrative errors may appear or a simple delay in communication between the Agent and the members of the syndicate. Also, if drawdown’s are not made available on time to the borrower, this may cause it to default under loan agreements outside the syndicated loan agreement or under commercial contracts. This may be caused by delays in money transfers between the members of the syndicate and the Agent, considering that the Agent must make available the funds to the Borrower and could happen when the lenders are located in different parts of the world.

To conclude, it is my opinion that entering syndicated loans is very useful for borrowers, especially if they are of considerable size and have good credit reputation.

3.4 Syndications and Loan Sales

When syndication is undertaken, one bank, known as the lead bank, acts as syndicate manager, recruiting a sufficient number of other banks to makethe loan, negotiating details of the agreement, and preparing documentation. The manager/lead bank handles disbursements and repayments and is responsiblefor disseminating the borrower’s financial statements to the syndicate members. The manager/lead bank is paid a fee by the borrower for these services. Sometimes, the manager hires one or more other banks as co-managers who share in the fee inreturn for helping with the manager’s duties.

Loan syndications must be distinguished fromloan sales, where a single bank makes the loan and subsequently sells portions of it to other banks.

Loansales are of two types:"participations"and "assignments."Participation creates a new contract betweenthe original lender and the loan buyer. The contract between the borrower and the original lender remains unchanged. The borrower may noteven be aware that the loan has been sold. An assignment, on the other hand, creates a new financial obligation between the borrower and the loan purchaser, which replaces the contract between the borrower and the original lender. In contrast to both types of loan sales, a loan syndication creates a contract from the beginning between the borrower and each syndicate member.

Loan syndications and sales are by no meansmutually exclusive ways to accomplish a financing. After syndication is completed, syndicate members can sell assignments or participations in their sharesin the secondary market. While legal and contractual differences exist between syndications and loan sales, their economic function is similar.

In all cases, the bank acts as an intermediary between the borrower and the institution that ultimately holds the loan on its books. Syndications and loan sales add an extra step to simple financial intermediation and represent what may be termed "secondary intermediation" between the borrower and other financial institutions. Why has this process evolved? Penacchi (1988) suggests one reason might be avoidance of the effective regulatory tax arising from capital and reserve requirements.

This explanation applies when the selling bank carries a higher regulatory burden in the form of capital requirements than the buying institution. While this is undoubtedly true in some cases, much of the secondary intermediation takes place among banks facing similar regulatory requirements. In general, secondary intermediation allows banks to reduce their exposure to any one borrower and to reduce undesirable concentration. By allowing the bank to serve more borrowers, secondary intermediation provides the bank greater geographic and industry diversification. Some of this diversification may be necessary to comply with government regulations. In particular, syndications and loan sales make it possible for a small bank to participate in a loan to a large borrower, which may otherwise nothave been possible because of legislatively mandated lending limits. While secondary intermediation can have undeniable benefits, it may also result in additional risk for participating banks. In theory, syndicators and sellers have a legal obligation to make all relevant information about the borrower available to buyers and syndicate participants. Failure to do so constitutes a breach of fiduciary duty that is actionable in court.

Moreover, syndicate members and loan buyers are expected to perform their own analysis and credit evaluation rather than rely solely on representations made by syndicators and sellers. In practice, how-ever, buyers rely on the loan documentation provided by sellers to conduct their credit evaluation.This leaves open the possibility that buyers are not fully informed and are sold loans of inferior quality orare not adequately compensated through interest and fees for the risks they are taking. This potential riskfor the buyer, resulting from opportunistic behavior by the seller, may be present in different degrees among the various forms of secondary intermediation, such as syndications, participations, or assignments, because of the varying amount of contractual "distance" they put between the borrower and the ultimate holder of the loan. This distance is the smallest for syndications, where a separate contract exists at the outset between the borrower and each syndicate member, making syndications the form least susceptible to abuse. Assignments occupy an intermediate position because a contract does exist between the buyer and the borrower, though it is not created at the time the loan is underwritten. Finally, participations are the most susceptible to abuse because the buyer must rely exclusively on the sellingbank for information, monitoring, and enforcement of the loan covenants.One mechanism that could protect buyers of participations and assignments is recourse, that is, acontractual obligation by the seller to buy back the loan at face value if it fails to meet certain standards of performance.

However, for banks to be able to take the loans they sell off their balance sheets, regulators require that the loans be sold without recourse. If a loan is sold with recourse, the sale is considered a borrowing for regulatory purposes. The bank must then retain the loan on its balance sheet and reservecapital against it, thus defeating the major purpose of the sale. For this reason, most loans are sold without recourse. Nevertheless, it is possible that some sort of implied unofficial recourse takes place in the market, anyway. A bank that sells a loan that subsequently defaults may take it back to preserve its reputation and the good will of the buyer, even if it has no contractual obligation to do so.

The evidence for the existence of this practice is mostly anecdotal, and its very nature makes it difficult to ascertain its frequency and importance in protecting buyers.This article focuses on loan syndications rather than participations or assignments because data on the quality of individual loans sold are not available. In contrast, data exist on the supervisory ratings of syndicated loans, and on the shares retained by agent banks. These data make it possible to compare the way lead banks syndicate high-quality and low-quality loans. Specifically, it can be determined if leadbanks keep a smaller portion of low-quality loans for themselves, letting other banks pick up a larger portion. In addition, the importance of lending limits and capital constraints can be tested by examining relationships between the size of the syndicated loan, the amount the lead bank keeps for itself, and the lead bank's capital.

3.5 Syndicated lending and agency costs

The transaction process of bank loan syndication can be divided into three main stages1. During the pre-mandated stage, after soliciting competitive offers to arrange the syndication from one or more banks (usually the main relationship banks), the borrower chooses one or more arrangers that are mandated to form a syndicate and negotiates a preliminary loan agreement. The syndication can either involve a sole mandate or a joint one, the latter implying the participation of more than one lead bank. Such syndications are usually chosen by the borrower in order to maximise the chances of achieving the desired loan syndication. The arranger is responsible for negotiating the key loan terms with the borrower, appointing the participants and structuring the syndicate.

During the post-mandated stage, the arranger prepares a documentation package - called an information memorandum - for potential syndicate members, containing information about the borrower's creditworthiness and the loan terms. The arranger largely determines the initial set of potential participants to target, and factors such as previous experience with the borrower and/or the arranger, in the industry sector or the geographic area, are strong drivers for being chosen by the arranger to join the syndicate.

Finally, the operational post-signing stage takes place after the completion date when the deal becomes active and the loan is operational, binding the borrower and the syndicate members by the debt contract. The syndicated loan transaction process is heavily dependent upon the arrangers because of their pivotal role in structuring the deal, negotiating the terms of the loan agreement, and organising the syndicate. However, the success of the syndication process is a function of negotiations and information flows between all the parties involved in the transaction: borrower, arrangers, and other syndicate members. Therefore, the fact that loan syndication involves several actors and is a complex process involves specific agency costs which can increase borrowing costs and thus are harmful for borrower's wealth.

First, private information about the borrower can create adverse selection problems, as the arranger may be inclined to syndicate loans for unreliable borrowers. However, such an opportunistic behavior can damage the arranger's reputation, having a negative impact on the success of future syndications (Pichler and Wilhelm, 2001). Hence, this "threat of reputation loss" can serve as a disciplining device of the arranger's behavior. Second, participating banks may delegate monitoring to the arranger, but the banks are not in the loop as to what the arranger is doing, which might result in situations of moral hazard. In addition, the arranger has less incentive to monitor the borrower than if it were to lend the full amount of the loan (Pennachi, 1998). Third, the borrower's financial distress is an important factor in syndication as it is more complicated to reorganise and reformulate the agreement for the borrower because a collective decision needs to be taken by the lenders (Bolton and Scharfstein, 1996).

4.0 CONCLUSION

We provide a new theory of loan syndication in which banks join the syndicate to control their risks. The theory predicts that syndicates form to finance risky investments in industries with substantial ex post barriers to entry. Loan syndication leads to more entry and exit.

5.0 SUMMARY

This study found that loan syndications are driven primarily by the lead bank's capital considerations, both in the form of its capital-to-asset ratio and its loan-to-capital ratio. It found no evidence that lead banks exploit participating banks by persuading them to take a larger share of inferior loans. The lack of evidence of such opportunistic behavior in syndications does not necessarily mean that it is also absent in loan sales, which may be more susceptible to it because of their contractual nature.

6.0 TUTOR MARKED ASSIGNMENT

1. Discuss syndicated lending and agency costs.
2. Discuss pros and cons for the borrower to enter a syndicated loan agreement.

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MODULE 3

UNIT 1 DISTINGUISHING FEATURES/FUNCTIONS OF MERCHANT AND DEVELOPMENT BANKS.

CONTENTS

1.0 INTRODUCTION

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

2.0 OBJECTIVES

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

- discuss the features and functions of merchant banks
- discuss development banks and their functions in Nigeria.

3.0 MAIN CONTENT

3.1 Functions of Merchant Banks

Merchant banking services comprise primarily corporate finance services and banking services. Corporate finance services range from the management of the issue of private and public equity shares to corporate debt securities. Merchant banks provide expertise in the arrangement of syndicated loans for the financing of large-scale industrial projects, general financial and investment advisory services, company floatation, mergers and reconstructions, financial planning and portfolio management. Banking services are essentially loans and advances, deposits, acceptances, foreign exchange transactions, international trade and equipment leasing.

Merchant banking functions in Nigeria is the same as merchant banks in UK and other European countries.

The following are the functions of merchant bankers in Nigeria:

- Corporate Counseling
- Project Counseling
- Capita l Structuring
- Portfolio Management
- Issue Management
- Credit Syndication
- Working Capital
- Venture Capital
- Lease Finance
- Fixed Deposits
- Development Banks

(i) Corporate Counseling

Corporate counseling covers counseling in the form of project counseling, capital restructuring, project management, public issue management, loan syndication, working capital fixed deposit, lease financing, acceptance credit etc., The scope of corporate counseling is limited to giving suggestions and opinions to the client and help taking actions to solve their problems. It is provided to a corporate unit with a view to ensure better performance, maintain steady growth and create better image among investors.

ii) Project Counseling

Project counseling is a part of corporate counseling and relates to project finance. It broadly covers the study of the project, offering advisory assistance on the viability and procedural steps for its implementation.

a. Identification of potential investment avenues.
b. A general view of the project ideas or project profiles.
c. Advising on procedural aspects of project implementation
d. Reviewing the technical feasibility of the project
e. Assisting in the selection of TCO‘s (Technical Consultancy Organisations) for preparing project reports
f. Assisting in the preparation of project report
g. Assisting in obtaining approvals licenses, grants, foreign collaboration etc., from government
h. Capital Structuring
i. Arranging and negotiating foreign collaborations, amalgamations, mergers and takeovers.
j. Assisting clients in preparing applications for financial assistance to various national and state level institutions banks etc.,
k. Providing assistance to entrepreneurs coming to Nigeria in seeking approvals from the Government of Nigeria.

(iii) Capital Structure

Here the Capital Structure is worked out i.e, the capital required, raising of the capital, debt-equity ratio, issue of shares and debentures, working capital, fixed capital requirements, etc.,

(iv) Portfolio Management

It refers to the effective management of securities i.e., the merchant banker helps the investor in matters pertaining to investment decisions. Taxation and inflation are taken into account while advising on investment in different securities. The merchant banker also undertakes the function of buying and selling of securities on behalf of their client companies. Investments are done in such a way that it ensures maximum returns and minimum risks.

(v) Issue Management

Management of issues refers to effective marketing of corporate securities viz., equity shares, preference shares and debentures or bonds by offering them to public. Merchant banks act as intermediary whose main job is to transfer capital from those who own it to those who need it. The issue function may be broadly divided in to pre issue and post issue management.

a. Issue through prospectus, offer for sale and private placement.
b. Marketing and underwriting
c. Pricing of issues

(vi) Credit Syndication

Credit Syndication refers to obtaining of loans from single development finance institution or a syndicate or consortium. Merchant Banks help corporate clients to raise syndicated loans from commercials banks.

Merchant banks helps in identifying which financial institution should be approached for term loans. The merchant bankers follow certain steps before assisting the clients approach the appropriate financial institutions.

a. Merchant banker first makes an appraisal of the project to satisfy that it is viable
b. He ensures that the project adheres to the guidelines for financing industrial projects.
c. It helps in designing capital structure, determining the promoter‘s contribution andarriving at a figure of approximate amount of term loan to be raised.
d. After verifications of the project, the Merchant Banker arranges for a preliminary meeting with financial institution.
e. If the financial institution agrees to consider the proposal, the application is filled and submitted along with other documents.

(vii) Working Capital

The Companies are given Working Capital finance, depending upon their earning capacities in relation to the interest rate prevailing in the market.

(viii) Venture Capital

Venture Capital is a kind of capital requirement which carries more risks and hence only few institutions come forward to finance. The merchant banker looks in to the technicalcompetency of the entrepreneur for venture capital finance.

(ix) Fixed Deposit

Merchant bankers assist the companies to raise finance by way of fixed deposits from the public. However such companies should fulfill credit rating requirements.

(x) Other Functions

- Treasury Management- Management of short term fund requirements by client companies.
- Stock broking- helping the investors through a network of service units
- Servicing of issues- servicing the shareholders and debenture holders in distributing dividends, debenture interest.
- Small Scale industry counseling- counseling SSI units on marketing and finance
- Equity research and investment counseling – merchant banker plays an important role in providing equity research and investment counseling because the investor is not in a position to take appropriate investment decision.
- Assistance to NRI investors - the NRI investors are brought to the notice of the various investment opportunities in the country.
- Foreign Collaboration: Foreign collaboration arrangements are made by the Merchant bankers.

Recent Developments in Merchant Banking and Challenges Ahead:

The recent developments in Merchant banking are due to certain contributory factors in Nigeria. They are;

(a) The Merchant Banking was at its best during 1985-1992 being when there were many new issues. It is expected that 2010 that it is going to be party time for merchant banks, as many new issue are coming up.

(b) The foreign investors – both in the form of portfolio investment and through foreign direct investments are venturing in Indian Economy. It is increasing the scope of merchant bankers in many ways.

(c) Disinvestment in the government sector in the country gives a big scope to the merchant banks to function as consultants.

(d) New financial instruments are introduced in the market time and again. This basicallyprovides more and more opportunity to the merchant banks.

(e) The mergers and corporate restructuring along with MOU and MOA are giving immense opportunity to the merchant bankers for consultancy jobs.

However the challenges faced by merchant bankers in India are;

1. SEBI guideline has restricted their operations to Issue Management and Portfolio Management to some extent. So, the scope of work is limited.
2. In efficiency of the clients are often blamed on to the merchant banks, so they are into trouble without any fault of their own.
3. The net worth requirement is very high in categories I and II specially, so many professionally experienced person/ organisations cannot come into the picture.
4. Poor New issues market in India is drying up the business of the merchant bankers. Thus the merchant bankers are those financial intermediary involved with the activityof transferring capital funds to those borrowers who are interested in borrowing.

The activities of the merchant banking in India are very vast in the nature of:

- The management of the customers securities
- The management of the portfolio
- The management of projects and counseling as well as appraisal
- The management of underwriting of shares and debentures
- The circumvention of the syndication of loans
- Management of the interest and dividend etc

Micro-Finance Banks

Micro-finance Banks in Nigeria are self-sustaining financial institutions owned and managed by local communities to render services to their respective communities. They are meant to promote agriculture, rural as well as economic growth through development at grassroots level.

Though their activities are geared towards rural banking, they are also noted for accepting deposits, running other banking services and investing funds in agriculture apart from providing facilities to farmers.

Nigerian Agricultural Coperative and Rural Development Bank (NACRDB)

In view of the short comings of the Commercial and Merchant banks, the Nigerian Agricultural Bank Limited was established in 1973 by the federal Government to deal exclusively with agricultural loans. The bank was established to meet the needs of the national agricultural credit institutions following regional establishments. The provision for the establishment of the bank was “knotted in the bud” during the 1st national development plan period of 1962-1968 but was not implemented until the 2nd period which spanned between 1970 and 1974.

The establishment of this specialised bank was actualised following the acceptance of the recommendations made in Stoneham's report and subsequent inclusion in the 1970-1974 Development plan. By the plan, the proposed agricultural cooperative bank which was meant to operate in all states of the federation will assist farmers in the area of cooperative farming and agricultural marketing cooperatives.

The bank was meant to make funds available directly to cooperatives, credit-worthy individuals and Governments. The objective for which it was established was therefore to "provide credits and loans for agricultural development projects thereby enhancing the level of and quality of agricultural production". The name of the bank was changed to the Nigerian Agricultural Cooperative Bank (NACB) in 1978 with a mandate to give loans to cooperative societies as on-lending and in turn to individual farmer-members. No collateral security is expected to be charged though the bank charges reasonable amount as interest based on its policy of subsidy on agric. loans and operated 100 per cent security on loans except those granted to small-holder farmers under the Small Holders Loan Scheme (SHLS). The requirements for the Certificate of occupancy, survey plans and real assets securities are usually waived.

As a result of the merger policy on the Peoples' bank of Nigeria, the Better Life for rural Dwellers Scheme and the NACB, the bank was transformed into the Nigerian Agricultural Coperative and Rural Development Bank (NACRDB) in the year 2000 to cater for other aspects of rural development.

Agricultural Credit Guarantee Scheme Funds (ACGSF)

The funds was established by the Federal Government of Nigeria Decree No. 20 of 1977 to guarantee in respect of loans granted by commercial and merchant banks for agricultural purposes, with the ultimate aim of increasing banks' lending to agricultural sector. The scheme took off with a joint contributory grant by the Central Bank of Nigeria and the Federal Government at 40 per cent and 60 per cent respectively. Under the Scheme, bank loans were guaranteed at 75 per cent of the amount in default, net the amount of the security. The is operated using the working guidelines to cover the financing of all crops including tree crops fish farming and fish capture and animal husbandry, farm machinery, hire services as well]as integrated agricultural projects.

