



NATIONAL OPEN UNIVERSITY OF NIGERIA

SCHOOL OF BUSINESS AND HUMAN RESOURCE

COURSE CODE: BHM 209

COURSE TITLE: Principles of Banking

COURSE GUIDE
BHM: 209

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Course Title: Principles of Banking

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1.0 INTRODUCTION

You are welcome to BHM 209: Principles of Banking. BHM 209 is a two credit unit course at 200 level B.Sc. in Entrepreneur and Business Management. It is an introduction to the study of banking practice and management. The course has fifteen units with appropriate local content for the Nigerian learner.

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

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

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

Course Aims

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

6.0. Course Objectives

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

- i. Make a general overview and explain the evolution, origin and growth of banking institutions.
- ii. State and explain the functions of banking Institutions and discuss their role in economic development of Nigeria.
- iii. Identify and explain the theories and principles of banking
- iv. Describe the objectives, Instruments and importance of monetary policy in economic development
- v. Explain the role of the money and capital markets in the development of the Nigerian economy

- vi. Describe the role of International Financial Organizations in economic development of Developing countries.
- vii. Identify and discuss the role of Non-bank Financial Institutions in economic development of Nigeria.

7.0. Course Materials and Structure

The learner is admonished to read through this course guide to get familiarised with the structure of the course. This is to be done by reading the study units properly and attempting all self assessment exercises, completing and submitting all tutor marked assignments for the course and consulting recommended sources for further reading.

Each unit contains self assessment exercises and in appropriate places you are required to submit assignments for assessment purposes. There will be a final examination at the end of the course. Each unit should take you about two (2) hours to complete, giving you a total of about thirty (30) hours to complete the course. In order to successfully complete the course on time, you are advised to draw up a personal time schedule that will enhance the achievement of this goal.

Find below the components of this course.

Study Units

MODULE 1: EVOLUTION, ORIGIN AND GROWTH OF BANKS

UNIT 1: Evolution, Origin and growth of banks

UNIT 2: Commercial Banking

UNIT 3: Central Banking

UNIT 4: Merchant Banking

UNIT 5: Development and Specialised banks

MODULE 2: BANKING THEORIES, PRINCIPLES, MANAGEMENT AND SYSTEMS OF BANKING

- UNIT6:** Non-Bank Financial Institutions (NBFIs)
- UNIT 7:** Theories of banking
- UNIT 8:** Principles of money and banking
- UNIT 9:** Principles of bank lending and Portfolio Management
- UNIT 10:** System of Banking and Essentials of a sound banking system
- UNIT 11:** Bank Resources Management and Bank Regulations in Nigeria
- MODULE3: MONETARY POLICY AND INTERNATIONAL FINANCIAL ORGANIZATIONS**
- UNIT 12:** Money
- UNIT 13:** Monetary Policy
- UNIT 14:** Money and Capital Markets
- UNIT 15:** International Financial Organizations

Course Summary

Module 1 introduces you to the evolution, origin, and growth of banking institutions. Module 2 discusses the theories of banking and the essential of sound banking system. Module 3 is an analysis of monetary policy and financial market in Nigeria. It also discusses international financial organizations.

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

4.0. STUDY PLAN

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

Unit/module	Title of study unit	Week/activity	Assignment
	Course guide	1	Course guide form
Module 1			
Unit 1	Evolution origin and growth of banks	2	Tutor-marked assignment
Unit 2	Commercial Banking	3	Tutor-marked assignment
Unit 3	Central Banking	4	Tutor marked Assignment

Unit 4	Merchant Banking	5	Tutor-marked assignment
Unit 5	Development and Specialized Banks	6	Tutor-marked assignment
Module 2			
Unit 6	Non – bank Financial Institutions	7	Tutor – Marked assignment
Unit 6	Theories of Banking	8	Tutor-marked assignment
Unit 7	Principles of money and banking	9	Tutor-marked assignment
Unit 8	Principles of bank lending and portfolio management	10	Tutor Marked Assignment
Unit 9	Systems of Banking and Essentials of a sound banking system.	11	Tutor-marked assignment
Module 3			
Unit 10	Bank Resources Management and Bank Regulations in Nigeria	12	Tutor-marked assignment
Unit 11	Money	13	Tutor Marked Assignment
Unit 12	Monetary policy	14	Tutor-marked assignment
Unit 13	Money and Capital Markets	15	Tutor-marked assignment
Unit 14	International Financial Organizations	16	Tutor-marked assignment
	Revision	16	Assignment
	Examination	17	
		18	
	Total		

References/Further Readings

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

- Adekanya,F(1986). The Elements of Banking in Nigeria:3rd Edition. Lagos; F and A Publishers
- Ademu, W.A.(2004). The Nigerian Financial Institutions.In Mai-lafia D.I.:Readings in the Nigerian Banking System. Department of Economics, University of Jos.
- Akingbola, E.(2000).’The concept of Universal Banking’:Abuja, CBN Bullion,Vol.24,No.4,Oct/Dec.
- Anyanwu, J.C.(1993). Monetary Economics: Theory, Policy and Institutions. Onitsha; Hybrid Publishers.
- Anyanwu,J.C.and Oaikhenan, H.E. (1995). Modern Macroeconomics: Theory and Aplications in Nigeria.Onitsha. Joanee Educational Publishers Ltd.
- CBN (2004). Financial Markets in Nigeria.Abuja: A CBN publication.

- Chizea, B.I.(2000). 'The concept of Universal Banking':Abuja, CBN Bullion,Vol.24,No.4,Oct/Dec
- Ekezie, E.S.(1997). The Elements of Banking: Money, Financial Institutions and Markets.Onitsha; Africana- Fep Publishers Ltd.
- Ezeuduji,F.U.(2000). 'Historical Perspectives in Banking Practices Worldwide.' Abuja; CBN Bullion vol.24;No4
- Goshit,G.G.(2006). 'banking Reforms and Monetary Policy Performance in Nigeria (1986-2004). Department of Accounting, University of Jos. Nigerian Accounting Horizon, Vol.1, No.1.
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- Imala, O.I. (2000). ' Arguments for and against universal Banking': Abuja, CBN Bullion,Vol.24,No.4,Oct/Dec
- International Monetary Fund (1991). Banking Crises: Cases and Issues. Washington D.C. IMF Publication Services.
- Jhingan,M.L.(2004).Money, Banking International Trade and Public Finance. Seventh Edition. Delhi,Vinda Publications (P)Ltd.
- Nmadu,T.M. (1999). Human Resources Management: An introduction.Jos: Joffegan Associates
- NDIC (2004).Bank Liquidation in Nigeria(1994-2004).Abuja; NDIC Publications.
- Oguji, C.O.N; Okafor, J.N. and Nzewi, A.S. (2004). The Comprehensive Basic Economics.Onitsha: Joanee Educational Publishers Ltd.
- Ogwumike,F.O.(2001). 'An Appraisal of poverty and poverty reduction strategies in Nigeria".Abuja: CBN Economic and Financial Review,Vol.37, No.4
- Okojie-Ibiayo,M.I.(2004). Elements of Banking: Accountancy Approach. Lagos; Printed and Published by Emmanuel Concepts, Nigeria.
- Oyewole, S.A. (1992). Essays in money and Banking. Ibadan: Fountain Publication
- Samuel, J.M. and Wilkes, F.M. (1980). Management of Company Finance: 3rd Edition. Butler and Tanner, Great Britain
- Vaish, M.C.(2000). Monetary Theory. Fifteenth Edition. New Delhi: Vikas Publishing PVT LTD

5.0. HOW TO GET THE MOST FROM THIS COURSE

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

Each unit has common features which are designed purposefully to facilitate your reading. The first feature being an introduction to the unit, the manner in which each unit is integrated with other units and the entire course. The second feature is a set of learning objectives which let the learner to know what should be done by the time the unit is completed. These objectives should

guide your study. After completing the unit, you should go back and check whether you have achieved the objectives or not. The next feature is self assessment exercises, study questions which are found throughout each unit. The exercises are designed basically to help you recall what you have studied and to assess your learning by yourself. You should do each self assessment exercise and the study question as you come to each in the study unit. The next features are conclusion and summary at the end of each unit. These help you to recall all the main topics discussed in the main content of each unit. There are also tutor-marked assignments at the end of appropriate units. Working on these questions will help you to achieve the objectives of the unit and to prepare for the assignments which you will submit and the final examination.

It should take you between three to four hours (3-4 hrs) to complete a study unit including the exercises and assignments. Upon the completion of the first unit, you are advised to note the length of period it took you and use this information to draw up a timetable to guide your study of the remaining units. The margins on either sides of each page are meant for you to make notes on main ideas or key points for your usage when revising the course. These features are for your usage to significantly increase your chances of passing the course.

Course Delivery

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

Tutorial Sessions

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

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

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

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

Facilitation

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

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

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

Information about the location and time of facilitation will be available at your study course. This is a flexible arrangement between you and your tutorial facilitator. You should contact your tutorial facilitator whenever:

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

Counselling

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

Assessment

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

Self Assessment Exercises (SAEs)

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

6.0. Tutor-Marked Assignments (TMAs)

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

Guidelines for Writing Tutor Marked Assignments

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

Course code _____

Course title _____

Tutor marked assignment number _____

Name _____

Date of submission _____

Matriculation number _____

2. You should ensure to be brief and straight to the point in your answers. Such answers should be based on your course material, further readings and experiences. However, you are **NOT** to copy from any of these materials. In the event you do so, you will be penalised. You are to give relevant examples and illustrations.
3. Use ruled foolscap-sized paper for writing your answers. Remember to make and keep a copy of your assignments
4. Your answers are to be hand written by you and using a margin of about 1.5 inches of the left side and about 5 lines before the answer to the next question for your tutorial facilitator's comments.
5. Upon the completion of each assignment, ensure it reaches your tutorial facilitator on or before the deadline.

