



**NATIONAL OPEN UNIVERSITY OF NIGERIA**  
**91, Cadastral Zone, University Village Jabi, Abuja**  
***FACULTY OF MANAGEMENT SCIENCES***

**COURSE GUIDE**

- Course Code:**            **BFN304**
- Course Title:**           **FINANCIAL SYSTEMS**
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## **1.0 INTRODUCTION**

BFN 304: Financial Systems is a three credit course for students offering B. Sc. Banking and Finance in the School of Management Sciences. The course consists of eighteen (18) units, that is, three (3) modules of six (6) units for each module. The material has been developed to suit undergraduate students in Banking and Finance at the National Open University of Nigeria (NOUN) by using an approach that analyzes practice of banking. A student who successfully completes the course will surely be in a better position to handle the intricacies of practical banking operations.

The course guide tells you briefly what the course is about, what course materials you will be using and how you can work your way through these materials. It suggests some general guidelines for the amount of time you are likely to spend on each unit of the course in order to complete it successfully. It also gives you some guidance on your tutor-marked assignments. Detailed information on tutor-marked assignment is found in the separate assignment file which will be available in due course.

## **2.0 WHAT YOU WILL LEARN IN THIS COURSE**

This course will introduce you to some fundamental aspects of financial systems generally. It also includes: Financial System; Types and Characteristics of Financial Assets; International Financial System; Capital Market; Money Market; Nigerian Financial System; Operations of Capital Market in Nigeria; Operations of Money Market in Nigeria; Central Banking; Commercial Banking; Merchant Banks; Development Banks; Universal Banks; Rural Banking; Marketing of Bank Services; Investment Companies; Insurance Companies; and Comparative Banking and Financial System.

## **3.0 COURSE AIMS**

The course aims, among others, are to give you an understanding of the intricacies of financial systems and how to apply such knowledge in managing financial institutions and their operations. The Course will help you to appreciate types of banks in operations in the country, models of commercial banking after abolition of universal banking in the country, relationships between customers and the banks and forms of collateral securities that can be accepted by banks for loans and advances, among others topics.

The aims of the course will be achieved by:

- (i) Discussing Financial System;
- (ii) Mentioning and Explaining Types and Characteristics of Financial Assets;
- (iii) Explaining International Financial System;
- (iv) Defining Capital Market;
- (v) Explaining Money Market;

- (vi) Explaining the Nigerian Financial System;
- (vii) Discussing the Operations of Capital Market in Nigeria;
- (viii) Explaining Operations of Money Market in Nigeria;
- (ix) Mentioning and Discussing functions of Central Banking;
- (x) Identifying and Explaining functions of Commercial Banking;
- (xi) Listing and Discussing the functions of Merchant Banks;
- (xii) Discussing the role of Development Banks;
- (xiii) Explaining the concept of Universal Banking;
- (xiv) Discussing the rationale for Rural Banking;
- (xv) Explaining the intricacies of Marketing of Bank Services;
- (xvi) Discussing the functions of Investment Companies;
- (xvii) Explaining the role of Insurance Companies; and
- (xviii) Discussing Comparative Banking and Financial System.

#### **4.0 COURSE OBJECTIVES**

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

- (i) Discuss Financial System;
- (ii) Mention and Explain Types and Characteristics of Financial Assets;
- (iii) Explain International Financial System;
- (iv) Define Capital Market;
- (v) Explain Money Market;
- (vi) Explain the Nigerian Financial System;
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- (xii) Discuss the role of Development Banks;
- (xiii) Explain the concept of Universal Banking;
- (xiv) Discuss the rationale for Rural Banking;
- (xv) Explain the intricacies of Marketing of Bank Services;
- (xvi) Discuss the functions of Investment Companies;
- (xvii) Explain the role of Insurance Companies; and
- (xviii) Discuss Comparative Banking and Financial System.

## **5.0 WORKING THROUGH THIS COURSE**

To complete this course, you are required to read all study units, attempt all the tutor marked assignments and study the principles and practice of lending and credit administration in this material provided by the National Open University of Nigeria (NOUN). You will also need to undertake practical exercises for which you need access to a personal computer. Each unit contains self-assessment exercises, and at certain points during the course, you will be expected to submit assignments. At the end of the course is a final examination. The course should take you about a total of 17 weeks to complete. Below are the components of the course, what you have to do, and how you should allocate your time to each unit in order to complete the course successfully on time.

## **6.0 COURSE MATERIALS**

Major components of the course are:

- (i) Course Guide
- (ii) Study Units
- (iii) Textbooks
- (iv) Assignment file

## **7.0 STUDY UNITS**

The study units in this course are as follows:

### **Module 1**

- Unit 1: Financial System
- Unit 2: Types And Characteristics Of Financial Assets
- Unit 3: International Financial System
- Unit 4: Capital Market
- Unit 5: Money Market
- Unit 6: Nigerian Financial System

### **Module 2**

- Unit 7: Operations Of Capital Market In Nigeria
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- Unit 9: Central Banking
- Unit 10: Commercial Banking
- Unit 11: Merchant Banks
- Unit 12: Development Banks

## **Module 3**

Unit 13: Universal Banks

Unit 14: Rural Banking

Unit 15: Marketing Of Bank Services

Unit 16: Investment Companies

Unit 17: Insurance Companies

Unit 18: Comparative Banking And Financial System

### **8.0 ASSIGNMENT FILE**

In this course, you will find all the details of the work you must submit to your tutor for marking. The marks you obtain for these assignments will count towards the final mark you obtain for this course. Further information on assignments will be found in the assignment file itself and later in the section on assessment in this course guide. There are 18 tutor-marked assignments in this course; which you are expected to attempt all of them.

### **9.0 PRESENTATION SCHEDULE**

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

### **10.0 ASSESSMENTS**

There are two aspects to the assessment of the course: first are the tutor-marked assignments; and second is a written examination. In tackling the assignments, you are expected to apply information, knowledge and techniques gathered during the course. The assignments must be submitted to your tutor for formal assessment in accordance with the deadlines stated in the *Presentation Schedule* and the *Assignment File*. The work you submit to your tutor will count for 30% of your total course mark. At the end of the course, you will need to sit for a final written examination of ‘three hours’ duration. This examination will also count for 70% of your total course mark.

### **11.0 TUTOR-MARKED ASSIGNMENT (TMAs)**

There are fifteen tutor-marked assignments in this course and you are advised to attempt all. Aside from the course material provided, you are advised to read and research widely using other references (under further reading) which will give you a broader viewpoint and may provide a deeper understanding of the subject. Ensure all completed assignments are submitted on schedule before set deadlines. If for any reasons, you cannot complete your work on time, contact your tutor before the assignment is due to discuss the possibility of an extension. Unless in exceptional circumstances, extensions may not be granted after the due date for the submission of the assignments.

## **12.0 FINAL EXAMINATION AND GRADING**

The final examination for this course will be of ‘three hours’ duration and have a value of 70% of the total course grade. All areas of the course will be assessed and the examination will consist of questions, which reflect the type of self-testing, practice exercises and tutor-marked problems you have previously encountered. All areas of the course will be assessed. Utilise the time between the conclusion of the last study unit and sitting for the examination to revise the entire course. You may find it useful to review your self-assessment tests, tutor-marked assignments and comments on them before the examination.

## **13.0 COURSE MARKING SCHEME**

The work you submit will count for 30% of your total course mark. At the end of the course, you will be required to sit for a final examination, which will also count for 70% of your total mark. The table below shows how the actual course marking is broken down.

## **14.0 ASSESSMENT MARKS**

Assignments (TMAs): 4 assignments, best 3 will be used for the Continuous Assessment, which will constitute a total of 30%. Final Examination of 70% for overall course marks.  
**Total of Continuous Assessment and Final Examination is 100% for the Course.**

## **15.0 TUTORS AND TUTORIALS**

There are 15 hours of tutorials provided in support of this course. You will be notified of the dates, times and location of these tutorials, together with the names and phone numbers of your tutor, as soon as you are allocated a tutorial group. Your tutor will mark and comment on your assignments, keep a close watch on your progress and on any difficulties you might encounter as they would provide assistance to you during the course. You must submit your tutor-marked assignments to your tutor well before the due date (at least two working days are required). They will be marked by your tutor and returned to you as soon as possible. Do not hesitate to contact your tutor by telephone, e-mail, or discussion group if you need help.

The following might be circumstances in which you would find help necessary, when you:

- do not understand any part of the study units or the assigned readings.
- have difficulty with the self-tests or exercises.
- have a question or problem with an assignment with your tutor’s comment on an assignment or with the grading of an assignment.

You should try your possible best to attend the tutorials. This is the only chance to have face-to-face contact with your tutor and to ask questions which are answered instantly.

You can raise any problem encountered in the course of your study. To gain the maximum benefit from course tutorials, prepare a question list before attending them. You will learn a lot from participations in discussions.

## **16.0 SUMMARY**

BFN 30: Practice of Banking intends to expose the undergraduate students to the fundamentals of banking practices, bank and customer relationships, accounts of customers, services of various types of banks, and securities being accepted for loans and advances. Upon completing the course, you will be equipped with the necessary knowledge of banking system required to produce a good research work in banking and finance. We hope you enjoy your acquaintances with the National Open University of Nigeria (NOUN). We wish you every success in the future.



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**COURSE DEVELOPMENT**

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**HEAD OF DEPT: Dr. (Mrs.) Ofe I. Inuwa**

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## **UNIT 1: FINANCIAL SYSTEM**

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### **1.0 INTRODUCTION**

The economies around the world consist of two distinct but inter-related sectors. These economic sectors are also mutually dependent on each other on a cyclical basis. They are: the real sector of the economy that is involved in the production and exchange of goods and non-financial services; and the financial sector that is into the creation and exchange of financial assets and liabilities in addition to the provision of financial services, the core function of the sector.

The financial sector refers majorly to the financial intermediaries and facilitating institutions involved in the promotion of financial flows in the economy; as operational within the ambit of relevant regulations, rules and laws. The financial system which is operational and incorporated in the purview of financial sector of the economy constitutes the subject matter of discussion in this first study unit of the course material.

### **2.0 OBJECTIVES**

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

- i) explain the meaning of a financial system
- ii) mention the functions of a financial system
- iii) discuss the operations of a financial system

- iv) identify and explain the components of a financial system
- v) mention and discuss major participants in the operations of a financial system

### **3.0 MAIN CONTENT**

#### **3.1 DEFINITION OF A FINANCIAL SYSTEM**

The financial system can be precisely defined as a system rules and regulations and set of financial arrangements, institutions, markets, operations and agents. It also involves the mechanism whereby they relate to one another within the financial sector of an economy and with rest of the world; in the provision of financial services (Ashamu, 2006).

Furthermore, it is an omnibus term which encompasses the generality of financial intermediaries that operate in the financial sector and the institutional facilities being employed in its operational activities within the economy. Furthermore, the term also incorporates a system of rules, regulations and operational norms which govern financial transactions and financial flows through and within the economy.

The financial system, as you will appreciate from above analysis, functions by providing needed facilities with which it directly and indirectly interface between savings-surplus and savings-deficit units within the economy (Nwite, 2005). The former unit of the economy refers to group of individuals and organizations within the economy that has more funds that they require for current utilization and therefore, constitute the savers and suppliers of surplus funds to the financial system. Hence the latter unit is at the receiving end because it is the actual user of the surplus funds being supplied by the players of the former unit in the financial system.

The corporate entities and institutions that constitute the surplus-deficit unit in terms of the investing group within the economy that are interested in raising more funds than that which is currently available for operations. Therefore, they make use of some instruments to raise needed funds through the operations of the financial system, in enhancing the quantum of their operational capital outlays.

The mutual interactions between savings-surplus and savings-deficit units within the economy provide the opportunity for organizations interested in raising funds to have access to surplus funds with the utilization of varied financial instruments. These financial instruments constitute some claims on their fortunes in exchange for funds being raised from the financial system. On the other hand, the interactions between both groups avails the fund suppliers the opportunities to access income yielding financial assets in exchange for some liabilities on their operations.

The system of interactions which border on financial transactions creates financial assets from the surplus unit of the economy and financial liabilities for the deficit unit of the economy. This implies that the mutual interactions which create financial transactions

between the two groups ultimately generate continuous exchanges of claims and counter-claims over financial assets. The exchanges within the financial transactions create flows of financial assets and liabilities among the participants in the financial system of any economy around the world.

### **SELF-ASSESSMENT EXERCISE 1**

Explain the term Financial System.

### **3.2 FUNCTIONS OF A FINANCIAL SYSTEM**

The financial system performs some vital functions to the economy, which tend to enhance the performance of the economy toward its growth and development. Such functions include the following:

1. The financial system provides the necessary market mechanism for mutual interactions between the suppliers of funds and the fund raisers that use the funds for short-term and long-term purposes.
2. It also ensures that necessary operating procedures, rules and regulations are provided for the smooth interactions and transactions within the confines of the system.
3. The system provides facilities for the custody, distribution and marketing of financial assets by the participants.
4. The system ensures the smooth and orderly transfer and delivery of financial instruments among the participants.
5. It has inbuilt mechanism of moderating the pricing regime of financial instruments or securities as well as the cost of raising funds by the users.
6. The financial system ensures adequate stock of money to service the needs of the economy.
7. It facilitates the transfer of money between economic units, which borders on financial intermediation.
8. The financial system also helps to mobilize the collection and storage of savings.

### **SELF-ASSESSMENT EXERCISE 2**

What are the functions of a financial system?

### **3.3 OPERATIONS OF A FINANCIAL SYSTEM**

The financial system operates on the basis of interactions among participants, and above all frequent flows of financial instruments being employed for raising funds by the corporate entities and government institutions in need of finances from the suppliers of surplus funds. The required funds are from the surplus unit of economic being channeled to the users of deficit units of the economy.

The implication of the above analysis is that the mutual interactions and seamless flows of financial instruments come under regulatory purview of some sort. The necessary regulations which are very critical for the smooth operations of financial system arise from the indirect intervention by the financial agents (in free economies) and direct intervention (in mixed and regulated economies) by the government in some countries around the world.

The pertinent issue, as you may ask, is the nature of incentive that does motivate surplus-funds savers to channel their funds to the financial markets for the use of those corporate entities and institutions that operate in funds-deficit unit of the economy. The fact is that the suppliers of surplus funds are normally compensated largely in form of interest, capital gains, and dividends, which constitute incomes to them. In the same vein, the financial intermediaries such as the stock brokers, jobbers, investing houses and share underwriters receive commissions and profits for their intermediary role.

In the process of the operations of the financial system, there arises the need for settlement of the funds that are made available by the suppliers of such funds. This constitutes some additional obligation to the funds raisers and users besides the payment of interest and dividends to the suppliers of funds. This essentially ensures self perpetuating system since such funds from incomes to suppliers of funds constitute the primary source for supplementary outflows of funds to those organizations that operate in funds-deficit unit of the economy.

Nevertheless, situations arise when the system experience some distortions as a result of leakages and injections of funds. Leakages when some funds and incomes are taken out of the system such as repatriation of incomes and dividends out of the economic system by the foreigners and siphoning of funds into financial systems of other countries. This is where the issue of money laundering comes into play in an economic system. On the other hand, injections of funds come into play when money that is either earned or sourced abroad is made available to the local funds raisers in the system. Hence as some funds are being withdrawn from the system some compensatory funds are being injected into the system which may or may not find equalization on comparative basis.

### **3.4 PARTICIPANTS IN FINANCIAL SYSTEM**

The financial system operates on a network of a mechanism of which there are some vital constituents that play strategic role in its structural operations. Therefore, these structural parts of the network constitute the components of a financial system. Such components of the financial system include Primary system participants, Financial markets, Financial intermediaries, Financial instruments, and Financial system regulators.

All these important components of a financial system are discussed in the subsequent subsections of this study unit.

#### **3.4.1 Primary System Participants**

These are the primary operators of the financial system in terms of the suppliers of funds and the raisers of funds. The former group, as you have observed from earlier discussion in this study unit, refers to those with surplus funds for investment while the latter group involves those participants that are in need of funds with which to enhance the operations of their organizations.

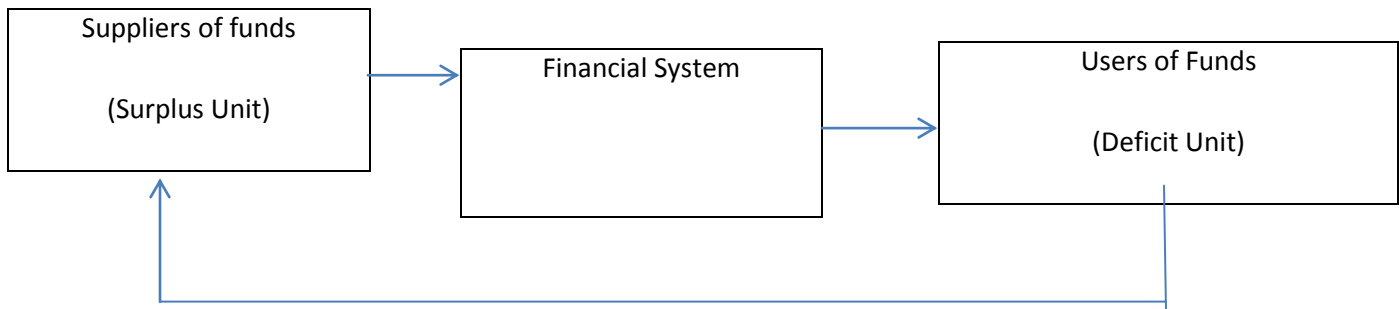
The funds raisers are those corporate entities that are into the production of goods and related services in the real sector of the economy. Therefore, they normally raise funds from suppliers to sustain the operational activities of their companies and institutions. The private sector- entities in particular need such funds with to ensure further investment in their operations.

In the process of raising funds, the corporate entities and institutions make use of financial instruments such as:

- Shares, e.g., equity shares and preference shares;
- Bonds, e.g., government bonds and corporate bonds;
- Treasury bills;
- Treasury certificate;
- Loan Stock;
- Bill of Exchange; and
- Promissory Notes.

The presence of the primary operators in the financial system ensures that there are financial flows among the participants in the process of supply of and demand for funds. It is instructive for you to note that there is a continuous shifting of roles because there are no permanent funds raisers and permanent suppliers of funds. Therefore, a funds raiser at one time can become a supplier of funds at some other time in the cyclical nature of the financial system. The diagram (Fig. 1.1) below aptly demonstrates the relationship.

**Figure 1.1: Relationship between Suppliers and Users of Funds.**



**Source:** Illustration by the Authors.

Furthermore, more often than not, the financial operators are not restricted to only one role because some of them often double as primary participants in the process of raising or supplying funds in their individual positions in the financial system. The funds raisers and suppliers often constitute subsystems of institutions and facilitators in the operations of the financial system.

In categorical terms, the suppliers of funds include the following individuals and institutions:

- i) Individuals and household units as savers of surplus funds;
- ii) Institutional investors such as insurance companies, etc;
- iii) Commercial banks and other types of banks;
- iv) Primary Mortgage institutions; and
- v) Specialized government agencies in charge of credits on periodic basis.

The funds raisers, in categorical terms, include the following entities and institutions:

- a) Business enterprises of various categories;
- b) Public corporations of government owned companies; and
- c) Government such national, regional, state of municipal/local councils

These funds raisers make use of appropriate channels to reach suppliers of funds. The small enterprises make use of private placement and personal contacts for raising their funds while large entities make use of securitized channels for raising their funds. The financial instruments, which have been identified earlier in this study unit, are still relevant in raising the funds regardless of the size of the entities or institutions involved.

### **SELF-ASSESSMENT EXERCISE 3**

Differentiate between funds suppliers and funds raisers in the operations of a financial system.

### **3.4.2 Financial Intermediaries**

These are the facilitators of the financial transactions that take place with the financial system. They serve as mediators between funds raisers and suppliers of funds. Therefore, they facilitate the issuance and exchange of financial instruments. Such intermediaries include the following:

- i) Commercial and merchant banks
- ii) Specialized banks, e.g., investment banks, development banks;
- iii) Primary mortgage institutions; and
- iv) nsurance companies, etc.

The various banks perform profound role in terms of intermediary functions since in the process of financial intermediation, they source for surplus funds form savers and channel the funds to the prospective users.

### **3.4.3 Financial Markets and Financial Instruments**

These constitute the network for the transactions of the financial system because these markets provide the necessary framework for carrying out the operations of the system. The financial markets are in two categories, which include the capital market and money market.

The money market is used for raising short-term funds for the operations of the funds raisers. The financial instruments being used in this market include: Treasury bills; Treasury certificate;Certificates of Deposits;Bill of Exchange; and Promissory Notes.

On the other hand, the capital market deals with funds that are supplied by savers and raised by users on a long-term basis. The financial instruments being used in the capital market include the following:

- i) Equity Shares;
- ii) Preference Shares;
- iii) Government Bonds;
- iv) Corporate Bonds;
- v) Debenture Stocks;
- vi) Mortgage Loan Stocks;
- vii) Equipment Leases;
- viii) Hire Purchase; and
- ix) Development Loan Stock used by government



In addition, there are other varied financial instruments being used in various economies around the world. This implies that the above list is by no means exhaustive.

#### **SELF-ASSESSMENT EXERCISE 4**

Mention the various financial instruments being used for long term funds.

#### **3.4.4 Financial System Regulators**

There are agencies that regulate the operations of the financial system in free market economies without direct government intervention. The only form of intervention by the government is through the enactment of relevant Acts. Such Acts of Parliament are laws meant to provide equal opportunity or platform for all players, smooth operations, and safeguarding the national interest of the country. Therefore, all the participants in the financial system are under obligations to adhere to them.

The relevant regulators of financial systems in free market economies as well as mixed economies include Securities and Exchange Commission (SEC) and The Stock Exchange (The Exchange), among other regulatory agencies that may evolved out of necessity. There are other contemporary issues such as corporate governance and accounting standards that prompt the formation of agencies to mount surveillance on the practices in various economies around the world.

#### **4.0 CONCLUSION**

The discussion in this unit, as you have observed, is indicative of the fact that financial system encompasses financial intermediaries and institutional facilities as well as system of rules, regulations and operational norms which govern financial transactions and financial flows within the economy. Therefore, the financial system provides necessary market mechanism for mutual interactions between suppliers of funds and fund raisers for short-term and long-term purposes.

The financial system operates through a mechanism which involves interactions among participants that ensure frequent flows of financial instruments for raising funds by corporate entities and government institutions in need of finances. The components of a system, as you have also learned, include primary system participants, financial markets, financial intermediaries, financial instruments and financial system regulators.

#### **5.0 SUMMARY**

The topics that we have discussed in this study unit include exposition on the concept of financial system, the functions being performed by a financial system, the nature of its operations and the main participants in financial system. Such participants that have been

discussed in the study unit include: primary system participants; financial intermediaries; financial markets and instruments; and financial system regulators.

In the next study unit, you will be taken through the discussion on international financial system.

## **6.0 TUTOR MARKED ASSIGNMENT**

Mention and discuss the main players in the operations of a financial system.

## **7.0 REFERENCES AND FURTHER READING**

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- **FURTHER READING**

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## **UNIT 2: INTERNATIONAL FINANCIAL SYSTEM**

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### **1.0 INTRODUCTION**

The international economic system is partly driven by financial system which implies that there exists an international financial system that lubricates the operations of such economic scheme. This implies that international financial system, just like the overall international economic scheme, has main players and network of participants that are scattered around the world. The players in this system and the participants are responsible for the operations and transactions that are carried out therein.

The network of participants in international financial system operates in cohort with the main players towards ensuring smooth and transparent operations of this system. This is because in the scheme of things, there are regulators and aiding institutions of the international financial system that are found in the network of participants. Therefore, the regulators and aiding institutions of the international financial system play strategic role in the overall operations and transactions being carried out by the main players in the system. Therefore, the discussion in this study unit has to do with identifying such players and participants while analyzing their individual positions in international financial system

### **2.0 OBJECTIVES**

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

- explain the meaning of international financial system
- identify and explain main players in international financial system
- mention and discuss major participants in the operations of international financial system
- discuss the various perspectives on international financial system

### **3.0 MAIN CONTENT**

#### **3.1 DEFINITION OF INTERNATIONAL FINANCIAL SYSTEM**

The international financial system consists of institutions, their customers, and financial regulators that interact and operate act on a global stage. The term is regarded in an all-bracing to constitute the various official and legal arrangements that govern international financial flows in the form of loans, investment, payments for goods and services, interest and profit remittances (James and Heikki, 2007).

In basic terms, the main elements of international financial system are the surveillance and monitoring of economic and financial stability, and provision of multilateral finance to countries with balance of payments difficulties. Therefore, the organization at the nerve-centre of the system is the International Monetary Fund (IMF). This is because IM, in line with its charter, is bequeathed with the responsibility of ensuring its effective running (James and Heikki, 2007).

In another perspective, there is the view that international financial system holds that the system involves the interplay of financial companies, regulators and institutions operating on a supranational level. The global financial system can be divided into regulated entities (international banks and insurance companies), regulators, supervisors and institutions like the European Central Bank or the International Monetary Fund. The system also includes the lightly regulated or non-regulated bodies, which collectively is known as the “shadow banking” system. Essentially, this covers hedge funds, private equity and bank sponsored entities such as off-balance-sheet vehicles that banks use to invest in the financial markets (James and Patomäki, 2007).

In evolutionary terms, the history of financial institutions can be traceable to the first commodities exchange in Europe, the Burges Bourse in 1309 and the first financiers and banks in the 15th–17th centuries in Central and Western Europe. The first global financiers were the Fuggers (1487) in Germany; the first stock company in England (Russian Company 1553); the first foreign exchange market (The Royal Exchange 1566, England); the first stock exchange, the Amsterdam Stock Exchange 1602 (Cassis, 2006).

The remarkable developments in the history of global financial system include the establishment of the Gold Standard (1871–1932), the founding of the International Monetary Fund (IMF) and the World Bank at Bretton Woods 1944. Others include the

abandonment of the US dollar as reserve currency in 1971, the abandonment of fixed exchange rates in 1973 and China pegging its currency, the Yuan, to the US Dollar in 1994, which led to their accumulation of more than \$1trillion of international reserves (Flandreau, Holtfrerich and James, 2003).

### **3.2 Main Players of International Financial System**

#### **1) International Financial institutions**

These include important financial institutions such as banks, hedge funds whose failure may cause a global financial crisis, the International Monetary Fund and the Bank for International Settlements.

#### **2) Customers of Global financial system**

These include multinational corporations, as well as countries, with their economies and government entities, for instance, the central banks of the G20 major economies, finance ministries, EU, NAFTA, and OPEC, among others.

#### **3) Regulators of Global Financial System**

Many of these regulators play dual roles because they operate as financial organizations at the same time. These include International Monetary Fund, Bank for International Settlements, particularly its Global Economy Meeting (GEM), in which all emerging economies' Central Bank governors are fully participating, has become the prime group for global governance among central banks.

Such apex banks' governors include President of the European Central Bank, financial regulators of the U.S.A (the US agency quintet of Federal Reserve, Office of Comptroller of the Currency, Federal Deposit Insurance Corporation, Commodity Futures Trading Commission, Federal Reserve Board, Securities and Exchange Commission, Europe (European Central Bank) and the Bank of China, besides others.

#### **SELF-ASSESSMENT EXERCISE 1**

List and explain the various players in International Financial System.

### **3.3 NETWORK OF PARTICIPANTS IN INTERNATIONAL FINANCIAL SYSTEM**

The network of participants in international financial institutions includes financial institutional institutions, governments, regional institutions and academic institutions. The balkanization of the participants represents a mere estimation, because as you have observed from foregoing discussion that by their nature, multinational players in international financial system

are organized in network. Therefore, their multiple functions often overlap with chief executives on financial institutions occupying associated appointments in numerous organizations, which revolve from private to public employment.