Security require included charge on land , movable properties of borrowers , life insurance policy stocks and shares of personal guarantee on security acceptable to the facilitating commercial banks. Loans were initially guaranteed under the concessionary interest rate up to August 1978, when the de-regulation of interest started.

Other Development Banks in NigeriaThese includes:
(a) The Nigerian Industrial Development Bank (NIDB)
(b) The Nigerian Bank for Commerce and Industries (NBCI)
(c) The defunct Federal Mortgage Bank (FMB)

Specialised Banks
These banks are created by the Federal Government to cater mainly for the banking needs of the relatively suppressed segments of the Nigerian society. Examples include:

(i) The defunct peoples' bank of Nigeria (PBN)
(ii) The Community Banks (now transformed into the micro-finance Banks)
(iii) Urban Development Banks (UDB)

Non-Bank Financial Institutions (NBFI)
Commonly called "other financial Institutions and funds", they intermediate in the wider financial system. Examples are Nigerian deposit insurance Corporation(NDIC), Insurance companies , finance houses , Discount houses , Bureau de Change, National Providence Funds etc.

Other Domestic Sources:
Financial Markets
Represents a forum where surplus funds are channeled into productive use through a process of financial intermediation. It consists of the money markets for short term funds and capital market for long term funds. Not necessarily a physical location as we have in the goods market but a mechanism through which funds are transferred (bought and sold) through the banks (physical location) or through tele-communication system (non-physical location), using financial instruments. Note that the process through which funds are channeled from the surplus (depositors) to the deficit (borrowers/Needs) units for a return (interest) is called financial intermediation.

Classification of Credits
Credit can be classified on the basis of time, purpose, security, Lenders and Borrowers.

A. Classified on the basis of Time:
This classifies credit into three major areas as short, medium and long-term.

A (i) Short-term Loans
The short- term loans are generally advanced to meeting annual recurring purchases like seeds, feeds, fertilizers, hired labour, expenses on herbicides, pesticides and machinery service charges. It is therefore termed "seasonal loans or production loans or crop loans" and it is usually expected that the loans (principal) and the interest would be repaid through the income received through the enterprise in which it is invested. Time limit to repay such a loan is one year or at most 18 months.

A (ii) Medium-term Loans
They are advanced for comparatively longer span assets like machines, wells threshers, sheds for livestock, shelter and farm structures, diesel engine, irrigation structure etc. The returns accrued from the use of such assets are usually spread over more than one production season. Repayment period spans between 15 months and 5 years.

A (iii) Long-term Loans
These are related to long life assets like land, farm buildings construction of permanent drainages or irrigation system etc. which require large sum of money as initial investment. Benefits generated through such assets are spread over the entire life span of the asset. Repayment period ranges from 5 years to 20 years.

B. Classification According to Purpose of the Loan
Credit could be classified based on the purpose of the loan as crop loan, poultry/dairy/piggery loan, machinery and equipment loan, forestry loan, fishery loans etc. This type of loan signifies relationship between time of usage and the rate of returns (profitability). Sometimes loans could be classified as "production loan" or "consumption loan"

C. Classification According to Security Offered

Loans can be classified as secured and unsecured loans. Security is usually advanced against tangible assets like land, livestock or any capital asset, as either medium or long term loans. Note that credit worthiness may sometimes count much more than the security offered, which if doubtful, may result in willful default. Secured loans can be further classified on the basis of the type of security offered as:

(i) Mortgage loans

They are where legal mortgage of tangible and intangible properties like land, land improvement and other infrastructures are offered.

(ii) Hypothecated loans

They are legal ownership of assets e.g. machinery and equipment, financed remains with the lender though physically possessed by the borrowers. The private lenders often ask for gold, jewelry and/or land as security reminds the borrower of his obligations towards repayment.

D. Classification according to the Lenders:

Classified as Institutional and non-institutional credit.

Classification according to Borrowers:

Credit can be classified on the basis of the borrower as producers, business concerns etc. Such classification has equity considerations.

3.2 Credit Assessment: The 5 Cs of Credit

The 5Cs of Credit that must be considered in lending are:

(i) Character
(ii) Capacity
(iii) Capital
(iv) Condition and
(v) Credit worthiness

(i) Character

The term “Character” implies credit characters related to the qualities of individuals which makes him conscious of the debt obligations. These characters include the borrowers’ moralcharacters like honesty, integrity, sense of responsibility and trustworthiness. It is one of the basic cornerstones in assessing the risk-bearing ability of the borrower. Borrowers with highly rated credit character can withstand unforeseen events and save themselves insolvency. A borrower noted for timely repayment shows a reflection of an ideal credit character. Character is also correlated with the returns and repayment capacities of the borrowers.

(ii) Capacity

This shows the capacity of the borrower to pay his debts as at when due. Since payments oftendepend in part on income, the capacities of borrowers to pay will depend on the income rather than on savings.

(iii) Capital

Capital refers to the equity or net worth of a farm business. It assures that funds are available to repay loans if character, capacity prove to be inadequate. Capital also represents one of the cornerstones for measuring the risk bearing ability of the borrower.

(iv) Condition

Also signifies the financial conditions of the borrower which has direct relevance with the risk bearing ability as well.

(v) Credit worthiness

it shows the ability of the borrower and creditor to be able to pay off or settle its debt.

3.3 Universal Banking

A good deal of interest is generated in Nigeria in the concept of universal banking in view of the expansion of the activities of all Nigeria development banks into traditional commercial banking activity such as working capital finance and the participation of commercial banks in project finance, an area earlier confined to all Nigeria as well as state level financial institutions. Further, the reforms in the financial sector since 1992 have ushered in significant changes in the operating environment of banks and financial institutions driven by deregulation of interest rates and emergence of disintermediation pressures arising from liberalized capital markets.

Definition of Universal Banking

Universal banking refers to the combination of commercial banking and investment banking including securities business. “Universal banking can be defined as the conduct of range of financial services comprising deposit taking and lending, trading of financial instruments and foreign exchange (and their derivatives) underwriting of new debt and equity issues, brokerage, investment management and insurance.”

The concept of universal banking envisages multiple business activities. Universal banking can take a number of forms ranging from the true universal bank represented by the German model with few restrictions to the UK model providing a broad range of financial activities through separate affiliates of the bank and the US model with a holding company structure through separately capitalised subsidiaries.

4.0 CONCLUSION

Though merchant banks are primarily concerned with the provision of medium and long term loans in the economy, they are not a substitute to commercial banks in any way, but they compliment the efforts of the commercial banks in an economy. This unit highlights the functions of merchant banks. It also shows the difference between merchant banks and commercial banks terms of operations.

5.0 SUMMARY

You have learned that Merchant banking is any person who is engaged in wholesale banking, medium and long-term financing, equipment leasing, debt factoring, investment management, issue and acceptance of bills and the management of unit trust. In this unit, you have also learned about the major differences between the Merchant bank and the commercial bank.

6.0 TUTOR-MARKED ASSIGNMENT

1. As a lending house, what are the 5’C to consider while lending.
2. What are the factors that led to the development and contribution of merchant banks in Nigeria?

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UNIT 2 FINANCIAL INSTITUTION: OVERVIEW OF BANKING BUSINESS

CONTENTS

1.0 INTRODUCTION

A Bank is a familiar word and we all know that banks form an integral part of the very financial system. So, to understand banks and banking, it is desirable to get a macro perspective of the financial system as a whole. This leads us to the fundamental question as to what constitutes the financial system.

The Financial system is a set or aggregation of institutions, instruments, markets and services. A complex interplay of these components makes the financial system vibrant.

As with any other system, the financial system too has a paramount objective, i.e. to ensure smooth flow of money from those who have it [savers] to those who want to use it [borrowers], so that the latter can make an effective use of the same, in the process benefiting themselves, the savers and the economy as a whole.

This topic provides the reader with an overview of the banking business. The banking system, comprising commercial banks, investment banks, and Islamic banks, is the primary mover of funds and the main source of financing to support economic activities in Nigeria. The non-bank financial intermediaries, comprising development financial institutions, provident and pension funds, as well as insurance companies and tankful operators, complement the banking institutions in mobilising savings and meeting the financial needs of the economy.

2.0 OBJECTIVES

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

- discuss the constituents of the financial system
- explain the structure of the financial system of nigeria
- list the objectives of bank negara nigeria
- explain the main functions of commercial banks, investment banks, and Islamic banks.
- explain the importance of the banking business to the economy.
- describe the financial sector master plan and capital market master plan.
- discuss the impact of globalisation on Nigerian banks

3.0 MAIN CONTENT

3.1 Financial System – Constituents

The financial institution has always been a driving force in the development of a country. These institutions tend to serve as a means of economic growth and success of a country. At the moment, the financial institutions are now the backbone of success of finance in Nigeria for both small and large organisation. Financial Institutions are engaged in the business of, money or finance‟. They can be further classified into three categories:

i. Intermediaries
ii. Non-Intermediaries
iii. Regulatory Agencies

3.1.1 Intermediaries

Intermediaries are the financial institutions that accept deposits from the savers and channel the same as lending/ investment to the users. In other words, financial intermediaries function as a bridge between the savers and the users in any economy.

The financial intermediaries by their smooth"conduit function‟ make the economy infinitely more efficient in the usage of money.

Examples of financial intermediaries are:

i. Conventional Banks,
ii. Islamic Banks
iii. Investment Companies,
iv. Non-Banking Finance Companies [NBFCs],
v. Insurance Companies,
vi. Mutual Funds,
vii. Stock Brokerages,
viii. Credit Card Companies

3.1.2 Non-Intermediaries

These are popularly known as Supranational. These institutions fund the users of money, but, as a matter of policy, do not accept deposits from ordinary savers. They get funds from their owners or members as capital contribution or subscription & not from depositors.

Classic examples of such institutions are:

i. Asian Development Bank.
ii. World Bank.
iii. International Monetary Fund (IMF).

3.1.3 Regulatory Agencies

These are agencies whose sole function is to monitor and regulate the functioning of the intermediaries and non-intermediaries and are referred to as „Regulatory Authorities‟. They are like the traffic cops that lay down the "Do's and Don'ts" for the players in the market. To make their regulations enforceable, these agencies are generally armed with punitive powers, which can be exercised in case of non-compliance by any of the players.

Examples:
Banking Sector: In the Nigeria context, Central Bank Of Nigeria is the regulatory agency vis-à-vis the banking system. In US it is called the Federal Reserve Bank. Capital Market: Financial regulators, such as the U.S. Securities and Exchange Commission and in Nigeria, the Securities Commission is responsible for regulating the capital market segment to ensure that investors' interests are protected.

3.2 Financial System of Nigeria

The Nigeria financial system is structured into two major categories:

1. Financial Institutions: The Financial Institutions comprise Banking System and Non-bank Financial Intermediaries
2. Financial Market: The Financial Market in Nigeria comprises four major markets namely:
   i. Money & Foreign Exchange Market,
   ii. Capital Market,
   iii. Derivatives Market, and
   iv. Offshore Market

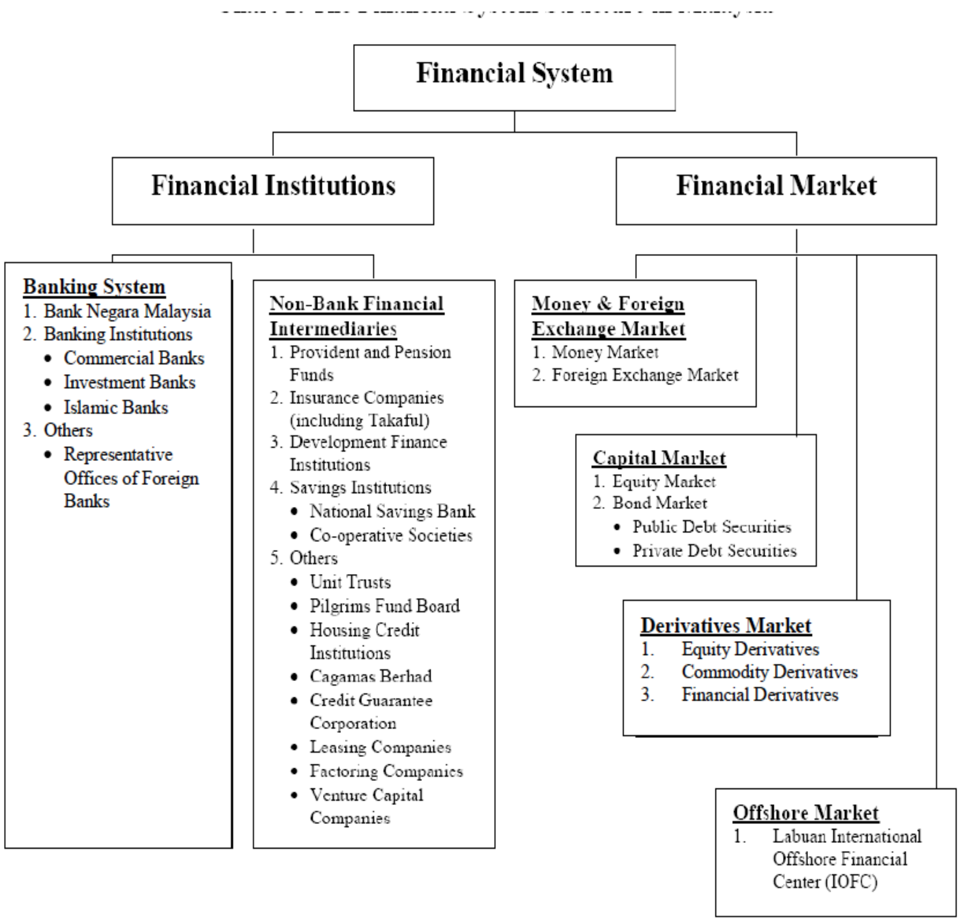

Fig.2.1: Financial System of Nigeria
Source: Central Bank of Nigeria

The activities of financial institution have led to the understanding on how globalisation takes effect and how it tends to bridge the gap in the financial institution. Due to the growth in this sector, the sector has experience the globalisation wind which had sweep across other sector of the society

3.3 Impacts of Globalisation – Recent Developments

3.3.1 What is Globalisation?

Globalisation means different things to different people. Generally, it refers to an economic process that leads to increasing integration of economies around the world. As a result of increased integration, there is increasing economic interdependence among these economies through markets for goods, services, and factors of production.

3.3.2 The Pros and Cons of Financial Globalisation

Pros

i. To the emerging market economies like Malaysia, globalisation allows them to further develop their capital markets by broadening and diversifying the structure of national capital markets to include the development of tradable securities. Such development complements the traditional role played by the banking systems to meet financing needs of these economies. It also encourages financial innovation and spurs economic growth.

ii. From the borrowers' perspective, financial globalisation provides more choices of financial instruments which they can tap at competitive costs from a broader range of providers. Therefore, firms can reduce their borrowing costs and enhance their competitiveness.

Cons

i. Financial markets have become more volatile and this poses a threat to financial stability, particularly to the banking system. The current financial crisis which has translated into an economic crisis and its aftermath effects (in terms of large output and welfare loss) supports this point.

ii. Globalisation of the financial markets also results in excessive volatility of asset prices. The recent financial crisis showed that asset prices (such as property prices, commodity prices and share prices) were overshot before they burst. Worse still, they were substantially misaligned from economic fundamentals for a relatively long period of time.

3.3.3 Recent Developments in Asia and the World

A key implication of globalisation for the finance and capital market is that of heightened global competition for business amid the increased cross-border interaction and integration of markets and their participants. The emergence and expansion of market economies, the removal of trade barriers, greater cross-border interconnectivity, the spread of education and the impact of applied technology are all increasing the degree of integration of global financial markets and competition therein.

Over the last two decades, the emerging market economies, including Malaysia, have become more integrated through financial markets. During this period, these economies had introduced measures to gradually liberalise their financial markets, following the successful pursuit of export-led indutrialisation in the 1970s and 1980s.

4.0 CONCLUSION

The CBN and Ministry of Finance has been drawn up as a comprehensive blueprint for the Nigeria financial market and will spearhead the reform and improvement needed to establish local and global credibility for the country's financial market based on the development of the financial institution in Nigeria, and the advance of globalisation, which has led to the bridge in barriers that existed in the country, financial globalisation has been able to curb such gab and led to development of the sector, making in to grow in a geometric rate.

5.0 SUMMARY

In this topic we have briefly provided an overview of the Malaysian Banking System. We discussed the financial market intermediaries and briefly explained their functions and importance to the economic development of the country.

The current forces of globalisation, deregulation in the financial sector and the development of information and communications technology are some of the factors leading to intense competition faced by the financial markets of emerging economies, in an environment of increasing liberalisation and globalisation. Nigeria is consistently assessing and reviewing significant financial market developments and regulatory issues.

6.0 TUTOR-MARKED ASSIGNMENT

1. How has globalisation impact on the development of the financial institution in Nigeria?
2. What are the merit and demerit of financial globalisation?

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UNIT 3 BANKING FINANCIAL INSTITUTIONS

CONTENTS

1.0 INTRODUCTION

Banks are primarily concerned about advancing short-term loans to its customers. The question therefore is who meets the needs of those who are in need of long-term loans? In this unit, we shall learn about the concept and meaning of Merchant and Development Banks as a provider of long-term funds for development. The evolution of merchant and development banks in Nigeria economy and other countries will also be discussed.

2.0 OBJECTIVES

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

- define the meaning of merchant and development banks
- explain the concept of merchant and development banks in Nigeria.