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

7.0. Final Examination and Grading

The final examination for BHM 209 will be for 2½ hours duration and will carry 70% of to the total course grade. The examination will be made up of questions which reflect the kinds of self

assessment exercises, study questions and tutor marked assignments which you have previously encountered. Remember that all areas of the course will be assessed. The period between finishing the last unit and taking the examination should be used to revise the entire course. You are advised to review your answers to the self assessment exercises and the tutor marked assignments before the commencement of the examination. You are to note that the following determine your eligibility to sit for the final examination.

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

Course Marking Scheme

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

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

8.0. CONCLUSION

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

I wish you success in the course and hope that you will find BHM 209- Principles of Banking not only interesting but useful and rewarding.

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Course Title: Principles of Banking

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INTRODUCTION

You are welcome to BHM 209: Principles of Banking. BHM 209 is a two credit unit course at 200 level B.Sc. in Entrepreneur and Business Management. It is an introduction to the study of banking practice and management. The course has fifteen units with appropriate local content for the learner.

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

BHM 209 – Principles of Bank provides you with a good and sound foundation upon which you will develop the full potentials and understanding of the field of banking. The course is intended to equip you with the basic and fundamental principles, theories and practice of banking.

This is done by introducing you to the theoretical concepts of banking, principles and theories of banking, and management of banking institutions. Upon the completion of this course, you should be able to understand the principles, theories, basic concepts and functions of banks, the role of both banking and Non-bank financial institutions in the economic development of Nigeria.

Course Objectives

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

- i. Make a general overview and explain the evolution, origin and growth of banking institutions.
- ii. State and explain the functions of banking Institutions and discuss their role in economic development of Nigeria.
- iii. Identify and explain the theories and principles of banking
- iv. Describe the objectives, Instruments and importance of monetary policy in economic development
- v. Explain the role of the money and capital markets in the development of the Nigerian economy
- vi. Describe the role of International Financial Organizations in economic development of Developing countries.
- vii. Identify and discuss the role of Non-bank Financial Institutions in economic development of Nigeria.

I wish you success in the course and hope that you will find BHM 209-Principles of Banking not only interesting but useful and rewarding.

UNIT 1: EVOLUTION, ORIGIN AND GROWTH OF BANKS

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- 3.0. Main Content
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 - 3.3. Growth of Banks
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- 4.0. Conclusion
- 5.0. Summary
- 6.0. Tutor- Marked Assignment
- 7.0. References/Further Readings

1.0. INTRODUCTION

You are warmly welcome to your first Unit of learning in this course-Principles of Banking. You have read the course guide and have known what to expect in this course. Therefore, for this first unit we shall commence with the concept of Banking and refresh your memory on the definitions and meaning of banking. We shall also look at the origin and growth of banks the world over and particularly, briefly consider the growth of banks in our country-Nigeria. Meanwhile, before you continue, let us look at the objectives of this unit.

2.0. OBJECTIVES

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

- Explain the concept of banking
- Define a bank
- Trace the origin of banking
- Explain the growth of Banking in Nigeria

3.0. EVOLUTION, ORIGIN AND GROWTH OF BANKS

3.1. The Concept of Banking

Today, the term, bank, means different things to different people in different economies. In order to reconcile the divergent views on the meaning and characteristics

of banks, the banking laws in each economy provides operational definition and functional classification which governs banking practices in the economy. In practical terms, a bank means what the operating banking law in an economy defines as a bank (Ezeuduji, 2000:8).

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

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

3.2. Origin of Banking

The word “bank” is used in the sense of a commercial bank. It is of Germanic origin though some people trace its origin to the French word “Banqui” and the Italian word “Banca”. It referred to a bench for keeping, lending and exchanging of money or coins in the market place by money lenders and money exchangers. There was no such word as “banking” before 1640, although the practice of safe-keeping and savings flourished in the temple Babylon as early as 2000B.C.

Many of today’s banking services were first practiced in ancient Lydia, Phoenicia, China, and Greece, where trade and commerce, flourished. The 200BC temples in Babylonia made loans from their treasuries as early as. The In Greece also, some elements of banking activities took place which the temples of ancient Greece served as safe deposit vaults for the valuables of worshippers. The Greeks also coined money and developed a system of credit. On the other hand, the Roman Empire had highly developed banking system, and its bankers accepted deposits of money, made loans, and purchased mortgages.

Self- Assessment Exercise 1

What do you understand by banking?

3.3. Growth of Banks

Shortly after the fall of Rome in AD 476, banking decline in Europe. The increase of trade in 13th century in Italy prompted the revival of banking. The money exchangers of the Italian states developed facilities for exchanging local and foreign currency. Soon merchants demanded other services, such as lending money, and gradually bank services were expanded. The first bank called the “Bank of Venice” was established in Venice, Italy in 1157 to finance the monarch in his war. The bankers of Lombardy were famous in England. But modern banking began with English gold smiths only after 1640.

3.3.1. Growth of Banks in Nigeria

In Nigeria, commercial banking pre - dates central banking and laid the foundation of the Nigerian financial system as far back as the late nineteenth century. The first commercial bank in Nigeria was the African Banking Corporation which opened its first branch in Lagos in 1892. The bank experienced some initial difficulties and eventually decided to transfer its interest to Elder Dempster and Co. in 1893. This led to the formation of a new bank known as the British Bank of West Africa (BBWA) in 1893 which is today known as the First Bank Nigeria PLC. Another bank known as the Bar Clays Bank DCO (Dominion, Colonial and overseas) opened its first branch in Lagos in 1917. This bank is known today in Nigeria as the Union Bank Nigeria Plc. British and French Bank, now called United Bank for Africa Plc was established in 1949 making it the third expatriate bank to dominate early Nigeria's commercial banking. The foreign banks came principally to render services in connection with international trade, so their relations at that time were chiefly with the expatriate companies and with the government. They largely ignored the development of local African entrepreneurship. These three banks controlled almost about 90% of the aggregate bank deposits as at then. From 1914 to the early part of 1930s, several abortive attempts were made to establish locally owned and managed banks to break the foreign monopoly. This was as a result of the weakness of those indigenous banks in such areas as capitalization and management; and given the total absence of regulation by any government agency, the indigenous banks could not survive the hostile and unfair competition posed by the foreign banks. It was therefore not surprising that by 1954, a total of 21 out of 25 indigenous banks had failed and went into self – liquidation.

In a nutshell, historically, the Nigerian banking industry had evolved in four stages. The first stage can be best described as the unguided *laissez – faire* phase (1930-59), during which several poorly capitalized and unsupervised indigenous banks failed before their tenth anniversary. The second stage was the controlled regime (1960-1985), during which the Central Bank of Nigeria (CBN) ensured that only “fit and proper” persons were granted banking license, subject to a minimum paid – up capital. The third stage was the post Structural Adjustment Programme (SAP) or decontrolled regime (1986-2004), during which the Neo – liberal philosophy of “free entry” was over stretched and political authorities on the bases of patronage dispensed banking licenses. The emerging fourth stage is the era of consolidation (2004-to a foreseeable future), with major emphasis on recapitalization and proactive regulation based on prudential principles.

In the area of Central Banking, the West African Currency Board (WACB) carried out banking operations in the former British colonies in West Africa before independence. The problems of the WACB led to the establishment of Central Banks in these colonies. In Ghana, it came into being in 1957, in Nigeria 1959, Sierra Leone in 1964, and in the Gambia 1964. The Central Bank of Nigeria (CBN) was established by the Central Bank Act of 1958. It was to replace the West African Currency Board (WACB) of the colonial government as part of the preparation for independent Nigeria.

Self-Assessment Exercise2

Carefully describe the growth of banking in Nigeria.

4.0. CONCLUSION

The above analyses show that banking business is an old business which started some centuries ago and has continued to grow over time. The growth and development of banking activities in the countries of the world differ from country to country depending on the level of economic and technological development of each country.

5.0. SUMMARY

In this unit, you have learned about the evolution, origin and growth of banks. The unit has also explained the concept of banking and has also thrown light on the growth and development of banks in the Nigerian economy.

6.0. Tutor-Marked Assignment

1. Explain the concept of banking.
2. Discuss the growth of banks in the Nigerian economy

7.0. References/Further Readings

- Adekanya, F. (1986). *The Elements of Banking in Nigeria*: 3rd Edition. Lagos; F and Publishers A
- Ezeuduji, F. U. (2000). 'Historical Perspectives in Banking Practices Worldwide.' Abuja; CBN Bullion vol. 24; No 4
- Jhinghan, M. L. (2004). *Money, Banking International Trade and Public Finance*. Seventh Edition. Delhi, Vinda Publications (P) Ltd.

UNIT 2: COMMERCIAL BANKING

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 - 3.4.2. An illustration of the process of credit creation**
 - 3.4.3. Limitation of the power of banks to create credit**
 - 3.5. Balance sheet of commercial banks**
 - 3.5.1. What is a Balance sheet?**
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- 7.0. References/Further Readings**

1.0. INTRODUCTION

In the last unit, you read through important definitions of banks and the evolution and growth of banks. In this unit, you are going to learn about what a commercial bank is, its functions in the economy, and the role it performs in the development of an economy. Besides, you shall also learn about how money or credit is created in an economy, the limitations of the power of banks to create credit and the concept of balance sheet.