### **3.3.1 Global Financial Institutions**

The most prominent international financial institutions include the following:

#### **1. The International Monetary Fund (IMF)**

The International Monetary Fund (IMF) keeps watch over international balance of payments accounts of member states. The IMF has the responsibility of acting as the lender of last resort for members in financial distress such as currency crisis, problems meeting balance of payment when in deficit and debt default. Membership of the Fund is based on quotas, or the amount of money a country provides to the fund relative to the size of its role in the international trading system.

#### **2. International Bank for Reconstruction and Development (IBRD)**

The establishment of this international bank otherwise known as World Bank is aimed at providing funding, take-up credit risk or offer favorable terms to development projects mostly in developing countries that couldn't be obtained by the private sector. The other multinational development banks (e.g., ADB, AfDB, etc) and other international financial institutions (e.g., IFC, etc) also play specific regional or functional roles.

#### **3. World Trade Organization**

The World Trade Organization settles trade disputes and negotiates international trade agreements in its rounds of talks, which is currently regarded as the Doha Round).

#### **4. Bank for International Settlement (BIS)**

The Bank for International Settlement(BIS) which is based in Basel Switzerland is both a bank as well as an intergovernmental organization for central banks worldwide. It has numerous subsidiary bodies, which most importantly include the Basel Committee on Banking Supervision, the Financial Stability Board, and the Bank for International Settlement Joint forum on financial conglomerates. It publishes global bond market capitalization data.

#### **5. The World Economic Forum**

The World Economic Forum is a Swiss non-profit foundation based in Geneva which hold meeting annually in Davos.

#### **6.Private International Financial Institutions**

The most prominent private international financial institutions include the following:

- i) The Institute of International Finance (IIF) is a trade organization of the world's largest commercial banks and investment banks.
- ii) The World Federation of Exchanges (WFE) is in charge of publishing global stock capitalization information in annual reports.
- iii) The Global Financial Markets Association (GFMA) consists of European, Asian and North American financial market associations: These are the Association for Financial Markets in Europe (AFME) in London and Brussels, the Asia Securities Industry & Financial Markets Association (ASIFMA) in Hong Kong, and the Securities Industry and Financial Markets Association (SIFMA) in New York and Washington DC.

These global financial institutions are investment bankers, insurance companies, or commercial banks that active in the stock, bond, foreign exchange, derivatives and commodities markets. There are others include global financial institutions include investing private equity such as mortgage in hedge funds and pension funds, mutual funds, and sovereign wealth funds, among others.

International lobbying firms also play a role in international financial systems because they increasingly develop cross-border lobbying arms to influence international negotiations. For example, Podesta Group, a Washington lobbying firm, founded *Global Solutions* to influence multilateral free trade agreements, such as the Trans-Pacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (TTIP), and any other issues "at the intersection of trade, economics, politics and diplomacy".

## **SELF-ASSESSMENT EXERCISE 2**

List and discuss most prominent global international financial institutions.

### **3.3.2 Governments**

Governments act in various capacities within the international financial system, traditionally primarily through their finance ministries. They pass the laws to regulate financial markets, set the tax weight for private sector, such as banks, funds and exchanges. At the same time governments also participate in global financial markets through discretionary spending and borrowing. They are closely tied to, though in most countries independent of central banks that issue government debt, set interest rates and deposit requirements, and intervene in the foreign exchange market through guidelines from their ministries of finance as implemented by their apex banks.

### **3.3.3 Regional institutions**



There are regional institutions that also participate in international financial system. These include the following:

- i) Commonwealth of Independent States (CIS);
- ii) North American Free Trade Agreement (NAFTA);
- iii) Euro zone with its ECB or European Central Bank;
- iv) EU Department of Internal Market and Services, led by the European Commissioner for Internal Market and Services, which has produced an expert review of Financial Regulation, the Liiskanen report, in 10/2012;
- v) EBA or European Banking Authority, which replaced the CEBS or Committee of European Banking Supervisors; and
- vi) The European Shadow Financial Regulatory Committee (ESFRC)

### **3.3.4 Academic institutions**

Academic institutions also play a special role in the international financial system since they educate the professionals working in the international financial system. The group of economists, executive officers and financial analysts who drive the research work for the effective operations of the international financial system.

The famous Harvard Business School, for example, makes use of *Executive Education programmesto* prepare executives from all over the world for new levels of leadership. Furthermore, in most cases, many central bank chiefs around the world are Harvard educated, such as Mario Draghi of the European Central Bank, present Deputy Governor at the Bank of England, Stanley Fischer, the Governor of the Bank of Israel, John de Gregorio in Chile, AthanasiosOrphanides in Cyprus, Phillip Lowe, Deputy Governor of the Reserve Bank of Australia and Oliver Blanchard of the IMF.

These eminent economists meet every two months in the eighteen-man group of the Economic Consultative Committee of the above mentioned Banks for International Settlements in Basel. At the same time, academic institutions are both investors of their revenues, including incomes from international patents or other international business operations, and creditors in the global financial system.

## **3.4 PERSPECTIVES ON INTERNATIONAL FINANCIAL SYSTEM**

There are three primary approaches to viewing and understanding the global financial system.

### **1. Liberal Perspective**

The liberal view holds that the exchange of currencies should be determined not by state institutions but instead individual players at a market level. This view has been labeled as the Washington Consensus.

## **2. Social Democratic Perspective**

The social democratic view advocates the tempering of market mechanisms, and instituting economic safeguards in an attempt to ensure financial stability and redistribution. Examples include slowing down the rate of financial transactions, or enforcing regulations on the behavior of private firms.

## **3. Neo Marxists Perspective**

Neo Marxists Perspective holds the view that the political North comprising the developed countries abuses the financial system to exercise control over developing countries' economies, which promotes inequality between the advanced economies and the less developed nations.

### **SELF-ASSESSMENT EXERCISE 3**

Mention and explain the various perspectives on international financial system.

## **4.0 CONCLUSION**

The discussion in this unit, as you have observed, is indicative of the fact that there exists an international financial system. And therefore, there are players such as international banks, financial institutions, customers and regulators. Furthermore, the most prominent international financial institutions include the International Monetary Fund (IMF), International Bank for Reconstruction and Development (IBRD), World Trade Organization, Bank for International Settlement (BIS), the World Economic Forum, and Private International Financial Institutions. You have also observed that governments around the world, regional institutions, and academic institutions also play strategic roles in the operations of the international financial system.

## **5.0 SUMMARY**

The topics that we have discussed in this study unit include major players in international financial system, global financial institutions, network of actors in international financial system, and perspectives on international financial system.

In the next study unit, you will be taken through the discussion on Nigerian financial system.

## **6.0 TUTOR MARKED ASSIGNMENT**

Mention and discuss the main players in the operations of the international financial system.

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## **UNIT 3: NIGERIAN FINANCIAL SYSTEM**

### **CONTENTS**

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
  - 3.1 Evolution of Nigerian financial system
    - 3.1.1 Foundation Phase
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## **1.0 INTRODUCTION**

The Nigerian financial system constitutes an important sector of the economy since, just like any financial system, it occupies a strategic role. In terms of such role, it provides a smooth mechanism through which funds flow from the surplus spending unit of the economy to the deficit spending unit. The strategic function of the financial system in the country's economy is carried out through process of financial intermediation. This is informed by the fact that by attracting funds from surplus unit of the economy and channeling same for the use of the deficit unit, it engages in financial business of sort. In this study, therefore, the nature of the country's financial system is the subject of discussion.

## **2.0 OBJECTIVES**

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

- i) mention the various evolutionary phases of the Nigerian financial system
- ii) identify the participants in Nigerian financial system
- iii) identify and explain regulatory institutions in Nigerian financial system
- iv) list the functions of the financial system in Nigeria

## **3.0 MAIN CONTENT**

### **3.1 EVOLUTION OF NIGERIAN FINANCIAL SYSTEM**

The financial sector is the nucleus of the financial system and productive activity in the country. It is made up of network of banks and other financial institutions as well as a range of financial instruments. Such participants are banks, insurance companies, specialized banks, capital market, finance companies, discount houses, bureau de change, mortgage institutions, microfinance banks, and development finance institutions (DFIs). They occupy particular areas of the economy. The Nigerian financial system has gone through several stages of development over the years. These phases are identified and discussed below.

#### **3.1.1 Foundation Phase**

This phase was focused on the establishment of institutions and development of necessary legislative framework. The phase is approximately from 1950 to 1970. During this period, the Central Bank of Nigeria (CBN), the apex regulatory authority in the Nigerian financial sector was established. The CBN derives its legal authority from the CBN Act No. 24 of 1991 (Amended in 1997, 1998, and 1999) and the Banks and Other Financial Institutions Act (BOFIA) No. 25 of 1991 (Amended in 1997, 1998 and 1999) and presently the CBN Act 2007, which preceded the CBN Act of 1958 and Banking Act of 1969 (Prosper, 2011).

#### **3.1.2 Expansion Phase**

This expansion phase was directed at availing the public of banking activities and this was facilitated by the increase in network of branches. This involves the expansion of banks branches into the rural and semi areas. The phase also witnessed priority lending to some sector of the economy. This phase takes approximately from 1970 – 1985 (Prosper, 2011).

#### **3.1.3 Consolidation and Reform Phase**

This phase coincided with the Structural Adjustment Programme (SAP), which started in 1986, representing an era in Nigeria's financial sector reform. The monetary authorities relaxed the control and liberalize the sector. There was a deregulation of the economy and many institutions were set-up to regulate the growing financial sector. For example, there was the establishment of Nigeria Deposit Insurance Corporation (NDIC) in 1988, the Security and Exchange Commission (SEC) though established by SEC Act of 1979 but was further strengthened by SED Act of 1989 and Investment and Securities Act No. 45 of 1999 (Prosper, 2011).

## **SELF-ASSESSMENT EXERCISE 1**

Identify and discuss the evolutionary phases in the Nigerian financial system.

### **3.2 REGULATORY FRAMEWORK OF NIGERIAN FINANCIAL SYSTEM**

The financial institutions that operate in the country's financial system come under regulatory framework of established government agencies comprising 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), and Federal Mortgage Bank of Nigeria (FMBN).

The regulatory authorities of the financial institutions in the country are identified and discussed below.

#### **3.2.1 Federal Ministry of Finance (FMF)**

The Federal Ministry of Finance is one of the ministries that the affairs of the country generally. The Federal Ministry of Finance in particular has the responsibility of advising the Federal Government on its fiscal operation and therefore, co-operates with Central Bank of Nigeria (CBN) on monetary matters in the country.

#### **3.2.2 Central Bank of Nigeria (CBN)**

The Central Bank of Nigeria (CBN) as the apex bank is charged with the regulatory authority of the financial system. The Bank was established at the instance of the enactment of the Central Bank of Nigeria Act of 1958 and commenced operations on 1st July 1959.

It performs many functions in the process of regulating the banking institutions, which include:

- i) Promoting monetary stability and a sound financial system;
- ii) Acting as banker and financial adviser to the Federal Government;
- iii) Acting as banker of last resort to other banks;
- iv) Encouraging the growth and development of all financial institutions;
- v) Overseeing the overall development of the banking sector; and
- vi) Licensing banks and finance companies.

## **SELF-ASSESSMENT EXERCISE 2**

Describe the role of the apex bank in Nigeria financial system.

### **3.2.3 Nigerian Deposit Insurance Corporation (NDIC)**

The Nigerian Deposit Insurance Corporation (NDIC) plays complement role to the CBN in the regulation of the banking institutions in the economy. The Corporation commenced operations effectively in 1989 and it is autonomous of the Central Bank of Nigeria (CBN) in the discharge of its statutory obligations in the country's financial system. Nevertheless, it reports to Federal Ministry of Finance on its activities.

Therefore, the Corporation performs the following functions in the financial system of the country.

- a) The Corporation supervises the operations of various banks in the economy.
- b) It provides deposit insurance and related services for banks;
- c) It aids in the promotion of confidence in the banking industry in the country;
- d) It is empowered to examine the books and affairs of insured banks and other deposit taking financial institutions
- e) It generates funds from licensed banks to provide cover for depositors' money; since such banks are mandated to pay 15/16 of 1 per cent of their total deposit liabilities as insurance premium to the Corporation

### **3.2.4 The Securities and Exchange Commission (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.

There are some vital functions which are being performed by the Commission, among which include the following:

- i) The Commission approves and regulates mergers and acquisitions of publicly quoted companies;
- ii) The Commission also authorizes the establishment of unit trusts;
- iii) The Commission also handles;
- iv) It has the responsibility of maintaining surveillance over the capital market towards enhancing its efficiency.
- v) The Commission issues guidelines for the establishment of Stock Exchanges in different locations of the country due furtherance of the deregulation of the



- capital market.
- vi) The Commission releases guidelines on foreign investment in the

### **3.2.5 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 centralizes 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. The Office also keeps tab on debts being taken by government at various levels (federal, state and local government) from the capital market. These debts are in form of Federal Government Development Loan Stock, State Government Bonds and Local Government Bonds.

### **3.2.6 National Insurance Commission (NAICOM)**

The National Insurance Commission (NAICOM) has been established to replace the Nigerian Insurance Supervisory Board (NISB). The Commission serves as the watchdog over the operations of the various insurance companies operating in Nigeria. Hence NAICOM is charged with effective administration, supervision, regulation and control of the business of insurance in Nigeria.

The specific functions of the National Insurance Commission (NAICOM) include:

1. Establishment of standards for the conduct of insurance business;
2. Protection of insurance policy holders against unfair practices by insurance companies;
3. Establishment of a bureau to which complaints may be submitted against insurance companies and their intermediaries by members of the public;
4. It ensures adequate capitalization and reserve for the operations of insurance companies in the country;
5. It also ensures good management and high technical expertise in the operations of insurance companies; and
6. The Commission ensures judicious fund placement by insurance companies towards meeting claims by their clients.

### **SELF-ASSESSMENT EXERCISE 3**

Describe the role of the National Insurance Commission in Nigeria financial system.

#### **3.2.7 Federal Mortgage Bank of Nigeria (FMBN)**

The Federal Mortgage Bank of Nigeria (FMBN) has been established to replace the defunct Nigerian Building Society, whose assets and liabilities it has inherited. The Bank as the foremost institution in the mortgage industry performs some vital functions. Such functions of the bank are as give below. Specifically performs.

1. The Bank provides banking and advisory services for mortgage institutions and operations in the country;
2. The Bank undertakes research activities pertaining to housing provision in the country;
3. The Bank is empowered to licence primary mortgage institutions in the country;
4. The Bank is empowered to regulate primary mortgage institutions that operate in the country; and
5. The Bank also acts 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. Federal Mortgage Bank of Nigeria (FMBN) is under the control of the Central Bank of Nigeria.

### **SELF-ASSESSMENT EXERCISE 4**

What are the functions of Federal Mortgage Bank of Nigeria (FMBN) in the Nigeria financial system?

#### **3.2.8 Financial Services Co-ordinating Committee (FSCC)**

The Committee has been established in 1998 charged with the primary responsibility to promote safe, sound and efficient financial sector in the country. The membership of the Committee is drawn from the key regulatory and supervisory institutions in the financial system in the country. Therefore, the membership comes mainly from 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 is chaired by the Minister of Finance who co-ordinates the activities of all regulatory institutions in the financial system in the country.

#### **4.0 CONCLUSION**

In this study unit, we have identified and discussed the participants and regulators of the Nigerian financial system. These participants in the country's financial system include Central Bank of Nigeria, Commercial Banks, Federal Mortgage Bank, Insurance Companies, Nigerian Stock Exchange, Securities and Exchange Commission. The other participants include Brokerage Firms, Investment Houses, Pension Funds Institutions, and Mortgage Institutions. The financial system from our discussion is under regulations of institutions such as Federal Ministry of Finance (FMF), Central Bank of Nigeria (CBN), Nigeria Deposit Insurance Corporation (NDIC), Securities and Exchange Commission (SEC), National Insurance Commission (NAICOM), and Federal Mortgage Bank of Nigeria (FMBN). The Federal Ministry of Finance occupies the apex position in the regulatory network of the system.

#### **5.0 SUMMARY**

The topics that we have discussed in this study unit include the evolutionary phases of the country's financial system. The other area of discussion revolves around the regulatory framework of the country's financial system in terms of those institutions that regulate the operations and transactions in this system.

In the next study unit, you will be taken through the structure and reforms of Nigerian financial system

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

Mention and discuss the main players in the operations of the Nigerian financial system.

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## **UNIT 4: STRUCTURE AND REFORMS OF NIGERIAN FINANCIAL SYSTEM**

### **CONTENTS**

- 3.1 Structure of the Nigerian Financial System
- 3.2 Banking Institutions in Nigerian Financial System
- 3.3 Non Banking Institutions in Nigerian Financial System
- 3.4 Reforms in the Nigerian Financial System
  - 3.4.1 The 1986 Reforms
  - 3.4.2 The 2004 Reforms
  - 3.4.3 The 2009 Reforms
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor Marked Assignment
- 7.0 References and Furthermore Reading

### **1.0 INTRODUCTION**

The preceding study unit has been used to give an overview of the Nigeria financial system. The Nigerian financial system, as you have learned, comprises various institutions such as the apex bank, commercial banks, mortgage banks, and non financial institutions such as insurance companies, among others. In this study unit, we discuss the structure of the financial system in Nigeria, taking into consideration the various regulatory agencies in the system.

### **2.0 OBJECTIVES**

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

- i) Explain the structure of the Nigerian financial system
- ii) Mention and discuss the banking institutions in Nigerian financial system
- iii) List and explain non banking institutions in Nigerian financial system
- iv) Mention and explain various reforms in the Nigerian financial system

### **3.0 MAIN CONTENT**

#### **3.1 STRUCTURE OF THE NIGERIAN FINANCIAL SYSTEM**

The structure of the Nigerian financial system can be discussed based on the institutions and regulatory agencies that are established by the government towards realization the basic goals of financial intermediation. In the preceding study unit, you have been exposed to the fact that there are some institutions and organizations in the Nigerian financial system.

The institutions in the structure of the Nigerian financial system comprise bank and non-bank financial institutions which are regulated by the:

- i) Federal Ministry of Finance (FMF);
- ii) Central Bank of Nigeria (CBN);
- iii) Nigeria Deposit Insurance Corporation (NDIC);
- iv) Securities and Exchange Commission (SEC);
- v) National Insurance Commission (NIC);
- vi) Federal Mortgage Bank of Nigeria (FMBN); and
- vii) National Board for Microfinance Banks (NBFB).

### **SELF ASSESSMENT EXERCISE 1**

Describe the structure of the Nigerian financial system.

## **3.2 BANKING INSTITUTIONS IN NIGERIAN FINANCIAL SYSTEM**

### **1. 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. The apex bank promotes monetary stability and a sound financial system as well as acting as the banker of last resort to the banks. The Bank also encourages the growth and development of financial institutions. Its enabling law of 1991 empowers the CBN some degree of more flexibility in regulating and overseeing the banking sector and licensing finance companies which was hitherto operated outside any regulatory framework.

In essence, the CBN occupies the apex position of the country's banking system. The apex bank is thus charged with responsibility of regulating and supervising the financial operations and related activities of all the banking institutions and other financial institutions generally. The regulatory authorization of the Central Bank of Nigeria (CBN) derives from the law establishing its operations. This is actually based on the 1958 Act of Parliament and amended severally in 1991, 1993, 1997, 1998, 1999 and 2007.

In the latest amended regarding the CBN Act of 2007 of the country, it is charged with the overall control and administration of the monetary and financial sector policies of the Federal Government. Concomitantly,

The apex bank (CBN) is charged with the following objectives in its operations:

1. Ensuring monetary and price stability;
2. Issuance legal tender currency in Nigeria;
3. Maintaining external reserves for safeguarding the international value of the legal tender currency;

4. Promoting a sound financial system in Nigeria; and
5. Acting as banker to the Federal Government and
6. Providing economic and financial advice to the Federal Government.

In related terms, the apex bank has the responsibility of administering the Banks and Other Financial Institutions Act (1991) as amended. This is with the singular essence of ensuring high standards of banking practice and financial stability through its surveillance activities, and also the promotion of an efficient payment system in the country.

Furthermore, in line with the apex bank's fundamental functions, CBN has been performing some basic developmental functions. Such functions are directed on all the principal sectors of the Nigerian economy in areas of financial, agricultural and industrial sectors.

There are other categories of financial institutions which are being supervised by the apex in the country such as follows:

- i) Bureaux-de-Change (BDCs)
- ii) Commercial Banks
- iii) Development Finance Institutions. (DFI's)
- iv) Discount Houses
- v) Finance Companies (FCs)
- vi) Merchant Banks
- vii) Microfinance Banks (MFBs)
- viii) Non-Interest or Islamic Banks
- ix) Mortgage Banks (PMBs)

## **2. 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, The FMBN is empowered to licence 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. The FMBN is under the control of the Central Bank.

## **3. National Board for Microfinance Banks (NBFB)**

The board was originally established and known as National Board for Community Banks, was to supervise and control the erstwhile community banks. Presently, and at the

advent of microfinance banks, the board has the responsibility of supervising and controlling these microfinance banks in the economy.

## **SELF ASSESSMENT EXERCISE 1**

Mention and discuss the various non banking institutions in the structure of the Nigerian financial system.

### **3.3 NON BANKING INSTITUTIONS IN NIGERIAN FINANCIAL SYSTEM**

#### **1. Federal Ministry of Finance (FMF)**

The Federal Ministry of Finance has the responsibility of advising the Federal Government on its fiscal operations. It also has the responsibility of co-operating with the Central Bank of Nigeria in monetary issues in the economy. In the amendment of 2007 regarding the laws governing the apex bank, the Central Bank of Nigeria is mandated in its operations to be reporting through the Federal Ministry of Finance to the Presidency.

#### **2. The Nigerian Deposit Insurance Corporation (NDIC)**

The NDIC compliments the regulatory and supervisory role of the CBN. It is however autonomous of the CBN and reports to Federal Ministry of Finance. The 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% of their total deposit liabilities as insurance premium to the NDIC. A depositor's claim is limited to maximum of N50000.00 in the event of a bank failure.

#### **3. Securities and Exchange Commission (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.

There are some vital functions which are being performed by the Commission, among which include the following:

- vii) The Commission approves and regulates mergers and acquisitions of publicly quoted companies;
- viii) The Commission also authorizes the establishment of unit trusts;



- ix) The Commission also handles;
- x) It has the responsibility of maintaining surveillance over the capital market towards enhancing its efficiency.
- xi) The Commission issues guidelines for the establishment of Stock Exchanges in different locations of the country due furtherance of the deregulation of the capital market.
- xii) The Commission releases guidelines on foreign investment in the insurance industry.

#### **4.National Insurance Commission (NAICOM)**

The specific functions of the National Insurance Commission (NAICOM) include:

- 7. Establishment of standards for the conduct of insurance business;
- 8. Protection of insurance policy holders against unfair practices by insurance companies;
- 9. Establishment of a bureau to which complaints may be submitted against insurance companies and their intermediaries by members of the public;
- 10. It ensures adequate capitalization and reserve for the operations of insurance companies in the country;
- 11. It also ensures good management and high technical expertise in the operations of insurance companies; and
- 12. The Commission ensures judicious fund placement by insurance companies towards meeting claims by their clients.

#### **5. 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 centralizes 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. The Office also keeps tab on debts being taken by government at various levels (federal, state and local government) from the capital market. These debts are in form of Federal Government Development Loan Stock, State Government Bonds and Local Government Bonds. a

#### **6. Financial Services Coordinating Committee (FSCC)**

This is a committee established to co-ordinate the activities of all regulatory institutions in the financial system. The Committee is chaired by the Federal Minister of Finance. The Committee has been established in 1998 charged with the primary responsibility to

promote safe, sound and efficient financial sector in the country. The membership of the Committee is drawn from the key regulatory and supervisory institutions in the financial system in the country. Therefore, the membership comes mainly from 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 is chaired by the Minister of Finance who co-ordinates the activities of all regulatory institutions in the financial system in the country.

## **SELF ASSESSMENT EXERCISE 2**

Discuss the various non banking institutions in the structure of the Nigerian financial system.

## **3.4 REFORMS IN THE NIGERIAN FINANCIAL SYSTEM**

There are various reforms that have bedeviled the Nigerian financial system over the years. Such spate of reforms is meant to enhance its performance in the economy. These reforms are identified and discussed below.

### **3.3.1 The 1986 Reforms**

The reform of the foreign exchange market, which until then was also controlled, began in 1986. Indeed, the financial sector reform was a component of the comprehensive economic reforms programmed, Structural Adjustment Program (SAP), which was adopted in 1986.

The introduction of the program was on the heels of the rejection of IMF loan package with its conditionalities, a decision that reflected the consensus of a nationwide debate. The main financial sector reform policies applied were deregulation of interest rates, exchange rate and access into banking business. Other reform measures included establishment of Nigeria Deposit Insurance Corporation (NDIC), strengthening the regulatory and supervisory institutions, upward review of capital market deregulation and introduction of indirect monetary policy instruments. Some distressed banks were liquidated while the Central Bank of Nigeria took over the management of others. Government share holdings in some banks were also sold to the private sector. The reform of the foreign exchange market in 1986 began with the dismantling of exchange controls and establishment of a market-based autonomous foreign exchange market. Bureau de changes' were allowed to operate from 1988 (Prosper, 2015).

### 3.3.2 The 2004 Reforms

Before the reforms started in 2004, the Nigerian banking sector was still weak and fragmented, often financing short-term arbitrage projects rather than productive private investments. The major problems of many Nigerian banks (Prosper, 2015) can be summarized below. Such problems include:

- i) Weak corporate governance, evidenced by high turnover in the Board and management staff, inaccurate reporting and non-compliance with regulatory requirements, falling ethics and de-marketing of other banks in the industry;
- ii) Late or non-publication of annual accounts that obviates the impact of market discipline in ensuring banking soundness;
- iii) Gross insider abuses, resulting in huge non-performing insider related credits;
- iv) Insolvency, as evidenced by negative capital adequacy ratios and shareholders' funds that had been completely eroded by operating losses;
- v) Weak capital base, even for those banks that have met the minimum capital requirement, which currently
- vi) stands at N1.0 billion or US\$7.53 million for existing banks and N2.0 billion or US\$15.06 million for new banks, and compared with the RM2.0 billion or US\$526.4 million in Malaysia; and
- vii) Over-dependency on public sector deposits, and neglect of small and medium class savers.

CBN assessment of 2004 shows that the overall health of the Nigerian banking system could be described as generally satisfactory but the state of some banks was unsatisfactory. CBN's ratings of all the banks, classified 62 as sound/satisfactory, 14 as marginal and 11 as unsound, while 2 of the banks did not render any returns during the period. The weaknesses of some of the ailing banks were manifested by their overdrawn positions with the CBN, high incidence of non-performing loans, capital deficiencies, weak management and poor corporate governance. In the same breadth, the insurance sector went through the process with only about 71 insurance companies sailing through. The industry is now recapitalized to the tune of over N200.0 billion from the pre-consolidation position of just N30 billion. These reforms were complemented by improved regulatory and oversight function by the Central Bank (Prosper, 2015).

The banks were brought in the process of migration from a prudential supervision system to a risk based approach within the framework of the Basel – II Accord. Various measures were similarly implemented to ensure a smooth liquidation of banks that failed to meet the capitalization requirements. Three important legislations (CBN/BOFI Act, NDIC Act and Microfinance Act) were submitted to the National Assembly to strengthen the Consolidation programme. The bills sought to improve the autonomy of the Central bank in its monetary policy decisions; comprehensive framework for addressing the case

of private depositors, who may be affected by the liquidation process; and to support the development of the microfinance industry in Nigeria (Prosper, 2015).

### **3.3.3 The 2009 Reforms**

According to Prosper (2015), some interdependent factors are believed to have led to the creation of an extremely fragile financial system that was tipped into crisis by the global financial crisis and recession. These factors include;

1. Macroeconomic instability caused by large and sudden capital inflows; major failures in corporate governance at banks;
2. Lack of investor and consumer protection; inadequate disclosure and transparency about the financial position of banks; critical gaps in regulatory framework and regulations; uneven supervision and enforcement;
3. Unstructured governance and management process at the CBN; and weaknesses in the business environment in the country.