3.0 MAIN CONTENT

3.1 Banking Financial Institutions

The banking financial institutions play a major role in the financing business in an economy. This is a formal financial institution, which comprises of Central Bank of Nigeria, Commercial Banks, and Development Banks.

Central Bank of Nigeria (CBN)

The CBN constitutes the pivot of the country's money and capital market. It is the principal regulatory body. It executes monetary policies on behalf of the Federal Government ofNigeria. As the apex of the financial system, the CBN belongs to both the money and the capital market as the key operator without which the markets can scarcely exist. The CBN has a responsibility of establishing specialised institutions in Nigeria such as the Development Institutions. It has also played a major role in the establishment of the Securities and Exchange Commission. The CBN acts as the issue and underwriter of all Federal Government stocks.

Commercial Banks

They provide important financial services to industry and commerce**.** It is, however, a normal banking principle (that prudence requires) that they lend on short term that require a rapid repayment. The primary function of the banking system is the extension of credit to worthy borrowers. Generally, Commercial banks have a short term for most of the funds they hold. They are consequently constrained in their lending and investment policies. It is of course true that taken on aggregate, particularly in the growth situation, commercial streak of excess of deposits over short term loans, advances and withdrawals. They rely on funds, which they receive on time or fixed deposits for making medium term loans while the liquidity and safety reserves are traditionally placed on money market instruments such as Treasury Bills and commercial paper.

In making credit available, commercial banks in particular render a great social service, through their actions production is increased, capital investment are expanded, and a higher standard of living is realised.

Development Banks

These are institutions established for providing long-term finance for development. The genus usually referred to as development finance institutions occupies a wide band in terms of their constitutional arrangement and their specific areas of interest. One common feature of these institutions however, is that they are usually promoted by government and sometimes by international organisation. Development Banks provide medium and long-term finance for the development of the economy. The need for this kind of finance has become necessary because commercial banks provide only short-term finance and this is not adequate for development. Development institutions bridged the gap by providing medium and long-term finance. Development institutions serve as catalyst to development through the provision of various forms of venture capital and technical advice on the setting up of an Industrial, Agricultural or other forms of business enterprise. Examples of development institutions are the Nigerian Industrial Development Bank (NIDB), Nigerian Bank for Commerce and Industry (NBCI) Nigerian Agriculture and Co-operative Bank (NACB).

Co-operative Banks

Co-operative Banks is an institution established for the purpose of providing greater access to saving and borrowing facilities for co-operative societies and their members at relatively cheaper rates than those provided by Commercial Banks, since they deal with small scattered savers and borrowers who ordinarily will not qualify for financial assistance of Commercial Banks. Finally, Co- operative Banks improves the well-being of their members.

Merchant Banks

This is also called investment bank. It is a wholesaler banker whose deposits are usually in large amounts. With such large deposits, its loans are equally large. Merchant Banks advise companies wishing to raise new capital and help to advertise the shares to the public and to the underwriter, unsold shares. They provide short and long-term finance to companies. The Merchant Banks gives advice on mergers, acquisitions and capital structure of companies as well as arrange for companies wishing to hire equipment. In present day Nigeria, the universal bank performs the function of merchant banks.

SELF-ASSESSMENT EXERCISE

Identify various banking institutions in Nigeria.

3.2 Banking Financial Institutions and Their Functions

Banking financial institutions play a major function in financing business of an economy. These comprise of Commercial Banks, Central Bank, Nigerian Agricultural Co-operation and Rural Development Banks, etc. Their functions include the following:

1. **Intermediating Function:** They receive funds from surplus spender to deficit spender.

2. **Saving Function:** They help conduct public saving such as bonds, stock, and ensure savings flow from the financial market to goods and services for increased the standard of living.

3. **Internal Function:** They provide us with excellent store of wealth that generate income; do not wear out in time and having low risk. These wealth are usually profitable and non-perishable.

4. **Liquidity Function:** Money being the ultimate liquidity earns little or no interest when not invested. Investing cash (money) in the instrument of wealth brings interest, which can be converted, immediately into cash.

5. **Credit Function:** They provide us with credit to finance our consumption and investment especially in form of loans.

6. **Payment Function:** They serve as mechanism for making payment for goods and services with other facilities such as credit cards, electronic fund transfer.

7. **Risk Function:** These institutions also offer protection against life, health, property and income risk through the sales of insurance premium to businesses, consumers and government.

8. **Policy Function:** They serve as the channel through which the government carries out its policies to establish the economy and avoid inflation. Government does this by manipulating interest rates and prices.

SELF-ASSESSMENT EXERCISE

Identify the roles of the formal banking financial institution in an economy outline the activities of the non-bank financial institutions

4.0 CONCLUSION

This unit has highlighted the financial institutions in Nigeria. Banking and non-banking financial institutions and their functions were also discussed.

5.0 SUMMARY

This unit has discussed the financial institutions in Nigeria. It also explained the various activities of the banking and non-banking financial institutions. The benefit of these institutions to the economy were also highlighted

6.0 TUTOR-MARKED ASSIGNMENT

1. Identify the functions of banking financial institutions to the Nigerian economy.

2a. Outline and discuss the activities of the non-bank financial institutions.

2b. Identify four banking financial institutions in Nigeria.

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UNIT 4 MERCHANT BANK METHODS AND PROCESSES

CONTENTS

1.0 INTRODUCTION

In this unit you will learn about the fundamentals of merchant banks, its methods and processes. You will equally consider the transaction processes and classification of the banking sector within the financial sector.

2.0 OBJECTIVES

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

- define merchant processing
- discuss the transaction process works in a merchant bank
- explain the risk associated with merchant bank

3.0 MAIN CONTENT

3.1 Merchant Processing

Merchant processing is the acceptance, processing, and settlement of payment transactions for merchants. A bank that contracts with (or acquires) merchants is called an acquiring bank, merchant bank, or acquirer. Acquiring banks sign up merchants to accept payment cards for the network and also arrange processing services for merchants. They can contract directly with the merchant or indirectly through agent banks or other third parties.

A bank can be both an issuing bank and an acquiring bank, but banks most often specialise in one function or the other. Merchant processing is a separate and distinct line of business from credit card issuing. It is generally an off-balance sheet activity with the exception of merchant reserves and settlement accounts, both of which are discussed later in this chapter. Merchant processing involves the gathering of sales information from the merchant, obtaining authorisation for the transaction, collecting funds from the issuing bank, and reimbursing the merchant. It also involves charge-back processing. The vast majority of merchant transactions are electronically originated (as compared to paper-based) and come from credit card purchases at merchant locations or the point-of-sale (POS). Merchant processing increasingly includes transactions initiated via debit cards, smart cards, and electronic benefits transfer (EBT) products.

3.2 Transaction Process Overview

The payment networks are the center of the cardholder transaction process and maintain the flow of information and funds between issuing banks and acquiring banks. In a typical cardholder transaction, the transaction data first moves from the merchant to the acquiring bank (and through its card processor, if applicable), then to the associations, and finally to the issuing bank (and through its card processor, if applicable). The issuing bank ultimately bills the cardholder for the amount of the sale. Clearing is the term used to refer to the successful transmission of the sales transaction data. At this point, no money has changed hands; rather, only financial liability has shifted. The merchant, however, needs to be paid for the sale. Settlement is the term used to refer to the exchange of the actual funds for the transaction and its associated fees. Funds to cover the transaction and pay the merchant flow in the opposite direction: from the issuing bank to the Associations, to the acquiring bank, and finally to the merchant. The merchant typically receives funds within a few days of the sales transaction.

In a simple form, the clearing and settlement processes for payments can be illustrated with a standard four-corners model (as discussed in the FFIEC IT Examination Handbook, Retail Payment Systems Handbook (March 2004)). In this model, there is a common set of participants for credit card payments: one in each corner (hence, the term four-corners model) and one in the middle of the diagram. The initiator of the payment (the consumer) is located in the upper left- hand corner, the recipient of the card payment (the merchant) is located in the upper right-hand corner, and the relationships of the consumer and the merchant to their banks (the issuing bank and the acquiring bank, respectively) reside in the bottom two corners. The payment networks that route the transactions between the banks, such as Visa, are in the middle of the chart. The information and funds flows for a typical credit card transaction are illustrated in a four-corners model. Information flows are presented as solid lines while funds flows are represented by dashed lines.

Step 1: The consumer pays a merchant with a credit card
Step 2 and 3: The merchant then electronically passes the data through the applicable association electronic network to the issuing bank for authorisation
Step 4, 5, and 6: If approved, the merchant receives the authorisation to use and capture the transaction, and the cardholder accepts liability, usually by signing the sales slip
Step 7 and 8: The merchant receives payment, net of fees, by submitting the captured credit card transaction to its bank (the acquiring bank) in batches or at the end of the day
Step 9 and 10: The acquiring bank forwards the sales draft data to the applicable association, which is in turn forwards the data to the issuing bank to work on.

Hence, the association will determine the bank net debit position. The association settlement financial institution coordinates issuing and acquiring settlement positions. Members with net debit positions send funds to the Association settlement financial institution, which transmit owed funds to the receiving bank.

Step 11: The settlement process takes place using a separate payment network such as **Fedwire**.
Step 12: The issuing bank presents the transaction on the cardholder's next **billing statement**
Step 13: The cardholder pays the bank, either in full or via monthly payments.

3.3 Risks Associated with Merchant Processing

Some bankers do not understand merchant processing and its risks. Attracted to the business by the potential for increased fee income, they might underestimate the risk and not employ personnel with sufficient knowledge and expertise. They also might not devote sufficient resources to oversight or perform proper due diligence reviews of prospective third-parties. Many banks simply do not have the managerial expertise, resources, or infrastructure to safely engage in merchant processing outside their local market or to manage high sales volumes, high-risk merchants, or high charge-back levels. Many of a bank's risks may be interdependent with payment system operators and third parties. For example, the failure of any payment system participant to provide funding for settlement may precipitate liquidity or credit problems for other participants, regardless of whether they are party to payments to or from the failing participant.

For banks that engage in merchant programs or that are contemplating engaging in such programmes, examiners should look for evidence that management understands the activity's risks which include credit, transaction, liquidity, compliance, strategic, and reputation risk. A failure by management to understand the risks and provide proper controls over such risks can be very problematic, and even lethal, to the bank. Take, for example, the case of National State Bank, Metropolis, Illinois. Inadequate control of the credit and transaction risks associated with its merchant processing activities contributed to a high volume of losses that ultimately depleted capital, threatened the bank's liquidity, and led to its closing by the Office of the Comptroller of the Currency (OCC) in December 2000.15

Credit Risk

A primary risk associated with merchant processing is credit risk. Even though the acquiring bank typically does not advance its own funds, processing credit card transactions is similar to extending credit because the acquiring bank is relying on the creditworthiness of the merchant to pay charge-backs. Charge-backs are a common element in the merchant processing business and are discussed in more detail later in this chapter. They can result from legitimate cardholder challenges, fraud, or the merchant's failure to follow established guidelines. Charge-backs become a credit exposure to the acquiring bank if the merchant is unable or unwilling to pay legitimate charge-backs. In that case the acquiring bank is obligated to honor the charge-back and pay the issuing bank which could result in significant loss to the acquiring bank. In a sense, the acquiring bank indemnifies a third party (in this case, the issuing bank that in turn indemnifies the cardholder) in the event that the merchant cannot or does not cover charge-back. Banks have been forced to cover large charge-backs when merchants have gone bankrupt or committed fraud. Acquiring banks control credit risk by using sound merchant approval processes and closely monitoring merchant activities.

Transaction Risk
Acquiring banks are faced with the transaction risk associated with service or product delivery because they process credit card transactions for their merchants daily. The risk can stem from a failure by the bank or any party participating in the transaction to process a transaction properly or to provide adequate controls. It can also stem from employee error or misconduct, a breakdown in the computer system, or a natural catastrophe. The acquiring bank needs an adequate number of knowledgeable staff, appropriate technology, comprehensive operating procedures, and effective contingency plans to carry out merchant processing efficiently and reliably. A sound internal control environment is also necessary to ensure compliance with the payment networks' rules. Formal reconciliation processes are also essential to limiting risk.

The high transaction and sales volume normally encountered with merchant processing programs creates significant transaction and liquidity risks. A failure anywhere in the process can have implications on the bank. Examples include an issuing bank's inability to fund settlement to the acquiring bank or a processing center's failure to transmit sales information to the issuing bank, thus resulting in a delay of or failure of funding to the merchant bank.

Liquidity Risk
Liquidity risk can be measured by the ability of the acquiring bank to timely transmit funds to the merchants. Acquiring banks often limit this risk by paying merchants after receiving credit from the issuing bank. If the acquiring bank pays the merchant prior to receiving credit from the issuing bank, the acquiring bank could sustain a loss if the issuing bank is unable or unwilling to pay. Some acquiring banks delay settlement and pay merchants one day after receiving the funds from the issuing bank. The delay allows the acquiring bank time to perform fraud reviews. For delayed settlement, which most commonly occurs when transactions are identified as suspicious or unusual, management is expected to have established formal procedures. Because merchant deposits can be volatile, risk may also arise if the acquiring bank becomes reliant on the merchant's deposits as a funding source for other bank activities. Furthermore, substantial charge-backs could potentially strain the bank's financial condition and/or reputation to such a degree that its creditors may withdraw availability of borrowing lines.

Associations guarantee settlement for transactions that pass through interchange. As a result, they may require collateral pledges/security if a bank's ability to fund settlement becomes questionable. This can create significant liquidity strains and potentially capital difficulties, depending on the size of the collateral requirement and/or the financial condition of the bank.The Associations' rules allow them to assess the banks directly through the settlement accounts if the bank is not forthcoming with the collateral.

Compliance Risk

Compliance risk arises from failure to follow payment networks' rules and regulations, clearing and settlement rules, suspicious activity reporting requirements, and a myriad of other laws, regulations, and guidance. It can lead to fines, payment of damages, diminished reputation, reduced franchise value, limited business opportunities, reduced expansion potential, and lack of contract enforceability. Acquiring banks can limit compliance risk by ensuring a structured compliance management program is in place, the internal control environment is sound, and staff is knowledgeable. They can also limit risk by providing staff with access to legal representation to ensure accurate evaluation of items such as new product offerings, legal forms, laws and regulations, and contracts.

Strategic Risk

Strategic risk arises from adverse business decisions or improper implementation of those decisions. A failure by management to consider the bank's merchant processing activities in the context of its overall strategic planning is normally cause for concern. A decision to enter, maintain, or expand the merchant processing business without considering management's expertise and the bank's financial capacity is also normally cause for concern. Examiners should also pay close attention to how the acquiring bank plans to keep pace with technology changes and competitive forces. Examiners should look for evidence that the strategic planning process identifies the opportunities and risks of the merchant processing business; sets forth a plan for managing the line of business and controlling its risks; and considers the need for a comprehensive vendor management program. An evaluation of management's merchant processing expertise is critical to judging strategic risk. The bank's overall programmes for audit and internal controls, risk management systems, outsourcing of services, and merchant programme oversight are key to controlling the strategic risk.

Reputation Risk

Reputation risk arising from negative public opinion can affect a bank's ability to establish new relationships or services or to continue servicing existing relationships. This risk can expose the bank to litigation, financial loss, or damage to its public image. The bank's business decisions for marketing and pricing its merchant processing services can affect its reputation in the market place. Reputation risk is also associated with the bank's ability to fulfill contractual obligations to merchants and third parties. Most notably, the outsourcing of any part of the merchant processing business easily increases reputation risk. Decisions made by the acquiring bank or its third-parties can directly cause loss of merchant relationships, litigation, fines and penalties as well as charge-back losses. Concerns normally arise when the acquiring bank does not maintain strong processes for performing due diligence on prospective merchants and third- parties or perform ongoing evaluations of existing merchant and third-party relationships.

4.0 CONCLUSION

Examiners should expect that management fully understand, prior to becoming involved in merchant processing and continuing thereafter, the risks involved and its own ability to effectively control those risks. Merchant programs are specialised programs that require management expertise, significant operational support, and rigorous risk-management systems which would be a driving force in the industry. It can be a profitable line of business but, if not properly controlled, can result in significant risk to the bank.

Examiners should determine whether qualified management has been appointed to supervise merchant activities and to implement a risk management function that includes a merchant approval system and an ongoing merchant review programme for monitoring credit quality and guarding against fraud. Bank staff's knowledge and skill-sets are expected to be commensurate with the risks being taken. For example, personnel responsible for processing charge-backs should have the technical knowledge and understanding of charge-back rules, and personnel responsible for approving merchant applications should have the ability to properly evaluate creditworthiness and identify high-risk merchants.

Examiners assessing risks of merchant programmes should direct their attention to situations in which management has not put proper risk measurement systems in place to operate, monitor, and control the activity effectively. This includes situations that evidence the absence of regular management reports detailing pertinent information. Key reports generally include new merchant acquisitions, merchant account attrition, merchant portfolio composition, sales volumes, charge- back volumes and aging, fraud, and profitability analyses.

Examiner attention should be given to instances in which comprehensive, written merchant processing policies and procedures are absent or are not adequate for the size and complexity of operations. Necessary components of policies and procedures generally include:

- Clear lines of authority and responsibility (for example, the level of approval required to contract with certain types of merchants).
- Adequate and knowledgeable staff.
- Markets, merchant types, and risk levels the bank is and is not willing to accept.
- Limits on the individual and aggregate volume of merchant activity that correlates
- with the bank's capital structure, management expertise, and ability of operations to accommodate the volume (e.g., human and systems resources) as well as with merchants' risk profiles.
- Goals for portfolio mix and risk diversification, including limits on the volume of sales processed for higher-risk merchants and that take into account the level of management expertise.
- Merchant underwriting and approval criteria.
- Procedures for monitoring merchants, including financial capacity, charge-backs and
- fraud (regardless of who originates the merchants for the bank).
- Criteria for determining appropriate holdback or merchant reserve accounts.
- Procedures for settlement, processing retrieval requests and charge-backs,
- handling complaints, monitoring and reporting of fraud, and training personnel.
- Third-party risk management controls.
- Guidelines for accepting and monitoring agent banks.
- Guidelines for handling policy exceptions.
- MIS to keep management sufficiently informed of the condition of, and trends in, the
- Merchant program.
- Audit coverage.