2.0. OBJECTIVES

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

- Define and explain what a commercial bank is
- Enumerate and explain the functions of Commercial banks
- List and discuss the roles of commercial banks in economic development of a country
- Explain the concept of credit creation by commercial banks
- Illustrate the process of credit creation by commercial banks
- Discuss the limitation of the power of commercial banks to create credit
- Define balance sheet
- Explain the asset and the liability sides of the balance sheet

3.0. COMMERCIAL BANKING

3.1. What are Commercial Banks?

Commercial banks are those banks which perform all kinds of banking functions such as accepting deposits, advancing loans, credit creation, and agency functions. They are also called joint stock banks because they are organized in the same manner as joint stock companies. They usually advance short-term loans to customers. Of late, they have also started giving medium term and long-term loans in Nigeria. At the expiration of the date for all commercial banks in Nigeria to meet-up with the N25billion minimum capital requirement, the total of 25 commercial banks were able to meet up with the N25billion minimum capital requirement at December 31, 2005 (See table 1 below).

Table 1: Banks that met the ₦25billion Capital Requirement and the banks constituting each group.

S/N	CONSOLIDATED BANK	CAPITAL BASE (₦ BILLION)	CONSTITUENT BANK (S)
1.	Access Bank Plc	28.5	Access Bank, Marina International Bank & Capital Bank.
2.	AfriBank Plc	29	AfriBank & African International (Merchant Bankers).
3.	Diamond Bank	33.25	Diamond Bank & Lion Bank.
4.	EcoBank Nigeria	Over 25	EcoBank Nigeria.
5.	Equatorial Trust Bank	26.5	Equatorial Trust Bank & Devcom Bank.
6.	First City Monument Bank	30	FCMB, Cop. Development Bank & NAMB Limited.
7.	Fidelity Bank	29	Fidelity Bank, FSB International Bank & Manny Bank.
8.	First Bank Plc	44.62	First Bank of Nigeria, FBN Merchant Bankers & MBC International Bank.
9.	First Inland Bank	28	First Atlantic Bank, Inland Bank, IMB International Bank & NUB International Bank.
10.	Guaranty Trust Bank	34	Guaranty Trust Bank.
11.	IBTC - Chartered Bank	35	IBTC, Chartered Bank & Regent Bank.
12.	International Bank	51.7	Intercontinental Bank, Equity Bank, Global and Gateway Bank
13.	Nigeria International Bank	25	Nigerian International Bank City Group.
14.	Oceanic Bank	31.1	Oceanic Bank & International Trust Bank.
15.	Platinum Bank	26	Platinum Bank & Habib Bank.
16.	Skye Bank	37	Prudent Bank, EIB International, Cooperative Bank, Bond Bank & Reliance Bank.
17.	Spring Bank	Over 25	Citizens International Bank, Guardian Express Bank, ACB International Bank, Omega Bank, Fountain Trust Bank & Trans International Bank.
18.	Stanbic Bank	25	Stanbic Bank.
19.	Standard Chartered Bank	26	Standard Chartered Bank.
20.	Sterling Bank	25	Magnum Trust Bank, NAL Bank, Indo-Nigeria Bank & Trust Bank of Africa.
21.	United Bank of Africa	50	United Bank of Africa & Standard Trust Bank.
22.	Union Bank	58	Union Bank, Union Merchant Bank, Universal Trust Bank & Broad Bank.
23.	Unity Bank	30	Intercity Bank, First Interstate Bank, Tropical Commercial Bank, Pacific Bank, Centre Point Bank, NNB International Bank, Bank of the North, Societe Bancaire & New Africa Bank.
24.	Wema Bank	26.2	Wema & National Bank.
25.	Zenith Bank	38	Zenith Bank.

Source: Union Digest Vol. 9, NO. 3 & 4, December, 2005.

3.2. Functions of commercial Banks

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

Accepting Deposits: Commercial banks accept deposits from their customers on current and / or deposit accounts. Commercial banks perform this very important function

to all sectors of the economy by making available the facilities for the pooling of savings through the acceptance of deposits from the public and then making these funds available for economically and socially desirable purposes.

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

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

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

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

Commercial banks make the use of cheques : This eliminate the risks of money being stolen as well as other risks of carrying huge sums of money about.

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

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

Financing 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. We can thus conclude that the financing of foreign trade by commercial banks contributes to a free flow of trade between nations than if these services were not in existence.

Self-assessment Exercise1

Discuss the functions of commercial banks in Nigeria

3.3. The role of Commercial Banks in Economic Development

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

Commercial banks encourage savings: Since investments are made out of savings, the establishment of commercial banks, especially, in the rural areas makes savings possible. Commercial banks help in mobilizing savings through a network of branch banking. They include the low income earners to save by introducing variety of deposit schemes to suit the needs of individual depositors. They also mobilize idle savings of the few rich. By mobilizing savings, the banks channelled them into productive investments, hence economic development is enhanced.

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

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

Commercial banks enhance the development of international trade: These include acting as referees to importers, providing travellers' cheques, opening letters of credit as well as providing credit for exports. All these help to promote international trade.

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

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

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

3.4. Credit Creation by commercial Banks

3.4.1. The concept of Credit Creation

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

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

3.4.2. An illustration of the Process of Credit Creation.

Gigyang Bank Plc on receiving the first deposit of N10,000 places N1,000 in reserve and proceeds to lend the balance of N9,000. This is lent to its customer Mr. X to enable him to pay for some merchandise purchased from ROTRITNEN, who pay the cheque into ROTRITNEN'S account with Zingak Bank Plc. Zingak Bank Plc keeps 10% of the deposit as reserves and proceeds to lend 90% of the deposit (N8,100) to its customer Ritgak, who after his account has been credited, issues a cheque for the amount to Tongak Motors to pay for the cost of a new car, thus further creating a deposit within the banking system. When the original cash deposit of 10,000 has been used up and no bank has any excess reserve to lend, deposit will amount to

N100,000 (Ten times the cash deposit), while total loans will amount to N90,000. This process goes on and on and can be measured by the credit creation multiplier which is calculated as;

$$\frac{\text{Total Amount of New Deposits Created}}{\text{Amount of Original Advance}} = \frac{100,000}{10,000} = 10.$$

The deposit creation process is shown in the table below.

Money creation – The multiplier effect

10% Reserve Ratio.

Deposits		Reserves (10%)	Loans extended (90%)
	₦	₦	₦
Original Deposit	10,000	1,000	9,000
Redeposit - 1 st	9,000	900	8,100
Redeposit - 2 nd	8,100	810	7,290
Redeposit - 3 rd	7,290	729	6,561
Redeposit - 4 th	6,561	656	5,905
Redeposited-5 th	5,905	591	5,314
Redeposit - 6 th	5,314	531	4,782
Redeposit - 7 th	4,782	478	4,303
Redeposit - 8 th	4,303	430	3,872
Redeposit - 9 th	3,872	387	3,484
Redeposit - 10 th	3,484	348	3,135
Redeposit - 11 th	3,135	313	2,821
Redeposit - 12 th	2,821	282	2,538
Redeposit - 13 th	2,538	253	2,284
Redeposit - 14 th	2,284	228	2,055
Redeposit - 15 th	2,055	205	1,849
Redeposit - 16 th	1,849	184	1,664
Redeposit - 17 th	1,664	166	1,497
Redeposit - 18 th	1,497	149	1,347
Redeposit - 19 th	1,347	134	1,212
Redeposit - 20 th	1212	121	1,090
Maximum possible	:	:	:
Deposits	:	:	:
	10,000	10,000	90,000

The importance of the rate of reserve ratio must be noted. For instance, the higher the percentage of the ratio, the lower the ability of the bank (s) to create deposit and the lower the percentage, higher the ability of the bank (s) to create deposit.

3.4.3. Limitation of the Power of Banks to Create Credit

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

Availability of Cash: The credit creation power of banks depends upon the amount of cash they possess. The larger the cash, the larger the amount of credit that can be created by banks. The amount of cash that a bank has in its vaults cannot be determined by it. It depends upon the primary deposits with the bank. The bank's power of creating credit is thus limited by the cash it possesses.

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

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

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

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

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

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

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

Self-Assessment Exercise2

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

3.5. Balance Sheet of Commercial Banks

3.5.1. What is a Balance sheet?

A balance sheet is a statement which shows the assets and liabilities of a commercial bank 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. The balance sheet of a commercial bank provides a picture of its functioning. The balance sheet of a bank gives the true picture of how a bank is doing, how strong the bank is financially, how it is affected by monetary policy at the time of the balance sheet, and what uses the bank put its money into. As in the case of every company, the assets and liabilities of a bank must balance.

Every student of economics and banking should be able to analyse the balance sheet of a bank to be able to know the financial strength of the bank and the trend of monetary market. The format of a balance sheet which every commercial bank in Nigeria is required by section 27 of Decree No. 25 of 1991 to publish not later than four months after the end of its financial year is shown as below.

3.5.2. A Form of Balance sheet of Commercial Banks

LIABILITIES		ASSETS	
1.	Share Capital	1.	Cash
2.	Reserve fund	2.	Balances with the central Bank and other banks
3.	Deposits	3.	Money at call
4.	Borrowings from other banks	4.	Bills discounted and Purchased
5.	Bills payables	5.	Investments
6.	Bills for collection	6.	Loans, advances, cash credits and overdrafts.
7.	Acceptances, endorsements and other obligations	7.	Liabilities of customers f endorsements and other obligations.
8.	Contingent liabilities	8.	Fixed assets
9.	Profit Loss	9.	Profit and loss

3.5.3 Distribution of Assets

The assets of a bank are those items from which it receives income and profit. The items on the asset-side of a balance sheet include the following:

- viii. The first item on the asset side is the cash in liquid form consisting of coins and currency notes lying in reserve with it and in its branches to meet the demand of their

customers. An important function of a commercial bank is to provide its customers with notes and coins they need at the right time, in the right place and in the right denomination they require by keeping cash in the bank vaults and balances at the central bank of Nigeria (CBN).