The Central Bank of Nigeria (CBN) in response to the above problems, unveiled a ten-year reform blue print anchored on four cardinal reform programmes for the stabilization of the banking sector and the finance sector ingeneral. The main cardinal programmes for the sector's transformation (Prosper, 2015) involves

- i) Enhancing the quality of banks;
- ii) Establishing financial stability; and
- iii) Enabling healthy financial sector evolution and ensuring that financial sector contributes to the real economy.

The CBN initiated a five part programme (Prosper, 2015) to enhance the operations and quality of banks in Nigeria, which would consist of industry remedial programmes to fix the key causes of the crisis, implementation of risk based supervision, reforms to regulations and regulatory framework, enhanced provision for consumer protection and internal transformation of the CBN. It would also include the development of directional economic policy and counter-cyclical fiscal policies by the government and further development of capital markets as alternative to bank funding. Some of the potential levers for the new macro-prudential rules may include:

- a) Limiting capital market lending to a set proportion of bank's balance sheet;
- b) Prohibiting banks from using depositors' funds for proprietary trading, private equity or venture capital investment; and
- c) Adjusting capital adequacy and forward looking capital requirement driven by stress tests by the CBN.

## **SELF ASSESSMENT EXERCISE 4**

List and discuss the various reforms of the Nigerian financial system over the years.

#### **4.0 CONCLUSION**

This unit has been to expose to the various participants and their respective role in the Nigerian Financial System. Some of these participants are banking institutions such as the Central Bank of Nigeria and Federal Mortgage Bank, among others. Some other participants are the non banking institutions. These include the Federal Ministry of Finance, NDIC and NAICOM, among others. It is noted that through these various reforms, the Nigerian financial system has contributed immensely to thee conomic development of this country.

#### **5.0 SUMMARY**

The topics covered in this study unit include: structure of the Nigerian financial system; the banking institutions in Nigerian financial system; the non banking institutions in Nigerian financial system; and reforms in the Nigerian financial system

In the next study unit, we shall discuss the various types and characteristics of financial assets.

#### **6.0 TUTOR MARKED ASSIGNMEMNT**

1. Mention and discuss the various non banking institutions in the structure of the Nigerian financial system.
2. Identify and discuss the various non banking institutions in the structure of the Nigerian financial system.
4. List and discuss the various reforms of the Nigerian financial system over the years.

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## **UNIT 5: TYPES AND CHARACTERISTICS OF FINANCIAL ASSETS**

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### **1.0 INTRODUCTION**

There are peculiar instruments which can be regarded as financial assets that, just like products in ordinary markets, are tenable in the financial system. The use of such financial instruments of transactions is very critical to the existence of the financial system. This is hinged on the fact that these financial instruments are the products of operations in the financial markets and besides, the various funds raisers in the financial system make use of them to secure funds for their operational activities.

On the basis of the existence of two distinct financial markets in the financial system, the instruments of transactions are also grouped into two categories such that those of one financial market are not traded in the other. These financial instruments are therefore, traded in two separate markets such as the money market and capital market that are embedded in the financial system in all the world economies. In this study unit, the discussion is on financial assets which are financial instruments in any financial system.

## **2.0 OBJECTIVES**

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

- i) explain the meaning of financial assets
- ii) identify and discuss various types of financial assets
- iii) mention and explain peculiar characteristics of financial assets

## **3.0 MAIN CONTENT**

### **3.1 DEFINITION OF FINANCIAL ASSETS**

The financial assets are the financial instruments that are traded in the financial markets such as money market and capital market. These financial assets constitute the documentary evidence through the funds raise secure money from the investors and savers who have surplus to part with for the use of corporate entities and government. The financial assets are inherently products of transactions in both the money market and the capital market. Such markets are well established in some economies while they are just being entrenched in some other economies.

The financial assets as products of transactions in the financial markets can be denominated in various currencies particularly the local currencies of various economies around the world. There are those financial instruments that are traded across international boundaries in some countries especially in highly developed capital markets in US, UK, Japan, France, and South Africa, just to mention but a few. Such financial assets are usually denominated mainly in American dollars and any other international money that is acceptable around the world.

Financial assets are normally issued in units such that the number of subscribers can be in threshold of thousands. For instance, a State Government Bond can be a total sum of N30 billion but in the denomination of N1,000 per unit of subscription. Therefore, the total amount of the amount has to be subscribed by many if not numerous investors at the end of the subscription period. This arrangement of raising funds through the financial markets is applicable to all financial instruments (e.g., Federal Government Loan Stock, shares, debentures, treasury bills, treasury certificates, etc) being used in such markets.

### **SELF-ASSESSMENT EXERCISE 1**

Explain the term Financial Asset as it relates to the financial markets.

### **3.2 TYPES OF FINANCIAL ASSETS**



The financial assets can be grouped into two main categories such as debt instruments and equity instruments. These are explained below.

### **3.2.1 Debt Instruments**

These are the financial instruments that are normally used by corporate entities and government to raise funds on the basis of debt obligations. This implies that such financial instruments are repayable by the organizations issuing them for raising funds from the financial markets from their operations.

The holders, therefore, are entitled to the funds at maturity dates in addition to the regular income accruing to them on them on the basis of interest payments by the corporate entities and government. Some of such instruments can be redeemed before their maturity dates as agreed to by the parties involved in the transactions. Such financial assets or instruments are also negotiable, being capable of being traded for cash before their maturity date.

The various debt instruments being used for financial transactions in money market include the following:

- i) Treasury Bills;
- ii) Treasury Certificates;
- iii) Trade Bills;
- iv) Commercial Papers; and
- v) Certificate of Deposits.

The above list is not exhaustive since there are new ones which are being developed and there are various ones that are peculiar to some specific economies that may not be available in some other economies.

The various debt instruments being used for financial transactions in capital market include the following:

- i) Development Loan Stocks;
- ii) Debenture Stocks;
- iii) Bonds;
- iv) Mortgage Loan Stocks;
- v) Leases;
- vi) Preference Shares; and
- vii) Hire Purchase Contracts.

The above list is not exhaustive since there are variations in various world economies while there are new ones that are being developed. There are various ones that are peculiar to some specific economies that may not be available in some other economies.

## **SELF-ASSESSMENT EXERCISE 2**

Differentiate between debt instruments of the money market and debt instruments of the capital market.

### **3.2.2 Equity Instruments**

There are some financial instruments that are being used in the financial markets to raise equity funds by corporate entities. Such financial instruments are essentially Ordinary or Common Shares being used to raise funds to enhance the capital base of corporate organizations.

## **3.3 CHARACTERISTICS OF FINANCIAL ASSETS**

There are peculiar characteristics that are inherent in financial assets that are normally used partly to determine their pricing in the financial markets. These characteristics are identified and discussed below.

### **3.3.1 Moneyness**

The moneyness of the financial assets implies that they are easily convertible to cash within a defined time and determinable value. The cost of transactions involved in securing funds from them before the maturity date can be likened to agency cost besides the cost of discounting some of them, which reduces their face value. Therefore, these financial instruments are regarded as near money because of the ease with which they can be traded for cash. Examples are Treasury bills, Treasury certificates, Trade bills, Commercial papers, and Certificate of Deposits, among others.

### **3.3.2 Divisibility & Denomination**

The financial assets are usually made out in denominations depending on the face value that the corporate organizations and institutions that are using them to raise funds from the financial markets. The divisibility of such near money refers to the minimum monetary value in which a financial asset can be liquidated or exchanged for money by the holder.

Divisibility for financial assets is imperative so as to enable both suppliers and borrowers to understand the magnitude of funds involved in each of them; the borrowers have certain amount to source and the suppliers will like to know the amount that is required of him to part with for the transaction. It is also necessary so that a limit can be set for the minimum amount of subscription for each instrument and the overall amount of subscription that may accrue to a particular investor. For instance, many bonds can be denominated like N1,000 denomination while that of certificate of deposits are denominated from N500,000.

### **3.3.3 Reversibility**

The financial assets are highly reversible in the sense that they are like deposits in accounts of customers with the banks. This implies that the cost of investing in the financial assets and getting them back into cash is negligible. Hence reversibility of financial assets is often regarded as turnaround cost or roundtrip cost.

The most relevant part of the roundtrip cost as associated with financial assets constitutes what is known as the 'bid-ask spread' in which commissions cost of delivery an asset is entrenched. In the well-organized financial market there are market makers who take responsibility of assuming risk in associated with the financial assets while making the market or carrying inventory of financial assets.

Therefore, the spread being charged by the market makers varies in line with financial assets that are traded. Some financial assets carry less risk than others; for instance, marketable securities that can easily be converted into liquid cash with little or no hassles because they are more liquid than other financial assets. The risk involved in marketable securities or mortgage loan stock cannot be comparable with risk inherent in bond issue of a fledgling company.

The risk involved in market making is related to market forces that are twofold such as: Variability of the price; and Thickness of the market.

#### **a) Variability of Price of financial asset**

This is determined by some measure of dispersion in the price. It implies that the greater the variability in price, the greater the probability that the market maker may loose in the bargain. For instance, a speculative stock such as shares will be fraught with much larger short-run variations. On the other hand, Treasury bills, which government securities (or gilt-edged securities) exhibit stable price with less short-run variation.

#### **b) Thickness of the Market for financial asset**

The thickness of the market implies the frequency of transactions on a given financial asset. A thin market reflects a financial asset that has few trades on a regular or continuous basis, hence the greater the order flows on it the shorter the time that the asset will be held in the inventory of market makers. Therefore, such financial asset will exhibit smaller probability of an unfavourable price movement while it is in the inventory of market makers.

A thick market is associated with market where frequent transaction on financial assets is being exhibited and this varies from market to market. Hence a particular market for a financial asset such as shares may be thick while in another such financial asset may be thin. For instance, the shares of blue-chip firms will exhibit thickness in transactions while the shares of small companies may exhibit thinness in transactions in a given market situation.

### **SELF-ASSESSMENT EXERCISE 3**

Differentiate between Variability of Price and Thickness of the Market for financial assets.

#### **3.3.4 Cash Flow**

This refers to the return that an investor will derive from holding a financial asset, which invariably depends on all the cash distributions that the asset will pay holders. This is expressed in terms of the dividend on shares or coupon yield payments that are associated with bonds. The return on investment in a financial asset is also affected by the repayment of the principal amount for a debt instrument and any expected price variation of the stock.

In calculation of expected returns on a financial asset, factors that should be considered include non-cash payments in form of stock dividend yield and options to purchase additional stock or the distribution of other securities that must be factored in the consideration. The issue of inflation implies that there is difference between normal effective return and real effective return on financial assets. Therefore, the net real return on financial assets is the amount of cash returns that are accruable after adjusting the nominal returns against inflation.

#### **3.3.5 Maturity Period**

In financial parlance, the maturity period refers to the length of time within which the corporate entity or institution that employs a financial instrument to raise funds will use the funds before its payment back to the holders of such instrument. For instance, a bond can be held by a corporate entity for a period of thirty (30) years while that of government can extend to a period of ninety-nine (99) years before their repayment to the holders.

There are some financial instruments being traded in the financial markets that may not reach the stated maturity dates before they are terminated by the corporate entities. There are reasons that may be responsible for such situation which include the following:

- i) Bankruptcy:-** a situation in which the company is being unable to meet its external financial obligations and therefore, declared bankrupt;
- ii) Reorganization:-** a situation in which the company is restructuring its ownership structure and operations; and
- iii) Call Provision:-** the financial instrument being associated with call provision.

The case of call provision implies that the company as the debtor or user of the funds takes responsibility of setting aside sinking funds with which to redeem the instruments eventually. The sinking fund is normally made as one of the contractual obligations that are established in the agreement or indenture regulating the usage of the funds from the financial instrument.

### **SELF-ASSESSMENT EXERCISE 3**

What are the reasons that may be responsible for terminating financial assets by corporate entities before their stated maturity dates.

#### **3.3.6 Convertibility**

This characteristic implies that a financial asset or instrument can be converted into another class of asset which will still be held by the corporate entity has original used to raise funds for its operations. The conversion can take a form of bond being converted to bond, preference shares being converted to equity shares, and a company bond being converted into equity shares of the company.

The opportunity for convertibility of financial instruments into another financial assets has to be entrenched in the covenant which has been written to guide the contractual agreement on the instrument or to regulate the behaviour of the company using the funds from the instruments. Nevertheless, such a provision can be negotiated in the course of the usage of the funds by a company especially when the holders discover that the company is manipulating its operational and financial records to shortchange them.

#### **3.3.7 Currency**

Financial assets are normally denominated in currencies of the various countries around the world. This implies financial assets of the Nigerian financial system are denominated in Naira such as Federal Government Loan Stock, Treasury Bills, Treasury Certificate, Shares and Corporate and State Government Bonds. Those financial assets in Japan are denominated in Yen, those in the United States of America are in Dollars, those in United Kingdom are in Pounds Sterling while those in China are in Yuan, etc.

You have also learned from the initial section of this study unit that financial assets as products of transactions in the financial markets can be denominated in various currencies particularly the local currencies of various economies around the world. Nevertheless, there are those financial instruments that are traded across international boundaries in some countries especially in highly developed capital markets in US, UK, Japan, France, and South Africa, just to mention but a few. Such financial assets are

usually denominated mainly in American dollars and any other international money that is acceptable around the world.

Furthermore, it is important for investors to know the currency in which certain financial assets are denominated when buy them. For instance, the recent ECO Bank shares were denominated in US dollars when they were offered to the public for subscription. These shares were floated across international boundaries many countries in Africa. Therefore, the use of an international currency such as the US dollars made it easier for the bank to handle the transactions in the stock seamlessly. Nevertheless, subscribers were made to pay the equivalent of their total amount of subscription in their local currencies. The dividends for these shares are also being paid in US dollars.

Dual currency securities may be issued in some instances. For instance, the EURO Bonds are issued in dual currencies for ease of transactions by multiple subscriptions by various investors around the world. Therefore, it is the policy on EURO Bonds to pay interest in one currency while the principal repayment is effected in another currency.

### **3.3.8 Liquidity**

You have learned from above that one of the main characteristics of financial assets is the moneyness of such instruments which implies that they are easily convertible to cash within a defined period and determinable value. The cost of transactions involved in securing funds from them before the maturity date can be likened to agency cost besides the cost of discounting some of them, which reduces their face value.

Hence, these financial instruments are regarded as near money because they are highly liquid in terms of the ease with which they can be traded for cash. Good examples of highly liquid financial instruments include Treasury bills, Treasury certificates, Certificate of Deposits, Bills of Exchange, and shares of blue chip companies, e.g., Shares of Cadbury, First Bank, Guaranty Trust Bank, etc.

However, there are some financial instruments that cannot be easily converted to cash whenever the holders need money. Therefore, they are illiquid because the holders may have to retain them till they are matured; alternatively they can only trade them for very insignificant value in capital markets where there are jobbers that may be willing to carry them in their stock of securities. Presently there are no jobbers operating in the Nigerian Stock Exchange, and hence the stock brokers in the Exchange are usually not willing to trade in financial instruments of weak corporate entities.

### **3.3.9 Predictable Returns**

The return on financial assets must be predictable for the purpose of their being patronized by investors. For instance, the investors should be able to know the percentage of interest that are attached to certain debt instruments before they will be prepared to stake their funds on them. This is because performance of a company cannot be taken for

granted due to the mere fact that top management and the boards of directors are known to be manipulating the accounting records of their companies these days.

This is more reason why investors are always very skeptical in patronizing financial instruments of some corporate entities due to their antecedents in manipulating their accounting records. The cases of Cadbury in Nigeria and Enron in the US are classical testimonies to the unwholesome accounting practices in the operations of companies around the world.

However, the returns on bonds, development loan stocks, and preference shares are determinable so that the investors are aware about the expected returns on their investment. There other government securities such as Treasury bills and Treasury certificates which are traded in money market that command fixed returns. The apex bank has the responsibility in their issuance and also their repayment as well as the payment of their returns to the subscribers. Therefore, State government bonds, Federal Government development loan stocks, Treasury bills and Treasury certificates are regarded as gilt-edged securities because their returns as well as principal amount of investment in these securities must be paid as at when due for settlement.

The issue of unpredictability of future returns on some securities such as equity shares results from volatility in earnings by the companies in their operations. However, the unpredictability to future returns can be measured on how it relates to the level of volatility of a given financial asset. The returns on equity shares like dividends are the residual payments from the earnings of corporations. Nevertheless, the attraction in these shares is the possibility of capital appreciation in their value but subject to the performance of their corporations and capital market operational forces.

### **3.3.10 Tax Status of Returns**

The returns on various financial assets are subject to tax status because they are taxable earnings. The tax authorities are interested in collection of taxes on earnings from financial assets as securities which are regarded as incomes for investors. However, the tax status on financial assets varies from one economy to another.

The rate of such taxes on financial assets is also subject to variation from time to time depending on the interest of the government which must be adhered to by the tax authorities. The tax status on financial assets also differs from one type of security to another depending on the nature of the issuing companies or institutions such as Federal, State, or local government.

## **SELF-ASSESSMENT EXERCISE 5**

Mention and explain the various characteristics that are inherent in financial instruments.

## **4.0 CONCLUSION**

The discussion in this unit, as you have observed, is indicative of the fact that there exists some financial instruments regarded as financial assets that are involved in transactions in the financial markets, which comprise money market and capital market.

Accordingly, the financial assets are in two categories for the two financial markets. Therefore, from the discussion, we have identified Treasury Bills, Treasury Certificates, Trade Bills, Commercial Papers, and Certificate of Deposits as financial instruments for the money market. Those of the capital market from the discussion include Development Loan Stocks, Debenture Stocks, Bonds, Mortgage Loan Stocks, Leases, Preference Shares, and Hire Purchase Contracts. The peculiar characteristics of these financial assets, as we have enumerated and discussed in this study unit, include moneyness, divisibility & denomination, reversibility, cash flow, maturity, convertibility, currency, liquidity, predictable returns, and tax status of the returns.

## **5.0 SUMMARY**

The topics that we have discussed in this study unit include the exposition on the term financial assets, identifying the types of financial assets (such as debt instruments and equity instruments) traded in money and capital markets and lastly mentioning and explaining the various characteristics of financial assets.

In the next study, you will be taken through discussion on the financial market & instruments.

## **6.0 TUTOR MARKED ASSIGNMENT**

Mention and discuss the main characteristics of the financial assets being traded in financial markets.

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## **UNIT 6: FINANCIAL MARKET & INSTRUMENTS**

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### **1.0 INTRODUCTION**

There are financial instruments that can be issued and used to run the operations of a corporate entity. Such instruments are traded in the financial markets. This implies that financial market refers to the type of market that is being used to deal in financial instruments. Some of these instruments are used for raising short term funds before being repaid back to the investors. There are other ones that are issued and used to raise funds for a long term period. The transactions on the former group of instruments take place in the money market while the transactions on the latter group of instruments take place in the capital market. In this study unit, therefore, we shall discuss all these financial instruments.

### **2.0 OBJECTIVES**

After studying this unit, you should be able to:

- Explain financial market
- List and explain money market instruments
- Mention and discuss capital market instruments

### **3.0 MAIN CONTENT**

#### **3.1 CONCEPTUALIZATION OF FINANCIAL MARKET**

The financial market exists for the purpose of mobilization and intermediation of fund. This implies that through the financial market, funds are transmitted from the surplus sector of the economy to the deficit unit of the economy. The funds as mobilized in this market might be a short term basis or a long term basis, depending on the nature of instrument involved and the method of transaction.

The operations of the financial market involve commercial banks, merchant banks, the development banks, finance houses and individuals such as stock brokers and investors. The Financial markets are generally categorized into two namely: the money market for raising short term funds and the Capital market for raising long term funds.

The maturity of financial instruments that are traded differentiates markets determines the nature of the market segments. If the securities traded are short-term instruments, the market is called a money market. When maturities exceed one (1) year, the market is considered a capital market. Another differentiation is whether the securities are new (offered in the primary market) or already existing (traded in the secondary market). When bills are sold to the public for the first time, the sale takes place in a primary money market. Investors buy or sell existing bills through dealers and these transactions occur in secondary money markets. A counterpart in the capital market would be an initial public offering of common stock; a primary capital market transaction. The subsequent exchange of stock through stockbrokers occurs in the secondary capital market.

### **SELF ASSESSMENT EXERCISE 1**

Explain the term Financial Market.

### **3.1 MONEY MARKET AND INSTRUMENTS**

The money market is the financial market in which financial instruments are traded with maturity of up to one (1) year. Money markets enable market participants to borrow or lend liquid assets and thereby meet needs for cash or investment of cash. The money market is characterized by availability of liquid assets. These are assets that may be converted into cash quickly, without significant loss of value. Investing excess liquid assets, that is, lending, reduces the opportunity cost of holding cash or cash equivalents. Borrowing short-term funds eliminates disruption that would be caused by temporary cash flow deficits.

Trading in such instruments also involves opportunity cost in respect of holding cash. The opportunity cost refers to that rate of return that could be earned if the next best alternative to cash were held by an investor, that is, that rate of return that is forgone when an investor holds cash. The federal government uses the money market to implement certain phases of monetary policy such as adjustments to the money supply. It does this through the Central Bank which establishes government objectives with respect to the money supply, interest rates, and credit availability.

The most widely traded money market instruments include Treasury bills, Repurchase agreements, Negotiable certificates of deposit, Commercial paper, and Bankers acceptances. Among all these instruments, the last three are traded in physical form. The

remaining instruments are kept track of in book-entry form (electronic record keeping) with written confirmations.

Money market instruments have certain qualities that make them useful for wholesale (large) transactions such as follows:

**i) Liquidity**

This describes the ability to convert an asset into cash with relative ease while not significantly depressing its price in the process. It is perhaps the most important quality.

**ii) Default risk**

This is the risk of non-payment of principal or interest, which must be minimal in order for the security to be considered a safe haven for excess liquidity.

**iii) Short time to maturity**

This is given that adverse price movements attributable to interest rate changes are smaller for shorter-term assets, which helps ensure that interest rate changes will not affect the security's market value materially.

Money market instruments include the following:

**1. Treasury Securities**

Treasury securities are obligations of the government. They are issued to cover government budget deficits (excess of expenditures over revenues) and to refinance maturing government debt. The most common are bills, notes, and bonds. Treasury bills have original maturities of 1 year or less, while notes are for 1 to 10 years, and bonds have maturities greater than 10 years.

**2. Treasury bills (T-bills):**

Treasury securities are short-term obligations of the government with original maturities of 1 year or less. Treasury bills and other Treasury securities (with less than 1 year of remaining life) are the most important instruments in money markets.

**3. Federal Funds**

Federal funds are not formal securities. They are immediately available funds that are loaned or borrowed among financial institutions. Such funds are borrowed between financial institutions, usually for a period of 1 day -overnight.

**4. Call money:**

These are loaned funds that are repayable upon the request of either party. All transactions go through one of the licensed companies such as in Japanese. The term of a call money loan can range from a half-day to 7 days. Half-day money is borrowed at 9:00 A.M. and repaid at 1:00 P.M. or borrowed at 1:00 P.M. and repaid at 3:00 P.M.

Unconditional money is repaid the following day. Fixed maturity money is repaid in 2 to 7 days.

### **5. Overnight call Money and other short-term deposits**

These are traded in inter-bank market, an aspect of the money market (short-term exchange of liquid assets) for banks with no intermediary. Overnight call money and other short-term deposits are the common vehicles, and collateral is rarely required.

Some discount houses, or instance, in the United Kingdom have traditionally served to provide short-term credit in the U.K. banking system by entering into call money arrangements with individual banks. Banks with surplus funds lent them to discount houses, and banks in need of liquidity called in their discount house loans. More recently, however, a parallel set of money markets has developed.

### **6. Repurchase agreement (repo):**

This is an agreement between buyer and seller in the sale of securities to reverse the transaction in the future at a specified date and price. These transactions commonly involve Treasury securities, but they may also involve government agency securities. Repurchase agreements are typically as short term in nature as federal funds (or call money). Overnight, term, or continuing basis repurchase agreements are all negotiated. Unlike collateralized federal funds transactions, in which title to the securities does not change, in a repurchase agreement title does transfer to the purchaser.

### **7. Government agency securities:**

Securities issued by an agency of the federal government particularly in the U.S. with implicit backing of the federal government. Repurchase agreements are essentially collateralized loans. A financial institution with large holdings of Treasury securities sells some portion of them for a predetermined period of time to obtain liquidity and promises to repurchase the securities at the end of that period. On the other side of the transaction is an institution with excess liquidity. The amount of the transaction is relatively large, and the interest rate is below the federal funds rate. The lower rate is justified, because the transaction is collateralized by government securities.

### **8. Negotiable Certificates of Deposit**

This is a financial instrument issued by a bank documenting a deposit, with principal and interest repayable to the bearer at a specified future date. The negotiable certificate of deposit is a bearer instrument and a term deposit but not demand deposit. Overtime, banks were able to increase the rate paid on negotiable CDs to attract more deposits as the need arose. This innovation brought widespread adoption of bank liability management, which enables banks to attract funds by offering higher interest rates and thereby changing their deposit base.

### **9. Banker's acceptance:**

This is a time draft or postdated instrument payable to a seller of goods, with payment guaranteed by a bank. In these instruments, the credit of the bank substitutes for the credit of the purchaser, and the seller is ensured payment. Further, unlike an open trade credit arrangement (in which the seller provides credit for a period of time), the seller need not wait for payment. A banker's acceptance is immediately negotiable; the seller can either receive discounted payment at the accepting bank or hold the draft until the date of maturity. Banker's acceptances are particularly important in international trade with Maturities are 1, 3, or 6 months. Average maturity is 3 months.

### **SELF ASSESSMENT EXERCISE 2**

Mention and explain instruments of money market.

### **3.3 CAPITAL MARKET AND INSTRUMENTS**

These are markets in which financial instruments with maturities greater than 1 year are bought and sold. Corporations secure financing through capital markets by selling long-term claims on their firms, whether in the form of bonds (liabilities) or stock (equity). Governments go to capital markets for operating funds, and households use them for residential mortgage financing. This describes the capital market instruments that are issued and traded within national boundaries.

#### **1. Ordinary Shares**

The ordinary share is a unit of capital ownership in a firm in terms of equity investment by the shareholders. The ordinary shares do attract returns at the end of the trading period (normally 12 months). It accords its holders right of ownership in the asset of the firm. The ordinary shareholder can vote in the AGM (Annual General Meeting) of the firm. Currently in a public company no single individual is allowed to own more than 10% of the total issued shares of the firm. The ordinary share is assets (a financial asset) that are traded at will. Normally dividends can be paid as return to holders of ordinary shares. There exist also the preference shares.

#### **2. Preference Shares**

The preference shares are debt instruments in a firm. The holders of preference share are not owners of the firm since they cannot vote in the AGM of their firm. Preference share attract fixed dividend or interest e.g. 10% preference share of N100,000 will attract a finance interest of N10,000. However, the preference share is also regarded as shares in firm depending on the nature of the preference share. There are several forms of preference shares. There is the cumulative preference share, participating preference share, convertible preference share, redeemable preference shares etc.

### **3. Debentures**

These are long term debt securities normally offered for public subscription. They generally attract a fixed rate of return called interest. Most times Debentures are securities in a particular asset of the firm in such case tagged secured debenture. An unsecured debenture is one not secured on any particular asset of the firm. Debentures are mostly sold either at premium or at discount.

### **4. Development Loan Stock**

These are financial instruments that allow the government to borrow money for a long period of time up to 25 years, bearing interest and capital repayment, thereon. The principal amount can only be repaid back to the holder after the maturity date but the interest is normally on periodic basis as contained in the prospectus of the offer. The instrument is normally issued by the central bank on behalf of the government.