5.0 SUMMARY

Examiners should insist that the bank hold capital sufficient to protect against risks from its merchant business. In addition, they should determine whether management has established sound risk limits on the merchant processing volume based on the bank's capital structure, the risk profile of the merchant portfolio, and the ability of management to monitor and control the risks of merchant processing.

Associations limit the processing volume a bank can generate based upon the bank's capital structure, high-risk merchant concentrations, and charge-back rates. Banks operating outside the established thresholds (which may vary and are subject to change) are generally considered to be high-risk acquiring banks by the applicable Association and may be subject to additional activity limits or collateral requirements.

6.0 TUTOR-MARKED ASSIGNMENT

1. What is Merchant Processing?
2. What are the risks associated with Merchant processing?

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UNIT 5 THE STRUCTURE OF THE NIGERIA FINANCIAL SYSTEM

CONTENTS

1.0 INTRODUCTION

Banking and finance have become an important aspect of our society. This process has lead to the development and advancement of our banking system and financial establishment within the country. It has come to knowledge that, banking and finance is one source of revenue generation in a society, by providing loans and job opportunities to the country. Banking and finance comprises all the financial institution in the country and the regulatory bodies which tend to regulate the banking and finance sector.

2.0 OBJECTIVES

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

- explain the roles of the regulatory authorities in the nigerian financial system.
- describe the structure of nigeria financial system
- explain what is meant by money market and its institutions

3.0 MAIN CONTENT

3.1 The Structure of the Nigerian Financial System

The Nigerian financial system comprises of bank and non-bank financial institutions which are regulated by the Federal Ministry of Finance (FMF), Central Bank of Nigeria (CBN), Nigeria Deposit Insurance Corporation (NDIC), Securities and Exchange Commission (SEC), National Insurance Commission (NAICOM), Federal Mortgage Bank of Nigeria (FMBN), and the National Board for Community Banks.

3.2 Regulatory Authorities

The Federal Ministry of Finance (FMF)

The Federal Ministry of Finance advises the Federal Government on its fiscal operation and co-operates with CBN on monetary matters. And it generally contributes to the budgeting system of a country and provides and oversight to the inspection of budget supervision and implementation.

The Central Bank of Nigeria (CBN)

The CBN is the apex regulatory authority of the financial system. It was established by the Central Bank of Nigeria Act of 1958 and commenced operations on 1st July 1959. Among its primary functions, the Bank promotes monetary stability and a sound financial system, and acts as banker and financial adviser to the Federal Government, as well as banker of last resort to the banks. The Bank also encourages the growth and development of financial institutions. The central Bank has proven to be economy regulators of a country, and in terms of Nigeria it can be seen in recent years and times to be an important aspect on determining the growth of our economy in terms of both local and international trades which include financial trade as well. Enabling laws made in 1991 gave the Bank more flexibility in regulating and overseeing the banking sector and licensing finance companies, which hitherto operated outside any regulatory framework.

The Nigerian Deposit Insurance Corporation (NDIC)

The NDIC complements the regulatory and supervisory role of the CBN. It is seen as a body which controls the activity of the insurance industry and its component. This body forms an important part of the insurance industry, due to the fact that it oversea the activity of the players in the industry and also provide a safe level playing ground for both the insurer and the insured. It is however autonomous of the CBN and reports to Federal Ministry of Finance. NDIC effectively took off in 1989 and was set up to provide deposit insurance and related services for banks in order to promote confidence in the banking industry. The NDIC is empowered to examine the books and affairs of insured banks and other deposit taking financial institutions. Licensed banks are mandated to pay 15/16 of 1 per cent of their total deposit liabilities as insurance premium to the NDIC. A depositor's claim is limited to a maximum of N50, 000.00 in the event of a bank failure.

The Nigerian Deposit Insurance Corporation (NDIC) has concluded plans to hike the insured deposit of banks to N200, 000.

The Securities and Exchange Commissions (SEC)
This is formerly called the Capital Issues Commission; the SEC was established by the SEC Act of 27th September 1979, which was further strengthened by the SEC Decree of 1988. It is the apex regulatory organ of the capital market. The Commission approves and regulates mergers and acquisitions and authorises the establishment of unit trusts. In the course of deregulation of the capital market, the function of price determination has been transferred to the issuing houses. The SEC maintains surveillance over the market to enhance efficiency. It issues guidelines on the establishment of Stock Exchanges in furtherance of the deregulation of the capital market. Following the enactment of the Nigerian Investment Promotion Commission Decree and the Foreign Exchange (Monitoring and Miscellaneous Provisions) Decree in 1995, SEC released guidelines on foreign investment in the Nigerian capital market.

Debt Management Office (DMO)
The Federal Government of Nigeria took a major step in addressing the debt problems recently by establishing an autonomous Debt Management Office (DMO). The creation of the DMO consolidates debt management functions in a single agency, thereby ensuring proper coordination. The DMO centralises and coordinates the country's debt recording and management activities, including debt service forecasts; debt service payments; and advising on debt negotiations as well as new borrowings.

National Insurance Commission (NAICOM)
The National Insurance Commission (NAICOM) replaced the Nigerian Insurance Supervisory Board (NISB). The NAICOM is charged with effective administration, supervision, regulation and control of the business of insurance in Nigeria. Its specific functions include the establishment of standards for the conduct of insurance business, protection 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. NAICOM ensures adequate capitalisation and reserve, good management, high technical expertise and judicious fund placement in the insurance industry.

The Federal Mortgage Bank of Nigeria (FMBN)

The FMBN took over the assets and liabilities of the Nigerian Building Society. The FMBN provides banking and advisory services, and undertakes research activities pertaining to housing. Following the adoption of the National Housing Policy in 1990, FMBN is empowered to license and regulate primary mortgage institutions in Nigeria and act as the apex regulatory body for the Mortgage Finance Industry. The financing function of the Federal Mortgage Bank of Nigeria was carved out and transferred to the Federal Mortgage Finance, while the FMBN retains its regulatory role. FMBN is under the control of the Central Bank of Nigeria.

Financial Services Co-ordinating Committee (FSCC)

The Committee was established in 1998 and charged with the primary responsibility to promote safe, sound and efficient financial sector in the country. It's membership is drawn from the key regulatory and supervisory institutions in the nations financial system, namely, Central bank of Nigeria (CBN), Security and Exchange Commission (SEC), National Insurance Commission (NAICOM), Corporate Affairs Commission (CAC) and the Federal Ministry of Finance. This committee chaired by the Ministry of Finance co-ordinates the activities of all regulatory institutions in the financial system.

4.0 CONCLUSION

Banking and finance comprises all the financial institutions in the country and the regulatory bodies which tends to regulate the banking and finance sector. Some of the regulatory Authorities are Federal Ministry of Finance (FMF), Central Bank of Nigeria (CBN), Nigeria Deposit Insurance Corporation (NDIC), Securities and Exchange Commission (SEC), National Insurance Commission (NAICOM), Federal Mortgage Bank of Nigeria (FMBN), and the National Board for Community Banks.

5.0 SUMMARY

This unit has discussed the Nigerian financial systems while explaining the roles played by each of the regulatory authorities in the financial sector.

6.0 TUTOR-MARKED ASSIGNMENT

In a country like nigera, where there is fast growth in the financial institution or industry. As a financial analyist, discuss the relevance of financial authorities and list the financial authories in Nigeria.

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MODULE 4

UNIT 1 MEASURING THE EFFECT OF REGULATION ON PERFORMANCE OF BANKING

CONTENTS

1.0 INTRODUCTION

The effect of banking sector reforms on corporate governance and concluded that to check abuses in the emerging consolidated banking system institutionalisation of good corporate governance practice is both necessary and desirable. Some school of thought conducted a study that quantifies regulatory efforts to use capital requirements to control risk-shifting by U.S. banks during 1985 to 1994 and investigates how much risk-based capital requirements and other deposit insurance reforms improved this control. The result revealed that capital discipline did not prevent large banks from shifting risk onto the safety net. Banks with low capital and debt-to-deposits ratios overcame outside discipline better than other banks. Mandates introduced by 1991 legislation have improved but did not establish full regulatory control over bank risk-shifting incentives. That is why Scott (2010) regards Capital requirements as key element in containing systemic risk. Adams (2004) evaluated effect on bank regulation and supervision on the risk asset and income performance of banks in Nigeria and observed increase in banks distress as major reason for the various reforms. He argued that bank mismanagement and adverse ownership influence and other form of insiders' abuse couples with political consideration process especially as regard debt recovery created difficulties to reducing distress in the financial system as submitted by Sanusi (2002).

2.0 OBJECTIVES

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

- measure the effect of regulation on performance of banking
- evaluate the problems and challenges of bank regulation.

3.0 MAIN CONTENT

3.1 Measuring the Effect of Regulation on Performance of Banking

The major purpose of the various financial sector reforms is to strengthen the banking industry and position it to meet the world standard. Bank supervision entails not only enforcement of rule and regulation, but also judgment concerning the soundness of bank asset, its capital adequate and management. Therefore effective supervision is expected to lead to a healthy banking industry that possesses the power to propel the economic growth (Ogunleye 2001, Adam 2005, Soludo 2007, Scott 2010).

The reform programme is expected to engender a diversified, strong and reliable banking sector in the country. In a view of the above, Balogun, 2007 opined that in order to give objective assessment of the outcome of the banking sector reforms there is the need to specify the evaluating criteria. He used descriptive statistics and economic methods to test the hypothesis that each phase of reform as identified in the literature culminated into improve incentives for the provision of better services to the economy as a whole. The assumption was that the post reform values of measure of institution and policy response performance represent significant improvement over the pre-reform value among these measures according to Balogun (2007) are branch network, increase supply and improved access to credit improvement in selected financial sectors and distress ratio, and above all increased profit earnings as well as increased ability to complete within the global economy. The empirical result confirms that eras of pursuit of market reform were characterised by improved incentive. However these did not translate to increased credit purvey to the real sector. Also while growth was suffered in eras of control the reform era was associated with rise in inflationary pressures. Among the pitfalls of the reforms identified by the study are faulty premise and wrong sequencing of reforms, frequent reversal and /or non sustainability of reforms.

3.2 Problems and Challenges of Bank Regulation

The various reforms have been acquired to be necessary but it is debatable if they yielded the anticipated result (Balogun 2007). The new policy initiative will no doubt pose some challenges to both the economy as well as the banking system as observed by Ogunleye (2005)that given the fury of activities that have attended effort of bank to comply with the new consolidation policy and the antecedent of some operators in the system, there are concerns on the need to strengthen corporate governance in banks in order to boost public confidence and ensure efficient and effective functioning of the banking system on the effect of small business. Emeria and Okafor (2008) identified merger and acquisition as one of the instrument of recent banking reforms in Nigeria, using cross sectional survey research and ordinary least square regression analysis the result observed two effect of merger and acquisition as static effect and dynamic effect.

The static effect resulted in positive relationship between small businesses lending and bank size because for each N1 deposit received about N0.33k was given out to small business. However, dynamic effect of merger and acquisition in the Nigerian banking sectors which was reported as restructuring, direct and external effect gave on opposite result. The restructuring and direct effect shows that bank size is negatively related to small business lending and also there is a negatively relationship between external loan by institution like microfinance institution and small business lending.

Aminu (2004), identified human resources realignment technology integration, stakeholders concern, monitoring and supervision problems as culminating from the consolidation of banks in Nigeria. Abati (2006) submitted that the biggest losers in the banking consolidation was the human element especially depositors in the liquidated banks and workers of the merged banks, observing conflicting conditions of service for workers within the same grade level in some emergent banks. The policies also have implication for the supervisory authorities in the country like the central bank of Nigeria (CBN) and Nigeria deposit insurance corporation (NDCI) most essentially. Though the number of bank has reduced drastically the need to cope with the complex system of the new mega banks require greater surveillance and monitoring by the CBN.

The announcement of the new recapitalisation policy as well as its implementation have induced a shake-out in the banking industry which pose a new set of challenges to the Nigeria deposit insurance corporation. According to Ogunleye (2005), following the announcement, the interbank market was adversely affected as interbank placements by the big players in the market were withdrawn from the smaller banks as precautionary measure. There was also a wave of flight to safety by depositors who were apprehensive of the survival of their bank, thus creating capital flight problem. The development complied with the planned phased withdrawal of public sectors funds from the universal banks made by the liquidity position of some banks precarious, this among other emerging challenges would put pressure on NDCI; both pre-consolidation and post consolidation challenges.

Ogunleye (2005), further identified the post consolidation challenges as possibility of bank failure where Merger and Acquisition (M&S) failed thus run the risk of liquidation. Other challenges are the inadequate executive capacity as to the need for NDIC to ensure the effective merging of information technology system, business lines, products, culture and people by the new mega banks, weak corporate governance that will put pressure NDIC and other regulators to ensure probity, transparency and accountability. There is also the supervisory approach that would need to be broadened, closing information gap between banks and investing public and the need to establish asset Management Company. Pressure would be on NDIC to put in place some specific insurance design feature that will ensure adequate deposit protection.

Aminu (2004), argued that the policy of recapitalisation was a subtle way of compelling banks to merge with a submission that Merger and Acquisition are business imperatives that should not be forced or hurriedly conclude as was the case in Nigeria. In the bankers position paper presented to the Senate Committee on banking, insurance and other financial institutions, bankers argued that the Nigerian socio-political and macroeconomic environment is fraught with a lot of imperfections and inadequacies that make the comparison with other countries a mere theoretical postulations (Aminu & Ologbondiyan that while Malasia with a population of 23 millions has a GDP of 104.6 billion and per capital GDP of $4,528.14, the Nigerian economy with a population of 125.8 million has GDP of 3.04 billion and per capita GDP of $24.2. It was also observed that in spite of the superior strength of the South African economy over that of Nigeria the minimum capital requirement of banks in South Africa is $39.06 million (N5 billion), while credit is 5.4% as against the Nigerian $192.3 million (N25 billion) and 32.25% credit extension to the Federal Government. It was also argued that the capital base of N25 billion will do more of harm than benefit to the banking industry and thus highlighted the major pitfalls to be crowding out other sectors, unethical practices like tactical money laundering, mass unemployment and neglect of micro lending to small businesses needed for growth of the economy.

4.0 CONCLUSION

The reform programme is expected to engender a diversified, strong and reliable banking sector in the country. In a view of the above, it was argued that in order to give objective assessment of the outcome of the banking sector reforms there is the need to specify the evaluating criteria. He used descriptive statistics and economic methods to test the hypothesis that each phase of reform as identified in the literature culminated into improve incentives for the provision of better services to the economy as a whole.

5.0 SUMMARY

In this unit, we have discussed about the effect of regulation on performance of banking; and how to evaluate the problems and challenges of bank regulation.

6.0 TUTOR-MARKED ASSIGNMENT

Explain the problems and challenged of Bank regulations.

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UNIT 2 SYSTEMS OF BANKING AND ESSENTIALS OF A SOUND BANKING SYSTEM

CONTENTS

1.0 INTRODUCTION

The countries of the world practice different banking systems. The type of banking system practice by any country depends on the banking rules and regulations, the size of the economy and the level of development of the banking and the financial system of the economy among other factors. The most common banking systems in most developed and developing countries of the world includes the Unit banking, Branch banking and Corresponding banking. Others include Universal banking, Group banking, and Chain banking among others. You shall also learn about the essentials of a sound banking system in this Unit.

2.0 OBJECTIVES

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

- identify and explain each banking system
- mention and explain the advantages and disadvantages of unit banking
- enumerate and explain the advantages and disadvantages of branch banking
- list and discuss the essentials of a sound banking system

3.0 MAIN COMNENT

3.1 Systems of Banking

3.1.1 Unit Banking

Unit banks are independent, one-office- banks. Their operations are confined to a single office. The unit banks operate in small towns, cities and rural areas in Nigeria. Examples of Unit banks in Nigeria are the community banks and other banks that exists only in particular communities that established them without any branch anywhere. The existence of unit banking in the USA is due to legal restrictions which prevent the growth of monopoly in banking. Some unit banks have grown to large sizes but they operate under severe restrictions which limit or prohibit the establishment of branches particularly in the U.S.A.

A. Advantages of Branch Banking

Unit banks, being independent and one-office-banks, posses certain advantages which include:-

i) The provision of prompt and efficient services to customers
ii) Personal relations with the people (Since its organisers and staff are local people) which help in mobilising large resources for the bank.
iii) Meeting the financial needs of the people promptly and efficiently because of the usual on-the-sport decision making by the banking management.
iv) Enjoying the advantages of branch banking as they are connected with a big bank through correspondent banking system.

B. Disadvantages of Unit Banking

Some of the disadvantages of unit banking include;

i) Failure to spread risks as the unit banking operations are localized in a particular area, the failure of customers to repay loan in time may bring disaster to the bank.

ii) Limited resources at its deposal which always leads to bank failure during financial and economic crisis.

iii) Non-diversified banking services to its customers because of its inability to establish branches and higher cost.

iv) Absence of economies of large scale operations. The unit banking system cannot have advantages of large scale banking in that it cannot recruit more efficient and highly paid staff, and cannot enjoy the economies of large scale and intensive specialisation and division of labour

3.1.2 Branch Banking

Under this banking system, a big bank has a number of branches in different parts of the country and even outside the country. The branch banking is the most prevalent banking system in most of the countries of the world. In Nigeria, all the commercial banks quoted in the stock exchange market have at least a branch in almost all the 36 states of the federation including the Federal Capital Territory Abuja.