- ix. The second item on the right hand side of the commercial banks balance sheet is in the form of balances with the central banks and other banks. The commercial banks are required to keep a certain percentage of 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 seasonal demand for cash is high.
- x. The third item, money at call relates to very short – term loans advances to bill brokers, discount houses and acceptance houses. The banks charges low interest on these loans.
- xi. 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.
- xii. The fifth item, investments by the bank in government securities, state bonds and industrial shares, yields a fixed income to the bank. The bank can sell its securities when there is need for more cash.
- xiii. 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 recognized securities.
- xiv. The seventh item included liabilities of the banks 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 minimal commission for all acceptances and endorsements which is a source of income.
- xv. 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 deprecation every year.
- xvi. The last item include profits retained by the bank after paying corporation tax and profits to shareholders.

3.5.4. Distribution of liabilities (Sources of Funds)

The liabilities of a commercial bank are claims on it, these are items which form the sources of its funds. These liabilities are in the real sense of it, public funds, hence they show the sources of funds for the banks which they invest to make profit.

- i. The first item on the liabilities side is the share capital of the bank which is contributed by its share holders and is a liability to them.
- ii. The second item is the reserve fund which 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 shareholders.

- iii. 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. The fourth item is the borrowings from other banks. 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. The fifth item is the bills payables. Bills payables refer to the bills which the bank pays out of its resources.
- vi. Bills for collection constitute the sixth item on the liabilities side of the balance sheet of the commercial bank. 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. 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. The eighth item is the contingent liabilities which relate to those claims on the bank which are unforeseen such as outstanding forward exchange contracts, claims on acknowledged debts, etc.
- ix. The last item is the profit and loss which shows profit payable to shareholders which are liabilities on the bank.

The balance sheet of a particular bank shows its financial soundness. By studying the balance sheets of the major commercial banks of a country, you can be well informed about the trend of monetary market. The bank balance sheet reflects banks 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 of deposits and its role as an element in the nation's monetary system in demand deposits.

4.0. CONCLUSION

The foregone analyses indicate that commercial banks are indispensable in the development process of an economy. Therefore, it is very essential for the government to provide the necessary conducive atmosphere for commercial banks to operate in the economy.

5.0. SUMMARY

In this unit, we have learned about;

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

6.0. TUTOR-MARKED ASSIGNMENT

1. Discuss the functions of commercial banks in Nigeria.

7.0.REFERENCES/FURTHER READINGS

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UNIT 3: CENTRAL BANKING

Content

1.0.Introduction

2.0.Objectives

3.0.Main Content

3.1.The concept of Central Bank

3.2.Functions of Central Bank

3.3.Credit control by Central Bank

3.3.1. Objectives of Credit Control

3.3.2. Methods of Credit Control

3.4.Differences between Central Bank and Commercial Bank

4.0.Conclusion

5.0.Summary

6.0.Tutor-Marked Assignment

7.0.References/Further Readings

1.0. INTRODUCTION

The Central Bank is one of the most important institutions in the financial system of a country. In this unit, you shall learn about what a central bank is and its functions in an economy. You shall equally learn about Credit Control in an economy by the central bank, objectives of credit control and methods of credit control by the central bank. This unit will also help you to actually understand the major differences between central bank and commercial bank.

2.0. OBJECTIVES

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

- Explain what a central bank is
- Enumerate and explain the functions of a central bank
- State and explain the objectives of credit control in an economy
- List and discuss methods of credit control
- Explain the major differences between commercial banks and central banks

3.0. CENTRAL BANKING

3.1. The concept of Central Bank

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

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

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

A Central bank is very different in both its organization and functions compared to other types of banking institutions. Since it is said to be at the apex of any banking system, the law or charter that establishes a central bank is normally very different from those other laws or legislations establishing other types of banks. The Central Bank of Nigeria (CBN) was established on March 17th, 1958 by the Central Bank Ordinance of 1958. The bank effectively came into existence and fully operational on 1st July, 1959.

3.2. Functions of Central Bank

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

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

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

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

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

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

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

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

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

Self-Assessment1

Discuss the functions of the Central Bank of Nigeria

3.3. Credit Control by the Central Bank

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

3.3.1. Objectives of Credit Control

The Central Bank controls credit to achieve the following:

- i. Maintenance of relative stability in domestic prices: One of the major objectives of controlling credit in the economy is to stabilize the price level in the country. Frequent changes in prices adversely affect the economy. This is because excessive increases or decreases in prices make it difficult for economic planning and decision making as a result of the uncertainty in the economy. Inflationary or deflationary trends can be prevented by judicious credit control policy in the economy.
- ii. To stabilize the rate of foreign exchange: with the change in the internal price level, exports and imports of the country are affected when prices fall, export increase and decrease. Consequently, the demand for domestic currency increase in the foreign market and its exchange rate rises. On the contrary, a rise in domestic currency, increases in the foreign market and its exchange rate rises. On the contrary, a rise in domestic prices leads to a decline in export and an increase in imports. As a result, the demand for foreign currency increases and that of domestic currency increases and that of domestic currency falls, thereby lowering the exchange rate of the domestic currency. Since it is the volume of credit money that affects prices, the central bank can stabilize the value of foreign exchange by controlling bank credit.
- iii. To protect the outflow of Gold: The Central Bank holds the gold reserves of the country in its values. 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. Central bank has to control credit in order to prevent such outflows of gold to other countries.
- iv. To control business cycles: Business cycles is a common phenomena of market economies which lead to periodic fluctuations in production, employment, and prices. They are characterized by alternating periods of prosperity and depression. During prosperity, there is large expansion in the volume of credit, and production, employment and prices rise. During depression, credit contracts, and production, employment and prices fall. The central bank can counteract such cyclical fluctuations through contraction of bank credit during boom periods, and expansion of bank credit during depression.
 - v. To achieve growth with stability: In recent years, the principal objective of credit control is to achieve growth with stability. The other objectives, such as price stability, foreign exchange stability, etc, are regarded as secondary. The aim of credit control is to help in achieving full employment and accelerated growth with stability in the economy without inflationary pressures and balance of payments deficit.

3.3.2. Methods of Credit Control

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

On the other hand, qualitative methods control the use and direction of credit. These involve selective credit controls and direct action. The methods of credit control by the Central Bank of Nigeria (CBN) are discussed as below:

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

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

Open Market Operations (OMO): Open Market Operations (OMO) is another method of quantitative credit control used by the Central Bank of Nigeria (CBN). This method refers to the sale and purchase of securities, bills and bonds of government as well as private financial

institutions by the Central Bank. There are two principal motives of Open Market Operations. One, to influence the reserves of commercial banks in order to control their power of credit creation. Two, to affect the market rates of interest as so to control the commercial bank credit. The effect is that when the central bank sells securities to the market, the commercial bank's reserves is reduced. In this way, open market operations reduce or enhance, respectively the banking system's ability to create credit and hence money supply.

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

Selective credit control: Selective or qualitative methods of credit control are meant to regulate and control the supply of credit among its possible suppliers and uses. They are different from quantitative or general methods which aim at controlling the cost and quantity of credit. Unlike the general instruments, selective instruments do not affect the total amount of credit but the amount that is put to use in a particular sector of the economy.

This confers on the CBN the power to regulate the terms on which credit is granted in specific sectors. These powers or controls seek typically to regulate the demand for credit for specific uses and the period of time over which the loan is to be paid. This involves official interference with the volume and directions of credit into those sectors of the economy which planners believe are of crucial importance to economic development. These tools include Moral suasion and selective credit controls or guidelines.

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

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

Self-Assessment Exercise2

Enumerate and explain the major ways in which the Central bank of Nigeria controls Credit supply in the economy.

3.4. Difference between Central Bank and Commercial Bank

A Central bank is basically different from a commercial bank in the following ways:

- i. The Central Bank is owned by government, whereas the commercial bank is owned by shareholders.
- ii. The Central Bank is the apex financial institution and banking structure of the country. The commercial bank is one of the organs of the money market.
- iii. The Central Bank is a non-profit institution which implements the economic policies of the government. But the commercial bank is a profit-making institution.
- iv. The Central Bank is a banker to the government and does not engaged itself in ordinary banking activities. The commercial bank is a banker to the general public.
- v. The Central Bank has the monopoly of issuing notes, while the commercial banks can issue only cheques. The notes are legal tender but cheques are in the nature of near money.
- vi. The Central Bank is the bankers' bank. As such, it grants accommodations to commercial banks in the form of rediscount facilities, keeps their cash reserves, and clears their balances. On the other hand, the commercial bank advances loans to and accepts deposits from the public.
- vii. The Central Bank is the custodian of foreign currency reserves of the country while the commercial bank is the dealer of foreign exchange.

4.0. CONCLUSION

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

5.0. SUMMARY

In this unit, we have learned about;

- i. The concept of Central Bank,
- ii. The functions of the Central bank,
- iii. Credit control by Central bank,
- iv. Objectives of credit control,
- v. Methods of credit control, and
- vi. The difference between central bank and Commercial Bank

6.0. TUTOR-MARKED ASSIGNMENT

Why do you think in your own opinion the Central Bank of any Country controls its credit supply?