### **5. Bonds**

Bonds are sometimes issued with stock warrants attached. Warrants are options to purchase common stock at a specified price up to a specified date. Should the bondholder decide to exercise the option and purchase stock, it is not necessary to surrender the underlying bond. Again, bondholders will exercise their warrants only if the market value of the stock exceeds the specified (exercise) price of the warrant. Bonds are an important source of capital for the federal government, states and municipalities, and private corporations. However, private-sector equity financing in the form of common stock has historically been a more important source of financing.

Municipal bonds include all debt instruments issued by local, county, and state governments. Issuers use proceeds from the sale of municipal bonds to finance public utilities, school construction, roads, transportation systems, and industrial development. An appealing feature is that municipal bond interest payments to the holder are exempt from federal income taxation.

### **6. Mortgages**

Mortgages are long-term loans that are secured by real property. They are long-term liabilities collateralized by real property. Commonly, monthly payments are made that fully repay both principal and interest over the term of the loan. Mortgages are issued to purchase real estate. Commercial mortgages are used to finance real estate for business purposes, such as office buildings and shopping malls. These mortgages have consistently grown faster than multifamily-dwelling mortgages and even faster than home mortgages.

### **Self-Assessment Exercise 3**

List and explain the various instruments being used to raise funds through the operations of capital market in Nigeria.

## **4.0 CONCLUSION**

The Financial Market exists for the purpose of mobilization of funds, which are transmitted from the surplus sector of the economy to the deficit unit of the economy. The funds as mobilized in this market might be a short term basis or a long term basis, depending on the nature of instrument involved and the method of transaction. The financial market is divided into two distinct parts such as capital market and money market. These distinct markets have their peculiar financial instruments, each group reflecting peculiar maturity dates. Such financial instruments are not just for the use of the corporate entities but are also available for government use in raising funds for operations.

## **5.0 SUMMARY**

In this study unit, we have discussed topics such as:

- Conceptualization of Financial Market;
- Money Market and Instruments; and
- Capital Market and Instruments.

In the next study unit, we shall take you through discuss on capital market.

## **6.0 TUTOR MARKED ASSIGNMENT**

1. Mention and explain instruments of money market.
2. List and explain the various instruments being used to raise funds through the capital market.

## **7.0 REFERENCES/FURTHER READINGS**

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## **UNIT 7: CAPITAL MARKET**

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### **1.0 INTRODUCTION**

The capital market is another arm one of the financial system. This compliments the money market in providing the needed channel through which the corporate entities and the government can raise funds to finance their operations for many years. The capital market provides funds for long-term use by the government and corporate entities; the money market provides the government and corporate entities funds for short-term use in their operations. Therefore, the capital market plays vital role in the capital formation in the economy in relation to its operations which channel funds from institutional investors for the use of the corporate entities and the government in undertaking capital projects. In this study, therefore, the nature of capital market, its operations, and financial instruments being traded in it, among others, constitute the subject of discussion.

### **2.0 OBJECTIVES**

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

- explain the nature of capital market

- discuss the operations of capital market
- differentiate between primary market and secondary market
- list and explain the capital market instruments
- mention and explain capital market securities
- identify and discuss the participants of capital market

### **3.0 MAIN CONTENT**

#### **3.1 MEANING AND OPERATIONS OF A CAPITAL MARKET**

##### **3.1.1 Meaning of Capital Market**

Capital market refers to a market where the financial institutions mobilize the savings of the people and lend them for long term, period for raising new capital in country. Capital Market, in other words, refers to the long term borrowing and lending of capital funds. In another perspective, capital market is a market in which financial securities such as stocks, bonds and government loan instrument are bought and sold.

Corporate entities and governments therefore, use capital market to raise funds for their operations and programmes respectively. For example, a company may float an initial public offer while a government may issue bond or development loan stock to raise funds for new projects or ongoing public programmes

Investors purchase securities (stocks or bonds) in the capital markets in order to extract some returns or earn profits on their investment. Capital markets include primary markets, for the initial public offers of securities that are placed with investors through issuing houses and underwriters, and secondary markets, in which all subsequent trading on existing securities takes place.

There are financial regulators and agencies such as stock exchange and Securities and Exchange Commission in the secondary markets that regulate their operations.

In other words, capital markets refer to financial markets for the buying and selling of long-term debt- or equity -backed securities. As a financial market, the market serves as conduit for facilitating the wealth of savers to those who need for long-term productive uses, such as companies or governments that engage in long-term investments.

Transactions in modern capital markets are almost invariably carried out based on computer-operated electronic trading systems; most can be accessed only by entities within the financial sector or the treasury departments of governments and corporations, but some can be accessed directly by the public.

There are many thousands of such systems, most only serving only small parts of the overall capital markets. Entities hosting the systems include stock exchanges, investment banks, and government departments. Physically the systems are hosted all over the world, though they tend to be concentrated in financial hubs or centres such as Lagos, London, New York, and Hong Kong, among others

There is an important division between the stock markets mainly for equity securities, in form of shares, which investors purchase for the purpose of having ownership interest in the companies that float such securities. The other is the bond markets which cater for creditors when they subscribe to the securities floated by companies for raising funds on the basis of debts that have maturity dates before they are repaid back to the holders.

### **SELF-ASSESSMENT EXERCISE 1**

Discuss the nature of the capital market in any economy.

#### **3.1.2 Operations of a Capital Market**

In respect of the operations of the capital market, there are different players that are active in the secondary segment of the market. Such players include the following.

##### **i) Regular individual investors**

These participants in the market account for a small proportion of trading, though their share still plays some significant role in the market. A few wealthy individuals who could afford an account with a broker, but transactions are now much cheaper and accessible over the internet.

##### **ii) Traders**

These are the jobbers and stock brokers. The jobbers in highly developed capital markets operate by buying securities with the intention of making profits. They do not transact business on behalf of any investors but behave like real traders who engage in buying and selling of capital market securities. The profit earned by the jobbers is called the jobbers turn. On the other hand, the stock brokers transact business on behalf of investors who pay commission on volume of transactions done for them by the stockbrokers.

There are numerous small traders who can buy and sell securities on the secondary markets using platforms provided by brokers which are accessible through electronics means such as with web browsers. When such an individual trades on the capital markets, it will often involve a two stage transaction.

First they place an order with their broker, on the strength of which the broker executes the trade. If the trade can be done on an exchange, the process will often be fully automated. If a dealer needs to manually intervene, this will often mean a larger fee.

### **iii) Investment banks**

Traders in investment banks will often make deals on their bank's behalf, as well as executing trades for their clients. Investment banks will often have a department called *capital markets*. Staff in such department try to keep abreast of the various opportunities in both the primary and secondary markets, and will advise major clients accordingly.

### **iv) Pension and Sovereign Wealth Funds**

These players tend to have the largest holdings, though they tend to buy only the highest grade securities which are safest types of bonds and shares, and often don't trade all that frequently.

### **v) Hedge funds**

These are increasingly making most of the short-term trades in large sections of the secondary markets of advanced economies such as the UK and US stock exchanges, which is making it harder for them to maintain their historically high returns, as they are increasingly finding themselves trading with each other rather than with less sophisticated investors.

## **SELF-ASSESSMENT EXERCISE 2**

Mention and explain the major players in the capital market.

## **3.2 PRIMARY MARKET**

### **3.2.1 OPERATIONS IN PRIMARY MARKET**

The capital market is operated in two main segments such as the primary market and the secondary market. The primary market is used for transactions on new stocks or bond issues, which are handled by issuing houses and underwriters.

The main entities seeking to raise long-term funds on the primary capital markets are governments (which may be local, state or federal) and business enterprises (companies). Governments tend to issue only bonds, whereas companies often issue either equity or bonds.

The main entities purchasing the bonds or stock include pension funds, hedge funds, sovereign wealth funds, and less commonly wealthy individuals and investment banks trading on their own behalf.

### **3.2.2 CHARACTERISTICS OF PRIMARY MARKET**

The characteristics of a primary market include the following.

This is the market for new long term capital. The primary market is the market where the securities are sold for the first time. Therefore it is also called New Issue Market (NIM).

In a primary issue, the securities are issued by the company directly to investors. The company receives the money and issue new security certificates to the investors. Primary issues are used by companies for the purpose of setting up new business or for expanding or modernizing the existing business.

The primary market performs the crucial function of facilitating capital formation in the economy. The new issue market does not include certain other sources of new long term external finance, such as loans from financial institutions. Borrowers in the new issue market may be raising capital for converting private capital into public capital; this is known as 'going public'

### **SELF-ASSESSMENT EXERCISE 3**

What are the characteristics of the primary market.

#### **3.2.3 Transactions on Government Securities**

When a government wants to raise long term finance it will often sell bonds to the capital markets. In the 20th and early 21st century, many governments would use investment banks to organize the sale of their bonds. The leading bank would underwrite the bonds, and would often head up a syndicate of brokers, some of whom might be based in other investment banks. The syndicate would then sell to various investors.

For developing countries, a multilateral development bank would sometimes provide an additional layer of underwriting, resulting in risk being shared between the investment bank(s), the multilateral organization, and the end investors. However, in recent years, it has been increasingly common for governments of the larger nations to bypass investment banks by making their bonds directly available for purchase over the Internet. Many governments now sell most of their bonds by computerized auction. Typically

Large volumes of bonds are put up for sale in one tranche and a government may only, through the apex bank, hold a small number of auctions each year. Some governments will also sell a continuous stream of bonds through other channels. The biggest single seller of debt is the US Government; there are usually several transactions for such sales every second, which corresponds to the continuous updating of the US real time debt clock.

#### **3.2.4 Transactions on Corporate Securities**

When a company wants to raise money for long-term investment, one of its first decisions is whether to do so by issuing bonds or shares. If it chooses shares, it avoids increasing its debt, and in some cases the new shareholders may also provide non monetary help, such as expertise or useful contacts.

On the other hand, a new issue of shares can dilute the ownership rights of the existing shareholders, and if they gain a controlling interest, the new shareholders may even replace senior managers. From an investor's point of view, shares offer the potential for higher returns and capital gains if the company does well.

Conversely, bonds are safer if the company does poorly, as they are less prone to severe falls in price, and in the event of bankruptcy, bond owners are usually paid before shareholders.

When a company raises finance from the primary market, the process is more likely to involve face-to-face meetings than other capital market transactions.

When they choose to issue bonds or shares, Companies will typically enlist the services of an investment bank to mediate between themselves and the market. A team from the investment bank often meets with the company's senior managers to ensure their plans are sound.

The bank then acts as an underwriter, and will arrange for a network of brokers to sell the bonds or shares to investors. This second stage is usually done mostly through computerized systems, though brokers will often phone up their favored clients to advise them of the opportunity.

Companies can avoid paying fees to investment banks by using a direct public offering, though this is not a common practice as it incurs other legal costs and can take up considerable management time.

#### **SELF-ASSESSMENT EXERCISE 4**

Differentiate between the nature of transactions on government securities and that of the corporate securities.

### **3.2.5 METHODS OF ISSUING NEW SECURITIES**

The major issuers of securities particularly the shares are the corporate entities. Government bonds are commonly referred to as "gilt-edged" securities. Intermediaries such as brokers and banks (especially merchant banks) are often used by borrowers to administer the issuing of new bonds.

Bonds can be issued in the primary market using several different methods. Both equities and bonds can be issued through the following ways:

#### **1. Public Subscription**

This presupposes that a prospectus is issued. The document contains details of the company issuing the security such as bond or shares, and of the securities themselves.

Members of the public can then subscribe to the security, and the borrower or an intermediary on behalf of the borrower will allocate the securities to subscribers on issue date by means of a certain process.

## **2. Private Placing**

The securities (e.g., shares or bonds) can also be issued through private placing. This method is used when the borrower (or an intermediary on behalf of the borrower) places bonds or shares with certain investors selected by the borrower. The selected investor would then receive a certain amount of bonds or shares at issue date and pay the borrower the issue price for the bonds received.

## **3. Tender Method**

A third method used to issue bonds or shares is known as the "tender" method. The borrower or intermediary will issue a media statement that bonds or shares will be issued in the market on a certain date.

The details of the bonds or shares and the capitalisation of the issue (total nominal amount to be issued) will also be communicated. Interested parties are then invited to tender before a certain date for these bonds. Tenders from interested parties would normally consist of the nominal amount plus the percentage of the nominal amount that the interested party is willing to pay for the shares or bonds at issue. The company or borrower usually allots the shares or bonds in order of highest tenders first, but it is in his power to decide who will receive the securities at issue date.

## **4. Tap Method**

Another method that is used to issue new instruments is known as the "tap" method, whereby not all the shares or bonds are allocated at the first issue through any of the above three methods. If, for instance, the company or borrower wants to issue N1,000 million worth of shares or bonds he can choose to issue only N600 million at the first issue. The borrower or intermediary then starts creating a secondary market for these instruments by buying and selling the issued instruments in the secondary market. This process, where one party buys and sells the same instrument in the market, is known as market making.

The market maker thus has a bid (to buy) and an offer (to sell) in the market for the same instrument, trying to create an active and liquid market in this instrument. The "tap" method is then used by the borrower or intermediary, whereby more instruments are sold in the market than that bought back. By using this method, the amount of the issue is increased, often without the market realising it.



This method can also be used in inverse form to decrease the total outstanding loan. The ultimate user of the funds from the securities in the capital market can use the tap method, because the company is allowed to trade in its own securities. This is possible in the equities market because a company is allowed to buy its own shares.

## **SELF-ASSESSMENT EXERCISE 5**

Mention and explain the methods of issuing new securities.

### **3.3. SECONDARY MARKET**

In the secondary markets, existing securities are sold and bought among investors or traders, usually on a stock exchange, characterized by over-the counter, or operated electronically in highly developed economies. The existence of secondary markets increases the willingness of investors in primary markets, as they know they are likely to be able to swiftly cash out their investments if the need arises.

Transactions in secondary markets: Most capital market transactions are executed electronically, but in less developed stock exchanges sometimes traders are directly involved and sometimes unattended computer systems in highly developed stock exchanges execute the transactions, such as in algorithmic trading system.

Most capital market transactions take place on the secondary market. On the primary market, each security can be sold only once, and the process to create batches of new shares or bonds is often lengthy due to regulatory requirements.

On the secondary markets, there is no limit on the number of times a security can be traded, and the process is usually very quick. With the rise of strategies such as highly frequency trading, a single security could in theory be traded thousands of times within a single hour.

Transactions on the secondary market don't directly help raise finance, but they do make it easier for companies and governments to raise finance on the primary market, as investors know if they want to get their money back in a hurry, they will usually be easily able to re-sell their securities.

Sometimes secondary capital market transactions can have a negative effect on the primary borrowers - for example, if a large proportion of investors try to sell their bonds, this can push up the yields for future issues from the same entity. In modern time, several governments have tried to avoid as much as possible the penchant for borrowing into long dated bonds, so they are less vulnerable to pressure from the markets.

A variety of different players are active in the secondary markets. Regular individuals account for a small proportion of trading, though their share has slightly increased; in the

20th century it was mostly only a few wealthy individuals who could afford an account with a broker, but accounts are now much cheaper and accessible over the internet.

These days there are now numerous small traders who can buy and sell on the secondary markets using platforms provided by brokers which are accessible with web browsers. When such an individual trades on the capital markets, it will often involve a two stage transaction. First they place an order with their broker, then the broker executes the trade. If the trade can be done on an exchange, the process will often be fully automated. If a dealer needs to manually intervene, this will often mean a larger fee.

Traders in investment banks will often make deals on their bank's behalf, as well as executing trades for their clients. Investment banks will often have a department called capital markets: staff in this department try to keep aware of the various opportunities in both the primary and secondary markets, and will advise major clients accordingly. Pension and Sovereign wealth funds tend to have the largest holdings, though they tend to buy only the highest grade (safest) types of bonds and shares, and often don't trade all that frequently.

## **SELF-ASSESSMENT EXERCISE 6**

Differentiate between primary market and secondary market.

## **3.4 CAPITAL MARKET INSTRUMENTS & SECURITIES**

### **3.4.1 CAPITAL MARKET INSTRUMENTS**

The principal capital market instruments used for long term funds include the following:

- (i) Mortgages.
- (ii) Corporation bonds.
- (iii) State and local government bonds.
- (iv) Federally sponsored credit agency securities.
- (v) Finance company bonds.
- (vi) Commercial banks bonds and commercial paper.
- (viii) Corporate stock.

Capital market instruments are fixed-income obligations that trade in the secondary market, which means anyone can buy and sell them to other individuals or institutions. Marketable securities are exchanged through the organized markets for example, stock exchanges and its Representative dealers and brokers who sell and buy marketable securities on behalf of their customer in exchange of commission.

Therefore, the capital market instruments fall into four categories such as: Treasury securities; government agency securities; municipal bonds; and corporate bonds.

### **1. Treasury Instruments**

All government securities issued by the Treasury department of Govt. are fixed income instruments. They may be bills, notes, or bonds depending on their times to maturity. Specifically, bills mature in one year or less, notes in over one to 10 years, and bonds in more than 10 years from time of issue government securities which confer debt obligations on the government.

### **2. Government Bonds and Loan Stocks**

Government y securities are sold by the apex banks on behalf of the government to support specific programs, but they are not direct obligations of the treasury department. Mortgage bonds are issued and sold for the purpose of using the proceeds to purchase mortgages from insurance companies or savings and loans; and the home loan which sells bonds and loans the money to its banks, which in turn provide credit to savings and loans and other mortgage-granting institutions. Other agencies are the government banks for cooperatives.

### **3. State and Local Government Bonds**

These bonds are issued by local government entities as either general obligation or revenue bonds. General obligation bonds are backed by the full taxing power of the municipality, whereas revenue bonds pay the interest from revenue generated by specific projects. These bonds differ from other fixed-income securities because they are tax-exempt. The interest earned from them is exempt from taxation by the government and by the state that issued the bond, provided the investor is a resident of that state. For this reason, these bonds are popular with investors in high tax brackets.

**4. Corporate Bonds** Corporate bonds are fixed-income securities issued by industrial corporations, public utility corporations, or railroads to raise funds to invest in plant, equipment, or working capital. They can be broken down by issuer, in terms of credit quality in terms of maturity i.e. short term, intermediate term, or long term, or based on some component of the indenture.

## **3.4.2 CAPITAL MARKET SECURITIES**

These are fixed-income obligations that trade in the secondary market, which means anyone can buy and sell them to other individuals or institutions. Marketable securities are exchanged through the organized markets for example, stock exchanges and its Representative dealers and brokers who sell and buy marketable securities on behalf of their customer in exchange of commission.

Instruments issued and traded in the capital market differ in certain characteristics, such as: term to maturity; interest rate paid on the nominal value; interest payment dates; and nominal amount in issue.

## **1. Interest Rate Securities**

The interest paid on the nominal amount of capital market securities (called the coupon rate) appears on the certificate received by the holder (the investor) of such a security. This coupon rate is one of the parameters used to determine the consideration paid for the security when traded in the secondary market. Most securities are issued at a fixed coupon rate.

Capital market securities are physical certificates and the issuer of the security keeps a register of owners. This register is used by the borrower (issuer) to pay interest to the lender (owner of the security) on the interest payment dates indicated on the certificate. When an instrument is sold to a new owner in the secondary market, the buyer is registered as the new owner on the settlement date of the transaction.

For administrative purposes the register of the issuer closes for registration of new owners, normally one month prior to the interest payment date. The date when the register closes is known as the last day to register. This means that the person or company, who is registered as the owner one month before the interest payment date on the register, will receive the interest on the payment date.

If a bond is sold and settled between the last day to register and the interest payment date, the seller will receive the interest payment. The buyer is then known to buy the instrument "ex interest" (without interest). Nevertheless, if a transaction takes place before the last day to the register, the buyer buys the instrument "cum interest" (including interest), because he will be registered as the owner before the register closes, and will receive the next interest payment.

## **2. Zero-rated coupons**

These are long-dated securities with many terms to maturity with zero-rated coupons which are capital market instruments issued by borrowers of money such as blue chip firms. These instruments do not earn interest on the capital amount invested by the lender, and are therefore issued and traded at a discount on the nominal value, similar to discount instruments in the money market such as bankers acceptances and treasury bills.

The market value (nominal value less discount) of zero or nil-rated coupon bonds depends on the yield that the investor (lender) expects on his investment. The redemption amount, which is the only cash inflow for the investor, is equal to the nominal value of the bond, and is thus known to the investor.

Since the redemption date is also known, the investor can calculate the amount that he is willing to pay for the bond according to the yield (expressed in terms of interest rate) that he wants to earn on the investment. This yield on zero-rated coupon bonds is normally linked to the market rate on long-term (capital market) investments.

### **3. Asset-backed Securities**

Where an asset exists which represents cash inflow stream such as a normal loan or investment, a bond can be issued to fund this asset. The bond income is then derived or backed by the income stream of the asset. The performance on the bond is then dependent on the asset performance.

#### **SELF-ASSESSMENT EXERCISE 7**

Mention the capital market securities and its instruments of transactions.

### **3.5 INSTITUTIONAL PARTICIPANTS IN CAPITAL MARKET**

There are a number of financial institutions which are directly involved with real investment in the economy. These institutions mobilize the saving from the people and channel funds for financing the development expenditure of the industry and government of a country.

The financial institutions take maximum care in investing funds in those projects where there is high degree of security and the income is certain. The main institutional sources of capital market are as follows:

#### **(i) Insurance Companies**

Insurance companies are financial intermediaries. They call money by providing protection from certain risks to individuals and firms. The insurance companies invest the funds in long term investments primarily mortgage loans and corporate bonds.

#### **(ii) Pension Funds**

The pension funds are provided by both employees and employers. These funds are now increasing utilized in the provision of long term loans for the industry and government.

#### **(iii) Building Societies**

The building societies are now activity engaged in providing funds for the construction, purchase of buildings for the industry and houses for the people.

#### **(iv) Investment Trusts**

The investment trust mobilize saving and meet the growing, need of corporate sector, The income of the investment trust depends upon the dividend it receives from shares invested in various companies.

#### **(v) Unit Trust**

The Unit Trust collects the small savings of the people by selling units of the trust. The holders of units can resell the units at the prevailing market value to the trust itself.

#### **(vi) Saving Banks**

The saving banks collect the savings of the people. The accumulated saving is invested in mortgage loans, corporate bonds.

#### **(vii) Specialized Finance Corporation**

The specialized finance corporations are being established to help and provide finance to the private industrial sector in the form of medium and long term loans or foreign currencies.

#### **(viii) Commercial banks**

The commercial banks are also now activity engaged in the provision of medium and long terms loans to the industrialists, agriculturists, specialist finance institutions, etc., etc.

#### **(ix) Stock Exchange**

The stock exchange is a market in existing securities (shares, debentures and securities issued by the public authorities). The stock exchange provides a place for those persons who wish to sell the shares and also wish to buy them. Stock Exchange, thus helps in raising equity capital for the industry

### **SELF-ASSESSMENT EXERCISE 8**

Mention and discuss the respective role of the institutional participants in capital market.

### **4.0 CONCLUSION**

The discussion in this unit, as you have observed, is indicative of the fact that there exists capital market within the ambit of the financial market, which supplies funds for long-term use by the government and corporate entities in their operations. There are primary

and secondary markets which are used for the new issues of securities and trading on old securities respectively. The participants in the operations of the capital market include central banks of various countries, the commercial banks, investment banks, insurance companies, corporate entities, mortgage banks, mortgage institutions, and pension funds institutions, among others.

The instruments of transactions in the capital market include mortgages, corporation bonds, state and local government bonds, federal government bonds and development loan stock, finance company bonds, commercial banks bonds and shares, and corporate stock. The capital market securities, which are fixed-income obligations that trade in the secondary market, include interest rate securities, zero-rated coupons, and asset-backed securities.

## **5.0 SUMMARY**

The topics that we have discussed in this study unit include meaning and operations of a capital market, primary market and secondary market of a capital market, methods of issuing new securities in the primary market, capital market instruments & securities, and institutional participants in capital market.

In the next study, you will be taken through operations of money market in Nigeria.

## **6.0 TUTOR MARKED ASSIGNMENT**

1. Differentiate between primary market and secondary market.
2. Mention the capital market securities and its instruments of transactions.
3. Mention and discuss the respective role of the institutional participants in capital market.

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## **UNIT 8: MONEY MARKET**

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  - 3.4 Money Market Instruments
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### **1.0 INTRODUCTION**

The money market is one of the two markets in the financial system. This compliments the capital market in providing the needed channel through which the corporate entities and the government can raise funds to finance their operations. While the capital market provides funds for long-term use by the government and corporate entities, the money market provides the government and corporate entities funds for short-term use in their operations. Therefore, the money market plays vital role in the economy in relation to its operations which channel funds from the savers to the users of such funds on short-term basis. In this study, therefore, the nature of money market, its operations, and financial instruments being traded in it, among others, constitute the subject of discussion.

### **2.0 OBJECTIVES**

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

- explain the meaning of money market
- discuss the operations of money market
- identify and explain money market financial instruments
- list the functions of money market

### **3.0 MAIN CONTENT**

#### **3.1 DEFINITION OF MONEY MARKET**

The money market is a component of the financial market for assets being used for short-term borrowing of funds by corporate entities and government. This implies that the money market is used for buying and selling of financial instruments with original maturities within a period of one year. The transactions in money market are carried out over the counter and are on wholesale basis. There are various instruments that are traded on as being issued by corporate entities and government for raising funds for the short-term use.

Such financial instruments being used in the money market include Treasury bills, Treasury certificates, Commercial papers, Bankers' acceptances, Certificates of deposits, Bills of exchange, Repurchase agreements, Federal funds, Short-lived mortgages, and Asset-backed securities.

Money market provides liquidity funding for both corporate entities and government. In particular, the government makes of the window of opportunities of what is called open market operation for the transactions on Treasury bills and Treasury certificates. There are some variations in other economies in terms of financial instruments being used the government to raise short-term funds for operations, for instance, the federal funds.

On the other hand, corporate entities make use of financial instruments such as Commercial papers, Bankers' acceptances, Certificates of deposits, Bills of exchange, Repurchase agreements, Short-lived mortgages, and Asset-backed securities for raising short-term funds for their operations. There are other financial instruments being used for short-term funds by corporate entities in some other economies that are not listed above.

### **SELF-ASSESSMENT EXERCISE 1**

What do you understand by money market?

### **3.2 OPERATIONS OF MONEY MARKET**

In terms of its operations, the money market consists of financial institutions and dealers in money or credit facilities who wish to either borrow or lend. Participants in the money market normally borrow and lend for short periods of time, ranging from some days such as money at calls and short notices to thirteen (13) months. The operations in money market generally involve trades in short-term financial instruments which are commonly called "paper." This is in contrast with the operations of the capital market which are essentially for longer-term funding, which is supplied by bonds and equity issues.

The core of the operations of the money market is the area of interbank lending. The commercial banks normally borrow and lend to each other using commercial papers, repurchase agreements and similar financial instruments. These financial instruments are often benchmarked, that is priced by reference, to the London Interbank Offered Rate (LIBOR) for the appropriate term and currency.

The finance companies typically fund themselves through the issue large amounts of asset-backed commercial paper (ABCP) which is secured by the pledge of eligible assets into an ABCP conduit. Examples of such eligible assets include auto loans, credit card receivables, residential and commercial mortgage loans, mortgage-backed securities and similar financial assets.

There are, however, certain large corporations or corporate entities that command strong credit ratings, such as General Electric Corporation and International Business Machines that issue commercial papers on their own credit. Other large corporations normally arrange for banks to issue commercial papers on their behalf through the commercial paper lines.

In countries like the United States, federal, state and local governments do all issue paper to meet their funding needs. States and local governments issue municipal paper while the federal government through the US Treasury (the apex bank of the US) issues Treasury bills to fund the public debts.

In the case of Nigeria, the federal government does issue Treasury Bills and Treasury Certificates to finance recurrent operations through the apex bank, that is, the Central Bank of Nigeria. Such operations are in the realm of the open market operations as the system is called in Nigeria.