A. Advantages of Branch Banking

The branch banking system has many advantages which make this system supervisor to the unit banking system. Some of the advantages of this system include;

i) Advantage of spreading risks geographically and industrially. If branches in particular area suffers losses due to recession in industries located there, the losses can be offset by profits from prosperous areas.

ii) Enjoys the advantage of large scale organisation because a large bank is able to recruit efficient and trained staff and pay better than unit banks. It also enjoys the advantage of specialisation and division of labour.

iii) Under this system, the bank enjoys the advantage of diversification of banking operations. Big banks can provide banking facilities to trade, industry, businessmen and the common man at cheaper rates and more efficiently than unit banks because they posses larger financial resources.

iv) The central bank of the country can control the banks more effectively under the branch banking system than under the branch banking Unit banking system. It is easier to control the credit policies of a few banks than those numerous unit banks.

B. Disadvantages of Branch Banking

The branch banking system has also some disadvantages which include the following;

i) Delay in decision taking under the branch banking system: there are bureaucratic procedures in decision making and the management of all the branches is under the control of the head office. This leads to delay in taking prompt decision by the branch managers. They have to refer all cases above certain limit for advance to the head office.

ii) Inability to meet the need of local business communities: The branch managers are not able to meet the borrowing needs of the local business community as efficiently and sympathetically as the unit banks. This is because the branch bank managers stays in one locality and have to operate under rules set by the head office. He may not know the needs of the customers at different branches and also may be concentrating more on bigger industries at the detriment of small scale businesses in the rural areas.

iii) Fear of loss: When branch banking spreads on a large scale, some of the branches may run under losses due to bad debts and low mobilization of deposits. Such situation may leads to huge loss to the bank thereby leading to its failure.

iv) In adequate supervision: As the big bank has a number of branches spread throughout the country, it is difficult to manage and supervise them effectively and efficiently. The control become relax, the banking services suffer and the clients are hit hard.

v) Unhealthy competition: Branch banking leads to competition among different banks in establishing branches at various places. This tendency leads to unnecessary increase in expenses.

SELF-ASSESSMENT EXERCISE

Define Unit Banking and discuss its advantages and disadvantages.

3.1.3 Group Banking

Group banking is part of the banking system in Nigeria. It is a type of multiple office banking consisting of two or more banks under the control of a holding company, which itself may or may not be a bank. The parent company controls and manages the operating banks under the group but each bank continues to keep its separate entity or name. The parent company pools the resources of the group and helps the group banks to make large loans and advances. An example of group banking in Nigeria is the Union Group which is made up of Union Bank of Nigeria Plc (Banking), UBN Merchant Bank (Merchant Banking), Union Assurance Co. Ltd (Insurance), Union Trustees (Trusteeship), and Union Homes Savings and Loans (Mortgage)

3.1.4 Chain Banking

Chain banking is a system where some individuals or group of individuals control one or more banks, as against control by a holding company under group banking. Chain banking occurs when an individual, family or some other close association of persons controls the operations of two or more banks. That is, it occurs when a syndicate or other small group of individuals with common interest own more than two banks. Chain banks are controlled throughdirectors, and a recognized organisation hierarchy beyond that of individual banks. A principal "key" bank frequently coordinates the management of the entire group and also serves as the depository for required reserves of state chartered holding company banks.

3.1.5 Correspondent Banking

It is a bank which acts as agent for another bank in a place where the latter has no office, or for some reasons, is unable to conduct certain operations for itself. All banks with overseas business require correspondent banks abroad, and the arrangements are usually reciprocal with each party maintaining balances with the other. Correspondent banking is a familiar banking feature in the U.S.A and Nigerian financial systems. The U.S.A is geographically a big country where there are thousands of banks which operates in restricted areas. The various types of banks are able to operate efficiently through a correspondent relationship with one another. The country banks have deposits with city banks and city banks have deposit in the state banks in the sameand other cities. The centre of correspondent banking is the New York City, followed by Chicago and other regional centres in big America cities.

Many banks have deposits in more than one centre and correspondent banks in one centre have correspondent relations with banks in other centres.

When a small bank maintains its deposits with a big correspondent bank having a network ofbranches, the later provides such services to the former as extending large credit facilities, facilitating foreign exchange transactions, cheque clearing and collection, purchase and sale ofsecurities etc. It also provides a wide range of other services to small banks which includereports on the state of the economy, advice on portfolio management, etc. In Nigeria, this kind ofrelationship between banks may exist between big commercial banks and Peoples Banks on one hand and between commercial banks and Community Banks on the other hand. The Peoples banks and the Community banks are not commonly found everywhere, so they resort to the useof some commercial banks as their corresponding banks.

SELF-ASSESSMENT EXERCISE

Describe Branch Banking and explain its advantages and disadvantages.

3.1.6 Universal Banking

Globally, Universal Banking (UB) is increasingly becoming the major route to doing banking as there appears to be a shift in the mindset from providing customers with only isolated banking services to that of providing them with a supermarket where all financial services are available. Universal banking refers to the combination of deposit-taking, the making of advances and the conducting of stock exchange business all under the same roof. Banks involved accept deposits of all sizes for the most varied terms, grant short, medium and long-term credit to the business sector and private customers, and at the same time carry on securities business on a more or less wide scale; handle payment transactions; finance imports and exports, and deal in foreign exchange, notes and coins.

The central bank of Nigeria in its draft guideline for the adoption of universal banking practice inAugust 2, 2000, defines universal banking as "the business of receiving deposits on current,savings or other accounts paying or collecting cheque drawn or paid in by customers, provisionof finance, consultancy and advisory services relative to corporate and investment matters,making or managing investments on behalf of any person and the provision of insurance marketing services and capital market business or such other services as the Governor of theCBN may by regulation designate as banking business". Banks under the universal banking programme can choose to undertake one or a combination of the following; clearing house activities, underwriting/issuing house business and insurance services.

Universal banking simply connotes collapsing the various regulatory divides that separate commercial and merchant banking activities. In other word, it is all about creating a level playingfield for both commercial and merchant banks. Historically, commercial banking, in line with its retail orientation, involves general commerceand by implication, a credit policy that favours short-term finance. On the other hand, merchantbanking or investment banking is about wholesale banking involving provision of long-termfinance to fund users. On this basis of specialisation, banks concentrate on one of wholesale banking, retail banking, private banking, savings and loan mortgage among others. However,under universal banking, authority is given to banks to decide on their portfolios of business,select appropriate delivery channels and infrastructure within an applicable regulatoryframework. The distinction between money, capital market and insurance business is removed.

The most important issue in this system is the fact that the statutory / regulatory dichotomy between commercial and merchant banking activities is dismantled and the difference between banks in terms of functions and activities will only exist as a matter of choice rather than byreason of regulatory barriers. The concept of universal banking came into operation in Nigeria in November, 2000. The universal banking system introduced in Nigeria was meant to result into huge finance conglomerates where any or all of the following services may be offered. Retail (Commercial banking) Cheque clearing funds management, investment (Merchant) banking services.

Financial advisory services including; Financial consulting; Unit trusts; Mutual funds; Mortgage finance, Securities trading including derivation, under writing business, Insurance (life and general), Trusteeship accounts, Pension funds, and Credit cards.

3.1.7 Electronic Banking

Electronic banking more commonly called the electronic funds transfer system (EFTS) refers to the application of computer technology to banking especially the payments (Deposittransfer) aspects of banking.

The major distinct pieces of hardware that comprises it are theAutomated Teller Machine (ATM), the point of scale (POS) system, and the automated clearing house (ACH).

An ATM can perform most of the routine banking functions that are now done by bank tellers-deposits can be made, funds withdrawn, funds transferred between savings and current accountetc. The customer operates the ATM by using a plastic card plus a personal identification number (PIN) know only to himself.

The POS involves a computer terminal in retail stores that will transfer funds instantly from thebank deposit of the customer to the bank deposit of the store in which he is making purchase. Inthe process, the computer will verify that the customer has sufficient funds to cover the purchase and will inform the customer of the new bank balance. The customer can also arrange foroverdrafts at the bank, so that “instant loan” (Up to a preset limit) can be made. On the other hand, the ACH is largely designed to transfer funds among banks electronically, although customers may also become involved. For example, a company may, with the authorisation of its employers record its monthly pay roll on electronic tape. The company then takes this type to its bank and that bank then uses the tape to deposit (In other banks) salaries directly to the credit of the employees. The ACH can also be used for preauthorised payments a recurring nature, e.g. instance premiums. The major merit of electronic banking lies in itsability to reduce costs given the number of cheques written in the economy each year.

3.2 Essentials of a Sound Banking System

The essentials of a sound banking system are regarded, as its liquidity and profitability. The secret behind any successful banking business is to distribute resources between the various forms of assets in such as way as to get a sound balance between liquidity and profitability, so that there is cash (at hand or quickly realisable) to meet every claim, and at the same timeenough income for the bank to pay its wages and earn profits for its shareholders. In addition, some of the essential issues modern banks also consider for a sound banking system include thefollowing:

3.2.1 High Degree of Liquidity

One of the essentials of a sound banking system is to have a high degree of liquidity. The bank holds a small proportion of its assets in cash. Therefore, its other assets must possess the criterion of liquidity so that they may be turned in to cash easily. This is only possible if the bank possess such securities which can be easily liquidated. The CBN has made it mandatory for commercial banks to keep a certain proportion of their assets in cash to ensure liquidity.

3.2.2 Safety of Bank's Money

Safety of banks' money is another essential of a sound banking system. Since the banks keep thedeposit of the people, it must ensure the safety of their money. Therefore, the banks are expected to make safe loans and investments and avoid unnecessary risks, if the debtors of the banks donot repay the loans on time and the banks loss their investments, the banks in the system willbecome insolvent. As a result, depositors in the system lose money and suffer hardship. Thus, the banks must ensure the safety of deposits in the system

3.2.3 Profitability

A sound banking system should be able to earn sufficient profits for the shareholders. Profits are essential for individuals and the entire system to be viable. Individual banks should be able topay corporation tax like any other company, pay interest to its depositors, dividend to shareholders, salaries to the staff and meet other expenses. Therefore, unless the banks earn, they may not operate soundly in the system. For this purpose, it must adopt judicious loan and investment policies.

3.2.4 Stability of the System

A sound banking system must be stable. It should operate rationally. There should neither beundue contraction nor expansion of credit. If the banks restrict the creation of credit when trade and industry need it most, it will affect the interests of the business community negatively. On the other hand, if it expands credit when the economic conditions do not permit such, it will lead to boom and inflation. The CBN help in achieving stability in the banking operations of the commercial banks by a judicious credit control policy.

3.2.5 Efficient Reserve Management

A sound banking system should be able to possess efficient reserve management ability. A bank keeps some amount of money in reserve for meeting the demand of its customers in case of emergency. Though the money kept in reserve is idle money, yet the bank cannot afford the risk of keeping a small amount in reserve. There are however, some statutory limits laid down by the Central Bank in maintaining minimum reserves with itself and with the central bank. However, how much reserve money should a bank maintain is governed by its own wisdom, experience and the size of the bank. The bank should manage its reserve policy effectively and efficiently without keeping too much or too little cash. It has to balance between profitability and safety.

3.2.6 Expansion

A sound banking system must be spread throughout the country. It should not be concentrated only in big towns and cities but also in rural and backward localities. It is only by wide spread expansion of the banking system that the deposits can be mobilised and credit facilities can be made available to trade, industry, agriculture, etc. This is especially in developing countries where the banking system must provide these facilities through its expansion in all areas.

3.2.7 Sufficient Elasticity

The elasticity of banking operations should have sufficient elasticity, in its lending operations. It should be in a position to expand and contract the supply of loanable funds with ease in accordance with the directives of the Central Bank of Nigeria.

4.0 CONCLUSION

The countries of the world practice different banking systems and the soundness of the bankingsector of the countries varies from country to country. This unit highlights systems of banking varying from unit banking, branch banking etc. to electronic banking. It also discusses essentials of a sound banking system.

5.0 SUMMARY

In this unit, you have learned about,

- Systems of banking
- Advantages and disadvantages of unit banking
- Advantages and disadvantages of branch banking
- Essentials of a sound banking system

6.0 TUTOR-MARKED ASSIGNMENT

Discuss the essentials of sound banking system.

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UNIT 3 MONEY MARKET

CONTENTS

1.0 INTRODUCTION

Money market has become an important market in the development of financial institution and market in a country. This money market serves as a means of generating loans to finance the development of a project. The money market has become an important aspect in the society, where by investors uses this channel to acquire and secure financial assistants or loands to drive the success of their organisation. Financial markets are broadly categorised into money and capital markets. The structure of a country's financial markets is dictated by the economic and financial development of its economy. As a country experiences growth in its wealth and income, its financial structure also becomes richer in assets, institutions and markets. In this unit, you shall learn about money and capital markets, the stock exchange and their functions respectively.

2.0 OBJECTIVES

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

- explain the concept of money market and its institutions
- identify and explain the instruments of money market
- identify and discuss the functions of money market

3.0 MAIN CONTENT

3.1 Money Market

3.1.1 What is a Money Market?

This is the market for short-term loan funds or short-term credit. The money market deals in short-term instruments that are readily convertible into cash, and whose maturity range between a few days and two years. Thus, the money market provides opportunity for those with surplus funds to lend at short -term, thereby meeting the demand of borrowers who are in need of temporary finance and can offer an acceptable claim. In Nigeria, the debt instruments traded in this market include treasury bills, treasury certificates, commercial papers, bankers' acceptances, promissory notes, certificates of deposits, bankers' unit fund and money at call.

Participants in the market include the commercial banks (the most dominant of the financial institutions in the intermediation of short-term funds), merchant banks, insurance companies and other savings-type institutions such as savings banks, individuals and others. The Central Bank of Nigeria CBN supports the market as lender of last resort through the provision of rediscount facilities for Federal Government short-term debt instruments and other eligible assets.

3.1.2 Instruments of Money Market

The following borrowing instruments are traded in the Nigerian money market:

Treasury Bills:
These are mere IOUs of government or short-term borrowing instruments of government with maturity duration of three months or 91days. Through these bills, government borrows funds to prosecute its programmes pending the collection of government revenues. Being a government borrowing instrument, loans granted through this means are considered less risky and hence treasury bills are popular with the commercial banks.

Treasury Certificates:
These are another popular government borrowing instruments in the Nigerian money market. They are medium-term government securities with maturity duration of one to two years. The idea behind their issuance is to bridge the gap between the treasury bill and long-term government securities. The treasury certificate differs from the call money scheme, which is an instrument for investment of surplus funds on an overnight basis, and from the treasury bills which provide a market for funds for periods not exceeding 91 days.

Call Money
The call money is another instrument used in the money market. This is an arrangement whereby the participating institutions invest monies surplus to their immediate requirements on an overnight basis with interest and withdrawable on demand. The rationale behind the call money arrangement derives from the realisation that while treasury bills provide opportunities for investment of short-term funds on a three-monthly basis, there is a need for facilities for investment of funds surplus to immediate requirements on an overnight basis. This has advantages for banks. For instance, unlike the statutory and other cash balances, call monies earn some returns and at the same time are withdrawable on demand. They thus act as a cushion which absorbs the immediate shock of liquidity pressures in the market. In this way, they provide a first line defence against cash since they can always be drawn up immediately to meet pressing cash shortages.

Certificate of Deposit
These are inter bank debt instruments designed to attract surplus fund of commercial banks into the merchant or investment banks. They help to reduce the excess liquidity to commercial banks.

Bankers Unit Fund (BUF)
These are outlets for investment of surplus funds by banks on government stocks. They are also means to reduce the excess liquidity in the banking system.

Bills of Exchange
A bill of exchange is an unconditional order in writing addressed by one person, signed by the person giving it, requiring the person to whom it is addressed to pay on demand, or at a fixed or determinable future time, a sum of money or to the order of a specified person or bearer. It originates from creditor and requires acceptance of the debtor before it can become

valid. When a bill is accepted, it can be discounted for immediate cash through the forum of money market.

SELF-ASSESSMENT EXERCISE

Define money market and discuss its instruments.

3.1.3 Functions of Money Market

Money market performs the under listed functions in Nigeria:

i. Promotion of an efficient allocation and utilisation of funds in the economy, thus ensuring non-existence of idle fund.

ii. Helps the commercial banks to hold lower cash reserve through provision of numerous investment outlets – treasury bills, call money, treasury certificates etc.

iii. Acts as an important source for short-term borrowing to the government.

iv. Helps to indigenise the credit base of the economy through provision of Nigeria securities.

v. Provision of an avenue or way for the implementation of government monetary policy.

vi . Provision of forum for fund mobilisation and allocation in the economy.

vii. Provision of opportunity for investment in fairly liquid and riskless assets.

viii. Help banks to invest their surplus funds in earning assets and thus minimising their cash holding.

ix. It promotes liquidity and safety of financial assets since through the forum of money market one can easily convert an undesired short-term security into cash.

3.1.4 Features of a Developed Money Market

A developed money market refers to one which is comparatively efficient in the sense that it is responsive to changes in demand for and supply of funds in any of its segments, and effects initiated in any part of it quickly spread to others without significant time lag. To be able to be considered as a developed money market, the market should be able to posses the following Features:

Presence of a Central Bank
A Central Bank with adequate legal powers, sufficient relevant information and the expertise, must exist as a lender of last resort and as the initiator and executor of monetary policy as a whole.