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UNIT 4: MERCHANT BANKING

Content

- 1.0. Introduction
- 2.0. Objectives
- 3.0. Main Content
 - 3.1. The concept of Merchant Banking
 - 3.2. Functions of Merchant Banks
 - 3.3. Banking Services
 - 3.4. Corporate Services
 - 3.5. Differences between Merchant Banks and Commercial Banks
- 4.0. Conclusion
- 5.0. Summary
- 6.0. Tutor-Marked Assignment
- 7.0. References/Further Readings

1.0. INTRODUCTION

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

2.0. OBJECTIVES

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

- Explain the concept of Merchant bank
- State and explain the functions of a Merchant Bank
- Differentiate between the banking services and the corporate services of the Merchant Bank
- Differentiate between Merchant bank and Commercial bank

3.0. MERCHANT BANKING

3.1. The Concept of Merchant Banking

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

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

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

Self-Assessment Exercise1

What do you understand by Merchant Banking?

3.2. Functions of Merchant Banks

Merchant banking services comprise primarily corporate finance services and banking services. Corporate finance services range from the management of the issue of private and public equity shares to corporate debt securities. Merchant banks provide expertise in the arrangement of syndicated loans for the financing of large-scale industrial projects, general financial and investment advisory services, company floatation, mergers and reconstructions, financial planning and portfolio management.

Banking services are essentially loans and advances, deposits, acceptances, foreign exchange transactions, international trade and equipment leasing.

3.2.1. Banking Services

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

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

Acceptances: Merchant banks accept bills of exchange from importers and exporters which are easily rediscountable.

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

Equipment Leasing: Leasing is a method of financing which enables a company to "rent" industrial equipment instead of buying it outright. Leasing involves the purchase of an equipment by a bank for a client who is unable to pay for the cost of the equipment at a time, but takes the possession of the equipment on an installment basis over a period of time. The equipment becomes that of the client on the completion of the payment for its cost. In this way, merchant banks help to promote the activities of their clients. Merchant banks lease equipments to farmers and industrialists.

Portfolio management: Most merchant banks in Nigeria have investment departments set up to manage the portfolios of customers. This includes arranging purchases and sales of securities (and offering advice on when and what to buy and sell) as well as attending to registrations, rights or bonus issues.

3.2.2. Corporate Finance Services

Issuing House Services: Merchant Bank acts as issuing House in the capital market. In this role they provide financial services to corporate entities including governments, government parastatals and companies seeking to raise long-term or permanent finance for their operations. They do this by sponsoring their capital issues and sales of their securities to the public. They provide advice on the current type of capital structure and determine the most appropriate time to make an issue. In addition, they advise on relevant government regulations, legislation and policies and in preparing all the necessary documents (e.g. the prospectus required for an application for quotation on the stock exchange) and give backing to an issue in the form of underwriting.

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

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

Self-Assessment Exercise 2

Discuss the main functions of merchant bank

3.3. Major Differences between Merchant Banks and Commercial Banks

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

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

4.0. CONCLUSION

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

5.0. SUMMARY

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

6.0. TUTOR-MARKED ASSIGNMENT

Clearly differentiate between a merchant bank and a commercial bank.

7.0. REFERENCES/ FURTHER READINGS

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UNIT 5: DEVELOPMENT AND SPECIALIZED BANKS

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- 1.0. Introduction
- 2.0. Objectives
- 3.0. Main Content
 - 3.1. What is a Development Banks?
 - 3.2. General Functions of Development Banks
 - 3.2.1. Banking Functions
 - 3.2.2. Development Functions
 - 3.3. Specialized Banks
 - 3.3.1. The Federal Savings Bank
 - 3.3.2. Peoples Bank of Nigeria
 - 3.3.3. Community Banks
- 4.0. Conclusions
- 5.0 Summary
- 6.0. Tutor-Marked Assessment
- 7.0. References/Further Readings

1.0. INTRODUCTION

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

2.0. OBJECTIVES

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

- Define a Development Bank
- Enumerate and explain the general functions of Development Bank
- Distinguish between the banking and development functions of a development bank
- Differentiate between Development Banks and Specialized banks in Nigeria.

3.0. DEVELOPMENT AND SPECIALIZED BANKS

3.1. What is a Development Bank?

Development banks are specialized financial institutions providing medium and long – term credit for the creation or expansion of agriculture, commercial and industrial enterprises in developing countries such as Nigeria. They are mostly established by government. The main objective of development banks is the promotion of economic development in the economy.

The idea of setting up development banks in Nigeria was mooted after the establishment of the CBN. It became apparent that there was an urgent need for banking institutions capable of providing medium and long-term finances, to fill the gaps in the economy which the merchant banks at that time were not well – equipped to service. The gaps were specifically made up of the priority sectors of the Federal Government such as the development of our agricultural and industrial sectors. Since these areas involve large expenditures which cannot be met by the commercial banks, because of the legal constraints and regulations by the CBN coupled with the rapid development within the economy, the need to establish development banks devoted primarily to stimulate these priority sectors of the economy and concerned with the promotion and finance of enterprises by the provision of long-term and intermediate finance was accepted.

The development banks operating in Nigeria includes the Nigeria Bank for Commerce and Industries (NBCI), the Nigeria Agricultural, Co-operation and Rural Development Bank (NACRDB), the Federal Mortgage Bank of Nigeria (FMBN), and the Nigerian Industrial Development Bank (NIDB).

Self-Assessment Exercise1

1. What is a Development Bank?

3.2. General Functions of Development Banks

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

3.2.1. Banking Functions

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

3.2.2. Development Functions

- i. Development banks provide promotional activities such as identifying and properly articulating investment proposals.
- ii. Development Bank facilitates the establishment of institutions and enterprises which fill specific gaps in the financial system.

- iii. They help to stimulate their nations' capital markets (Market for long-term loans) by selling their own stocks and bonds and / or selling and using the proceeds to invest in new enterprises.
- iv. Development Banks provide their clients with technical skill and advice at the preparatory and implementation stages of projects.
- v. They provide managerial assistance to their clients in project preparation and evaluation.
- vi. Development Banks ensure that allocations to projects are in line with the defined economic, social and political priorities of the government.
- vii. Development banks ensure efficient allocation to scarce financial resources in the development planning projects.
- viii. They thus help to quicken the pace of economic development.

3.3. Specialized Banks

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

3.3.1 The Federal Savings Bank (FSB International)

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

3.3.2. Peoples Bank of Nigeria

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

3.3.3. Community Banks

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

Self-Assessment Exercise2

Name and explain the purpose of any Specialized bank in Nigeria

4.0. CONCLUSION

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

5.0. SUMMARY

In this unit, we have learned about,

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

6.0. TUTOR-MARKED ASSIGNMENT

Discuss the general functions of Development Banks in Nigeria

7.0. REFERENCES/ FURTHER READINGS

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UNIT 6: NON-BANK FINANCIAL INSTITUTIONS (NBFIs)

CONTENT

1.0. Introduction

2.0. Objectives

3.0. Main Content

3.1. What are Non-Bank Financial Institutions (NBFIs)?

3.2. Distinction between banks and NBFIs

3.2.1. Credit Creation

3.2.2. Portfolio Structure

3.2.3. Risks

3.3. The role of NBFIs in Economic Development

3.3.1. Provision of Liquidity

3.3.2. Brokers of Loanable funds

3.3.3. Reduction of Risks

3.3.4. Savings Mobilization

3.3.5. Stability in the Capital Market

3.3.6. Economic Growth

3.3.7. Help to Business Sector and Government

4.0. Conclusion

5.0. Summary

6.0. Tutor – Marked Assignment

7.0. Reference / Further readings

1.0. INTRODUCTION

The Non-bank Financial Institutions of any financial sector are as important as the banking financial institutions of such an economy. In this unit, you shall learn about what Non-bank financial Institutions are; the differences between the bank and the Non-bank Financial Institutions; and their role in economic development of Nigeria.

2.0. OBJECTIVES

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

- Define and explain the concept of Non-bank Financial Institution.
- Differentiate between bank and Non-bank Financial Institution.
- Enumerate and explain the role of Non-bank Financial Institutions in economic development of a country.

3.0. NON-BANK FINANCIAL INSTITUTIONS (NBFIs)

3.1. What are Non-Bank Financial Institutions (NBFIs)?

These are institutions that act as intermediaries between the ultimate lenders and borrowers of funds. They are non-deposits taking institutions. They include such institutions as Insurance Companies, Stock-broking firms, Issuing Houses, Building Societies, Venture capital Companies, and specialized finance institutions like the Securities and Exchange, the Nigerian Deposit Insurance Corporation among many others.

The activities of these institutions are governed by various legal enactments. A large number of these institutions, particularly the privately owned investment and finance companies are engaged in such services as project finance, management consultancy, feasibility studies, issuing houses, leasing, investment advice, etc. Non-bank financial institutions rely on the banking system, individual deposits and insurance companies as their source funds.

Self-Assessment Exercise1

Define and explain the concept of Non-bank Financial Institutions

3.2. Distinction between Banks and NBFIs

Banks are different from non- bank financial institutions in the following respects:

3.2.1. Credit creation

The creation of credit or deposit is one of the most important functions of commercial banks. On the other hand, the Non-bank financial institutions do not create credit or money in the economy.