The trading companies often purchase bankers' acceptances which are normally tendered for payment to overseas suppliers. In this connection, the retail and institutional money market funds, some specific banks, the central banks of various countries, cash management programs, and merchant banks are often involved in the operations of the money market.

## **SELF-ASSESSMENT EXERCISE 2**

Discuss the operations of a money market.

### **3.3 PARTICIPANTS IN MONEY MARKET**

In terms of its participants in relation to the operations of the money market, there are financial institutions and dealers in money or credit facilities. These participants include the following.

- i) Central banks
- ii) Commercial banks
- iii) Investment banks
- iv) Merchant banks
- v) Mortgage banks
- vi) Insurance companies

- vii) Corporate entities
- viii) Mortgage Institutions
- ix) Pension Funds Institutions
- x) Discount Houses

### **SELF-ASSESSMENT EXERCISE 3**

Mention the participants in money market operations.

### **3.4 MONEY MARKET INSTRUMENTS**

In general terms, the various financial instruments being used for transactions in the money market are identified and discussed below.

#### **1. Certificate of deposit**

This is for time deposit, commonly offered to consumers by banks, thrift institutions, and credit unions.

#### **2. Repurchase agreements**

These are short-term loans, normally for less than two weeks and frequently for one day, arranged by selling securities to an investor with an agreement to repurchase them at a fixed price on a fixed date.

#### **3. Commercial papers**

These are short-term issues such as promissory notes issued by company at discount to face value and redeemed at face value

#### **4. Eurodollar deposits**

These are deposits made in U.S. dollars at a bank or bank branch located outside the United States.

#### **5. Federal agency short-term securities**

These are tenable in the U.S. as short-term securities issued by government sponsored enterprises.

#### **6. Federal funds**

These are tenable in the U.S. as interest-bearing deposits held by banks and other depository institutions at the Federal Reserve, the apex bank in U.S. These are

immediately available funds that institutions borrow or lend, usually on an overnight basis. They are lent for the federal funds rate.

### **7. Municipal notes**

These are tenable in the U.S. as short-term notes issued by municipalities in anticipation of tax receipts or other revenues.

### **8. Treasury bills**

They are short-term debt obligations of a national government that are issued to mature in three months.

### **9. Treasury certificates**

They are short-term debt obligations of a national government that are issued to mature in three to twelve months.

### **10. Money funds**

These are the pooled short maturity, high quality investments which buy money market securities on behalf of retail or institutional investors.

### **11. Foreign Exchange Swaps**

This involves exchanging a set of currencies in spot date and the reversal of the exchange of currencies at a predetermined time in the future. This is done within a period that is considerably short-lived such as within days or weeks and probably with months.

### **12. Short-lived mortgage and asset-backed securities.**

These are mortgage loans that have been floated on short-term basis which can be traded in the money market by the holders of the instrument. The asset-backed securities are also short-term instruments that can be traded in the money for cash by the holders. The issuance of these financial assets is based on the existence of money market, and as such they cannot be issued or traded for funds in the capital market.

### **SELF-ASSESSMENT EXERCISE 4**

List the instruments that are used for transactions in money market.

### **3.5 FUNCTIONS OF MONEY MARKET**

There are pertinent functions that the money market performs in any economy, among which are the: transfer of funds within the economy for short-term use and the market facilitates operations of the financial system. Such functions are highlighted below.

- a) Facilitates transactions between parties with surplus funds and parties with a deficit.
- b) Helps the corporate entities to raise funds with which to enhance their working capital.
- c) Provides facilities for discounting of financial instruments.
- d) Allows corporate entities to hedge against failure in meeting requirements of their operational activities.
- e) Allow governments to raise funds to meet current expenditure in their operations.
- f) Helps the government in implementing monetary policy through the open market operations.
- g) Operations in the money market help determine short-term interest rates in the economy.
- h) Enhances the growth and development of the economy.

### **SELF-ASSESSMENT EXERCISE 5**

Mention the functions of the money market in any economy.

## **4.0 CONCLUSION**

The discussion in this unit, as you have observed, is indicative of the fact that there exists money market supplies funds for short-term use by the government and corporate entities in their operations.

The participants in the money market, as you have learned, include central banks of various countries, the commercial banks, investment banks, insurance companies, corporate entities, mortgage banks, mortgage institutions, and pension funds institutions, among others. There are instruments of transactions which are peculiar to the money market and these include Treasury Bills, Treasury Certificates, Trade Bills, Commercial Papers, and Certificate of Deposits, among others. Lastly, there is a plethora of functions that the money market performs in the process of financial intermediation.

## **5.0 SUMMARY**

The topics that we have discussed in this study unit include the exposition on the nature of Money Market, the modality of its Operations, the participating institutions, the instruments of transactions and the functions the system performs in the economy.

In the next study, you will be taken through discussion on the operations of central banking.

## 6.0 TUTOR MARKED ASSIGNMENT

1. Mention and explain ten financial instruments used for transactions in money market.
2. What are the functions of the money market in any economy?

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## **UNIT 9: CENTRAL BANKING**

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### **1.0 INTRODUCTION**

The central bank is regarded as the apex bank in any economy because it occupies the top-most position in the pecking order in the banking industry. Therefore, it assumes all the trappings of regulating authority for the economy's banking operations. A central bank takes different nomenclatures in different economies around the world. For instance, it is known as Reserve Bank of India in India, Bank of England in England, Federal Reserve System in America, the Bank of France in France, and the Riksbank in Sweden, among other names which are peculiar to distinct economies around the world. In Nigeria, the apex bank in Nigeria is simply called the Central Bank of Nigeria, which was established in 1959.

### **2.0 OBJECTIVES**

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

- i) define the term Central Banking
- ii) identify the differences between a central bank and a commercial bank
- iii) Mention and explain the functions of a central bank
- iv) discuss the role of a central bank in control of credit in any economy
- v) identify and discuss the methods of controlling credit by a central bank



### **3.0 MAIN CONTENT**

#### **3.1 DEFINITION OF A CENTRAL BANK**

A central bank has been explained conceptually in many ways; some in relation to its position while other views are in terms of its functions. We shall throw light on such definitions.

According to Vera Smith, central banking is a banking system in which a single bank has either complete control or a residuary monopoly of note issue. Shaw defines a central bank as a bank which controls credit. Hawtrey opines that a central bank is that which is the lender of last resort. According to Day, a central bank is established to help control and stabilise the monetary and banking system in any economy.

In related terms, Sayers posits that the central bank constitutes the organ of government that undertakes the major financial operations of the government and in the course of conducting these operations and by other means, influences the behaviour of financial institutions so as to support the economic policy of the Government. This is based on Sayers believes that most importantly the central bank is the government's bank. According to Samuelson, a central bank refers to a banker to other bankers. And its duty therefore, is to control the monetary base and through control of the money stock in the economy it also controls the country's supply of money.

#### **3.2 Functions of Central Banks**

An all-inclusive view on the position of a central bank is the opinion of De Kock. According to Kock, a central bank is a bank which constitutes the apex of the monetary and banking structure of any economy, which in the national economic interest, performs the following functions:

- i) The regulation of currency accordance with the requirements of business and the general public for what purpose it is granted either the sole right of note issue or at least a part monopoly thereof;
- ii) The performance of general banking and agency for its country;
- iii) The custody of the cash reserves of the commercial banks, custody and management of the nation's reserves of international currency.
- iv) The granting of accommodation in the form of re-discounts and advances to commercial banks, bill brokers and dealers, or other financial institutions and the general acceptance of the responsibility of lender of last resort.
- v) The settlement of clearance balances between the banks; and
- vi) Control of credit in accordance with the needs of business while carrying out the broad monetary policy adopted by the country.

## **SELF-ASSESSMENT EXERCISE 1**

Explain the term central bank. Highlight the functions of a central bank as identified by De Kock.

### **3.2 DIFFERENCES BETWEEN CENTRAL BANK AND COMMERCIAL BANK**

There are basic differences between the central bank and a commercial bank in terms of their structure and operations in the following ways:

- i) 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.
- ii) The central bank does not operate as a profit-driven institution but only implements the economic policies of the government. But the commercial bank is a profit-making institution.
- iii) The central bank is owned by the government, whereas the commercial bank is owned by private individuals as shareholders.
- iv) The central bank is a banker to the government and does not engage itself in ordinary banking activities. The commercial bank is a banker to the general public.
- v) The central bank has the monopoly of issuing currency of the country as the legal tender but the commercial bank can issue only cheques on its customers; the currency notes and coins issued by a central bank constitute legal tender. But the cheques are mere near-money.
- vi) The central bank is the banker to commercial banks. Therefore, it grants window of opportunity for credits to commercial banks in the form of rediscount facilities, keeps their cash reserves, and clears their balances in cheque settlements. On the other contrary, the commercial bank accepts deposits from the general public and grants loans and advances to the customers.
- vi) The central bank controls credit in accordance with the needs and policy of the government and the business and economy generally. The commercial bank creates credit to meet the requirements of business.
- vii) 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 industries by underwriting shares and debentures, and agriculture by meeting its financial requirements through cooperatives or individually.

viii) Every country has only one central bank with its offices at important centres in the country. On the other hand, there are many commercial banks with hundreds of branches within and outside the country.

ix) The central bank is the custodian of the foreign currencies of the country while the commercial bank is a dealer in foreign exchange in terms of buying and selling.

## **SELF-ASSESSMENT EXERCISE 2**

What are the operational differences between a central bank and commercial banks?

### **3.3 FUNCTIONS OF A CENTRAL BANK**

A central bank performs the following functions based largely on the views of De Kock and accepted by the majority of economists.

#### **1. Regulator of Currency**

The central bank is the bank of issue. It has the monopoly of note issue. Notes issued by it circulate as legal tender money. It has its issue department which issues notes and coins to commercial banks. Coins are manufactured in the government mint but they are put into circulation through the central bank.

Central banks have been following different methods of note issue in different s. The central bank is required by law to keep a certain amount of gold and foreign securities against the issue of notes. In some countries, the amount of d foreign securities bears a fixed proportion, between 25 to 40 per cent of gold and notes issued. In other countries, a minimum fixed amount of gold and foreign currencies is required to be kept against note issue by the central bank.

The monopoly of issuing notes vested in the central bank ensures uniformity in the notes issued which helps in facilitating exchange and trade within the country. It brings stability in the monetary system and creates confidence among the public. The central bank can restrict or expand the supply of cash according to the requirements of the economy.

Thus it provides elasticity to the monetary system. By having a monopoly of note issue, the central bank also controls the banking system by being the ultimate source of cash. Last but not the least, by entrusting the monopoly of note issue to the central bank, the government is able to earn profits from printing notes whose cost is very low as compared with their value.

## **2. Banker, Fiscal Agent and Adviser to the Government**

Central banks everywhere act as bankers, fiscal agents and advisers to their respective governments. As banker to the government, the central bank keeps the deposits of the central and state governments and makes payments on behalf of governments. But it does not pay interest on government deposits. It buys and sells foreign currencies on behalf of the government. It keeps the stock of gold of the government.

Thus it is the custodian of government money and wealth. As a fiscal agent, the central bank makes short-term loans to the government for a period not exceeding 90 days. It floats loans, pays interest on them, and finally repays them on behalf of the government. Thus it manages the entire public debt. The central bank also advises the government on such economic and money matters as controlling inflation or deflation, devaluation or revaluation of the currency, deficit financing, balance of payments, etc. As pointed out by De Kock, central banks everywhere operate as bankers to the state not only more convenient and economical to the state, but also because of the intimate connection between public finance and monetary affairs.

## **3. Custodian of Cash Reserves of Commercial Banks**

Commercial banks are required by law to keep reserves equal to a certain percentage of both time and demand deposits liabilities with the central banks. On the basis of these reserves that the central bank transfers funds from one bank to another to facilitate the clearing of cheques. Thus the central bank acts as the custodian of the cash reserves of commercial banks and helps in facilitating their transactions. There are many advantages of keeping the cash reserves of the commercial banks with the central bank, according to De Kock. In the first place the centralisation of cash reserves in the central bank is a source of great strength to the banking system of a country.

Secondly, centralised cash reserves can serve as the basis of a large *and* more elastic credit structure than if the same amount were scattered among the individual banks. Thirdly, centralised cash reserves can *be* utilised fully and most effectively during periods of seasonal strains and in financial crises or emergencies. Fourthly, by varying these cash reserves the central bank can control the credit creation by commercial banks. *Lastly, the* central bank can provide additional funds on a temporary and short term basis to commercial banks to overcome their financial difficulties.

## **4. Custody and Management of Foreign Exchange Reserves**

The central bank keeps and manages the foreign exchange *reserves* of the country. It is an official reservoir of gold and foreign currencies. It sells gold at fixed *prices* to the monetary authorities of other countries. It also buys and sells foreign currencies at international prices. Further, it fixes the *exchange* rates of the domestic currency in terms of foreign currencies. It holds these rates within narrow limits in keeping with its

obligations as a member of the International Monetary Fund and tries to bring stability in foreign exchange rates. Further, it manages exchange control operations by supplying foreign currencies to importers and persons visiting foreign countries on business studies, etc. in keeping with the rules laid down by the government.

## **5. Lender of the Last Resort**

De Kock regards this function as a *sine qua non* of central banking. By granting accommodation in the form of re-discounts and collateral advances to commercial banks, bill brokers and dealers, or other financial institutions, the central bank acts as the lender of the last resort. The central bank lends to such institutions in order to help them in times of stress so as to save the financial structure of the country from collapse. It acts as lender of the last resort through discount house on the basis of treasury bills, government *securities* and bonds at "the front door" The other method is to give temporary accommodation to the commercial banks or discount houses directly through available window. The difference between the two methods is that lending at the front door is at the rate and in the second case at the market rate. Thus the central bank as lender of the last resort is a big source of cash and also influences prices and market rates.

## **6. Clearing House for Transfer and Settlement**

As bankers' bank, the central bank acts as a clearing house for transfer and settlement mutual claims of commercial banks. Since the central bank holds reserves of Commercial banks, it transfers funds from one bank to other banks to facilitate clearing of cheques. This is done by making transfer entries in their account on the principle of book-keeping. To transfer and settle claims of one bank upon others, the central bank operates a separate department in big cities and trade centres. This department is known as the "clearing house" and it renders the service free to commercial banks.

When the central bank acts as a clearing agency, it is time-saving and convenient for the commercial banks to settle their claims at one place. It also economises the use of Money. "It is not only a means of economising cash and capital but is also a means of testing at any time the *degree* of liquidity which the community is maintaining."

## **7. Controller of Credit**

The most important function of the central bank is to control the credit creation *power of commercial* bank in order to control inflationary and deflationary pressures within this economy. For this purpose, it adopts quantitative methods and qualitative methods. Quantitative methods aim at controlling the cost and of credit by adopting bank rate policy, open market operations, and by variations in reserve ratios of commercial banks. Qualitative methods control the use and direction of credit. These involve selective credit controls and direct action. By adopting such methods, the central bank tries to influence and control credit creation by commercial banks in order to stabilise economic activity in the country.

In addition to the above operational functions, the central banks in a number of developing countries have been entrusted with the responsibility of developing a strong *banking* system to meet the expanding requirements of agriculture, industry, trade and commerce. Accordingly, the central banks possess some additional powers of supervision and control over the commercial banks. Such responsibilities, among others, include: issuing of licences; the regulation of branch expansion; and ensuring that every bank maintains the minimum paid up capital and reserves as provided by law.

The other operational functions include: inspecting or auditing the accounts of banks; approval of the appointment of chairmen and directors of such banks in accordance with the rules and qualifications; controlling and recommendation of merger of weak banks in order to avoid their failures and protect the interest of depositors; recommending nationalization of certain banks to the government in public interest; to publish periodical reports relating to different aspects of monetary and economic policies for the benefit of banks and the public; and to engage in research and train banking personnel etc.

### **SELF-ASSESSMENT EXERCISE 3**

Mention and explain the functions of a central bank in any economy.

## **3.4 Central Bank as the Controller of Credit**

### **3.4.1 Objectives of Credit Control**

Credit control is the means to control the lending policy of commercial banks by the central bank. The central bank controls credit to achieve the following objectives:

#### **1) Stabilise the Internal Price Level**

One of the objectives of controlling credit is to stabilise the price level in the country. Frequent changes in prices adversely affect the economy. Inflationary or deflationary trends need to be prevented. This can be achieved by adopting a judicious policy of credit control.

#### **2. Stabilise the Rate of Foreign Exchange**

With the change in the internal prices level, exports and imports of the country are affected. When prices fall exports increase and imports decline. Consequently, the demand for domestic currency increases in the foreign market and its exchange rate rises. On the contrary, a rise in domestic prices leads to a decline in exports and an increase in imports. As a result, the demand for foreign currency increases and that of domestic currency falls, thereby lowering the exchange rate of the domestic currency. Since it is the volume of credit money that affects prices, the central bank can stabilise the rate of foreign exchange by controlling bank credit.

### **3. Protect the Outflow of Gold**

Some central bank holds the gold reserves of the country in its vaults. Expansion of bank credit leads to rise in prices which reduce exports and increase imports, thereby creating an unfavourable balance of payments. This necessitates the export of gold to other countries. The central bank has to control credit in order to prevent such outflows of gold to other countries.

### **4. Control Business Cycles**

Business cycles are a common phenomenon of capitalist countries 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 contract such cyclical fluctuations through contraction of bank credit during boom period and expansion of bank credit during depression.

### **5. Facilitates Expansion of Business Entities**

An important objective of credit control is the adjustment of the volume of credit to the volume of business. Credit is needed to meet the requirements of trade and industry. As business expands, larger quantity of credit is needed, and when business contracts less credit if needed. Therefore, it is the central bank which can meet the requirements of business by controlling credit.

### **6. Ensures Growth and Stability**

In recent years, the principal objective of credit control is to have growth with stability. The other objectives, such as price stability, foreign *exchange* rate stability, etc., are regarded as secondary. The aim of credit control is to help in achieving full employment and accelerated growth in the economy without inflationary pressures and balance of payment deficits.

### **SELF-ASSESSMENT EXERCISE 4**

Mention and explain the objectives of credit control in the economy.

#### **3.4.2 Methods of Credit Control**

The central bank adopts two types of methods of credit control. They are the quantitative and qualitative methods. *Quantitative* methods aim at controlling the cost and quantity of credit by adopting such techniques as variations in the bank rate, open market operations, and variations in the reserve ratios of commercial bank. On the other hand, *qualitative*

*methods* control the use and direction of credit. These involve selective credit controls and direct action.

### **1. Bank Rate or Discount Rate Policy**

The bank rate or the 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 the interest rate charged by the central bank at which it provides rediscount to banks through the *discount window*. 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. Borrowing from the central bank becomes cheap and easy. So the commercial banks will borrow more. They will, in turn, advance loans to customers at a lower rate. The market rate of interest will be reduced. This encourages business activity, and expansion of credit follows which encourages the rise in prices. The opposite happens when credit is to be contracted in the economy.

The central bank raises bank rate which makes borrowing costly from it. So the banks borrow less. They in turn, raise their lending rates to customers. The market rate of interest also rises because of the tight money market. This discourages fresh loans and puts pressure on borrowers to pay their past debts. This discourages business activity. There is contraction of credit which depresses the rise in price. Thus lowering the bank rate offsets deflationary tendencies and raising the bank rate controls inflation.

### **2) Open Market Operations**

Open Market Operations involve the selling and buying of government securities (such as Treasury Bills and Treasury Certificates) in the open market with the basic aim to regulate money supply in the economy. In the period of inflation, the central banks sell the government securities to the commercial banks and other financial institutions. This reduces their cash lending and credit creation capacities so that inflation can be controlled. On the other hand, during the period of recessions, the central banks buy back government securities from commercial banks and other financial institutions. This leaves the financial institutions with more cash balances for lending and thus increases their credit creation capacities. Through this action, recession can be controlled in the economy.

### **3) Repo Rates and Reverse Repo Rates**

Repo is a swap deal involving immediate sale of securities and a simultaneous repurchase of those securities at a future date at a predetermined price. Commercial banks and other financial institutions also deposit their funds with the central banks at a certain rate, which is called the Reverse Repo Rate. Repo rates and Reverse repo rates are used by the central banks to make liquidity adjustments in the financial markets.



#### **4) Cash Reserve Ratio**

The quantum of money supply in the economy is also influenced by the cash reserve ratio which is normally determined by the central bank. It is the ratio of a bank's time and demand liabilities to be kept in reserve with the central bank. A high cash reserve ratio reduces the flow of money in the economy and is used to control inflation. A low cash reserve ratio increases the flow of money and is used to control recession.

#### **5. Statutory Liquidity Ratio**

Under statutory liquidity ratio, it is mandatory for banks to invest a certain percentage of its time and demand liabilities in Government approved securities. The reduction in statutory liquidity ratio enhances the liquidity of commercial banks while an increase in statutory liquidity ratio decreases the liquidity of the banks. Hence this method and the other quantitative methods are used by the central bank to control the money supply in the economy.

#### **6. Marginal Requirement**

Marginal requirement of loan can be increased or decreased to control the flow of credit being granted to a customer of a bank, for example, bank will only grant a certain fraction of the value of the collateral security (e.g., an item of property) being pledged by a loan beneficiary. The marginal requirement can be 20% or 25% less than the value depending on the agreement between the bank and the customer. In case the flow of the credit has to be increased by the bank, the marginal requirement will be lowered.

#### **7. Rationing of credit**

Under this method there is a maximum limit placed on loans and advances that can be granted to a particular sector of the economy made, which the commercial banks cannot exceed. The sectors which are being favoured by the central bank can be allocated a higher percentage. For instance, a high ration of the loans and credits by a bank such as 35% can be allocated by the central bank for the agricultural sector of the economy and enforced by the apex bank.

#### **SELF-ASSESSMENT EXERCISE 5**

Mention and explain the methods of credit control in the economy.

#### **4.0 CONCLUSION**

The discussion in this study unit is indicative of the fact that each country has its own central bank but it carries distinct name in a peculiar country. The central bank is quite different from a commercial bank because of their distinct modes of operations. Therefore, the peculiar functions of a central bank in any economy include: regulation of currency, banker; fiscal agent and adviser to the government; custodian of cash reserves

of commercial banks; custody and management of foreign exchange reserves; lender of the last resort; clearing house for transfer and settlement; and controller of credit. Above all, it makes use of policy measure to control credit in the economy.

## **5.0 SUMMARY**

The various topics considered in this study unit include: Definition of a Central Bank; Differences between Central Bank and Commercial Bank; Functions of a Central Bank; Central Bank as the Controller of Credit; Objectives of Credit Control; and Methods of Credit Control. In the next study unit, we shall discuss commercial banking.

## **6.0 TUTOR MARKED ASSIGNMENT**

- a) Explain the term central bank.
- b) Mention and explain the operational functions a central bank.

## **7.0 REFERENCES/FURTHER READINGS**

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## **UNIT 10: COMMERCIAL BANKING**

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### **1.0 INTRODUCTION**

Banking institutions particularly the commercial banks evolved from trading activities of the merchants in the middle ages. Banks were known as banks until the seventh century. The temple of Babylon early as 2000 B.C. was noted for the practice of safe-keeping and savings. Nevertheless, the actions of the English goldsmiths and the merchants who were patronizing them for the purpose of safekeeping of their sales proceeds that gave birth to the modern banking practice. The first bank in Nigeria is the First Bank of Nigeria PLC as we know it today but the original name was Standard Bank as imported from the United Kingdom. The discussion in this study unit is on origin of banking practice particularly the commercial banking operations.

### **2.0 OBJECTIVES**

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

- i) explain the evolution and growth of commercial banking
- ii) identify and explain functions of commercial banks
- iii) discuss the balance sheet of a commercial bank
- iv) discuss the role of commercial banks in a developing economy

### **3.0 MAIN CONTENT**

#### **3.1 Evolution and Growth of Commercial Banking**

The word 'bank' used herein refers to a commercial bank, which is of Germanic origin though some writers attribute its origin to the French word 'Banque and the Italian word 'Banca, which originally refers to a bench for keeping, lending, and exchanging of money or coins in the market place by money lenders and money changers.

There was no such word as 'banking' before 1640 from available literature, although the practice of safe-keeping and savings flourished in the temple of Babylon as early as 2000 B.C Chanakya in his *Arthashastra* written in about 300 B.C. mentioned about the existence of powerful guilds of merchant bankers who received deposits, advanced loans and issued *hundis*(letters of transfer).

The Jain scriptures mention the names of two bankers who built the famous Dilwara Temples of Mount Abu during 1197 and 1247 A.D. The first bank called the 'Bank of Venice' was established in Venice, Italy in 1157 to finance the monarch in his wars. The bankers of Lombardy were very famous in England. But modern banking began with the English goldsmiths only after 1640. The first bank in India was the 'Bank of Hindustan' started in 1770 by Alexander & Co., an English agency house in Calcutta which failed in 1782 with closure of the agency house. But the first bank in the modern sense was established in the Bengal Presidency as the Bank of Bengal in 1806.

History apart, it was the 'merchant banker' who first evolved the system of Banking by trading in commodities than money. Their trading activities required the remittances of money from one place to another. For this, they issued 'hundis' remit funds. In India, such merchant bankers were known as 'Seths'.

The next stage in the growth of banking was the goldsmith. The business of goldsmith was such that he had to take special precautions against theft of gold and jewellery. If he seemed to be an honest person, merchants in the neighbourhood started leaving their bullion, money and ornaments in his care. As this practice spread, the goldsmith started charging something for taking care of the money and bullion. As evidence for receiving valuables, he issued a receipt. Since gold and silver coins had no marks of the owner, the goldsmith started lending them. As the goldsmith was prepared to give the holder of the receipt an equal amount of money on demand, the goldsmith receipts became instruments such as the cheques serving as a medium of exchange and a means of payment.

#### **SELF-ASSESSMENT EXERCISE 1**

Briefly trace the evolution of commercial banks.

## **3.2 Functions of Commercial Banks**

Commercial banks perform a variety of functions in the course of their operations which can be identified in various forms such as listed below:

- (1) accepting deposits;
- (2) advancing loans;
- (3) credit creation;
- (4) financing foreign trade;
- (5) agency services; and
- (6) miscellaneous services to customers.

We shall discuss these functions in the subsequent section of this study unit.

### **1) Accepting Deposits**

The bedrock of modern banking is revolves around this function. It appears as the oldest function of a bank and the banker used to charge a commission for keeping the money in its custody when banking was developing as an institution. Nowadays a bank accepts three kinds of deposits from its customers. The first is the *savings* deposits on which the bank pays small interest to the depositors who are usually small savers.

The depositors are allowed to draw their money by cheques up to a limited amount during a week or year. Businessmen keep their deposit in current accounts. They can withdraw any amount standing to their credit in current deposits by cheques without notice. The bank does not pay interest on such accounts but instead charges a nominal sum for services rendered to its customers. Current accounts are known as demand deposits. Deposits are also accepted by a bank in fixed or time deposits.

Savers who do not need money for a stipulated period of time, say, two months to longer periods ranging up to 10 years or more are encouraged to keep it in fixed deposit accounts. The bank pays a higher rate of interest on such deposits. Nevertheless, the rate of interest increases with the length of the time period of the fixed deposit. There is always the maximum limit of the interest rate which can be paid as the case may be in different economies.

### **2) Advancing Loans**

One of the primary functions of a commercial bank is to advance loans to its customers. A bank lends a certain percentage of the cash lying in deposits on higher interest rate than it pays on such deposits. This is how it earns profits and carries on its business. The bank advances loans in the following ways:

### **i) Cash Credit**

The bank advances loans to businessmen against certain specified securities. The amount of the loan is credited to the current account of the borrower. In case of a new customer a loan account for the sum is opened. borrower can withdraw money through cheques according to his requirement but pays interest on the full amount.

### **ii) Call Loans**

These are very short-term loans advanced to the bill broker for not more than fifteen days. They are advanced against first class bill of securities. Such loans can be recalled at a very short notice. In normal times they can also be renewed.