Presence of a Developed Commercial Banking System
A well developed money market should be characterised by the presence of a developed commercial banking system, along with a wide-spread banking habit on the part of the public.

Adequate Supply of a Variety and Quantity of Financial Assets
In a well developed money market, there should be an adequate supply of a variety and quantity of short-term financial assets or instruments such as trade bills, treasury bills, etc.

Presence of Well-Developed Sub-Markets
The existence of well- developed sub-markets and the adequate responsiveness to small changes in interest and discount rates make room for a well-developed money market. If the demand and supply of certain instruments dominate, the interaction between different interest rates will be limited.

Existence of Specialised Institutions
For competitiveness and efficiency, there must exist specialised institutions in particular types of assets, e.g. specialised discount houses, acceptance houses specialising in accepting bills, or specialised dealers in government securities.

Existence of Contributory Legal and Economic Factors
For the money market to be well-developed, there must exist appropriate legal provisions to reduce transaction costs, protect against default in payment, while prerequisite economic forces such as speedy and cheap transmission of information, cheap fund remittance, and adequate volume of trade and commerce, must exist.

3.1.5 Money Market Institutions

Discount Houses

A discount house is a special, non-bank financial institution intervenes in mobilising funds for investments in securities in response to the liquidity of the system. It does this by providing discount/rediscounting facilities in government short-term securities. In the process of shifting the financial system from direct market-based monetary control, discount houses were established to serve as financial intermediaries between the CBN, licensed banks and other financial institutions. Some of the discount houses currently in operation in Nigeria include First Securities Discount House Limited, Express Discount House Limited, Associated Discount House Limited, Kakawa Discount House Limited and Consolidated Discount House Limited.

Universal Banking

CBN has approved the introduction of Universal Banking in Nigeria. Since the release of the guidelines, more than ten banks have converted to universal banking status. Thus, such banks operate Commercial and Merchant functions.

Commercial and Merchant Banks

Commercial and Merchant Banks operate under the legal framework of the Banks and other Financial Institutions (BOFI) Act 25 of 1991 (as amended).

Commercial banks perform three major functions, namely, acceptance of deposits, granting of loans and the operation of the payment and settlement mechanism. Since the Government commenced active deregulation of the economy in September 1986, the commercial banking sector has continued to witness rapid growth, especially in terms of the number of institutions and product innovations in the market.

Merchant banks take deposit and cater for the needs of corporate and institutional customers by way of providing medium and long-term loan financing and engaging in activities such as equipment leasing, loan syndication, debt factoring and project advisers to clients sourcing funds in the market. The first merchant bank in Nigeria, Nigerian Acceptance Limited (NAL), started operations in 1960. Currently, there is a general banking operation. With this banks performs multiple operations whether commercial or merchant operation.

Community Banks

A community bank in Nigeria is a self-sustaining financial institution owned and managed within a community to provide financial services to that community. The National Board for Community Banks (NBCB) processes applications for the establishment of community banks. The first community bank commenced operation in December 1990. Since then, NBCB has issued provisional licences to 1,366 community banks and are expected to be issued final licences by the CBN after operating for two years.

3.1.6 Procedures for Establishing a Bank in Nigeria

1. Any person desiring to undertake banking business in Nigeria shall apply in writing to the Governor for the grant of a licence and shall accompany the application with the following:
    - A feasibility report of the proposed bank
    - A draft copy of the memorandum and articles of association of the proposed bank
    - A list of the shareholders, directors and principal officers of the proposed bank and their particulars
    - The prescribed application fee and
    - Other information, documents and reports as the bank may, from time to time, specify

2. After the applicant has provided all such information, documents and reports as the bank may require the shareholders of the proposed bank to deposit with the bank a sum equal to the minimum paid-up capital that may be applicable.
3. Upon the payment of the 25billion Naira paid-up capital, the Governor may issue a license with or without conditions or refuse to issue a licence and the Governor need not give any reason for the refusal.
4. Where an application for a licence is granted, the bank shall give written notice of that fact to the applicant and the licence fee shall be paid.

Please for more information, visit Central Bank of Nigeria Website: www.cenbank.org

4.0 CONCLUSION

The above unit has explained the financial institution and its uses along with its regulating bodies. It shows us the changes which the financial sector has undergone within the last 10 to 15 years, ranging from the hike in capital base for commercial banks, to that of mortgage banks and clearing houses.

5.0 SUMMARY

At the end of this unit, the student should be able to analyse the financial sector, and how it carries out its activities.

6.0 TUTOR-MARKED ASSIGNMENT

1. What are the procedures for establishing a bank in Nigeria?
2. Explain the money market instruments.

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UNIT 4 THE CAPITAL MARKET

CONTENTS

1.0 INTRODUCTION

In this unit, you will learn about the characteristics of the capital market and the factors influencing activities in the capital market. The unit explains the opportunities in the Nigerian financial market. Also, we shall discuss the functions of the Nigerian financial market.

2.0 OBJECTIVES

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

- explain the meaning of capital market
- [ist the characteristics of the capital market
- examine the functions of Nigerian capital market
- discuss the roles and benefits of the central securities clearing system

3.0 MAIN CONTENT

3.1 The Capital Market

What is a Capital Market?

The capital market is the market where long term funds are being raised, it mobilises surplus funds from the surplus unit of economy for usage by the deficit unit of the economy. Instruments traded in the capital market are of long term in nature. The capital market aside from providing a forum or fund mobilisation, also help in development of investment opportunities, willing investors can come to the market to buy investment instrument being offered at the capital market. The growth of the capital market also makes for the growth of the national economy. The capital market as a whole is a complex arrangement of institutions and mechanism where medium and long term funds are pooled and made available to organisation, government, and individuals.

The development of the capital market stems from the realisation that household, corporate and institutional savings can be mobilised and channeled for investment purpose thereby reducing the clamour for foreign sources of fund which often times have political and economic strings attached thereon. The possibility of mobilising funds domestically through the capital market induces expansion and growth by the firms through forward and backward integration which are made possible cheaply. The growth of any nation economically is measured by the value of its accumulated wealth and its growth through savings and investment. The capital market provides funds for such development. The growth rate of capital market depicts the growth in investment and the productive sector of the economy at large.

The financial instruments (or securities) traded in the market include equities or ordinary shares,industrial loans and preference shares, Federal Government Development Stocks, State Government bonds, company bonds and dentures and mortgages. Securities traded and in thecapital market mature as from three years and above. Participants in this market include, thecommercial, merchant and development or specialised banks, finance and insurance companies,provident and pension funds, other financial intermediaries like the Federal Savings Bank; and individuals. The non-bank financial institutions are dominant in this market just as commercial banks dominate the money market. As with the money market, the CBN is a major participant inthe market as it is statutorily required to absorb unsubscribed portions of government debt issues into its portfolio. The capital market is divided into two:

i. The primary (or New issue) market which deals with the selling of fresh or new securities; and

ii. The secondary (Stock exchange) which is concerned with the resale of old or second- hand securities.

The Nigerian Capital Market is a channel for mobilising long-term funds. This means of sourcing long term loans have been employed by major companies within the country, which has helped them in financing their business activities. The capital market in Nigeria serves as an avenue for the companies to sell their share to source for funds for investment and also look for investor to possibly invest in the company. The main institutions in the market include the Securities and Exchange Commission (SEC), which is at the apex and serves as the regulatory authority of the market, the Nigerian Stock Exchange (NSE), the issuing houses and the stock-broking firms. To encourage small as well as large-scale enterprises gain access to public listing, the NSF operates the main exchange for relatively large enterprises and the Second-Securities Market (SSM), where listing requirements are less stringent, for small and medium scale enterprises.

Given its operations both in the primary and secondary markets, the Nigerian Capital Market has recorded phenomenal growth in the first twenty years of its formal existence. The equity market capitalisation of N1.70 billion and listed equities of 92 in 1980, have risen to N472.9 billion and 196 listed equities at the end of 2000. 21 new issues valued at N16.71 billion were raised from the market to fund various expansion and developmental projects in the country in the year 2000.

Unit Trusts Scheme alsooperates on the market for the purpose of mobilising the financial resources of small and big savers and managing such funds to achieve maximum returns with minimum risk. Currently, there are 14 Unit Trust operations in the market.

3.2 Major Participants in the Nigerian Capital Market

- The Securities and Exchange Commission (SEC), which is responsible for the overall regulation of the entire market.
- The Nigerian Stock Exchange (NSE), a self-regulatory organisation in NCM that supervises the operations of the formal quoted market.

- Market Operators, this consists of the Issuing Houses (Merchant Banks and Stock broking firms), Stockbrokers, Trustees, Registrars, etc.
- Investors, Insurance Companies, Pension Fund, Unit Trusts (Institutional Investors) and Individuals.
- The Central Bank of Nigeria (CBN).
- The Federal Ministry of Finance

3.3 Evolution of the Nigerian Capital Market

The need to raise funds domestically informed the coming together of some eminent Nigerian and British national in the corporate world as exists in Nigeria. They jointly agree on seeking the formation of a forum that will enable fund on the long term bases to be raised locally, Until then, most times operating firms, borrow fund from the banks (mostly on short term basis) most of which have foreign nationality ownership. This desire for a capital market informed the appointment of a committee to advice the Federal Government on ways and means of establishing a stock market in Nigeria. This committee was formerly set up by the Federal ministry for Industry in May 1958. The Committee reported favorably in 1959 on the benefit of such a market. It also made the following recommendations among others;

1. The creation of facilities for dealing in shares
2. Measures to encourage savings and issue of securities of government and other organisation.
3. The establishment of rules regulating transfers

Thus in 1960 The Nigeria Stock Exchange was first incorporated as the LagosStock Exchange on 15th September as a non-profit making private limited liability company. It actually began operations on 5th June 1961 with anauthorised share capital.

3.3.1 Characteristics of the Capital Market

The capital market represents the forum for mobilising long term financial instrument. The major feature of the capital market involves:

1. Instrument traded in the capital market are intermediate and long term in maturity, involving both debt and equity.
2. The available financial instruments in the capital market come from fivegeneral categories of users; individuals and household

business and financial corporations; the federal governments; state and local government and foreign borrowers.

3. The supply of new funds are mainly channeled through financial institution from the same five sources of fund.
4. The scope of the market covers both long term financial instrument and medium term financial instruments.
5. The long term financial instruments are normally open for trading among investors in the counter and organised exchange market rather than the raising of new funds in the primary market.

3.3.2 Capital Market Instruments

The following instruments are traded in the capital market:

Equity Stocks (Shares)
These are units of capital of a company. Holders of equity stocks are co-owners of the company. Companies raise initial capital through the sale of shares in the capital market. Those who invest in equity stocks receive dividend per annum depending on the state of the company's profit.

Development Stocks
These are government long-term borrowing instruments which mature as from five years and above. The interest chargeable on such securities conforms to the time dimension.

Bonds/Debenture
These are fixed interest securities issued by public authorities and quoted enterprises to raise funds (mainly from the capital market). They are therefore debt or borrowing instruments of government and quoted companies. Bonds are largely associated with public authorities while debentures are often associated with the companies. Unlike the equity stock holders, bond and debenture- holders are creditors to the issuing enterprise(s). They therefore receive fixed interest payments and do not care to share in the risks, and therefore the profits of the enterprises.

3.3.3 Functions of Capital Markets

The capital market performs the following functions:

i. It provides local opportunities for borrowing and lending for long-term purposes.

ii. Enables the authorities to mobilise long-term capital for the economic development of the country.

iii. Provides foreign business with the facility to offer their shares, and the Nigerian public an opportunity to invest and participate in the shares and ownership of foreign businesses.

iv. Provide facilities for the quotation and ready marketability of shares and stocks, and opportunities and facilities to raise fresh capital in the market.

v. Maintains discipline in the market through introduction of a code of conduct, checking abuses and regulating the activities of the operators in the market.

vi. Provides a healthy and mutually acceptable environment for participation and co- operation of indigenous and expatriate capital in the joint effort to develop the Nigerian Economy to the mutual advantage of both parties through participation and ownership.

3.3.4 Differences between Money and Capital Markets

i. Whereas the capital market provides opportunities for sourcing medium and long- term loans and avenues for medium and long-term investments, the money market offers opportunities for sourcing short -term loans and making short-term investments.

ii. Whereas the capital market instruments mature as from three years and above, money market instruments mature within one year mainly.

iii. Whereas the participants in the capital market are mainly those that lend long, e.g. Development Banks, Merchant Banks, Finance Corporations, Stock Exchange and the Central Bank, the participants in the money market are largely those institutions that lend short e.g. the commercial banks, discount houses and acceptance houses.

SELF-ASSESSMENT EXERCISE

Identify and discuss the instruments of Capital Market in Nigeria.

3.4 Functions of the Nigerian Capital Market

The following are the functions of the Nigerian Capital market

1. The capital market acts as financial intermediary that refocuses funds from tile surplus sector to tile deficit sector.
2. The capital market provides corporate organisation individuals the opportunities to raise new funds
3. The capital market provides a market for existing securities and hence helps in proper valuation of both new and existing classes of stock.

Nigerian Securities and Exchange Commission (SEC)

The Nigeria Securities and Exchange Commission (SEC) came in to existence by virtue of the SEC Decree of 1979 which became effective from 1st April 1978 majorly to protect the interest of investors and to oversee an orderly development of the capital market. The commission is the apex regulatory body for the Nigerian capital market.

Functions of the Nigerian Securities and Exchange Commission (SEC)

The Major functions of the SEC include the following:

I. Registers all securities proposed to be offered for sale or for subscription by the public or to be offered privately with the intention that the securities shall be held ultimately by others than to those to whom the offers were made or registered stock exchange and securities dealers as stated by the Okigbo's committee on SEC.
2. Determine the amount and the time at which securities of a company are to be sold to the public.
3. Maintain surveillance over securities market to ensure orderly, fair, and equitable dealings in securities.
4. Registers stock exchange branches, registrars, investments advisers, securities dealers and their agents and control and supervises their activities with a view to maintain in standards of conduct and professionalism in the securities business.
5. Protects the integrity of the securities market against abuses arising from the practice of insider trading.
6. Acting as regulating or apex organisation for the Nigerian stock exchange and its branches to which it would be at liberty to delegate powers.
7. Create the necessary atmosphere for the orderly growth and development of the capital market. The SEC is also to undertake such other activities as are necessary for giving full effect to the provisions of the SEC decree.

The Central Securities Clearing System (CSCS)

The Central Securities Clearing system (CSCS) rests on the concept which provide an integrated central depository, clearing (electronic/book entry transfer of shares from seller to buyer and settlement (Payment for bought securities) for all stock market transactions. Established in 1992 (stemming from the 1989 conference of the Federation of International Stock Exchange of which the Nigerian stock exchange is a member) the Nigerian Stock Exchange endorsed the establishment of CSCS, following the recommendation of a group of 10 private companies which conducted a research on the operation of the financial market. Clearing settlement and delivery of transactions on the exchange are done electronically by the Central Securities Clearing System (CSCS). The CSCS a subsidiary of the Nigerian Stock Exchange was established as part of the effort to make the Nigerian Stock Market more efficient and investor – friendly, the CSCS also offers the custodian services. Transaction cycle currently has been reduced to four days (T +3) in the CSCS. The CSCS also help eliminate the bottle necks between registrars and company executives in issuing new certificates to investors.

3.5 The Stock Exchange Market

3.5.1 What is Stock Exchange market?

The stock exchange is an organised market for buying and selling of secondary, existing, old or second-hand securities (i.e. existing shares, stocks and bonds). The Nigerian Stock Exchange was founded in 1960 as Lagos Stock Exchange through the inspiration of the FederalGovernment, the NIDB, the CBN and the business community. Backed by the Lagos Stock Exchange Act of 1961, the exchange commenced business in June of the same year. As contained in the memorandum of association of the organisation, the objectives of theNigerian Stock Exchange (NSE) include:

i. The creation of an appropriate mechanism for capital formation and efficient resource allocation among competing projects

ii. The provision of special financing strategies for those projects with long – termgestation periods.

iii. Maintenance of fair prices for securities.

iv. Maintenance of discipline in the capital market.

v. To spread share ownership among Nigerians.

3.5.2 Functions of the Stock Exchange

The Nigerian Stock Exchange performs the following functions:

i. It provides liquidity to investors by maintaining the transfer of shares and other securities or by enabling holders of such securities to convert them into cash with ease.

ii. It is a source of capital to government and companies.

iii. It helps to maintain prices of securities by controlling the flow of stocks and shares into the market.

iv. It provides information on the value and prices of securities to investors.

v. It protects the investor / public against fraudulent practice since the participants in the market are known-licensed dealers.

vi. It stimulates inflow of foreign exchange into the economy by promoting issuance and sale of non – voting shares to foreign investors.

vii. It helps to maintain discipline in the capital market.

viii. It controls the activities of jobbers and brokers.

3.6 How to Access the Nigerian Capital Market

When a company or government wants to use the Capital Market to raise long-term funds, it must consult an issuing house or stockbroker. These specialists provide the company/government with financial advisory services. It is their duty to study the company’s performance over the years in order to determine its financial needs. More so, they do not only advise on the best option, they undertake total financial restructuring of the company before introducing the facility to the company.

The issuing house and the stockbroker liaise with the other parties – Registrars, Trustees, Auditors, Reporting Accountant, and Solicitors etc. to produce a marketing document known as the **PROSPECTUS.** The Prospectus is the document the public relies on for making investment decision. Necessary approvals from SEC and other bodies are obtained. If the financial option involves listing on the Stock Exchange, the brokers to the issues ensures that all necessary approval with the Exchange are also obtained since only stockbrokers can introduce issues to the Exchange.

On the completion of the offer, the proceeds of the issue are handed over to the company for executing the proposed business programme on long-term investment and the securities is listed on the Daily Official list of the Exchange.