3.2.2. Portfolio structure

Commercial banks differ from Non-bank financial institutions in their portfolio structure. Bank liabilities are very liquid. The liabilities of a bank are large in relation to its assets, because it holds a small proportion of its assets in cash. But its liabilities are payable on demand at a short notice. Many types of assets are available to a bank with ranging degree of liquidity. The most liquid assets are deposits with the central bank, treasuring bills and other short-term bills issued by the federal and state governments and large firms, and call loans to other banks, firms, dealers and brokers in government securities. The less liquid assets are the various types of loans to customers and investment in long-term bonds and mortgages. Thus banks have a large and varied portfolio on the basis of which they create liquidity.

Non-Bank Financial Institutions also create liquidity but in the form of savings and time deposits which are not used as a means of payment. They are limited in the choice of their assets and are also prohibited from holding certain assets. Thus the size of their portfolio is very small as compared with banks. They generally issue claims against themselves that are fixed in money terms and have maturities shorter than the direct securities they hold. They borrow for short period, and lend for long period. This is because of the small size of their portfolio and they hold less liquid assets than banks.

Self-Assessment Exercise2

Identify and explain the differences between the Bank and the Non-bank Financial Institutions.

3.2.3. Risk

Banks have to follow certain norms at the time of advancing loans. There are detailed appraisals of projects and hence delays in sanctioning, loans. On the other hand, Non-Bank Financial Institutions do not enter into detailed appraisals of projects, they have to follow less stringent rules for advances. There are no time delays in granting loans. Thus non-bank financial institutions are able to take greater risk and lesser supervision as compared to banks.

3.3. The role of NBFIs in Economic Development

Non-bank financial institutions have been playing an important role in economic development of Nigeria in the following directions.

3.3.1. Provision of liquidity

Non-bank financial institutions provide liquidity when they convert an asset into cash easily and quickly without loss of value in terms of money. NBFIs issue claims against themselves and supply funds. This they do by following two rules. First, they make short-term loans and finance them by issuing claims against themselves for longer periods, and second, they diversify loans among different types of borrowers.

3.3.2. Brokers of loanable funds

Non-bank financial institutions play an important role as brokers of loanable funds in the economy. They act as intermediaries between the ultimate savers and the ultimate investors. They sell indirect securities to savers and purchase primary securities from investors. Indirect securities are the short-term liabilities of financial intermediaries. On the other hand, primary securities are their earning assets but they are the debts of the borrowers. Thus, NBFIs act as brokers of loanable funds by changing debt into credit.

3.2.1. Reduce Risks

When the non-bank financial institutions convert debt into credit, they reduce the risk to the ultimate lenders. First, they create liabilities on themselves by selling indirect securities to the lenders then they buy primary securities from borrowers of funds. So by acting as intermediaries between the lenders and borrowers of funds, NBFIs take the risk on themselves and reduce it on the ultimate lenders. Moreover, by holding varied types of financial assets, they decrease their own risks. Low returns on some assets can be offset by high return on others.

3.2.2. Savings mobilization

NBFIs raise funds in the capital market and supply credit to investors. Expert financial services provided by them have been attracting larger share of public savings. Such services include easy liquidity, safety of principal and ready divisibility of savings into direct securities of different values.

3.3.5. Stability in the capital market

NBFIs deal in a variety of assets and liabilities which are mostly traded in the capital market. If there are no NBFIs, there would be frequent changes in the demand and supply of financial assets and their relative yields, thereby bringing instability in the capital market. As NBFIs function within a legal framework and set rules, they provide stability to the capital market and benefit savers and firms through diversified financial services.

3.2.3. Economic growth

NBFIs help in the growth process of the economy. They intermediate between ultimate lenders who are savers and ultimate borrowers who are investors. By performing this function, they discourage hoarding by the people, mobilize their savings and lend them to investors. Thus NBFIs encourage savings and investment which are essential for promoting economic growth.

3.2.4. They help the business sector, and the three tiers of government

For the business sector, they help by financing it through loans, mortgages, purchase of bonds, shares etc. Thus they facilitate investment in plant, equipment and inventories. They also help the three tiers of government financially by purchasing and selling of their securities.

4.0. CONCLUSION

This unit throws light on Non-bank financial institutions, its functions and roles. It also discusses the difference between bank and non-bank institutions.

5.0. SUMMARY

In this unit, you have learned about;

- i. What a Non-bank Financial Institution is,
- ii. The differences between the banking and the Non-bank Financial Institution.
- iii. The critical role of the Non-bank Financial Institutions in economic development of a country,

6.0.TUTOR-MARKED ASSIGNMENT

Enumerate and explain the role of NBFIs in the economic development of Nigeria.

7.0. REFERENCES/ FURTHER READINGS

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UNIT 7: THEORIES OF BANKING

Content

- 1.0. Introduction
- 2.0. Objectives
- 3.0. Main Content
 - 3.1. The Real Bill Theory
 - 3.2. The Shiftability Theory
 - 3.3. The Anticipated Income Theory
 - 3.4. The Liability Management Theory
- 4.0. Conclusion
- 5.0. Summary
- 6.0. Tutor-Marked Assignment
- 7.0. References/ Further Readings

4.0. INTRODUCTION

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

5.0. OBJECTIVES

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

- State and explain all the theories of banking
- Differentiate between all the theories of banking
- Identify and explain the weaknesses of the banking theories.

3.0. THEORIES OF BANKING

3.1. The Real Bills Doctrine

The Real Bills Doctrine or the commercial loan theory states that a commercial bank should advance only short-term self-liquidating loans to business firms. In other words, this theory holds that banks should lend only on “short-term, self-liquidating commercial papers. This is for the simple reason that a bank has liabilities payable on demand, and it cannot meet these obligations if its assets are tied up for long periods of time. Rather, a bank needs a continual and substantial flow of cash moving through it in order to maintain its own liquidity, and this cash flow can be achieved only if the bank limits its lending activities to short-term maturities.

Self-liquidating loans are those which are meant to finance the production, and movement of goods through the successive stages of production, storage, transportation and distribution. When such goods are ultimately sold, the loans are considered to liquidate themselves automatically. The theory states that when commercial banks make only short-term self-liquidating productive loans, the central bank, in turn should only lend to the banks on the security of such short-term loans. This principle would ensure the proper degree of liquidity of each bank and the proper

money supply for the whole economy. This in essence aim at the stabilization of the banking system.

The weakness of this theory stems from the failure to realize that the loans are made, given the value of the goods and not the good itself; and also the value of goods itself is subject to variations, given the state of the economy.

3.2. The Shiftability Theory

The Central thesis of this theory holds that the liquidity of a bank depends on its ability to shift its assets to someone else without any material or capital loss when the need for liquidity arises. This theory asserted that if the commercial banks maintain a substantial amount of assets that can be shifted on to the other banks for cash without material loss in case of necessity, then there is no need to rely on maturities. According to this view, an asset to be perfectly shiftable must be immediately transferable without capital loss when the need for liquidity arises. This is particularly applicable to short-term markets investments, such as treasury bills and bills of exchange which can be immediately sold whenever it is necessary to raise funds by banks. For example, it is quite acceptable for a bank to hold short-term open market investments in its portfolio of assets, and if a large number of depositors decide to withdraw their money, the bank need only sell these investments, take the money thus required and pay off its depositors. Therefore, the theory tried to broaden the list of assets demand legitimate for bank ownership, and hence redirected the attention of banks and the banking authorities from loans to investments as a source of bank liquidity that is; the fundamental source of liquidity is the banks secondary resources.

The flaw of this theory does not lie on the theory itself, but on the bank management practices to which the theory led. One bank could obtain the needed liquidity by shifting its assets but not so possible when all members of the bank behave the same way (Fallacy of composition). Hence, the problem of liquidity of the whole banking system is simply not solvable by commercial banks alone. This is where a central bank that is prepared to act quickly and decisively is an absolute necessity.

Self-Assessment Exercise1

What do you understand by the Real Bill Doctrine?

3.3. The Anticipated Income Theory

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

Self-Assessment Exercise2

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

3.4. The Liability Management Theory

According to this theory, there is no need for banks to grant self-liquidating loans and keep liquid assets because they can borrow reserve money in the money market in case of need. A bank can acquire reserves by creating additional liabilities against itself from different sources. These sources include the issuing of time certificates of deposits, borrowing from other commercial banks, borrowing from the central bank, raising of capital funds by issuing shares, and by ploughing back of profits.

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

4.0. CONCLUSION

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

5.0. SUMMARY

In this unit, we have studied about;

- i. The Real Bill Doctrine
- ii. The Shiftability Theory
- iii. The Anticipated Income Theory
- iv. The Liability Management Theory

6.0. TUTOR-MARKED ASSIGNMENT

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

7.0. REFERENCES/FURTHER READINGS

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Unit 8: PRINCIPLES OF MONEY AND BANKING

Content

1.0. Introduction

2.0. Objectives

6.0. Main Content

3.1. The Principle of time (time has value)

3.2. The principle of Risk Compensation

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

3.4. The principle of efficient Resources allocation by markets

3.5. The principle of Stability

7.0. Conclusion

8.0. Summary

9.0. Tutor-Marked Assignment

10.0. References/ Further Readings

1.0. INTRODUCTION

Understanding these principles of money and banking does not only helps you understand how the financial system works today in Nigeria, but also gives you an insight into why things go wrong, and what the consequences might be for future events in the economy. The simple Principles of money and banking you shall learn in this unit include the principle of time (time has value), the principle of risk compensation, the principle of decision making on the basis of adequate information, the principle of efficient resource allocation by markets, and the principle of stability.

2.0. OBJECTIVES

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

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

3.0. PRINCIPLES OF MONEY AND BANKING

3.1. The principle of Time; (time has value)

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

3.2. The principle of Risk compensation

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

Self-Assessment1

Explain the assertion that the principle of Risk is the basis of the Insurance Industry.