### **iii) Overdraft**

A bank often permits a businessman to draw cheques for a sum greater than the balance lying in his current account. This is done by providing the overdraft facility up to a specific amount to the businessman. But he is charged interest only on the amount by which his current account is actually overdraft and not by the full amount of the overdraft sanctioned to him by the bank.

### **iv) Discounting bills of Exchange**

If a creditor holding a bill of exchange wants money immediately, the bank provides him the money by discounting the bill of exchange. It deposits the amount of the bill in the current account of the creditor after deducting its rate of interest for the period of the loan which is not more than 90 days. When the bill of exchange matures, the bank gets its payment from the banker of the debtor who accepted the bill.

## **3) Credit Creation**

Credit creation is one of the most important functions of the commercial bank like other financial institutions, they aim at earning profits. For this purpose, they accept deposits and advance loans by keeping a 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 him 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.

## **4) Financing Foreign Trade**

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.

## 5) Agency Services

A bank acts as an agent of its customers in collecting and paying cheques, bills of exchange, drafts, dividends, etc. It also buys and sells shares, securities, debentures, etc. for its customers. Further, it pays subscriptions, insurance premiums, rent, electricity and water bills, and other similar charges on behalf of its clients. It also acts as a trustee and executor of the property and will of its customers. Moreover, the bank acts as an income tax consultant to its clients. For some of these services, the bank charges a nominal fee while it renders others free of charge.

## 6) Miscellaneous Services

Besides the above operational services, the commercial bank performs a number of other services. It acts as the custodian of the valuables of its customers by providing them lockers where they can keep their jewellery and valuable document. It issues various forms of credit instruments, such as cheques, drafts, travelers' cheques, etc. which facilitate transactions. The bank also issues letters of credit and acts as a referee to its clients. It also underwrites shares and debentures of companies and helps in the collection of funds from the public. Some commercial banks also publish journals which provide statistical information about money market and business trends of the economy.

### **SELF-ASSESSMENT EXERCISE 2**

Mention and discuss the functions being performed by commercial banks in its operations.

### **3.3 The Balance Sheet of a Commercial Bank**

The balance sheet of a commercial bank provides a picture of its functioning. It is a statement which shows its assets and liabilities on a particular date at the end of one year. The assets are shown on the right-hand side and the liabilities on the left-hand side of the balance sheet. As in the case of a company, the assets and liabilities of a bank must balance. The balance sheet which every commercial bank is required to publish once in a year is shown as under:



**Figure 10.1: Proto-type of a Bank Balance Sheet**

<i>Liabilities</i>	<i>Assets</i>
1. Share Capital	1. Cash
2. Reserve Fund	2. Balances with the Central Bank and other banks
3. Deposits	3. Money at Call and Short-Notice
4. Borrowings from other banks	4. Bills Discounted and Purchased
5. Bills Payable	5. Investments
6. Bills for Collection	6. Loans, Advances, Cash Credits and overdrafts
7. Acceptances, Endorsements and other obligations	7. Liabilities of Customers for Acceptances, Endorsements and other Obligations
8. Contingent liabilities	8. Property, Furniture, Fixtures less Depreciation
9.	9. Profit and Loss

**Source:** Jingham, M.I. (2008). Money, International Trade and Public Finance, 7<sup>th</sup>, p.132.

The analysis of the distribution of assets and liabilities of a commercial bank on the basis of the division given in Figure 1 above is given below.

### **3.3.1 Composition of the Bank Assets**

The assets of a bank are those items from which it receives income and profit.

#### **i) Liquid Cash**

The first item on the assets side is the cash in liquid form consisting of coins and currency notes lying in reserve with it and in its branches. This is a certain percentage of its total liabilities which it is required to keep by law. Cash reserve does not yield income to the bank but are essential to satisfy the claims of its depositors.

#### **ii) Balances with Central bank & other Banks**

The second item is in the form of balances with the central bank and other banks. The commercial banks are required to keep a certain percentage on their time and demand deposits with the central bank. They are the assets of the bank because it can withdraw from them in cash in case of emergency or when the seasonal demand for cash is high.

### **iii) Money at call and short notice**

The third item, money at call and short notices relates to very short-term loans advanced to bill brokers, discount houses and acceptance houses. They are repayable on demand within fifteen days. The bank charges low *rate* of interest on these loans.

### **iv) Bills discounted and purchased**

The *fourth* item of assets relates to bills discounted and purchased. The bank earns profit by discounting bills of exchange and treasury bills of 90 days' duration. Some bills of exchange are accepted by a commercial bank on behalf of its customers which it ultimately purchases. They are a liability but they are included under assets because the bank can get them rediscounted from the central bank in case of need.

### **v) Investment in Securities/Bonds/Industrial shares**

The fifth item, investments by the bank in government Securities, state bonds and industrial shares, yields fixed income to the bank. The bank can sell its securities when there is need for more cash.

### **vi) Loans and Advances**

The sixth item relating to loans and advances is the most profitable source of bank assets as the bank charges interest at a rate higher than the bank rate. The bank makes advances on the basis of cash credits and overdrafts and loans on the basis of recognised securities.

### **vii) Liabilities to the bank's customers**

In the *seventh item* are included liabilities of the bank's customers which the bank has accepted and endorsed on their behalf. They are the assets of the bank because the liabilities of customers remain in the custody of the bank. The bank charges a nominal commission for all acceptances and endorsements which is a source of income.

### **viii) Value of Fixed assets of the bank**

The *eighth* item relates to the value of permanent assets of the bank in the form of property, furniture, fixtures, etc. They are shown in the balance sheet after allowing for depreciation every year. The *last* item includes profits retained by the bank after paying corporation tax and profits to shareholders.

## **3.3.2 Composition of the Bank Liabilities**

The liabilities of a commercial bank are claims on it. These are the items which form the sources of its funds.

### **i) Share Capital of the bank**

Of the liabilities, the share capital of the bank is the first item which is contributed by its share holders and is a liability to the bank but represents claim to the numerous shareholders.

### **ii) Reserve Funds**

The *second item* is the reserve fund. It consists of accumulated resources which are meant to meet contingencies such as losses in any year. The bank is required to keep a certain percentage of its annual profits in the reserve fund. The reserve fund is also a liability to the shareholders.

### **iii) Time and Demand deposits**

The *third item* comprises both the time and demand deposits. Deposits are the debts of the bank to its customers. They are the main source from which the bank gets funds for investment and are indirectly the source of its income. By keeping a certain percentage of its time and demand deposits in cash the bank lends the remaining amount on interest.

### **iv) Borrowings from other Banks**

Borrowings from other banks is the *fourth item*. The bank usually borrows secured and unsecured loans from the central bank. Secured loans are on the basis of some recognized securities, and unsecured loans out of its reserve funds lying with the central bank.

### **v) Bills Payable**

The *fifth item* bills payable refers to the bills which the bank pays out of its resources.

### **vi) Bills for Collection**

The *sixth item* relates to bills for collection. These are the bills of exchange which the bank collects on behalf of its customers and credits the amount to their accounts. Hence it is a liability to the bank.

### **vii) Acceptance & Endorsement of Bills of Exchange**

The *seventh item* is the acceptance and endorsement of bills of exchange by the bank on behalf of its customers. These are the claims on the bank which it has to meet when the bills mature.

### **viii) Contingency Liabilities**

The *eighth item* contingent liabilities relates to those claims on the bank which are unforeseen such as outstanding forward exchange contracts, claims or acknowledged debts, etc.

## **ix) Profit Payable to Shareholders**

In the *last* item, profit and loss, are shown profit payable to the shareholders which are a liability on the bank.

The various items of the balance sheet as shown in Figure I portray conservative indicator of the assets and liabilities of commercial banks. The balance sheet of a particular bank shows its financial soundness. By studying the balance sheets of the major commercial banks of a country, one can also know the trend of the monetary market. The bank balance sheet reflects the bank's credit extension on its asset side in loans and investments, and on the liabilities side reflects the bank's operations as an intermediary in time deposits and its role as an element in the nation's monetary system in demand deposits."

### **SELF-ASSESSMENT EXERCISE 3**

Identify the items of a typical balance of a commercial bank, showing them in a tabular form.

## **3.4 Role of Commercial Banks in a Developing Country**

In the course of performing the usual commercial banking functions, banks in developing countries, in essence, play an effective role in their economic development. Against the backdrop of their economic status, the majority of the people in such countries engaged in traditional agriculture and subsistence farming. There is acute shortage of capital. People lack initiative and enterprise. Means of infrastructure are undeveloped. Industrial operations are comatose or depressed. The commercial banks, in their operational activities, help in overcoming these obstacles and promoting economic development. The role of a commercial bank in a developing country is marshaled out and discussed below.

### **1. Mobilising Savings for Capital Formation**

The commercial banks help in ; mobilizing savings through a network of branch banking. People in developing countries have low incomes but the banks induce them to save by introducing variety of deposit schemes to suit the needs of individual depositors. They also J mobilise idle savings of the few rich. By mobilising savings, the banks channelize them into productive investments. Thus they help in the capital formation of a developing country.

### **2. Financing Industry**

The commercial banks finance the industrial sector in a number of ways. They provide short-term, medium-term and long-term loans to industry. In India they provide short-

term loans. In some of the Latin American countries like Guatemala, they advance medium-term loans for one to three years. But in Korea, the commercial banks also advance long-term loans to industry. In India, the commercial banks undertake short-term and medium-term financing of small scale industries, and also provide hire-purchase finance. Besides, they underwrite the shares and debentures of large scale industries. Thus they not only provide finance for industry but also help in developing the capital market which, is undeveloped in such countries.

### **3. Financing Trade**

The commercial banks help in financing both internal and external trade. The banks provide loans to retailers and wholesalers to stock goods in which they deal. They also help in the movement of goods from one place to another by providing all types of facilities such as discounting and accepting bills of exchange, providing overdraft facilities, issuing drafts, etc.

Moreover, they finance both exports and imports of developing countries by providing foreign exchange facilities to importers and exporters of goods.

### **4. Financing Agriculture**

The commercial banks help the large agricultural sector in developing countries in a number of ways. They provide loans to traders in agricultural commodities. They open a network of branches in rural areas to provide agricultural credit. They provide finance directly to agriculturists for the marketing of their produce, for the modernisation and mechanisation of their farms for providing irrigation *facilities*, for developing land, etc.

They also provide financial assistance for animal husbandry, dairy farming, sheep breeding, poultry farming, pisciculture and horticulture. The small and marginal farmers and landless agricultural workers, artisans and petty shopkeepers in rural areas are provided financial assistance through the regional rural banks in India. These regional rural banks operate under a commercial bank. Thus the commercial banks meet the credit requirements of all types of rural people.

### **5. Financing Consumer Activities**

People in underdeveloped countries being poor and having low incomes do not possess sufficient *financial* resources to buy durable consumer goods. The commercial banks advance loans to consumers for the purchase of such items as houses, scooters, fans, refrigerators, etc. In this way, they also help in raising the standard of living of the people in developing countries by providing loans for consumptive activities.

### **6. Financing Employment Generating Activities**

The commercial banks finance employment generating activities in developing countries. They provide loans for the education of young people studying in engineering, medical

and other vocational institutes of higher learning. They advance loans to young entrepreneurs, medical and engineering graduates, and other technically trained persons in establishing their own business. Such loan facilities are being provided by a number of commercial banks in India. Thus the banks not only help in human capital formation but also in increasing entrepreneurial activities in developing countries.

## **7. Help in Monetary Policy**

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

Hence the commercial banks contribute much to the growth of a developing economy by granting loans to agriculture, trade and industry, by helping in physical and human capital formation and by facilitating the implementation of the monetary policy of the country.

## **4.0 CONCLUSION**

The modern commercial banks evolved from the activities of the merchants and the goldsmiths in Europe who provided the enabling environment for their growth. The commercial banks perform peculiar functions to the economy in the course of carrying out their operations. Such functions include: accepting deposits; advancing loans; credit creation; financing foreign trade; agency services; and miscellaneous services to customers. These banks play special role in the growth and development of any economy in which they operate.

## **5.0 SUMMARY**

The topics that we have discussed in this study unit include: Evolution and Growth of Commercial Banking; Functions of Commercial Banks; The Balance Sheet of a Commercial Bank; Composition of the Bank Assets; Composition of the Bank Liabilities; and Role of Commercial Banks in a Developing Country. In the next study unit, we shall discuss merchant banking as another genre in bank operations.

## **6.0 TUTOR MARKED ASSIGNMENT**

- 1) Mention and discuss the various functions performed by a bank.
2. Discuss the role of a commercial bank in promoting economic development.

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## **UNIT 11: MERCHANT BANKING**

### **CONTENTS**

- 1.0 Introduction
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- 3.0 Main Content
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- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor Marked Assignment
- 7.0 References/Further Readings

### **1.0 INTRODUCTION**

Banking institutions particularly the merchant banks evolved alongside with the evolution of the commercial banking in relation to the trading activities of the merchants in the middle ages. The merchant banks evolved to fill the gaps created by commercial banks in terms of the services that were not being performed by them in their operations. Such involvements of the merchant banks are principally in the areas of facilitating international trade, equipment leasing, and lending for investments in large-scale industries as well as loan syndication. Therefore, the discussion in this study unit is on the nature and operations of merchant banking.

### **2.0 OBJECTIVES**

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

- i) explain the meaning of merchant banking
- ii) discuss the development of merchant banks
- iii) discuss the Role of Lombardy Grain Merchants in development of merchant banks
- iv) discuss the role of money changers in medieval trade fairs in development of merchant banks



### **3.0 MAIN CONTENT**

#### **3.1 MEANING OF MERCHANT BANKING**

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.

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 modernise the business, 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 (2013), 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.

In North America (McCrill, 2013), the merchant bank business model is somewhat different. Specialized services are typically offered that may be predominantly targeted to one industry. These "boutiques" as they called in North America charge for specific services. For example, a business may need only a short-term loan and a company would go to a merchant bank for that purpose only.

In another example, a business may need professional advice about how to structure a business transaction. This, the business will approach the merchant bank for such purpose. Merchant bankers do possess specific business skills, which a thorough understanding of a product or as peculiar and the industry in which it will be marketed, the ability to acquire outside capital and an understanding of product sales.

#### **SELF ASSESSMENT EXERCISE 1**

What is the meaning of Merchant Banking?

#### **3.2 DEVELOPMENT OF MERCHANT BANKS**

##### **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.

## **SELF ASSESSMENT EXERCISE 2**

Discuss the evolution of Merchant Banking citing the role played by Lombardy Grain Merchants.

### **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.

## **SELF ASSESSMENT EXERCISE 3**

Discuss the evolution of Merchant Banking citing the role played by Moneychangers in Medieval Trade Fairs in Europe.

### **3.3 FUNCTIONS OF MERCHANT BANKING**

The merchant banks perform various functions in the course of their operations in the economy. Such functions (Akrani, 211) 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 modernization of business operations.

#### **2. 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. Project Management**

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 plans for financing of projects, securing sources for project funding, and advising about concessions and incentives from the government.

### **4. 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.

### **5. Managing Public Issues of Companies**

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.

### **6. 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.

### **7. 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.

### **8. 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.

## **9. Revival of Sick Industrial Organizations**

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.

## **10. Portfolio Management**

Merchant banks their clients to manage their investment portfolios so as to ensure safety, liquidity, and profitability. They also offer expert guidance on investment decisions to their clients.

## **11. 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.

## **12. Leasing Services**

Merchant banks also deal in equipment leasing business by serving to guarantee lease contracts or buying and supplying equipment to companies on leasehold basis. Lease involves a contract between the owner of equipment called lessor and lesee in which the former party allows the latter to use the asset for a certain period of time for the payment of rental charges.

## **13. Financial Management Services**

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.

## **14. 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 4**

Mention and discuss the functions of Merchant banks.

## **4.0 CONCLUSION**

The merchant banks play a complimentary role to the commercial banks in any economy and it deals with corporate entities in its operations. Furthermore, we have discussed in this study unit that merchant banks arose from the activities of merchant banks and money changers in medieval period. The evolution of merchant banks therefore has been attributed to the Italian grain merchants, which first evolved in the Middle Ages. This was later aided by the growth of the Lombardy merchants and bankers. The operational functions of merchant banks, as we have discussed in this study unit, include financing of international trade, equipment leasing, corporate restructuring, and providing credits for project development, among others.

## **5.0 SUMMARY**

The topics that we have discussed in this study unit include: Meaning of Merchant Banking, Development of Merchant Banks, Role of Lombardy Grain Merchants and money changers in medieval trade fairs in development of merchant banks and Operational Functions Merchant banks. In the next study unit, we shall discuss development banks.

## **6.0 TUTOR MARKED ASSIGNMENT**

- 1) Mention and discuss the various functions performed by a bank.
2. Discuss the role of a commercial bank in promoting economic development.

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## **UNIT 12: DEVELOPMENT BANKS**

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  - 3.2 Community Development Banks
  - 3.3 Regional Development Banks
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### **1.0 INTRODUCTION**

Commercial and merchant banks only perform peculiar functions in the economy, which have not to do with the direct involvement in the development and welfare of the populace in any country. Therefore, development banks evolved to take up the challenge of catering for the direct development of the critical sectors of the economy as well as engaging in operations that can cater for the welfare of the citizens. Such preoccupation of the development banks concern funding of developmental projects and industrial undertakings in the economy. Therefore, the discussion in this study unit is on the nature and operations of development banks.

### **2.0 OBJECTIVES**

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

- i) explain the meaning of development bank
- ii) discuss the essence of Community Development banks
- iii) discuss the role of Regional Development Banks

### **3.0 MAIN CONTENT**

#### **3.1 DEVELOPMENT BANKS**

Development banks include multibillion-dollar entities like the World Bank, but most are smaller regional and local lenders spread throughout the world. They exist to fund projects that improve the material well-being of people, particularly those living in



poverty. A development bank, in short, does what most commercial banks cannot do: it funnels capital into projects of dubious profitability. To achieve these ends most development banks and there are perhaps hundreds in the United States alone are geared toward grassroots economic assistance.

There are two kinds of development banks:

1. Community development banks are local banks that deal primarily with individuals and small organizations in their immediate area. They are private, nongovernment institutions and may be affiliated with commercial banks.
2. Regional development banks, also known as multilateral development banks, operate in various parts of the world through the support of national governments.

The two types have little in common from an organizational point of view, but they share the common goal of combating poverty and economic hardship by infusing capital into local economies.

### **SELF-ASSESSMENT EXERCISE 1**

Discuss the term Development Bank.

### **3.2. COMMUNITY DEVELOPMENT BANKS**

Although they are private institutions, community development banks differ from commercial banks in salient ways. They are always located in depressed urban and rural areas, where there are very few if any banks or bank branches. While they offer such standard commercial services as checking and savings accounts and loans, they also have important nonbank functions, such as investing in low cost housing projects and in technical assistance programs. For these reasons, development banks, unlike commercial banks, have access to many private and government grant funds.

Development banks also are more stringently regulated by the federal and state governments. Even lending services of development banks differ from commercial banks, since the former are mandated to provide loans as small as \$500, which commercial banks would consider unprofitable. Development banks promote these enterprises by providing loans on easier terms, often for smaller sums than would be profitable for most commercial banks.

Still, community banks are by and large profit-making institutions, with additional, nonprofit functions. They are almost always established by individuals and organizations rooted in the community they wish to serve. They often evolve from a grassroots community development project. For example, a recent Newark, New Jersey, housing association, initially financed by charities and government subsidies, is now a development bank. By injecting depressed urban and rural areas with much needed

capital, these banks empower their communities to revitalize their neighborhoods and strengthen local businesses. A major reason for the endemic poverty of many urban and rural areas is the absence or near absence of financial institutions. Southeast San Diego, for instance, a depressed neighborhood of 250,000 residents, possessed only one branch bank until a development bank was founded.

Not all development banks are successful. The undertaking of such an enterprise is risky, due to factors often beyond the control of most banks of this kind: the prevalence of urban crime and the inexperience of many in the local community with even such basic banking services as checking and savings accounts. The risks of lending to startup businesses in poor areas also are higher than in affluent areas. However, Chicago's South Shore Bank, a national model of a community development bank, established in 1973, began with only \$42 million in assets which, by 1998, had risen to \$650 million. Because of the profitability of South Shore Bank and the resulting economic revival it has nurtured in Chicago's traditionally depressed south side, this bank has had many imitators.

The community development bank idea is not new. In fact, providing financial services to the entire community, including impoverished people, is what small banks used to do. Small banks and credit unions, however, are struggling for survival nowadays, especially since the banking industry was deregulated in the 1980s. As a result of the intensification of competition among banks, they are reluctant to establish branches in areas that entail unusually high risk and the expectation of low returns.

Most banks would be unwilling to invest in community services or provide loans to nonprofit institutions at the rate that they do, it not that the federal Community Reinvestment Act of 1977 (CRA), which stipulates that commercial banks must provide credit services to all segments of the community in which they are located.

This still does not make them development banks, but it does mean that all banks since 1977 have some development functions. Amendments to the CRA in the mid-1990s strengthened its requirements that banks document how they benefit their communities.

## **SELF-ASSESSMENT EXERCISE 2**

Identify the term Community Development Bank.

## **3.3 REGIONAL DEVELOPMENT BANKS**

By contrast, regional development banks have tended to deal with governments, both as backers and as clients, but this has been changing. They also raise a great deal of their capital through financial markets, such as by issuing bonds, and like all banks, through the successful performance of their assets.

Among the major regional development banks in various regions around the world include the following:

1. African Development Bank (AfDB);
2. Asian Development Bank (ADB);European Investment Bank (EIB);
3. Inter-American Development Bank (IDB);
4. North American Development Bank (NADBank); and
5. International Bank for Reconstruction and Development (IBRD) or World Bank.

The World Bank, by far the best known of these, actually consists of several member organizations that undertake its operations. The unit that conducts most of the banking operations per se is the International Bank for Reconstruction and Development, which lends member countries a collective average of \$20 billion per year. Other World Bank agencies educate and train people in ways to best use the resources at hand. Examples of this work include promoting sustainable and effective agricultural practices, advising governments on economic policies, and teaching private-sector managers and workers how to use new technology.

Regional development banks finance a wide number of projects, ranging from construction of hydroelectric plants to deployment of fiber-optic cable. Many are also actively engaged in advancing social policies that promote freedom and human rights. The trend in development loans has been toward greater private-sector involvement. Many of the most prominent development banks, including the World Bank and the NADBank, are dealing more with private lending institutions and securing funds for ambitious private-sector projects.

In this role the development banks have used their influence not necessarily their reserves to secure private funding for worthy causes. Contributing some capital along the way, the banks also take on the functions of economic advisers and investment bankers. These efforts to align development banks better with commercial interests and practices have been well received, and stand in contrast to the banks' former image as lethargic financiers of government works projects.

### **SELF-ASSESSMENT EXERCISE 3**

Identify the term Regional Development Bank.

## **4.0 CONCLUSION**

The development bank is normally established, as we have discussed in this study unit, and saddled with the responsibility to cater for the direct development of the critical sectors of the economy as well as engaging in operations that can cater for the welfare of the citizens. Thus development banks do preoccupy themselves with funding of developmental projects and industrial undertakings in the economy. There are regional

and community development banks in addition to the global one (the World Bank) which caters for global development by offering loans and grants to various countries around the world.

## **5.0 SUMMARY**

The topics that we have discussed in this study unit include: Meaning of Development Bank, Essence of Community Development banks, and the Role of Regional Development Banks, which are established in various parts of the world. In the next study unit, we shall discuss universal bank in terms of another variety of banks operating in different economies around the world.

## **6.0 TUTOR-MARKED ASSIGNMENT**

Differentiate between Community Development Banks and Regional Development Banks.

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## **UNIT 13: UNIVERSAL BANKS**

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- 3.0 Main Content
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  - 3.2 Advantages of Universal Banking
  - 3.3 Disadvantages of Universal Banking
- 4.0 Conclusion
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- 6.0 Tutor Marked Assignment
- 7.0 References/Further Readings

### **1.0 INTRODUCTION**

There are variations in the operations of commercial banks so that some commercial banks special in providing peculiar services to the public while some other ones are known to delve into operations that are very fluid in nature. Such is the case with the universal banks. This is because universal banks are known for operations which go beyond commercial by combining these services with investment banking services as well as insurance and stock broking services, among others. The discussion in this study unit is on operations of universal banking in a given economy.

### **2.0 OBJECTIVES**

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

- i) explain the meaning of universal banking
- ii) identify and explain advantages of universal banking
- iii) mention and explain disadvantages of universal banking

### **3.0 MAIN TEXT**

#### **3.1 MEANING OF UNIVERSAL BANKING**

Universal banking refers to a banking system that combines the commercial banking, investment banking (asset management, trading, and underwriting), development banking, insurance operations and many other financial activities. It is a financial banking system in which all financial products are available under one roof. This implies that a universal bank is a bank that performs commercial bank functions in addition to other functions in areas of merchant banking, mutual funds, factoring, credit cards, housing

finance, car loans, retail loans, and insurance services, among others. Therefore, it is known as a financial services supermarket.

Universal banking is best suited for very large banks because such banks provide a lot of funds for the operations of many companies and therefore, they are bound to take part in the corporate governance management of these companies. As large banks, these banks have a large number of branches within the country where it operates and even all over the world. Hence they provide many different financial services to their clients.

The universal banking genre is very relevant to the United Kingdom and the US, where historically a distinction drawn between pure investment banks and commercial banks. In US, for instance, the practice of universal banking emanated from the Glass- Steagal Act of 1933. However, in both US and UK, the regulatory barriers against the combination of investment banks and commercial banks have largely been removed, resulting in the emergence of a number of universal banks.

In the case of other countries, the practice is less relevant to their economies with the exception of India, as there is no regulatory distinction between investment banks and commercial banks. Thus, banks of a very large size tend to operate as universal banks, while the smaller ones tend to specialise in commercial banking operations or as investment banks. This is particularly so in countries with European banking tradition. Notable examples of such universal banks include BNP Paribas and Societe Generale of France; HSBC and RBS of the United Kingdom; Deutsche Bank of Germany; Bank of America, Citigroup, JP Morgan Chase and Wells Fargo of the United States; and UBS and Credit Suisse of Switzerland.

### **SELF-ASSESSMENT EXERCISE 1**

Explain the term Universal Banking.

### **3.2 ADVANTAGES OF UNIVERSAL BANKING**

Since universal banks hold stakes (equity shares) of many companies. Their operations will engender investors' confidence in allied companies of the bank because investors have full confidence and faith in the holding companies' operations the bank will closely watch all the activities of the allied companies in which they hold some stake.

1. Universal banking creates economies of scale in operations because it results in lower costs with higher output of operations while ensuring better products and services.
2. It ensures efficient resource utilisation because the bank makes use of its structure to render diverse form of banking operations such as investment banking, merchant banking services, and insurance services, among others, and by implications diversifying risks in its operations.

3. Universal banks are known to invest their client's money in different types of Mutual funds and also venture into the share market as well as equity holdings and therefore, they can also manage their client's varied investments profitably.
4. Since universal banks diversify their activities they can utilise the financial expertise at their disposal to provide different financial services including the overhead cost for their operations since their diverse operations are provided under one roof, by using the same structure.
5. The universal banks can easily market (sell) all their financial products and services through their many branches. They can ask their existing clients to buy their other products and services. This requires less marketing efforts because of their well-established brand name. For e.g. ICICI may ask their existing bank account holders in all their branches, to take house loans, insurance, to buy their Mutual funds, etc. This is done very easily because they use one brand name (ICICI) for all their financial products and services.
6. Universal banking offers all financial products and services under one roof. One-stop shopping saves a lot of time and transaction costs. It also increases the speed or flow of work. So, one-stop shopping gives benefits to both banks and their clients.
7. Universal bank provides an ideal solution for an investor's quest to have access to varied investment options, thus saving a lot of time and cost for the investment.

## **SELF-ASSESSMENT EXERCISE 2**

Identify the advantages that are inherent in universal banking.