For individuals wishing to invest in the Capital Market in form of buying shares, what they need do is to consult a Stock broking firm and register with the broking firm. For more information on investing in the Nigerian Capital Market contact: www.nigerianstockexchange.com

4.0 CONCLSION

In the unit, we examine the factors influencing activities in the capital market and requirements for listing on the NSE.

Financial markets in general deal in financial assets and liabilities of various maturities andconsist of institutions, instruments, rules and regulations which guide the mobilisation of fundsfrom the surplus units of the economy to the deficit units. The role of the money and capital markets in the economic development of Nigeria has continued to attract increasing attention among policy makers. This unit examines the concept of money and capital markets. It alsothrows light on the functions of money and capital market. The differences between money andcapital markets are highlighted; special attention is given to stock exchange market and itsfunctions.

5.0 SUMMARY

In this unit, you have learned about

i. The concept of capital markets
ii. The functions in the economy
iii. The differences between money and capital markets
iv. The Stock Exchange Market

6.0 TUTOR-MARKED ASSIGNMENT

Define Stock Exchange Market and explain its functions.

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UNIT 5 MERCHANT BANKS AND DEVELOPMENT BANKS

CONTENTS

1.0 INTRODUCTION

The financial system of a country is a complex and closely integrated set of sub systems of financial institutions, markets, instruments and financial services which facilitate the transfer and allocation of funds efficiently and effectively. The Nigeria financial system consists of both organised (formal) and unorganised (informal) segments. The formal financial system comes under the purview of Ministry of Finance, Reserve Bank, Securities and Exchange Board and other regulatory bodies.

Financial institutions are the intermediaries who facilitate in mobilising savings and allocation of funds in an efficient manner and include banking and non banking institutions. Financial markets provide the transmission mechanism whereby various participants' demands and requirements interact to set a price for financial claims. The main financial markets in India include the market for short term securities (money market) and for long term securities (capital market). Financial markets are also classified as primary and secondary markets. While the primary market deals in new issue of securities, the secondary market is meant for trading in existing securities (stock exchange and over the counter market). Primary equity market includes public issues, right issues, offer for shares and private placement of shares. Financial instruments represent the claims against a person or an institution for the payment at a future date, a sum of money and/or a periodic payment in the form of interest or dividend. Financial securities are classified as primary (direct) and secondary (indirect) securities. The primary securities are issued by the ultimate borrower of funds to the ultimate investor as shares and debentures while secondary securities are issued by the financial intermediaries to the ultimate savers (bank deposits, insurance policies, mutual funds etc.).

2.0 OBJECTIVES

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

- explain the meaning of merchant bank
- trace development of merchant banking in Nigeria
- analyse the functions of merchant bank
- explain the meaning of development banks
- trace the evolution of development banks in Nigeria
- analyse the functions of development banks
- trace the history of Nigerian industrial development bank
- discuss the federal mortgage bank of Nigeria (FMBN)
- discuss the Nigerian agriculture and cooperative bank (NACB)
- analyse the functions of Nigerian agriculture and cooperative bank

3.0 MAIN CONTENT

3.1 The Meaning of Merchant Bank

According to the Nigerian Banking Amendment Decree (No.88) of 1979, Merchant Bank means any person in Nigeria who is engaged in wholesale banking, medium and long-term financing, equipment leasing, debt factoring, investment management, issue and acceptance of bills and the management of unit trust. They are also called Acceptance Houses or Discount Houses.

A merchant bank deals with the commercial banking needs of international finance, long-term company loans, and stock underwriting. This type of bank does not have retail offices where a customer can go and open a savings or checking account. It is sometimes said to be a wholesale bank, or in the business of wholesale banking because these banks tend to deal primarily with other banks of the same kind, as well as large financial institutions. In the USA, for instance, merchant banks are known as investment banks (Jhingan, 2004).

The most familiar role of the merchant bank is stock underwriting. A large company that wishes to raise money from investors through the stock market can hire this type of bank to implement and underwrite the process. The bank determines the number of stocks to be issued, the price at which the stock will be issued, and the timing of the release. It then files all the paperwork required with the various market authorities, and it is also frequently responsible for marketing the new stock, though this may be a joint effort with the company and managed by the merchant bank. For very large stock offerings, several banks may work together, with one being the lead underwriter.

By limiting their scope to the needs of large companies, these banks can focus their knowledge and be of specific use to such clients. Some specialise in a single area, such as underwriting or international finance.

Many of the largest banks have both retail and merchant division. The divisions are generally very separate entities, as there is little similarity between retail banking and what goes on in a merchant bank. Although the lives of most people are probably affected every day in some way by decisions made in this type of bank, many people are unlikely ever to visit or deal directly with one. They usually operate behind the scenes and away from the spotlight.

3.1.1 Development of Merchant Banking in Nigeria

Merchant banking will rightly be said to have started in Nigeria with the registration of Nigerian Acceptance on 25th November, 1960, and the Philip Hills (Nigeria) Limited on 14th September, 1960. Between 1960 and 1969, these two banks operated in Nigeria as the only licensed merchant banks. In 1969, the two merged to form the Nigerian Acceptances Limited now called NAL Merchant Bank Limited. The merger was resorted to due to limited activities of the two banks. NAL Merchant Bank remained the only operating merchant bank in Nigeria until 1973. The indigenization Decree requires 40:60 percent -

expatriate/indigenous equity ownership in the banking industry. The oil boom of the 1970s and the Third National Development Plan helped to increase the activities of the merchant bank. This also led to an upsurge in the merchant banking industry in Nigeria. The second merchant bank to enter the market was the United Dominion Trust Bank (Nigeria) Limited, which was licensed in July 1973. Following its licensing as a merchant bank, it changed its name to UDT (Nigeria) Limited in April, 1974. Today, it answers the Nigerian Merchant Bank.

In 1974, the First National Bank of New York (Nigeria) Limited was licensed. This was followed by the First National Bank of Chicago (Nigeria) Limited lately known as International Merchant Bank (Nigeria) Limited in 1975. Following the Federal Government's decision to participate in all foreign-owned banks operating in the country, the First National City Bank of New York (Nigeria) Limited, gave up its license in protest and closed its operation in late 1976. Two other banks: - Chased Merchant Bank (Nigeria) Limited (licensed in 1974) and Investment Company of Nigeria (ICON) Merchant Bankers Limited- joined in 1975. Presently, Chase Merchant Bank answers Continental Merchant Bank.

In 1979, the Nigeria-America Merchant Bank came into operation. Two merchant banks: - Merchant Banking Corporation (Nigeria) Limited and Indo-Nigerian Merchant Bank (Nigeria) Limited- commenced business in 1982 though they were granted licenses in 1981. In 1982, three new merchant banks: -Merchant Bank of Africa (Nigeria) Limited, First City Merchant Bank Limited and ABC Merchant Bank Limited were granted licenses. The first two commenced business operations in 1983 while the third started operations in 1984. Another of the merchant banks to be licensed is the Grindlays Merchant Bank (Nigeria) Limited (1984). In 1986, Financial Merchant Bank Limited was approved.

3.1.2 The Functions of Merchant Banking

The Functions of Merchant Banking are listed as follows:

i. **Raising Finance for Clients** Merchant Banking helps its clients to raise finance through issue of shares, debentures, bank loans, etc. It helps its clients to raise finance from the domestic and international market. This finance is used for starting a new business or project or for modernisation or expansion of the business.

ii. **Broker in Stock Exchange** Merchant bankers act as brokers in the stock exchange. They buy and sell shares on behalf of their clients. They conduct research on equity shares. They also advise their clients about which shares to buy, when to buy, how much to buy and when to sell. Large brokers, Mutual Funds, Venture Capital companies and Investment Banks offer merchant banking services.

iii. **Project Management** Merchant bankers help their clients in many ways. For e.g., advising about location of a project, preparing a project report, conducting feasibility studies, making a plan for financing the project, finding out sources of finance, advising about concessions and incentives from the government.

iv. **Advice on Expansion and Modernisation** Merchant bankers give advice for expansion and modernization of the business units. They give expert advice on mergers and amalgamations, acquisition and takeovers, diversification of business, foreign collaborations and joint-ventures, technology upgrading, etc.

v. **Managing Public Issue of Companies** Merchant bank advise and manage the public issue of companies. They provide the following services related to public issue of securities:
   a. Advise on the timing of the public issue.
   b. Advise on the size and price of the issue.
   c. Acting as manager to the issue, and helping in accepting applications and allotment of securities.
   d. Help in appointing underwriters and brokers to the issue.
   e. Listing of shares on the stock exchange, etc.

vi. **Handling Government Consent for Industrial Projects** A businessman has to get government permission for starting of the project. Similarly, a company requires permission for expansion or modernisation activities. For this, many formalities have to be completed. Merchant banks do all this work for their clients.

vii. **Special Assistance to Small Companies and Entrepreneurs** Merchant banks advise small companies about business opportunities, government policies, incentives and concessions available. It also helps them to take advantage of these opportunities, concessions, etc.

viii. **Services to Public Sector Units** Merchant banks offer many services to public sector units and public utilities. They help in raising long-term capital, marketing of securities, foreign collaborations and arranging long-term finance from term lending institutions.

ix. **Revival of Sick Industrial Units** Merchant banks help to revive (cure) sick industrial units. It negotiates with different agencies like banks, term lending institutions, etc. It also plans and executes the full revival package.

x. **Portfolio Management** A merchant bank manages the portfolios (investments) of its clients. This makes investments safe, liquid and profitable for the client. It offers expert guidance to its clients for taking investment decisions.

xi. **Corporate Restructuring** It includes mergers or acquisitions of existing business units, sale of existing unit or disinvestment. This requires proper negotiations, preparation of documents and completion of legal formalities. Merchant bankers offer all these services to their clients.

xii. **Money Market Operation** Merchant bankers deal with and underwrite short-term money market instruments, such as:
   a. Government Bonds.
   b. Certificate of deposit issued by banks and financial institutions.
   c. Commercial paper issued by large corporate firms.
   d. Treasury bills issued by the Government (Here in Nigeria by CBN).

xiii. **Leasing Services** Merchant bankers also help in leasing services. Lease is a contract between the lessor and lessee, whereby the lessor allows the use of his specific asset such as equipment by the lessee for a certain period. The lessor charges a fee called rentals.

xiv. **Management of Interest and Dividend** Merchant bankers help their clients in the management of interest on debentures / loans, and dividend on shares. They also advise their client about the timing (interim / yearly) and rate of dividend.

SELF-ASSESSMENT EXERCISE

What is the most familiar role of the merchant bank?

3.2 The Meaning of Development Banks

Development banks are specialised financial institutions providing medium and long-term credits to selected sectors of the economy. Such sectors include Agriculture, Commerce and Industry, Housing, etc.

These banks are government-established institutions for special purposes. In Nigeria, such banks include the Nigerian Industrial

Development Bank (NIDB) established in 1964 to carry on business of assisting enterprises engaged in industry, commerce, agriculture and exploitation of natural resources in Nigeria; the Nigerian Bank for Commerce and Industry (NBCI) established in 1973 in the wake of indigenisation exercise to ensure that the exercise is successful; the Nigerian Agricultural and Cooperative Bank (NACB) established on March 1973 to develop the agricultural sector; the Federal Mortgage Bank of Nigeria (FMBN) established in January 1977 to cater for housing problems in Nigeria, the Nigerian Export-Import Bank (NEXIM) established in 1991 to provide both finance and insurance services to imports and exports businesses.

3.2.1 Evolution of Development Banks in Nigeria

Development banking in Nigeria was established, as a result of strong needs to close the gap created by the inability of the operating banks in Nigeria such as commercial banks, central bank and merchant banks to provide the needed funds to finance some special sectors of the economy. Such sectors which must be financed mainly with long-term and sometimes with medium term funds, need finance from specialised banks such as development banks. These banks were established for the purpose of providing medium and long-term loans for capital projects in agriculture, commerce, industry and other essential projects that are necessary for economic development of the country. Such loans are usually provided from the banks internal resources. For projects that require huge capital resources than it cannot provide alone, development bank usually mobilises other financial institutions to raise the required loan for the organisation that requires it.

Apart from providing medium and long-term loans for capital projects in specific areas as already mentioned, development banks render ancillary services like providing technical advice on new and existing projects to their customers, engaging in promotional activities to stimulate interests among their customers on new projects which the banks consider necessary and profitable.

The commercial banks in operation provided short-term funds which were as a result of the nature of funds available to them. Occasionally, they provided medium-term funds and long-term basis. Development banks perform this function by providing long-term loans for capital projects in specific areas.

The first development finance institution to be set up in Nigeria is Nigeria Local Development Board (NLDB) in 1946. This bank was succeeded by regional development boards of the former Western, Eastern and Northern blocks in the country in 1949. These institutions were named Colony Development Board (CDB). In 1956, the Federal Loans Board (FLB) was set up following the federal character of Nigeria. In 1959, the Investment comes after its five years operation into the first development bank after independence in 1964. This bank was later transformed to Nigerian Industrial Development Bank (NIDB) Limited established on January 22, 1964. NIDB monopolised the development business until three other Federal Government development banks were formed in the 1970s. In Nigeria, we have the Nigerian Industrial Development Bank (NIDB), the Nigerian Bank for Commerce and Industry (NBCI) and the Nigerian Agricultural Co-Operative Bank (NACB) now known as Nigerian Agricultural, Co-Operative and Rural Development Bank Limited (NACRD). These banks are owned by the federal government.

Following the reconstruction of the Nigerian Industrial Development Bank Limited, NIDB in 2001, which incorporated the mandate of the Nigerian Bank of Commerce and Industry (NBCI), the (NBCI) appear to have lost its identify. Today you may not discuss the NBCI without seeing it as a part of NIDB. Nevertheless, since NBCI, is still in existence, having not been swallowed by the NIDB, it can still be referred to. The NBCI was established through Decree 22 of 5th May 1973 by the Federal Government of Nigeria. The bank which is believed to be a child of circumstance because it came up after the Nigeria's civil when the Indigenisation Decree was set up. It started its operation on 4th October, 1974. The bank's authorised capital at inception was N50 million with N35 million of this fully paid up and subscribed by the Federal Government with 60 per cent contribution and the Central Bank of Nigeria, which contributed the remaining 40 per cent.

The bank (NBCI) when established was meant to assist the implementation of the Indigenisation Decree of 1972. By the Decree No. 22 of 2nd April 1973, the bank was to provide equity capital and funds by way of loans to indigenous persons, institutions and Nigerians for medium and long-term investments in industry and commerce at such rates and upon board in accordance with the policy directed by the Federal Executive Council (FEC). This Decree empowered the bank to borrow monies from any source it can, to enable it meet its obligations and discharge its functions.

3.2.2 Functions of Development Banks

The nine important functions of development banks in Nigeria are as follows:

i. To promote and develop small-scale industries (SSI) in Nigeria;
ii. To finance the development of the housing sector in Nigeria;
iii. To facilitate the development of large-scale industries (LSI) in Nigeria;
iv. To help the development of agricultural sector and rural Nigeria;
v. To enhance the foreign trade of Nigeria;
vi. To help to review (cure) sick industrial units;
vii. To encourage the development of Nigerian entrepreneurs;
viii. To promote economic activities in backward regions of the country; and
ix. To contribute in the growth of capital markets;

Now let's discuss each important function of development banks one by one:

i. **Small Scale Industries (SSI)** Development banks play an important role in the promotion and development of the small-scale sector. The Federal Government of Nigeria (FGN) started Nigerian Industrial Development Bank (NIDB) Limited on January 22, 1964 to provide medium and long-term loans to Small-Scale Industries (SSI) units. NIDB) provides direct project finance, and equipment finance to SSI units. It also refinances banks and financial institutions that provide seed capital, equipment finance, etc., to SSI units.

ii. **Development of Housing Sector** Development banks provide finance for the development of the housing sector. The FGN started the National Housing Fund (NHF) through the National Housing Fund Act 1992. The Federal Mortgage Bank of Nigeria Act of 1993 also came into being to provide long-term credit facilities to mortgage institutions in Nigeria and encourage and promote the development of mortgage institutions at the rural, local, State and Federal levels.

According to the FMBN Act of 1993, the functions of the Federal Mortgage Bank are to-

a. provide long-term credit facilities to mortgage institutions in Nigeria at such rates and such terms as may be determined by the Board in accordance with the policy directed by the Federal Government, being rates and terms designed to enable the mortgage institutions to grant comparable facilities to Nigerian individuals desiring to acquire houses of their own;

b. license and encourage the emergence and growth of the required number of viable secondary mortgage institutions to service the need of housing delivery in all parts of Nigeria;

c. encourage and promote the development of mortgage institutions at rural, local, State and Federal levels;

d. supervise and control the activities of mortgage institutions in Nigeria

e. collect, manage and administer the National Housing Fund in accordance with the provisions of the National Housing Fund Act;

f. do anything and enter into any transaction which in the opinion of the Board is necessary to ensure the proper performance of its functions under this Act

iii. **Large Scale Industries (LSI)** Development banks promote and develop large-scale industries (LSI). Development financial institutions like NIDB, NBCI, NACB (now NACRD), etc., provide medium and long-term finance to the corporate sector. They provide merchant banking services, such as preparing project reports, doing feasibility studies, advising on location of a project, and so on.

iv. Agriculture and Rural Development Development banks like National Bank for Agriculture & Rural Development (NABARD) help in the development of agriculture. NABARD started in 1982 to provide refinance to banks, which provide credit to the agriculture sector and also for rural development activities. It coordinates the working of all financial institutions that provide credit to agriculture and rural development. It also provides training to agricultural banks and helps to conduct agricultural research.

v. **Enhance Foreign Trade** Development banks help to promote foreign trade. Government of Nigeria started Export-Import Bank of Nigeria (EXIM Bank) in 1982 to provide medium and long-term loans to exporters and importers from Nigeria. It provides Overseas Buyers Credit to buy Nigeria capital goods. It also encourages abroad banks to provide finance to the buyers in their country to buy capital goods from Nigeria.

vi. **Review of Sick Units** Development banks help to revive (cure) sick-units. Federal Government of Nigeria (FGN) started NBCI to help sick units. NBCI is the main credit and reconstruction institution for revival of sick units. It facilitates modernisation, restructuring and diversification of sick-units by providing credit and other services.

vii. **Entrepreneurship Development** Many development banks facilitate entrepreneurship development. NABARD, State Industrial Development Banks and State Finance Corporations provide training to entrepreneurs in developing leadership and business management skills. They conduct seminars and workshops for the benefit of entrepreneurs.

viii. **Regional Development** Development banks facilitate rural and regional development. They provide finance for starting companies in backward areas. They also help the companies in project management in such less-developed areas.

ix. **Contribution to Capital Markets** Development banks contribute to the growth of capital markets. They invest in equity shares and debentures of various companies listed in Nigeria. They also invest in mutual funds and facilitate the growth of capital markets in Nigeria.