3.3. The principle of Decision-making on the basis of Adequate Information

At the core of microeconomics is the assumption of rational decision - making. Rational decisions are partly based on using all available information to make a decision. Some decisions are more important than others, e.g. buying a car vs buying your lunch. Some information are harder to gather than other types.

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

Self-Assessment Exercise2

Discuss the principle of time (Time has value) in banking Business.

3.4. The principle of efficient resources allocation by markets.

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

3.5. The principle of Stability

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

4.0. CONCLUSION

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

5.0. SUMMARY

In this unit, we have learned about;

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

8.0. TUTOR-MARKED ASSIGNMENT

Identify and discuss the principles of money and banking you know.

7.0. REFERENCES/ FURTHER READINGS

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UNIT 9: PRINCIPLES OF BANK LENDING AND PORTFOLIO MANAGEMENT

CONTENT

1.0.Introduction

2.0.Objectives

3.0.Main Content

3.1.Principle of Bank lending

3.1.1. Liquidity Principle

3.1.2. Principle of Profitability

3.1.3. Principle of safety of bank Funds

3.1.4. Principle of Diversity

3.1.5. Principle of Stability

3.2.Bank Portfolio Management

3.2.1. The concept of Portfolio Management

3.2.2. Objectives of Portfolio Management

3.2.2.1.Liquidity

3.2.2.2.Safety

3.2.2.3.Profitability

4.0.Conclusion

5.0.Summary

6.0.Tutor-Marked Assignment

7.0.References/ Further Readings

7.0. INTRODUCTION

In this unit, you shall learn broadly speaking, about two major issues. These are the principles of bank lending; and portfolio management. In the principles of bank lending, you shall get to know that these are the guiding principles for banks in terms of advancing loans to customers. The portfolio management on the other hand has to do with the day-to-day management of the total resources (wealth) of the bank.

8.0. OBJECTIVES

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

- Describe the principles which banks follow in terms of lending in the economy.
- List and explain each of the principles of bank lending in an economy.
- Define and explain the concept of Portfolio management
- State and explain the objectives of portfolio management

9.0. PRINCIPLES OF BANK LENDING AND PORTFOLIO MANAGEMENT

3.1. Principles of Bank Lending

Banks follow some principles in terms of lending in the economy. These principles include the following:

3.1.1. Liquidity principle

Liquidity is an important principle of bank lending. Banks lend for short periods only because they lend public money which can be withdrawn at any time by depositors. They, therefore, advance loans on the scarcity of such assets which are easily marketable and convertible into cash at a short notice. A bank chooses such securities in its investment portfolio which possess sufficient liquidity. It is essential because if the bank needs cash to meet the urgent requirements of its customers, it should be in a position to sell some of the securities at a very short notice without disturbing their market prices so much. There are certain securities such as government bonds which are easily saleable without affecting their market prices. The shares and debentures of large industrial concerns also fall in this category. Therefore, banks invest in government securities, shares and debentures of reputable companies.

3.1.2. Principle of profitability

This is the cardinal principle for making investment by banks. It must earn sufficient profits. Banks therefore, invest in such securities which assure a fair and stable return on the funds invested. The earning capacity of securities and shares depends upon interest rate and the dividend rate and the tax benefits they carry. Banks normally invest in securities that yields more returns than those that yield less returns, all things being equal.

3.1.3. Principle of safety of bank funds

The safety of funds lent is another principle of bank lending. Safety means that the borrower should be able to repay the loan and invest in time at regular intervals without default. The repayment of the loan depends upon the nature of security, the character of the borrower, his capacity to repay and his financial standing. Like other investments, bank investments involve risks. But the degree of risk varies with the type of security. Securities of Federal Government are said to be safer than those of the state and local governments. This is because the resources of the Federal Governments are higher than that of the state and local government resources. The banks always take into consideration the debt repaying ability of the governments while investing in their securities. Political stability, peace and security are prerequisites for this. It is safer to invest in the securities of a government having larger tax revenue and high borrowing capacity than in government securities with less tax revenue. Above all, the safety of bank funds depends upon the technical feasibility and economic viability of the project for which loan is advanced.

3.1.4. Principle of diversity

Commercial banks always follow the principle of diversity in choosing its investment portfolio. Banks invest their surplus funds in a particular type of security but different industries. They choose the shares and debentures of different types of industries situated in different regions of the country. Diversification aims at minimizing risks of the investment portfolio of banks. The principle of diversity also applies to the advancing of

loans to varied types of firms, industries, businesses and trades. These principles seek to emphasize the fact that “keeping all eggs in one basket is disastrous”. Banks need to spread their risks by giving loans to various traders and industries in different sectors of the economy and different parts of the country.

3.1.5. Principle of stability

Another important principle of banks’ investment policy is investment in those stocks and securities which possess a high degree of stability in their prices. The bank cannot afford any loss on its securities. It should, therefore, invest its funds in the share of reputable companies where the possibility of decline in their prices is remote. That is why banks normally invest more in debentures and bonds which are more stable than the shares of companies.

Self-Assessment Exercise1

Identify and explain the Principles of bank lending

3.2. Bank portfolio Management

The main aim of commercial banks is to seek profit like any other institution. Their capacity to earn profit depends upon their investments policy. Their investment policy, in turn, depends on the manner in which they manage their investment portfolio. Thus commercial banks investment policy emerges from a straight forward application of the theory of portfolio management to the particular circumstances of commercial banks.

3.2.1. The Concept of Portfolio Management

Portfolio refers to the securities held by an investor or the commercial paper held by a bank or other financial institutions. It could be a group of investments, asset of individual equities, bonds and other marketable assets the investor owns. Portfolio management involves the principles and procedures by which to manage such assets. Bank portfolio management therefore, refers to the prudent, management of a bank’s assets and liabilities in order to seek some optimum combination of income or profit, liability and safety. In banking, the parts of a bank’s asset portfolio include investments, liquidity, reserves, and loans, and their management involves the total balance sheet.

3.2.2. Objectives of Portfolio Management

There are three major objectives of portfolio management which banks follow. These include liquidity, safety and income or profit. These three objectives are opposed to each other. For examples, if the banks seek high profit, they may have to sacrifice some safety and liquidity. If they seek more safety and liquidity on the other hand, they may have to give up some income or profit. The main objectives of bank portfolio management are discussed below.

3.2.2.1. Liquidity

A commercial bank needs a high degree of liquidity in its assets which form one of the cardinal objectives of its portfolio management. The liquidity of an asset refers to the ease and certainty with which it can be turned into cash. The liabilities of a bank are payable on demand at a short notice. Therefore, it must hold a sufficiently large proportion of its assets in the form of cash and liquid assets for the purpose of profitability. If the bank keeps liquidity the upper most,

its profit will be low. On the other hand, if it ignores liquidity and aims at earning more, it will be disastrous for it. Thus, in managing its investments portfolio a bank must strike a balance between the objectives of liquidity and profitability. The balance must be achieved with a relatively high degree of safety. This is because banks are subject to a number of restrictions that limit the size of earning assets they can acquire.

3.2.2.2.Safety

Another objective of portfolio management by commercial banks is to achieve safety in their funds / assets. A commercial bank always operates under conditions of uncertainty and risks. It is uncertain about the amount and cost of funds it can acquire and about its income in the future. Moreover, it faces two types of risks. The first is the market risk which results from the decline in the prices of debt obligations when the market rate of interest rises. The second is the risk by default where the bank fears that the debtors are not likely to repay the principal and pay the interest in time. The risk is largely concentrated in customer loans, where banks have a special function to perform, and bank loans to business and bank mortgage loans are among the high-grade loans of these types. In the light of these risks, commercial banks have to maintain the safety of its assets.

Self-Assessment Exercise2

Define and explain the concept of Portfolio Management

3.2.2.3.Profitability

One of the principal objectives of portfolio management by a bank is to earn more profit. It is essential for the purpose of paying interest to depositors, wages to the staff, dividend to shareholders and meeting other expenses. It cannot afford to hold a large amount of funds in cash for that will mean foregoing income. But the conflict between profitability and liquidity is not very sharp. Liquidity and safety are primary considerations while profitability is subsidiary, for the very existence of a bank depends on the first two.

4.0. CONCLUSION

The unit discusses the principle of bank lending and the management of the portfolio of the bank which are very cardinal to the successful management of a bank and its profitability in the economy. In specific terms the unit recognizes liquidity, profitability, safety, diversity and stability among the banking lending principles while liquidity, safety and profitability are considered crucial objectives of portfolio management.

5.0. SUMMARY

In this unit, we have learned about the principles of bank lending and the portfolio management of a bank. While the principles of bank lending guide the lending activities of the bank, the portfolio management helps the bank in managing the resources (portfolios) of the bank.