### **3.3 DISADVANTAGES OF UNIVERSAL BANKING**

Universal banking System is known to offer all financial products and services under one arrangement. Therefore, it creates many problems because of multiplicity of rules and regulations they have to contend with but they are provided by the same bank.

1. Since universal banking is done by very large banks, their failure will have ripple effects on the banking industry and the whole economy. It can also affect the world economy in the case of such bank a multinational corporation operating in different countries around the world. For instance, the failure of the Lehman Brothers recently impacted negatively on the economies of some countries in Europe, America particularly the USA as well as India.
2. Such universal banks are very large, and therefore, they can easily get involved monopoly operations in the banking industry with many harmful effects on the other banks, and the public and the economic development of the country.



3. In combining commercial and investment banking can create conflict of interest. Because some banks may give more importance to one type of banking and give less attention to the other type of banking, which does not make commercial sense.
4. Universal banks may be tempted to take excessive risks, and therefore, there would arise operational problems as evidenced in the case of Nigerian environment, which informed the cancellation of such banking practice by the Central Bank of Nigeria.
5. Such banks may be focus their operations on unrelated areas while diverting depositors funds to such businesses which may not be in the interest of the depositors because of possible loss of investment by the banks.
6. The banks may be tempted to engage in unsound loans to share up the price of their shares which negates sound financial practices.
7. Such banks may be using depositors' funds in purchasing the shares of their subsidiaries in order to enhance their financial position whereas such companies may be operating on weak fundamentals.
8. The officials of such banks may be tempted to press their banking customers into investing in securities which the banks themselves were under pressure to sell due to their own pecuniary stake in the transaction.
9. Such banks may be tempted to use their own assets for securities of companies with weak operational fundamentals with consequent risk to the bank depositors' funds.

### **SELF-ASSESSMENT EXERCISE 3**

Identify the disadvantages that are inherent in universal banking.

### **3.4 UNIVERSAL BANKING IN NIGERIA**

It was introduced on 1st January 2001 by the Central Bank of Nigeria (CBN). According to CBN, universal banking scheme was introduced for purpose of harmonizing both merchant banking services with those of the commercial banking. But due to poor performance, it has been abolished by the apex bank, the Central Bank of Nigeria in recent years.

### **4.0 CONCLUSION**

We have discussed in this study the nature of universal banking which is essentially a banking system that combines the commercial banking, investment banking (asset management, trading, and underwriting), development banking, insurance operations and many other financial activities. It is a financial banking system in which all financial products are available under one roof. Therefore, a universal bank is the type of bank that performs commercial bank functions in addition to other functions in areas of merchant

banking, mutual funds, factoring, credit cards, housing finance, car loans, retail loans, and insurance services, among others.

## **5.0 SUMMARY**

In this study unit, we have discussed topics Meaning of Universal Banking, Advantages of Universal Banking, and Disadvantages of Universal Banking all in relation to universal banking genre. In the next study unit, we shall discuss rural banking operations.

## **6.0 TUTOR-MARKED ASSIGNMENT**

1. Discuss the nature of operations of a universal bank.
2. What are the advantages and disadvantages of universal banking?

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## **UNIT 14: RURAL BANKING**

### **CONTENTS**

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
  - 3.1 Meaning of Rural Banking
  - 3.2 Types of Services of Rural Banks
  - 3.3 Rural Banking Scheme in Nigeria
    - 3.3.1 Incentives from CBN for Participating Banks
    - 3.3.2 Reasons Responsible for Failure of Rural Banking in Nigeria
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor Marked Assignment
- 7.0 References/Further Readings

### **1.0 introduction**

In the preceding study units, we have discussed various types of conventional banks. The rural areas are not being served by the conventional banks. Therefore, they are being considered in the financial inclusion scheme, which informs the government to encourage, and even promulgate regulations on it, for commercial banks to establish some of their branches in the rural areas of the economies. The pushing of commercial banks to establish some branches in the rural areas through regulations has been the practice in the Nigerian economy in the past. This move is to help in providing services and above all, to mobilize rural savings for economic development. In this study, we shall discuss the rural banking scheme.

### **2.0 OBJECTIVES**

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

- i) explain the meaning of rural banking
- ii) identify and explain types of services offered by rural banks
- iii) discuss the rural banking scheme in Nigeria
- iv) mention the incentives granted for participating banks
- v) identify reasons responsible for failure of rural banking in Nigeria.

### **3.0 MAIN TEXT**

#### **3.1 REALM OF RURAL BANKING**

It is a rural bank is a financial institution that helps rationalize the developing regions or developing country to finance their needs specially the projects regarding agricultural progress.

The services provided by a commercial bank and those of the rural bank are the same. The rural bank provides bank accounts, accept deposits, grant loans etc. to its customers. The only difference between the two is the population they serve. Commercial banks serve the general population of the country that live in cities and towns whereas the rural banks serve the customers from the rural villages of the country.

Rural banking is a common practice in places where banking institutions are few and far between and people who need to carry out banking transactions may have difficulty finding a way to do so. With modern technology, more and more people have access to online systems that allow them to conduct certain types of banking without a nearby branch, but this technology is not available for everyone, and demand for rural banking is still high in some areas.

Rural banking is the process of conducting banking transactions out in the country where bank branches are too far away to be of use. Rural banking is popular for very small towns and farmers who live far away from areas of larger population and cannot make the drive to these locations whenever they need to use banking services. Typically, an agent of the bank will visit these rural locations and offer to make transactions in an official capacity.

##### **1. Service Process**

The agent who goes out into rural areas and helps account holders works for an MFI, or microfinance institution, which specializes in offering banking services to a certain area. The agent records and honors the transactions immediately, in the presence of the account holder.

##### **2. Operations**

Rural banking is very common in countries with emerging markets that are beginning to offer a wider selection of banking services. This includes places like India, China and Nigeria, among other countries in Africa.

##### **3. Technology**

Technology plays an important role in rural banking. One of the main problems agents run into is a question of identity--if the person they are working with is really the account

holder. Technology such as portable fingerprint scanners and cell phones with satellite service allow the agents to verify identity more accurately.

### **SELF-ASSESSMENT EXERCISE 1**

What is Rural Banking?

#### **3.2 Types of Services**

Rural banking attempts to offer all the basic banking services that people living in rural areas need such as identified and explained as follows.

1. Cash deposits are one of the most common services, since these occur on a regular basis and must often be done in person.
2. Loan and loan repayment services are also offered for those who cannot make their payments in any other way.

### **SELF-ASSESSMENT EXERCISE 2**

What are the services being provided by a Rural Banking?

#### **3.3 RURAL BANKING SCHEME IN NIGERIA**

It was introduced in 1977 and discarded in 1989. The objectives of the scheme among others include the following:

- i) Introduction of a banking habit among the rural dwellers;
- ii) Mobilization of savings from the rural areas for the purpose of channeling same to profitable portable ventures;
- iii) Creation of credit by way of equity and loans for small scale industries;
- iv) Development of agriculture and agro-allied industries in the rural areas; and
- v) Reducing to a comfort size, the drift of young men and women from the rural to the urban areas.

### **SELF-ASSESSMENT EXERCISE 3**

What are the reasons for the introduction of Rural Banking in Nigeria?

### **3.3.1 Incentives from CBN for Participating Banks**

The incentives granted to the participating banks by the Central Bank of Nigeria include the following:

- a) Waiving the requirements for feasibility survey report as a prerequisite for the establishment of rural bank branches;
- b) Allowing the banks the monopoly of providing banking services in the allocated centres for a period of three years; and
- c) Allowing the banks to write off the capital cost of erecting office blocks and staff quarters within three years.

### **SELF-ASSESSMENT EXERCISE 4**

What are the incentive reasons for the introduction of Rural Banking in Nigeria?

### **3.3.2 Reasons Responsible for Failure of Rural Banking in Nigeria**

There are various that are responsible for the failure of rural banking scheme in a Nigeria, among are the following:

- a) Government promoted the scheme when the country was managed on the basis of regulated economic system in place of free market system. When the government introduced the economic liberalization policy, the continued existence of the rural banking scheme became jeopardize;
- b) The rural banking scheme was unprintable in its operations because of the fixed overhead cost that could not be sustained by its returns;
- c) Most of the branches of the banks in the rural areas was discovered to be serving as conduit pipe for channeling rural savings to the urban areas;
- d) The emergence of the community baking scheme, which was designed by owned and operated by the communities, crippled the needed patronage for the rural branches of commercial banks; and

### **SELF-ASSESSMENT EXERCISE 5**

What are the reasons for the failure of Rural Banking in Nigeria?

## **4.0 CONCLUSION**

We have discussed in this study the nature of universal banking which is essentially a banking system that combines the commercial banking, investment banking (asset management, trading, and underwriting), development banking, insurance operations and

many other financial activities. It is a financial banking system in which all financial products are available under one roof. Therefore, a universal bank is the type of bank that performs commercial bank functions in addition to other functions in areas of merchant banking, mutual funds, factoring, credit cards, housing finance, car loans, retail loans, and insurance services, among others.

## **5.0 SUMMARY**

In this study unit, we have discussed topics Meaning of Universal Banking, Advantages of Universal Banking, and Disadvantages of Universal Banking all in relation to universal banking genre. In the next study unit, we shall discuss rural banking operations.

## **6.0 TUTOR-MARKED ASSIGNMENT**

1. Explain the term Rural Banking.
2. What are the reasons for the introduction of Rural Banking in Nigeria?

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## **UNIT 15: MARKETING OF BANK SERVICES**

### **CONTENTS**

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
  - 3.1 Features of Marketing of Bank Services
  - 3.2 Strategic Marketing of Bank Services
    - 3.2.1 Essential Considerations for Marketing of Bank Services
  - 3.3 Reasons for Marketing of Bank Services
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor Marked Assignment
- 7.0 References/Further Readings

### **1.0 INTRODUCTION**

Bank services are just like products. Therefore, they are normally developed, packaged, brought to the customers, and offered to them at appropriate prices and at the right time. Furthermore, the dynamic nature of the economy necessitates the need for marketing of banking services. This because banking operations evolved out of the changing environment and constant interplay of various environmental and interdependent factors that do impact on their fortunes. Therefore, the importance of a systematic approach to marketing of such services cannot be overstressed.

### **2.0 OBJECTIVES**

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

- i) identify and explain features of marketing of bank services
- ii) identify and explain steps involved in strategic marketing of bank services
- iii) discuss essential considerations for marketing of bank services
- iv) mention and explain reasons for marketing of bank services

### **3.0 MAIN CONTENT**

#### **3.1 FEATURES OF MARKETING OF BANK SERVICES**

- i) Banking product cannot be seen or touched like manufactured products (intangibility)



- ii) In marketing banking products, the product and the seller are inseparable; they together define the banking product (inseparability)
- iii) Banking products are products and delivered at the same time; they cannot be stored and inspected before delivering (perishability)
- iv) Standardization of banking product is difficult (variability)

### **SELF ASSESSMENT EXERCISE 1**

Identify the features of marketing of bank services.

### **3.2 STRATEGIC MARKETING OF BANK SERVICES**

Strategic marketing of banking services in relation to environmental demands requires the following steps:

- i) Identifying customers' financial needs and wants;
- ii) Developing appropriate banking services to meet these needs;
- iii) Pricing for the services so developed;
- iv) Setting up suitable outposts / banks branches; and
- v) Advertising to promote the services to the existing as well as prospective customers.

In a nutshell, as observed by Deryk Weyer of Barclays Bank call it “a process, consisting of identifying the most profitable markets now and in future; assessing the present and the future needs of the customers; setting business development goals and making plans to meet them; and managing various services and promoting them to achieve the plans – all in the context of a changing environment in the market”.

The above preoccupations in marketing of banking services cannot be overlooked in the face of competitive nature of the banking industry in Nigeria and other economies around the world. In essence, therefore, the marketing of bank services like marketing of products involves identifying and producing relevant bank products and offer them to the public at the appropriate time and right place and at the right prices. The purpose of the services is to satisfy the needs of the banking public.

### **SELF ASSESSMENT EXERCISE 2**

Identify the requirements for strategic marketing of bank services.

### **3.2.1 ESSENTIAL CONSIDERATIONS FOR MARKETING OF BANK SERVICES**

There are essential considerations that are required to push the services through to the acceptance of the bank customers. Such essentials include the following:

- i) Existing bank services;
- ii) Development in the economy;
- iii) Available technology;
- iv) Desires of the banking public;
- v) Nature of bank convenience services;
- vi) Global economic outlook;
- vii) Socio-economic relations among nations;
- viii) Development in international trade;
- ix) Demand of international finance; and
- x) Government economic and monetary policies.

### **SELF ASSESSMENT EXERCISE 3**

Identify the requirements for strategic marketing of bank services.

### **3.3 REASONS FOR MARKETING OF BANK SERVICES**

#### **1. Awareness among Customers**

Modern technology has made customers aware of the developments in the economic environment, which includes the financial system. Financial needs of the customers have grown multifold into various forms like quick cash accessibility, money transfer, asset security, increased return on surplus funds, financial advice, deferred payments etc. With a wide network of branches, even in a dissimilar banking scenario, customers expect the banks to offer a more and better service to match their demands and this has compelled banks to take up marketing in right earnest.

#### **2. Quality as a Key Factor**

In relation to the dynamic nature of the economy, in terms of the opening up of the various sectors of the economy, fast change has been experienced in every activity, and banking has been no exemption. Quality is the watchword in the competitive world, which is market driven and banks have had to face up to this emerging scenario. Moreso, the essence of quality services has to be demonstrated to the banking public in order to win their patronage by the banks.

### **3. Growing Competition**

Increased competition is being faced by the Indian banking industry from within the system with other agencies both, local and foreign, offering value added services. Competition is no more confined to resource mobilization but also to lending and other areas of banking activity. The foreign commercial bank with their superior technology, speed in operations and imaginative positioning of their services has also provided the necessary impetus to the Indian banks to innovate and co

### **4. Technology Advances**

Technological innovation has resulted in financial product development especially in the international and investment banking areas. The western experience has demonstrated that technology has not only made execution of work faster but has also resulted in greater availability of manpower for customer contact.

## **SELF ASSESSMENT EXERCISE 4**

What are the reasons for marketing of bank services?

### **4.0 CONCLUSION**

We have discussed in this study the nature of the marketing of bank services. We have considered the fact marketing of bank services requires some steps to be adhered to in order to make it produce the desired effects. There are also some requirements to be considered in strategic marketing of bank services. We have also shown in our discussion the reasons for the marketing of bank services, which include but not limited to growing completion, advancement in technology, awareness of customers, and quality of banking products.

### **5.0 SUMMARY**

In this study unit, we have discussed topics such as Features of Marketing of Bank Services, Strategic Marketing of Bank Services, Essential Considerations for Marketing of Bank Services, and Reasons for Marketing of Bank Services. In the next study unit, we shall discuss rural banking operations.

## **6.0 TUTOR-MARKED ASSIGNMENT**

1. Mention and discuss the requirements for strategic marketing of bank services.
2. What are the reasons for the marketing of bank services?

## **7.0 REFERENCES/FURTHER READINGS**

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## **UNIT 16: INVESTMENT COMPANIES**

### **CONTENTS**

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
  - 3.1 Meaning of Investment Company
  - 3.2 Mode of Operations of Investment Companies
  - 3.3 Types of Investment Company
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor Marked Assignment
- 7.0 References/Further Readings

### **1.0 INTRODUCTION**

Among the firms that operate in financial sector of any developed economy, there are investment companies that accommodate funds from small investors. Such companies pool the investments of small investors and invest the funds in the operations of corporate entities with the hope of generating reasonable returns for their shareholders.

Therefore, in this study unit, we shall discuss the nature of operations of investment companies.

### **2.0 OBJECTIVES**

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

- i) explain the meaning of an investment company
- ii) discuss the basic process of operations of investment companies
- iii) mention and discuss main types of investment companies

### **3.0 MAIN CONTENT**

#### **3.1 MEANING OF INVESTMENT COMPANY**

An investment company is a body corporate whose main business is holding securities of other companies purely for investment purposes. The investment company invests money or funds on behalf of its shareholders who in turn share in the profits and losses of its operations. In essence, an investment company is a firm that generates and invests funds

of investors in securities that are appropriate for their stated operational objectives, in return for a management fee.

In another perspective, investment company is a firm that provides investment advisory services and also operates mutual funds, which allows its clients to carry greater or lesser risk, depending on their particular investment goals. The investment companies that actively manages more than a certain amount money is normally required to register with the Securities and Exchange Commission.

### **SELF ASSESSMENT EXERCISE 1**

What is an Investment Company?

### **3.2 MODE OF OPERATIONS OF INVESTMENT COMPANIES**

The above exposition implies that an investment company is a business operation that holds securities issued by other companies as a means of earning returns from investments. These companies in turn issue securities to their own shareholders, who earn dividends as the investments of the company generate a return.

The money or funds being used to buy stocks issued by other corporations by investment companies is obtained from the proceeds of the sale of the investment securities issued by the investment company to their stockholders, along with any profits generated by the portfolio of the company itself.

The basic process for an investment company involves pooling the funds received from the sale of its own investment securities, and using those funds to secure other securities that are projected to earn a significant return within the amount of time desired.

An investment company may choose to focus on specific types of investments associated with a given industry, or take the approach of diversifying the investments as a means of insulating itself from downturns in one particular area of the market. As with individual investors, the strategy employed by the investment company depends greatly on the financial goals of the company and the amount of risk it is willing to assume in order to secure the right securities.

The return being generated by the investment company, from the stock and other securities it purchased from other companies, provides the funding it needs to pay dividends to its shareholders or security holders. The shareholders of investment companies can always anticipate a steady flow of dividends, as long as the companies are performing well, on the basis of the provision that apply to the issuance of the shares.

The investment company, in order to maintain and grow the amount of the returns and consequently the amount of dividends going for their shareholders, will monitor the

performance of its investments very closely by executing purchases and sale of securities when and as when the need arises in order to optimize the amount of return that is realized.

## **SELF ASSESSMENT EXERCISE 2**

Explain how Investment Company operate.

### **3.3 TYPES OF INVESTMENT COMPANY**

While the concept of investment companies are found in many economies around the world, peculiar country regulations are often used to define how they can be organized and operated, as well as determine the types of investment activity that they can utilize for the operations.

There are many types of investment companies such as identified below.

#### **1. Mutual Funds (Open-End Management Investment Companies)**

This type of investment company makes use of mutual funds as its primary investment strategy. It is the type of professionally managed collective investment scheme that pools money from many investors to purchase securities. Mutual Fund is most commonly applied only to those collective investment vehicles that are regulated and sold to the general public. They are sometimes referred to as investment companies or registered investment companies. Most mutual funds are open-ended investments, which imply that investors can buy or sell shares of the fund at any time.

#### **2. Closed-End Management Investment Companies (Closed-end Funds)**

This type of investment company focuses on securing closed-end in order to generate returns. As compared to the mutual fund company which makes use of mutual funds s its primary investment strategy. In some instances, the company may use of a variety of approaches which may include a combination of closed-end and mutual fund opportunities.

#### **3. Unit Investment Trusts**

This is a form of collective investment that is constituted under a trust deed. Unit trusts are pen-ended investments. Hence the underlying value of the assets is always directly represented by the total number of units issued multiplied by the unit price less the

transaction or management fee charged and any other associated costs. Each fund has a specified investment objective that determines the management aims and limitations.

The structure of unit investment trust involves some arrangements which dictate that:

- i) The fund manager runs the trust for profit.
- ii) The trustees ensure the fund manager keeps to the fund's investment objective and safeguards the trust assets.
- iii) The unit holders have the rights to the trust assets.
- iv) The distributors allow the unit holders to transact in the fund manager's unit trusts
- v) The registrars are usually engaged by the fund managers and generally act as middlemen between the fund managers and various other stakeholders.

#### **4. Face-Amount Certificate Company**

This is a regulated investment company that pays a stated amount to certificate holders on a stated maturity date. In other words, it is a financial institution that sells shares to individuals and invests in securities issued by other companies

A face-amount certificate company is a company that borrows from investors and offers its assets or other securities as collateral. The amount, the face value, is the principal on which the investor will earn interest from the company. The investors can redeem their certificates at maturity for the face value; alternatively, they can redeem the certificates early for a predetermined surrender value.

#### **5. Private Investment Funds**

These are simply private companies that make investments in stocks or bonds, but are limited to a number of investors which is than a hundred. They are private and are not regulated by the Securities and Exchange Commission. These funds are often composed of very wealthy investors.

### **SELF ASSESSMENT EXERCISE 3**

Identify and discuss the main types of investment companies.

#### **4.0 CONCLUSION**

We have discussed in this study the nature of investment companies; that they are financial companies that generate and invest money or funds on behalf of its shareholders who in turn share in the profits and losses of its operations. Such companies operate by holding securities issued by other companies as a means of earning returns from investments. These companies in turn issue securities to their own shareholders, who earn



dividends as the investments of the company generate a return. The basic process for an investment company involves pooling the funds received from the sale of its own investment securities, and using those funds to secure other securities that are projected to earn a significant return within the amount of time desired. We discovered from our analysis that there are many types of investment companies and these include: Mutual Funds (Open-End Management Investment Companies); Closed-End Management Investment Companies (Closed-end Funds); Unit Investment Trusts; Face-Amount Certificate Company; and Private Investment Funds

## **5.0 SUMMARY**

In this study unit, we have discussed topics such as Meaning of Investment Company, their Mode of Operations of Investment Companies, and Types of Investment Company. In the next study unit, we shall discuss insurance companies.

## **6.0 TUTOR-MARKED ASSIGNMENT**

1. Discuss the operations of investment companies.
2. Mention and discuss various types of investment companies.

## **7.0 REFERENCES/FURTHER READINGS**

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## **UNIT 17: INSURANCE COMPANIES**

### **CONTENTS**

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
  - 3.1 Meaning of Insurance Company
  - 3.2 Operations and Regulations of Insurance Companies
  - 3.3 Common Characteristics of Risks Insured by Insurance Companies
  - 3.4 Types of Insurance Products
  - 3.5 Benefits of Insurance Policies
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor Marked Assignment
- 7.0 References/Further Readings

### **1.0 INTRODUCTION**

Among the firms that operate in financial sector of any developed economy, there are insurance companies that accommodate the operational risks of corporate entities, public institutions and individuals in the society. Such companies create various policies which they sell to other companies and individuals who are interested and able to afford the periodic payments of premiums. The premiums generated from policy holders form a pool of funds for the operations of insurance companies; out of which they settle claims of the insured in the event of any calamities. Therefore, in this study unit, we shall discuss the nature of operations of insurance companies.

### **2.0 OBJECTIVES**

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

- i) explain the meaning of an insurance company
- ii) discuss the operations and regulations of insurance companies
- iii) identify and explain common characteristics of risks insured by insurance companies
- iv) mention and discuss main types of insurance policies
- v) list and explain the benefits of Insurance Policies

### **3.0 MAIN CONTENT**

#### **3.1 MEANING OF INSURANCE COMPANY**

Insurance companies are business organizations that carry on business in order to bear the risks of other companies in any economy. Therefore, they are called risk bearers. The insurance companies also bear the risk that individuals are willing to pay to avoid; such as risk of death, disability, property loss, litigation, and investment fluctuation, among other risks.

In return for their services, insurance companies receive premiums, which encourage them to carry business for underwriting risks of business organizations, public institutions, and individuals who are willing to insure their property.

#### **SELF ASSESSMENT EXERCISE 1**

What is an insurance company?

#### **3.2 OPERATIONS AND REGULATIONS OF INSURANCE COMPANIES**

In the course of their business, insurance companies collect and invest funds generated from premiums to meet future liabilities and make profit. The liabilities of insurance company are purely contingent liabilities because they depend on the occurrences of certain events in the future period of time.

In terms of regulation of the operations of insurance companies, a government agency called the National Insurance Commission (NAIC) is charge of regulatory activities in the country. There does not exist a federally-sponsored insurance to back the insurance industry, thus the individual credit ratings of insurers are important. The publicly quoted insurance companies in Nigeria are also subject to Securities and Exchange Commission's regulations.

Generally, the government through the Federal Ministry of Finance, regulates the type of assets permitted for insurance companies, required surplus (statutory surplus) in respect of assets and liabilities and their ability to meet obligations, and taxation. Fundamentally, the operational purpose of insurance companies is to spread risks out among all the policy holders. To accomplish this, and stay economically viable, they have to use business strategies in their operations for their survival and profitable business in order to satisfy their shareholders.

Generally, therefore, the insurance companies exist as financial institutions to:

- 1) Create proper policy language, and most insurance policies must be approved by the National Insurance Commission. They also typically follow either an ISO or AAIS standard in their operations.

- 2) They need to know how to rate the risks so they know how much premium to charge. They use actuarial studies for this. This is in consideration of the fact that some other companies can simply buy their rates.
- 3) Then they need to select the right risks (policy holders), and avoid the wrong policy holders. Like, for example, with auto insurance they may decline to insure people with drunk driving convictions. In other words, they need to create some underwriting standards.
- 4) Insurance companies also have to issue the policies and collect the premiums. Many insurance companies use independent agents to sell their insurance policies.
- 5) After that, they have to be ready to handle any claims or losses. They will need experienced claims adjusters to investigate, analyze, evaluate, and settle or defend all the claims.
- 6) Sometimes smaller insurance companies will buy re-insurance to protect against excessive losses. And they pay a premium for that re-insurance.
- 7) At the end of the year, they will calculate their underwriting ratio in consideration of: for every amount of money they received in premiums, how much did they pay out in either claims or administrative expenses; if they had a bad year, they may need to re-evaluate their functions; because if they paid out much more than they have taken in, they cannot stay in business. This will depend on how much the insurance company has in their cash reserves.

## **SELF ASSESSMENT EXERCISE 2**

Mention the pre-occupations of insurance companies.

### **3.3 COMMON CHARACTERISTICS OF RISKS INSURED BY INSURANCE COMPANIES**

Risk which can be insured by private companies typically shares seven common characteristics such as follows.

#### **1. Large number of similar exposure units**

Since insurance operates through pooling of monetary resources, the majority of insurance policies are provided for individual members of large classes, allowing insurers to benefit from the law of large numbers in which predicted losses are similar to the actual losses. Exceptions include Lloyd's of London, which is famous for insuring the life or health of actors, sports figures, and other famous individuals. However, all exposures will have particular differences, which may lead to different premium rates.

## **2. Definite loss**

The loss takes place at a known time, in a known place, and from a known cause. The classic example is death of an insured person on a life insurance policy. Fire, vehicles accidents, and worker injuries may all easily meet this criterion. Other types of losses may only be definite in theory. Occupational diseases, for instance, may involve prolonged exposure to injurious conditions where no specific time, place, or cause is identifiable. Ideally, the time, place, and cause of a loss should be clear enough that a reasonable person, with sufficient information, could objectively verify all three elements.

## **3. Accidental loss**

The event that constitutes the trigger of a claim should be fortuitous, or at least outside the control of the beneficiary of the insurance. The loss should be pure, in the sense that it results from an event for which there is only the opportunity for cost. Events that contain speculative elements, such as ordinary business risks or even purchasing a lottery ticket, are generally not considered insurable.

## **4. Large loss**

The size of the loss must be meaningful from the perspective of the insured. Insurance premiums need to cover both the expected cost of losses, plus the cost of issuing and administering the policy, adjusting losses, and supplying the capital needed to reasonably assure that the insurer will be able to pay claims. For small losses, these latter costs may be several times the size of the expected cost of losses. There is hardly any point in paying such costs unless the protection offered has real value to a buyer.

## **5. Affordable premium**

If the likelihood of an insured event is so high, or the cost of the event so large, that the resulting premium is large relative to the amount of protection offered, then it is not likely that the insurance will be purchased, even if on offer. Furthermore, as the accounting profession formally recognizes in financial accounting standards, the premium cannot be so large that there is not a reasonable chance of a significant loss to the insurer. If there is no such chance of loss, then the transaction may have the form of insurance, but not the substance.