3.2.3 History of Nigerian Industrial Development Bank

NIDB came into existence in 1964 after the restructuring of ICON. The new company was chartered to provide medium and long-term credit to existing and emerging industrial and mining firms in Nigeria. A reconstruction of ICON to NIDB brought in the Federal Government of Nigeria and the World Bank/International Finance Corporation as partners. Originally, the firm had 42 Lagos shareholders holding about 20 per cent of the equity and 56 foreign shareholders holding about 80% of the company. The company originally had a paid-up capital of 1 million pounds. After the restructuring, NIDB had an authorized capital of 5 million pounds with about 20 per cent of the shares of the bank held by Nigerians and about 10 per cent each held by the Central Bank of Nigeria and the International Finance Corporation (IFC). A few international finance houses also held shares, banks such as Chase

International Investment Corporation, Bank of America, Irving International Financing Corporation, IBEC, Northwest International Bank and Chemical Overseas Financial Corporation expanded their overseas risk portfolio and might have invested in the bank as a result of its relationship with Nigerian Stock Exchange.

The Nigerian Industrial Development Bank (NIDB) originally known as ICON; an acronym for Investment Company of Nigeria was a prominent national development finance institution in Nigeria. It was originally a privately managed firm involved in development financing in Nigeria and was then the major buyer and seller of stock on the Lagos Stock Exchange, while it also operated the exchange. A reconstructuring that began in January, 1964, created an outgrowth of ICON and a new firm, the Nigerian Industrial Development Company emerged. It was then the firm became fully a national development finance company along with other firms such as Nigerian Bank for Commerce and Industry (NBCI), Nigerian Agricultural and Cooperative Bank (NACB) and Federal Mortgage Bank of Nigeria (FMBN).

3.4 Federal Mortgage Bank of Nigeria (FMBN)

The Federal Mortgage Bank of Nigeria (FMBN) was established in 1956, known then as the Nigerian Building Society (NBS), a joint venture of the Commonwealth Development Corporation and the Federal and Eastern Governments of Nigeria.

Following the introduction of the Indigenisation Policy, the Federal Government, by Indigenisation Act 1973, undertook 100 percent ownership acquisition of the NBS and consequently renamed it the Federal Mortgage Bank of Nigeria (FMBN). The Bank operates as an effective vehicle for increasing the mobilization of long-term funds, lending volume and expansion of mortgage lending services to all segments of the Nigerian population. The FMBN started the management and administration of the contributory savings scheme known as the National Housing Fund (NHF) established by Act 3 of 1992. The NHF is a pool that mobilises long-term funds from Nigerian workers, banks, insurance companies and the Federal Government to advance loans at soft interest rates to its contributors.

In 1994, the Federal Mortgage Bank of Nigeria, with the promulgation of the FMBN Act 82 [1993] and the Mortgage Institutions Act 53 [1989] was accorded the status of the apex mortgage institution and thus ceded its retail function to an autonomous company, Federal Mortgage Finance

Limited (FMFL) which was carved out of the FMBN, itself fully owned by the Federal Government of Nigeria.

Under the reform of the housing sector based on the Federal Government's 2002/2006 National Policy on Housing and Urban Development, the FMBN was restructured into a Federal Government-Sponsored Enterprise (FGSE) with more focus on secondary mortgage and capital market functions. It plays the critical role of developing a robust mortgage finance system for the country. To meet its mandate, the FMBN has shifted operational emphasis to expand its functions from only social housing on-lending under the NHF to include commercial on-lending for housing, commercial mortgages refinancing, mortgage purchasing and warehousing and Mortgage-Backed Securitisation.

Under this mandate, it finances mortgages created by primary mortgage institutions (PMI) under the National Housing Fund Scheme and also gives estate development loans (EDL) to real estate developers. The bank's overall mandate is to promote the delivery of affordable and modern houses to Nigerians.

3.5 Nigerian Agriculture and Cooperative Bank (NACB)

Bank of Agriculture (BOA) Limited is Nigeria's premier agricultural and rural development finance institution, 100 per cent wholly owned by the Federal Government of Nigeria. The ownership structure is – Central Bank of Nigeria (CBN) (40%) and Federal Ministry of Finance Incorporated (60%). Bank of Agriculture Limited is supervised by Federal Ministry of Agriculture.

The Bank was incorporated as Nigerian Agricultural Bank (NAB) in 1973 and in 1978, was renamed Nigerian Agricultural and Cooperative Bank (NACB). Subsequently in 2000, it was merged with the People's Bank of Nigeria (PBN) and took over the risk assets of Family Economic Advancement Programme (FEAP) to become Nigerian Agricultural Cooperative and Rural Development Bank Limited (NACRDB, a name that has always be considered too long and unwieldy.

A plan to reposition the Bank into an effective and sustainable national agricultural and rural development finance institution in 2010 led to a further name change to Bank of Agriculture Limited (BOA). BOA is a Federal Government-owned development bank with a mandate to provide low-cost credit to small holder and commercial farmers, and small and medium rural enterprises. It also provides micro-financing to small and medium-scale non-agricultural enterprises. Their aim is to ensure effective delivery of agricultural and rural finance services on a sustainable basis to support the national economic development agenda, including food security, poverty reduction, employment generation, reduction in rural to urban migration, less dependency on imported food items, and increase in foreign exchange earnings.

3.6 Functions of Nigerian Agriculture and Cooperative Bank (NACB)

The followings are functions of NACB:

a. Work with cooperative groups at the States and Local Government level to prepare development action plans for themselves;

b. Enter into collaborative or on-lending MOU with State governments and cooperative associations and microfinance banks, specifying their respective obligations to improve the affairs of the groups and banks within a stipulated timeframe;

c. Monitor implementation of development action plans of cooperative associations and micro-finance banks and fulfillment of obligations under MOUs;

d. Provide financial assistance to cooperatives and micro-finance banks for establishment of technical, monitoring and evaluations cells;

e. Provide Organisation Development Intervention (ODI) through reputable training institutes like Federal Cooperative Colleges, Universities of Agriculture, and Departments of Agriculture of various universities in Nigeria;

f. Provide financial support for Federal Cooperative Colleges and Departments of Cooperative Studies in various universities and polytechnics;

g. Provide training for senior and middle level executives of local commercial bank branches, micro finance banks and cooperative associations;

h. Create awareness among the borrowers on ethics of repayment through local debt collectors and cooperative marshals that enforce timely repayment and prompt remittance of same to the lending institution;

i. Provide financial assistance to microfinance banks for building improved management information system, computerisation of operations and development of human resources.

3.7 Bank of Industry

It is a financial institution with a limited scope of services. Bank of industry sell certificates that are labeled as investment shares and also accept customer deposits. They then invest the proceeds in installment loans for consumers and small businesses. These banks are also known as Morris banks or industrial loan companies.

Bank of industry differ from commercial lenders because they accept deposits. They also differ from commercial banks because they do not offer checking accounts. Furthermore, the loans offered by bank of industry are often secured by a third party who acts as guarantor for the loan.

Instituted by this Administration to promote the growth and development of small and medium scale industries in the country, the Bank of Industry is a product of the merger of three development financial institutions. They are:

The Nigerian Bank of Commerce and Industry (NBCI) . The Nigerian Industrial Development Bank (NIDB) .The National Economic Reconstruction Fund (NERFUND)

The merger, which was carried out by the Federal Executive Council in January 2000, targets an effective harmonisation of the resources of all three institutions for efficient use in areas earmarked for industrial development.

The establishment of the Bank of Industry is one of the most powerful incentives for Nigeria's industrial development.

As follow-up to the initial creation of the Bank of Industry, President Olusegun Obasanjo formally launched the new Bank of Industry on 17 May 2002, which started operations with an initial capital base of N50 billion (about $500 million). The new bank, which is solely owned by the Federal Government, has offices in all 36 states of the federation.

Mandate of the Bank

The Bank of Industry was conceptualised by the Federal Government to "transform Nigeria's industrial sector and integrate it into the global economy through providing cheap financing and business support services to existing and new industries in order to achieve the attainment of modern capabilities to produce goods that are attractive to both domestic and external markets". Specifically, the Bank is expected to assist in resuscitating ailing industries and promoting new ones in all the geopolitical zones in the country. To this end, it is mandated to identify and assist: Projects that have large transformation impacts (by creating forward and backward linkages with the rest of the economy) § Projects that utilise domestic inputs § Projects that generate huge employment opportunities and Projects that produce quality products for the export market.

Structure of the Bank
The new Bank of Industry comprises four subsidiaries. They are:
Leasing Company of Nigeria Limited (LECON) &NIDB Trustees Limited (NTL) & NIDB Consultancy and Finance Limited (NIDB Consult) &Industrial and Development Insurance Brokers (IDIB)

Collapsing Previous Banks into the Bank of Industry: Reasons
When the Obasanjo Administration was inaugurated in 1999, it observed that privately owned commercial and merchant banks were not meeting the needs of industries, while government-owned Development Finance Institutions (DFIs) had not fulfilled the goal of channelling long-term finance to the industrial and agricultural sectors. Apart from being in a very poor financial state, DFIs needed to have their operations rationalised and streamlined to eliminate the duplication of functions. They also needed to refocus their energy and resources to perform more effectively. The poor performance of commercial and merchant banks and DFIs was a major reason for the set up the Bank of Industry.

With its establishment, President Obasanjo charged the management of the Bank to avoid the mistakes of the past by ensuring that loans and investments to industrial concerns are based purely on merit and professional consideration. He guaranteed that Government would continue to improve the investment regime in Nigeria by providing it with adequate financial resources as well as protecting it from political interference.

3.8 Merchant/Development Banks international operations

Merchant Banks in The United Kingdom
In the United Kingdom, merchant banks came on the scene in the late eighteenth century and early nineteenth century. Industrial revolution made England into a powerful trading nation. Rich merchant houses that made their fortunes in colonial trade diversified into banking. Their principal activity started with the acceptance of commercial bills

pertaining to domestic as well as international trade. The acceptance of the trade bills and their discounting gave rise to acceptance houses, discount houses and issue houses. Merchant banks initially included acceptance houses, discount houses and issue houses.A merchant banker was primarily a merchant rather than a banker but he was entrusted with funds by his customers. The term merchant bank is used in the United Kingdom (the oldest merchant bank in London was Baring Brothers and it was very prominent in Europe during the nineteenth century, and it had considerable representation in North and South America) to denote banks that are not merchants, sometimes for merchants who are not bankers and sometimes for business houses that are neither merchants nor banks. The confusion has arisen because modern merchant banks have a wide range of activities. Merchant banks in the United Kingdom (a) finance foreign trade, (b) issue capital, (c) manageindividual funds, (d) undertake foreign security business and (e) foreign loan business. Many major merchant banking activities (money-market lending, corporate finance and investment management), are also performed by money market dealers, commercial banks and finance companies, share brokers andinvestment consultants, and unit trust managers.

They also used to finance sovereign governments through grant of long-term loans. They financed the British government to purchase shares of the Suez Canal, helped America purchase the State of Louisiana from Napoleon by raising loans from money market in London; and Lazard Brothers grantedloan to Government of India for Durgapur Steel Plant.

A merchant bank should contain some eleven characteristics: high proportion of decision makers as a percentage of total staff; quick decision process; high density of information; intense contact with the environment; loose organisational structure, concentration of short and medium term engagements; emphasis on fee and commission income; innovative instead of repetitive operations; sophisticated services on a national and international level; low rate of profit distribution; and high liquidity ratio.

Since the end of the Second World War commercial banks in Western Europe have been offering multiple services including merchant banking services to their individual and corporate clients. British banks set up divisions or subsidiaries to offer their customers merchant banking services.

Merchant Banking in India

As planning and industrial policy envisaged the setting up of new industries and technology, greater financial sophistication and financial services are required. According to Goldsmith, there is a well proven link between economic growth and financial technology.

Economic development requires specialist financial skills: savings banks to marshal individual savings; finance companies for consumer lending and mortgage finance; insurance companies for life and property cover; agricultural banks for rural development; and a range of specialised government or government sponsored institutions. As new units were set up and businesses expanded, they required additional financial services which were then not provided by the banking system. Like the local banking system and the trade before, the local system of family enterprises was unsuited for raising large amounts of capital. A public equity or debt issue was the logical source of funds.

Merchant banks serve a dual role within the financial sector. Through deposits or sales of securities they obtain funds for lending to their clients (SEBI forbids lending by them): a function similar to most institutions. Their other role is to act as agents in return for fee. SEBI envisages a mandatory role for merchant banks in exercising due diligence apart from issue management, in buy-backs and public offer in takeover bids. Their underwriting and corporate financial services are all fee rather than fund based and their significance is not reflected in their total assets of the industry. SEBI has been pressing for merchant banks to be primarily fee based institutions.

Banking Commission Report, 1972

The Banking Commission in its Report in 1972 has indicated the necessity of merchant banking service in view of the wide industrial base of the Indian economy. The Commission was in favour of a separate institutions (as distinct from commercial banks and term lending institutions) to render merchant banking services. The Commission suggested that they should offer investment management and advisory services particularly to the medium and small savers.

The Commission also suggested that they should be able to manage provident funds, pension funds and trusts of various types.

Merchant banking activity was formally initiated into the Indian capital markets when Grindlays Bank received the license from Reserve Bank in1967. Grindlays which started with management of capital issues, recognised the needs of emerging class of entrepreneurs for diverse financial servicesranging from production planning and systems design to market research.

Apart from meeting specially, the needs of small scale units, it provided management consultancy services to large and medium size companies. Following Grindlays Bank, Citibank set up its merchant banking division in1970. The division took up the task of assisting new entrepreneurs and existingunits in the evaluation of new projects and raising funds through borrowingand issue of equity. Management consultancy services were also offered.Consequent to the recommendations of Banking Commission in 1972, that Indian banks should start merchant banking services as part of their multiple services they could offer their clients, State Bank of India started theMerchant Banking Division in 1972. In the initial years the SBI’s objective was to render corporate advice and assistance to small and medium entrepreneurs. The commercial banks that followed State Bank of India in setting up merchant banking units were Central Bank of India, Bank of India and Syndicate Bank in 1977; Bank of Baroda, Standard Chartered Bank and Mercantile Bank in 1978; and United Bank of India, United Commercial Bank, Punjab National Bank, Canara Bank and Indian Overseas Bank in late seventiesand early ‘80s. Among the development banks, ICICI started merchant banking activities in 1973, followed by IFCI (1986) and IDBI (1991).

Services Rendered by Merchant Banks

The working of merchant banking agencies and units formed subsequently tooffer merchant banking services has shown that merchant banks are renderingdiverse services and functions, such as organising and extending finance for investment in projects, assistance in financial management, acceptance house business, raising Eurodollar loans and issue of foreign currency bonds, financing of local authorities, financing export of capital goods, ships, hydropower installation, railways, financing of hire-purchase transactions, equipment leasing,mergers and takeovers, valuation of assets, investment management andpromotion of investment trusts. Not all merchant banks offer all these services.

Different merchant bankers specialise in different services. Merchant banking may cover a wide range of financial activities and in the process include anumber of different financial institutions. In the last 35 years new services and functions apart from issue management have been added.

4.0 CONCLUSION

In this unit you learnt the meaning of merchant bank, the development of merchant banking in Nigeria and the functions of merchant bank. You also learnt the meaning of development banks, the evolution of development banks in Nigeria and the functions of development banks. The discussion also took you to the study of the history of Nigerian Industrial Development Bank, the Federal Mortgage Bank of Nigeria (FMBN), the Nigerian Agriculture and Cooperative Bank (NACB) as well as the functions of Nigerian Agriculture And Cooperative Bank.

5.0 SUMMARY

Merchant banks are different from commercial banks. Merchant banks are secondary banks which specialise in a variety of activities such as financing trade, providing hire purchase, industrial finance, underwriting new issues, advising and arranging finance for mergers and takeovers, managing investments for institutions, management of non-resident investment, etc.

On the other hand, development banks are those financial institutions which provide term finance, promote entrepreneurship, enhance organisational effectiveness and upgrade know-how and do-how. They provide either loan or equity capital or both, as also advisory, promotional and entrepreneurial services. Thus, development banks administer a blend of financial and development services.

6.0 TUTOR-MARKED ASSIGNMENT

1. The most familiar role of the merchant bank is stock underwriting. Discuss.
2. List and explain the nine important functions of development banks in Nigeria.

7.0 REFERENCES/ FURTHER READING

The Nigerian Banking Amendment Decree (No.88) of 1979

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