## **6. Calculable loss**

There are two elements that must be at least estimable, if not formally calculable: the probability of loss, and the attendant cost. Probability of loss is generally an empirical exercise, while cost has more to do with the ability of a reasonable person in possession of a copy of the insurance policy and a proof of loss associated with a claim presented under that policy to make a reasonably definite and objective evaluation of the amount of the loss recoverable as a result of the claim.

## **7. Limited risk of catastrophically large losses**

Insurable losses are ideally independent and non-catastrophic, meaning that the losses do not happen all at once and individual losses are not severe enough to bankrupt the insurer; insurers may prefer to limit their exposure to a loss from a single event to some small portion of their capital base. Capital constrains insurers' ability to sell earthquake insurance as well as wind insurance in hurricane zones.

In the US, flood risk is insured by the federal government. In commercial fire insurance, it is possible to find single properties whose total exposed value is well in excess of any individual insurer's capital constraint. Such properties are generally shared among several insurers, or are insured by a single insurer who syndicates the risk into the reinsurance market.

### **SELF ASSESSMENT EXERCISE 3**

Mention and discuss the common characteristics of risks insured by insurance companies.

## **3.4 TYPES OF INSURANCE PRODUCTS**

There are varied types of insurance products that insurance companies do make available to individuals, corporate entities and public institutions. Such insurance services include the following:

### **1. Auto insurance**

Automobile insurance protects the policyholders against financial loss in the event of an incident involving a vehicle they own, such as in a traffic collision. The coverage of the policy generally includes: property coverage, for damage to or theft of the car; liability coverage, for the legal responsibility to others for bodily injury or property damage; and medical coverage, for the cost of treating injuries, rehabilitation and sometimes lost wages and funeral expenses.

### **2. Gap insurance**

Gap insurance covers the excess amount on a auto loan in an instance where your insurance company does not cover the entire loan. Depending on the company's specific policies it might or might not cover the deductible as well. This policy is designed for use by those who put low down payments, have high interest rates on their loans, and those with 60-month or longer terms. Gap insurance is typically offered by a finance company when the vehicle owner purchases their vehicle, but many auto insurance companies offer this coverage to consumers as well.

### **3. Income protection insurance**

Under this type of coverage, there are some constituent policies such as enumerated below.

#### **i) Disability insurance policy**

Disability insurance policies provide financial support in the event of the policy holders becoming unable to work because of disabling illness or injury. It provides monthly support to help pay such obligations as mortgage loans and facility associated with credit cards. Short-term and long-term disability policies are available to individuals, but considering the expense, long-term policies are generally obtained only by those with at least six-figure incomes, such as doctors, lawyers, etc. Short-term disability insurance covers a person for a period typically up to six months, paying a stipend each month to cover medical bills and other necessities.

#### **ii) Long-term disability insurance**

Long-term disability insurance covers an individual's expenses for the long term, up until such time as they are considered permanently disabled and thereafter Insurance companies will often try to encourage the person back into employment in preference to and before declaring them unable to work at all and therefore totally disabled.

#### **iii) Total disability insurance**

Total disability insurance provides benefits when a person is permanently disabled and can no longer work in their profession, often taken as an adjunct to life insurance.

#### **iv) Workers' compensation policy**

Workers' compensation insurance replaces all or part of a worker's wages lost and accompanying medical expenses incurred because of a job-related injury.

### **4. Casualty insurance**

Casualty insurance is a policy that insures against accidents, not necessarily tied to any specific property. It is a broad spectrum of insurance that a number of other types of insurance could be classified, such as auto, workers compensation, and some liability insurances.

### **i) Crime insurance**

Crime insurance is a form of casualty insurance that covers the policyholder against losses arising from the criminal acts of third parties. For example, a company can obtain crime insurance to cover losses arising from theft or embezzlement.

### **ii) Terrorism Insurance**

Terrorism Insurance is a policy that provides protection against any loss or damage caused by terrorist activities. This is very popular in the US established in the wake of September 2011 incident; It is meant as a federal program providing a transparent system of shared public and private compensation for insured losses resulting from acts of terrorism.

### **iii) Kidnap and ransom insurance**

Kidnap and ransom insurance is designed to protect individuals and corporations operating in high-risk areas around the world against the perils of kidnap, extortion, wrongful detention and hijacking.

### **iv) Political risk insurance**

Political risk insurance is a form of casualty insurance that can be taken out by businesses with operations in countries in which there is a risk that revolution or other political conditions could result in a loss.

## **5. Life insurance**

This policy also known as life assurance policy provides a monetary benefit to a decedent's family or other designated beneficiary. It may specifically provide for income to an insured person's family, burial, funeral and other final expenses. Life insurance policies often allow the option of having the proceeds paid to the beneficiary either in a lump sum cash payment or an annuity. In most states, a person cannot purchase a policy on another person without their knowledge.

Annuities provide a stream of payments and are generally classified as insurance because they are issued by insurance companies. They are regulated as insurance, and require the same kinds of actuarial and investment management expertise that life insurance requires. Annuities and pension that pay a benefit for life are sometimes regarded as insurance against the possibility that a retire will outlive his or her financial resources. In that sense, they are the complement of life insurance and, from an underwriting perspective, are the mirror image of life insurance.



Certain life insurance contracts accumulate cash values, which may be taken by the insured if the policy is surrendered or which may be borrowed against. Some policies, such as annuities and endowment policies, are financial instruments to accumulate or liquidate wealth when it is needed.

## **6. Property insurance**

Property insurance provides protection against risks to property, such as fire, theft or weather damage. This may include specialized forms of insurance such as fire insurance, flood insurance, earthquake insurance, home insurance, inland marine insurance or boiler. The term *property insurance* may, like casualty insurance, be used as a broad category of various subsidiary types of insurance such as aviation insurance, crop insurance, and fidelity bond policy, etc.

Home insurance, also commonly called hazard insurance or homeowners insurance provides coverage for damage or destruction of the policyholder's home. In some geographical areas, the policy may exclude certain types of risks, such as flood or earthquake that require additional coverage. Maintenance-related issues are typically the homeowner's responsibility. The policy may include inventory, or this can be bought as a separate policy, especially for people who rent housing. In some countries, insurers offer a package which may include liability and legal responsibility for injuries and property damage caused by members of the household, including pets.

## **7. Marine insurance**

Marine insurance and marine cargo insurance cover the loss or damage of vessels at sea or on inland waterways, and of cargo in transit, regardless of the method of transit. When the owner of the cargo and the carrier are separate corporations, marine cargo insurance typically compensates the owner of cargo for losses sustained from fire, shipwreck, etc., but excludes losses that can be recovered from the carrier or the carrier's insurance. Many marine insurance underwriters will include "time element" coverage in such policies, which extends the indemnity to cover loss of profit and other business expenses attributable to the delay caused by a covered loss.

## **8. Liability insurance**

Liability insurance is a very broad superset that covers legal claims against the insured. Many types of insurance include an aspect of liability coverage. For example, such policy will normally include liability coverage which protects the insured in the event of a claim brought by someone who slips and falls on the property; automobile insurance also includes an aspect of liability insurance that indemnifies against the harm that a crashing car can cause to others' lives, health, or property. The protection offered by a liability insurance policy is twofold: a legal defense in the event of a lawsuit commenced against

the policyholder. And there is the indemnification. This is payment on behalf of the insured in relation to a settlement or court verdict. Liability policies typically cover only the negligence of the insured, and will not apply to results of willful or intentional acts by the insured.

## **9. Credit insurance**

Credit insurance repays some or all of a loan when the borrower is insolvent. Specific types include the following:

- a) Mortgage insurance insures the lender against default by the borrower. Mortgage insurance is a form of credit insurance, although the name "credit insurance" more often is used to refer to policies that cover other kinds of debt.
- b) Many credit cards offer payment protection plans which are a form of credit insurance.
- c) Trade credit insurance is business insurance over the accounts receivable of the insured. The policy pays the policy holder for covered accounts receivable if the debtor defaults on payment.
- d) Collateral protection insurance (CPI) insures property (primarily vehicles) held as collateral for loans made by lending institutions.

## **10. Health Insurance**

This policy pays all or some of costs of medical treatment, indemnity or fee-for-service plans, and managed care by health management organizations (HMOs), and involves restricting provider choice and reimbursements for-profit, nonprofit, government providers.

## **11. Liability Insurance**

This policy insures against risk of litigation (attorney's fees, settlements, jury awards). The time and size of claims are also unpredictable.

## **12. Disability Insurance**

This policy insures against loss of ability to work in current or any occupation; short-term or long-term. The time and size of claims are more predictable, like life insurance

## **13. Long-term Care Insurance**

This policy pays all or some of costs for long-term nursing home care or in-home care for aged/disabled.

## **14. Structured Settlements**

This policy involves fixed payments over time due to disability or damages from a lawsuit. It is managed by life insurance companies

### **15. Guaranteed Investment Contracts (GICs)**

Under this policy, a firm pays single premium and the insurer guarantees annual rate of return, for example, 12% of the amount of the single premium for certain period of time such as five years. The period ranges from one to twenty years typically. At end of period, premium and interest is paid out. Given the fact that the policy involves large premium, such policies are purchased by institutional investors, especially the pension funds. The implication is that the insurer is bearing investment risk.

### **16. Annuities**

Under this policy, insurance company invests generated premiums in stock or bond portfolio earning a return for the investors. Premiums are paid over time or in lump-sum. The annuity payments are fixed or variable, often life-contingent. The income and capital gains are not taxable until withdrawn by investor. The policy involves some guarantee of return and principle compared to mutual fund. It has preferential tax treatment and higher expenses arising from the guarantee accorded to the policy.

### **SELF ASSESSMENT EXERCISE 4**

Identify and discuss the main types of insurance policies.

### **3.5 BENEFITS OF INSURANCE POLICIES**

The insurance companies have sprung up provide framework for safeguarding the interests of corporate entities and individuals from uncertainty by providing certainty of payment at a given contingency. Insurance generally comes to be more and more useful in modern affairs of business and individuals in the society. The importance of insurance can be marshaled out in the following ways:

#### **1. Insurance provides security and safety against some losses**

In case of life insurance payment is made when death occurs or the term of insurance is expired. Similarly, the property of insured is secured against loss on a fire in fire incident, against the loss at damage, destruction or theft of property and goods, etc.

## **2. Insurance policy affords the insured (companies and individuals) some peace of mind**

Hence there is the popularly held belief that “the security wish is the prime motivating factor” in insurance. The security obliterates fear and uncertainty. Basically, occurrences such as fire, windstorm, automobile accident, damage and death are almost beyond the control of human beings and the happenstance in any of these events may frustrate or weaken the human mind. By means of insurance, however, much of the uncertainty that centres about the wish for security and its attainment may be eliminated.

## **3. The Insurance policy protects mortgaged property from being confiscated by the mortgagor**

For instance, at the death of the owner of the mortgaged property, the property is taken over by the lender of funds and the family will be deprived of the uses of the property. On the other hand, the mortgagee wishes to get the property insured because in the event of damage or destruction of the property, he will lose his right to get the loan repaid. The insurance will provide adequate amount to the dependents at the early death of the property-owner to pay off the unpaid loans. Similarly, the mortgagee gets adequate amount at the destruction of the property.

## **4. Insurance policy eliminates dependency problem**

At the instance of death of the husband or father, the suffering of the family knows no bound. Similarly, at the instance of the destruction of property and goods, the family would also suffer. For instance, such occurrence reduces standards of living and members of such family may resort to begging from their relatives, neighbours or friends. Furthermore, the economic independence of the family is reduced or sometimes, lost totally. The insurance comes herein to assist them and provides adequate amount at the time of such sufferings as a form of compensation.

## **5. Generally insurance encourages some form of compulsory saving**

Most insurance policies combine the programs of insurance and savings. The saving with insurance has certain extra advantages such as:

- i) systematic saving is possible because regular premiums are required to be compulsorily paid. The saving with a bank is voluntary and one can easily omit a month or two and then abandon the program entirely;
- ii) In insurance the deposited premium cannot be withdrawn easily before the expiry of the term of the policy. As contrast to this, the saving which can be withdrawn at any moment will finish within no time;
- iii) The insurance will pay the policy-money irrespective of the premium deposited while in case of bank-deposit, only the deposited amount along with the interest is paid. The insurance, thus, provides the wished amount of insurance and the bank provides only the deposited amount; and

- iv) The compulsion or force to premium in insurance is so high that if the policyholder fails to pay premiums within the days of grace, he subjects his policy to void and may get back only a very nominal portion of the total premiums paid on the policy.

For the preservation of the policy, a policy holder has to try his level best to pay the premium. After a certain period, it would be a part of necessary expenditure to be incurred in operations. In absence of such forceful compulsion elsewhere life insurance policy constitutes ideal form of saving, which comes in form of compensation.

## **6. Life insurance provides profitable investment**

Individuals who may be unwilling or unable to handle their own funds would be pleased to find an outlet for their investment in life insurance policies. Endowment policies, multipurpose policies, deferred annuities are certain better form of investment. The elements of investment, regular saving, capital formation, and return of the capital alongwith certain additional return are perfectly observed in life insurance.

## **7. Life assurance enhances fulfillment of the needs of a person**

The needs of a person are divided into a) family needs, b) old-age needs, c) re-adjustment needs, d) special needs, e) the clean-up needs. Taking policy for life assurance by an individual provides him the opportunity to fulfill his needs.

## **SELF ASSESSMENT EXERCISE 5**

Identify and discuss the main benefits of insurance policies.

## **4.0 CONCLUSION**

We have discussed in this study the nature of insurance, which is the exclusive business of the insurance company. Insurance companies, therefore, are business organizations that carry on business in order to bear the risks of other companies in any economy. Hence insurance companies are called risk bearers. We have also discussed that in the course of their business, insurance companies collect and invest funds generated from premiums to meet future liabilities and make profit. The liabilities of insurance company are purely contingent liabilities because they depend on the occurrences of certain events in the future period of time. The common characteristics of risks that can be insured by insurance companies include: large number of similar exposure units; definite loss; accidental loss; large loss; affordable premium; calculable loss; and limited risk of catastrophically large losses. It has been brought to the fore, in the discussion in this

study unit, the fact that insurance companies are very beneficial to individuals, corporate organizations and the society at large.

## **5.0 SUMMARY**

In this study unit, we have discussed topics such as Meaning of Insurance Company, Operations and Regulations of Insurance Companies, Common Characteristics of Risks Insured by Insurance Companies, Types of Insurance Products, and Benefits of Insurance Policies

## **6.0 TUTOR-MARKED ASSIGNMENT**

1. List and discuss various types of insurance policies available companies and individuals.
2. Mention and discuss the common characteristics of risks insured by insurance companies.

## **7.0 REFERENCES/FURTHER READINGS**

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## **UNIT 18: COMPARATIVE BANKING AND FINANCIAL SYSTEM**

### **CONTENTS**

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
  - 3.1 Nature of Islamic and Conventional Banking and Finance
  - 3.2 Peculiarities of Islamic Banking System
  - 3.3 Islamic Banks' Modality of Financing
  - 3.4 Differences between Islamic and Conventional Banks
- 4.0 Conclusion
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### **INTRODUCTION**

The system of Islamic banking is different from the conventional banking system because it is a system of banking operations that are carried out based on the provisions of Islamic law called the *Shariah*. Such banking operations are therefore, guided by the principles of Islamic economics. Hence this implies that this form of banking system is a function of the Islamic system of legal principles as espoused by the Islamic tenets as opposed to the conventional banking system. In this study unit, therefore, we shall discuss the nature and operations of Islamic banking and financial system.

### **2.0 OBJECTIVES**

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

- i) explain the modality of Islamic banking system
- ii) mention and discuss the peculiarities of Islamic banking system
- iii) identify and explain modes of financing by Islamic banking system
- iv) mention and discuss differences between Islamic and conventional banks

### **3.0 MAIN TEXT**

#### **3.1 NATURE OF ISLAMIC BANKING AND FINANCE**

The general principle governing transactions under the Islamic law is permissibility. This is couched in Islamic jurisprudential maxim which holds that “the basic presumption is

that all transactions are permissible unless they are prohibited by a text” in the Islamic holy book (the *Quran*). This is indicative of the fact that all the banking transactions are permitted but with some variations such as sharing of profit and loss.

Islamic banking involves a system of banking activities or banking operations that are carried out based on the provisions of Islamic law couched as *Shariah*. The operations of such banking system are also guided by the principles of Islamic economics. (Aburime and Alio, 2009).

Fundamentally, Islamic law prohibits the collection and payment of interest (usury), which is also commonly called *riba* in Islamic discourse. Hence, Islamic banking is popularly referred to as profit and loss sharing bank system. Furthermore, transactions, instruments and contracts under the Islamic financial system do not permit gambling, dealings in pork, alcohol, ammunition, pornography and any other products and goods that are not compliant with the *Sharia* rules and principles.

As a value proposition (Sanusi, 2009), Islamic finance is market driven but with a moral dimension based on the Islamic value system as encapsulated in the *Sharia*. Lending is not a business in Islam. Linked to this, therefore, is the no interest rule. This means that a customer of an Islamic bank cannot earn interest on a loan nor be required to pay interest on loans. Therefore, any predetermined interest is prohibited.

The conventional banks services include accepting all forms of deposit, financing, issuing letter of credit, foreign exchange transactions, local and overseas guarantees, renting of safe, accepting and servicing of certificates and shares, investment trusteeship and accepting subscriptions in companies. In comparative terms, the general principle governing transactions under the Islamic law is permissibility. This is summarised by the Islamic jurisprudential maxim: “The basic presumption is that all transactions are permissible unless they are prohibited by a text.” The scholars and jurists of Islamic law are unanimous on prohibition of *ribā* as an exception to the general rule of permissibility of transactions. (Abikan, 2009).

The term *ribā* (Abikan, 2009) means increase, gain, excess or quantitative inequality. Before the advent of Islam, it was known in this same connotation as the excess charged to the borrower in consideration of the extension granted him for repayment of a loan after the initially agreed date of maturity. It is literally translated into English as usury or interest. In its technical Islamic law usage, it has been generally defined as an unlawful gain derived from the quantitative inequality of the counter-values in any transaction.

## **SELF ASSESSMENT EXERCISE 2**

What is Islamic banking?



### **3.2 PECULIARITIES OF ISLAMIC BANKING SYSTEM**

There are peculiar features of Islamic banking system (Abdul Gafoor, 2007) which are considered pertinent for discussion.

#### **1. Prohibition of Interest**

The most essential feature of Islamic banking is that it is interest-free. Islamic banks neither charge nor pay interest. Islam prohibits Muslims from taking or giving interest called *riba* regardless of the purpose for which such loans are made and regardless of the rates at which interest is charged.

#### **2. Low Consumer Lending**

Since Islamic banks do not charge interest rates, consumer loans are therefore unattractive since there is no profit to be derived in form of interests on the loans. Hence, Islamic banks deliberately avoid consumer lending.

#### **3. Profit and Loss Sharing**

A basic principle of Islamic banking is the sharing of profit and loss. Profit is lawful in Islam. The Islamic bank's primary objective is to earn profits. However, profit and loss sharing by Islamic banks is emphasized in a different way. Al-Arabi (1966) advances the idea that the bank could advance not only the capital procured through deposits but also the capital of its own shareholders on a profits-sharing basis. Islamic banks share their profits both with their investors and their depositors. This is because the depositors are also seen as owners of the capital used in deriving the profits. The depositors are also made to share in the banking risks.

#### **4. High Real Sector Investing**

Investment activities of Islamic banks have been favourably skewed towards the real sectors of the various economies in which they operate. Their investment activities usually border on equity financing, trade financing and real estate investments. In practice, Islamic banks have been concentrating on short-term trade finance which is less risky. This is more pronounced during the earlier years of an Islamic bank's operation.

This is because long-term financing requires expertise which is not always available. Furthermore, short-term financing is easier to administer, less risky, and the returns are much quicker. Islamic banks invest mostly through equity participation in companies, directly or in partnership with others. Participatory financing is a unique feature of Islamic banking, and can offer responsible financing to socially and economically relevant development projects.

#### **5. Mortgage Financing**

Islamic banks also participate in mortgage transactions by purchasing and reselling properties on a deferred payment basis. The bank buys a property from a seller and re-sells it to a buyer at a profit, while allowing the buyer to repay in installments.

Islam considers it lawful to charge a higher price for a good if payments are to be made at a later date, instead of granting loan to the buyer with which to purchase the item. The good or land is either registered in the name of the buyer or the bank until all the installments are paid.

## **6. Leasing Financing**

Leasing is another real sector investment option frequently utilized by Islamic banks. Under this investment mode, the banks would buy equipments and machineries and lease them out to their clients who may opt to buy the items eventually, in which case the periodic payments will consist of two components, that is, rental for the use of the equipment and installment payment towards the purchase price.

## **SELF ASSESSMENT EXERCISE 2**

Mention and explain the basic peculiarities of Islamic banking system.

### **3.3 ISLAMIC BANKS' MODALITY OF FINANCING**

Islamic banking system (Aburime&Alio, 2009) also has some peculiarities in financing which are considered pertinent for discussion. Islamic banks adopt several modes of acquiring assets or financing projects which border on investment financing, trade financing, lending and other financial services. These are discussed below.

#### **1) Investment Financing**

Islamic banks' modes of investment financing are participatory arrangements between banks and entrepreneurs. They reflect the Islamic view that the borrower must not bear all the risk or cost of a failure, resulting in a balanced distribution of income and thus not allowing monopolists to control the economy to the detriment of the consumers. Also, Shariah prohibits Islamic banks from investing in businesses that are considered immoral or haraam. Ethical investing is the only acceptable form of investment in Islam.

#### **2) Trade Financing**

Islamic modes of trade financing are as follows:

***(i) Mark-up Trade Financing***

The bank buys an item for a client and the client agrees to repay the bank the price and an agreed profit later on.

***(ii) Leasing***

The bank buys an item for a client and leases it to him for an agreed period and, at the end of that period, the lessee pays the balance on the price agreed at the beginning and becomes the owner of the item.

***(iii) Hire Purchase***

The bank buys an item for the client and hires it to him for an agreed rent and period, and, at the end of that period, the client automatically becomes the owner of the item.

***(iv) Sell-and-buy-back***

A client sells one of his properties to the bank for an agreed price payable now on condition that he will buy the property back after a certain time for an agreed price.

***(v) Letters of Credit***

The bank guarantees the import of an item, using its own funds, for a client on the basis of sharing the profit from the sale of the item on a mark-up basis. The possibility of interest involvement when dealing with a non-Islamic foreign bank in this regard is eroded by having excess liquidity with the bank. (Abdul Gafoor, 2007).

**3) Lending**

***(a) Loans with a Service Charge***

The bank lends money without interest but covers its expenses by levying a service charge not exceeding the proportionate cost of the operation, excluding the cost of funds and provisions for bad and doubtful debts. Prospective borrowers are required to pay this charge on each application, regardless of the amount required, the term of the loan or whether the application is granted or rejected.

The applicants to whom a loan is granted may be required to pay an additional prescribed fee for all the entries made in the bank's registers. This total charge is usually less than the interest charged by conventional banks a bonus for borrowers, and may be subject to a maximum set by the banking authorities as is the practice in Pakistan. The usual benchmark for the service charge is the actual expenditure which the bank incurs in scrutinizing the application and making its decision, and in maintaining the account until the loan is repaid. (Abdul Gafoor, 2007).

### ***(b) No-cost Loans***

The bank sets aside a part of its funds to grant no-cost loans to needy persons such as small farmers, entrepreneurs, producers, etc. and to needy consumers. In Pakistan, these are *qard-e-hasana loans* given on compassionate ground.

### ***(c) Overdrafts***

Islamic banks usually provide overdrafts, subject to a certain maximum, free of charge.

### **iv) Other Financial Services**

Islamic banks provide numerous other financial services such as money transfers, bill collections, and trade in foreign currencies at spot rate. In fact, Islamic banks are able to provide nearly all the services that are available in conventional banks. However, all these services are provided strictly on a commission or charge basis. (Abdul Gafoor, 2007).

## **SELF ASSESSMENT EXERCISE 3**

Mention and explain the Islamic banks' modes of financing.

## **3.4 DIFFERENCES BETWEEN ISLAMIC AND CONVENTIONAL BANKS**

The discernible differences between the conventional banks and Islamic banks (Abdul Gafoor, 2007) are as identified and discussed below.

### **1) Prohibition of Interest**

Islamic banks neither charge nor pay interest on loans. Their lending is principally of the murabaha cost-plus or mark-up mode. As a result, they experience a high rate of borrower delinquency, since their lending terms are less stringent than those of the conventional banks. Murabaha payments have often been held up because late payments cannot be penalized, in contrast to the interest system in which delayed payments would automatically mean increased interest payments.

### **2) Emphasis on Islamic Principles of Morality**

Islamic banks operate in accordance with the rules of Shariah known as Fiqh al-Muamalat Islamic rules on transactions. These rules place a premium on morality, as it relates to Islam. By virtue of the Shariah, Islamic banks are prohibited from investing in businesses that are considered immoral, or haraam e.g. businesses that sell alcohol or pork, gambling, and businesses that produce media such as gossip columns or pornography.

Moral purchasing is also encouraged. This practice is very much unlike that of most conventional banks which seek to emphasize profitability and sometimes contravene the existing laws and ethics of banking. Islamic banks, without doubt, seek to make profit; however, those profits must be in consonance with the Sharia and channelled for the wholesome development of the society.

### **3) Emphasis on Project Viability**

One of the main selling points of Islamic banking, at least in theory, is that, unlike conventional banking, it is concerned about the viability of the project and the profitability of the operation but not the size of the collateral. Islamic banks place less emphasis on collaterals than conventional banks. Good projects which might be turned down by conventional banks for lack of collateral would be financed by Islamic banks on a profit-sharing basis.

### **4) Variation in Returns on Deposits**

For Islamic banks, there tends to be a wider variation of rates of return. Furthermore, while conventional banks guarantee deposits and their rates of return, Islamic banks, working on the principle of profit and loss sharing, cannot guarantee any fixed rate of return on deposits. Many Islamic banks also do not guarantee the deposits either.

### **5) Higher Liquidity Risk**

Due to their specialization in equity and trade financing, Islamic banks tend to have higher levels of liquidity risk than their conventional counterparts. However, this is highly dependent on the stability of the economy. If the economy is stable, the risk would be minimized and vice-versa.

### **6) Lower Solvency Risk**

Due to their specialization in equity and short-term trade financing, Islamic banks tend to have lower levels of solvency risk than their conventional counterparts. This is because their solvency is tied to the solvency of all the trading institutions they have business affiliations with. This implies that Islamic banks are also highly dependent on the stability of the economy. However, since this banking is heavily dependent on trading activities, Islamic banks are bound to be easily affected by trade fluctuations and cycles. Hence in an unstable economy, their solvency risk is likely to be comparatively high.

## **SELF ASSESSMENT EXERCISE 4**

Mention the differences between Islamic and Conventional banks.

## **4.0 CONCLUSION**

We have discussed in this study the nature of Islamic banking, which is based on non-interest principle as compared to conventional banking system. The areas of difference

between Islamic banking operations and conventional banking include: prohibition of interest; emphasis on Islamic principles of morality; emphasis on project viability; variation in returns on deposits; higher liquidity risk; and lower liquidity risk. From discussion, we observed that there are peculiarities that are inherent in Islamic banking operations, which include: prohibition of interest; low consumer lending; profit and loss sharing; high real sector investing; mortgage financing; and leasing financing.

## **5.0 SUMMARY**

In this last study unit, we have discussed topics such as Islamic and Conventional Banking and Finance, Peculiarities of Islamic Banking System, Islamic Banks' Modality of Financing, and Differences Between Islamic and Conventional Banks

## **6.0 TUTOR-MARKED ASSIGNMENT**

1. List and discuss various modes of financing by Islamic banks.
2. Mention and discuss the peculiarities of Islamic banking operations.

## **7.0 REFERENCES/FURTHER READINGS**

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