6.0. TUTOR-MARKED ASSIGNMENT

Enumerate and discuss the objectives of portfolio management

7.0. REFERENCES/FURTHER READINGS

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UNIT 10: SYSTEMS OF BANKING AND ESSENTIALS OF A SOUND BANKING SYSTEM

CONTENT

- 3.0. Introduction
- 4.0. Objectives
- 5.0. Main Content
 - 5.1. System of banking
 - 5.1.1. Unit banking
 - 5.1.2. Branch Banking
 - 5.1.3. Group banking
 - 5.1.4. Chain banking
 - 5.1.5. Correspondent banking
 - 5.1.6. Universal banking
 - 5.1.7. Electronic banking
 - 5.2. Essentials of a Sound Banking System
 - 5.2.1. High degree of Liquidity
 - 5.2.2. Safety of Bank's money
 - 5.2.3. Profitability
 - 5.2.4. Stability of the system
 - 5.2.5. Efficient Reserve management
 - 5.2.6. Expansion
 - 5.2.7. Sufficient Elasticity
- 6.0. Conclusion
- 7.0. Summary
- 8.0. Tutor-marked Assignment
- 9.0. **References/ Further Readings.**

1.0. INTRODUCTION

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

2.0. **OBJECTIVES**

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

- Identify and explain each banking system
- Mention and explain the advantages and disadvantages unit banking
- Enumerate and explain the advantages and disadvantages of branch banking
- List and discuss the essentials of a sound banking system

3.0. **SYSTEMS OF BANKING AND ESSENTIALS OF A SOUND BANKING SYSTEM**

3.1. **Systems of Banking**

3.1.1. **Unit Banking**

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

A. Advantages of Branch Banking

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

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

B. Disadvantages of Unit Banking

Some of the disadvantages of unit banking include;

- i) Failure to spread risks as the unit banking operations are localized in a particular area, the failure of customers to repay loan in time may bring disaster to the bank.
- ii) Limited resources at its deposal which always leads to bank failure during financial and economic crisis.
- iii) Non-diversified banking services to its customers because of its inability to establish branches and higher cost.
- iv) Absence of economies of large scale operations. The unit banking system cannot have advantages of large scale banking in that it cannot recruit more efficient and highly paid staff, and cannot enjoy the economies of large scale and intensive specialization and division of labour.

3.1.2. Branch Banking

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

A. Advantages of Branch Banking

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

- i) Advantage of spreading risks geographically and industrially. If branches in particular area suffers losses due to recession in industries located there, the losses can be offset by profits from prosperous areas.
- ii) Enjoys the advantage of large scale organization because a large bank is able to recruit efficient and trained staff and pay better than unit banks. It also enjoys the advantage of specialization and division of labour.
- iii) Under this system, the bank enjoys the advantage of diversification of banking operations. Big banks can provide banking facilities to trade, industry, businessmen and the common man at cheaper rates and more efficiently than unit banks because they possess larger financial resources.
- iv) The central bank of the country can control the banks more effectively under the branch banking system than under the unit banking system. It is easier to control the credit policies of a few banks than those numerous unit banks.

B. Disadvantages of Branch Banking

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

- i) Delayance in decision taking under the branch banking system: there are bureaucratic procedures in decision making and the management of all the branches is under the control of the head office. This leads to delay in taking prompt decision by the branch managers. They have to refer all cases above certain limit for advance to the head office.
- ii) Inability to meet the need of local business communities: The branch managers are not able to meet the borrowing needs of the local business community as efficiently and sympathetically as the unit banks. This is because the branch bank managers stay in one locality and have to operate under rules set by the head office. He may not know the needs of the customers at different branches and also may be concentrating more on bigger industries at the detriment of small scale businesses in the rural areas.
- iii) Fear of loss: When branch banking spreads on a large scale, some of the branches may run under losses due to bad debts and low mobilization of deposits. Such situation may lead to huge loss to the bank thereby leading to its failure.

- iv) In adequate supervision: As the big bank has a number of branches spread throughout the country, it is difficult to manage and supervise them effectively and efficiently. The control become relax, the banking services suffer and the clients are hit hard.
- v) Unhealthy competition: Branch banking leads to competition among different banks in establishing branches at various places. This tendency leads to unnecessary increase in expenses.

Self- Assessment Exercise1

Define Unit Banking and discuss its advantages and disadvantages.

3.1.3.Group Banking

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

3.1.4 Chain Banking

Chain banking is a system where some individuals or group of individuals control one or more banks, as against control by a holding company under group banking. Chain banking results when an individual, family or some other close association of persons controls the operations of two or more banks. That is, it occurs when a syndicate or other small group of individuals with common interest own more than two banks. Chain banks are controlled through directors, and a recognized organization hierarchy beyond that of individual banks.

A principal “key” bank frequently coordinates the management of the entire group and also serves as the depository for required reserves of state chartered holding company banks.

3.1.5.Correspondent Banking

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

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

Self-Assessment Exercise 2

Describe Branch Banking and explain its advantages and disadvantages.

3.1.6. Universal Banking

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

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

Universal banking simply connotes collapsing the various regulatory divides that separate commercial and merchant banking activities. In other words, it is all about creating a level playing field for both commercial and merchant banks.

Historically, commercial banking, in line with its retail orientation, involves general commerce and by implication, a credit policy that favours short-term finance. On the other hand, merchant banking or investment banking is about wholesale banking involving provision of long-term finance to fund users. On this basis of specialization, banks concentrate on one of wholesale banking, retail banking, private banking, savings and loan mortgage among others. However, under universal banking, authority is given to banks to decide on their portfolios of business, select appropriate delivery channels and infrastructure within an applicable regulatory

framework. The distinction between money, capital market and insurance business is removed. The most important issue in this system is the fact that the statutory / regulatory dichotomy between commercial and merchant banking activities is dismantled and the difference between banks in terms of functions and activities will only exist as a matter of choice rather than by reason of regulatory barriers.

The concept of universal banking came into operation in Nigeria in November, 2000. The universal banking system introduced in Nigeria was meant to result into huge finance conglomerates where any or all of the following services may be offered.

- Retail (Commercial banking)

- Cheque clearing

- Funds management, investment (Merchant) banking services.

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

3.1.7. Electronic Banking

Electronic banking more commonly called the electronic funds transfer system (EFTS) refers to the application of computer technology to banking especially the payments (Deposit transfer) aspects of banking. The major distinct pieces of hardware that comprises it are the Automated letter Machine (ATM), the point of sale (POS) system, and the automated clearing house (ACH).

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

The POS involves a computer terminal in retail stores that will transfer funds instantly from the bank deposit of the customer to the bank deposit of the store in which he is making purchase. In the process, the computer will verify that the customer has sufficient funds to cover the purchase, and will inform the customer of the new bank balance. The customer can also arrange for overdrafts at the bank, so that “instant loan” (Up to a preset limit) can be made.

On the other hand, the ACH is largely designed to transfer funds among banks electronically, although customers may also become involved. For example, a company may, with the authorization of its employees record its monthly pay roll on electronic tape. The company then takes this tape to its bank and that bank then uses the tape to deposit (In other banks) salaries directly to the credit of the employees. The ACH can also be used for preauthorized payments of a recurring nature, e.g. insurance premiums. The major merit of electronic banking lies in its ability to reduce costs given the number of cheques written in the economy each year.

3.2. Essentials of a sound Banking System

The essentials of a sound banking system are regarded, as its liquidity and profitability. The secret behind any successful banking business is to distribute resources between the various

forms of assets in such a way as to get a sound balance between liquidity and profitability, so that there is cash (at hand or quickly realizable) to meet every claim, and at the same time enough income for the bank to pay its wages and earn profits for its shareholders. In addition, some of the essential issues modern banks also consider for a sound banking system include the following:

3.2.1. High degree of Liquidity

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

3.2.2. Safety of Bank's Money

Safety of banks' money is another essential of a sound banking system. Since the banks keep the deposit of the people, it must ensure the safety of their money. Therefore, the banks are expected to make safe loans and investments and avoid unnecessary risks. If the debtors of the banks do not repay the loans on time and the banks lose their investments, the banks in the system will become insolvent. As a result, depositors in the system lose money and suffer hardship. Thus, the banks must ensure the safety of deposits in the system.

3.2.3. Profitability

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

3.2.4. Stability of the System

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

3.2.5. Efficient Reserve Management

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

3.2.6.Expansion

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

3.2.7.Sufficient Elasticity

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

4.0. CONCLUSION

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

5.0. SUMMARY

In this unit, you have learned about,

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

6.0. TUTOR-MARKED ASSIGNMENT

Discuss the essentials of sound banking system.

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UNIT 11: BANK RESOURCES MANAGEMENT AND BANK REGULATIONS IN NIGERIA.

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- 1.0. Introduction
- 2.0. Objectives
- 3.0. Main Content
 - 3.1. Bank Resources Management
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1.0. INTRODUCTION

In a sense, the dual purpose of banking is to provide needed banking services, and to earn an appropriate return on the capital investment. These needed banking services reflect recognition of a bank's obligations to its customers and depositors, its shareholders, its staff, and the community and hence must play its part in making needed aid and justifiable credit available.

In addition, its obligation must look beyond local considerations, and conscientiously shape its institutional policies and practices to conform to the national pattern of monetary policy. The mission of a bank is the task of accomplishing such objectives with due regard for the conditions and constraints that must be observed, and in accordance with accepted criteria of successful accomplishment.

In fulfilling these tasks, the bank consciously manages its human resources, cash, credit, working capital and inventories judiciously and efficiently on daily basis. It is the primary

occupation of this unit to educate you on how banks manages these available resources and also expose you to the concept of bank regulation and bank fraud in Nigeria.

2.0. OBJECTIVES

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

- Discuss how a bank manages human, Working Capital, Cash, Credit and inventory resources.
- Define and explain the concept of Bank Regulation
- State and explain the objectives of bank regulations in Nigeria
- Identify some banking Laws and Regulations in Nigeria
- Discuss the benefits and problems of bank Regulations in Nigeria.
- Define and explain the concept of bank Fraud
- Identify and explain the types of bank Fraud

3.0. BANK RESOURCES MANAGEMENT AND BANK REGULATIONS IN NIGERIA

3.1. Bank Resources Management

3.1.1. Human Resource Management

Personnel management is an important element of the broader subject of human resources management (HRM), although in practice the two are frequently interchanged emphasizing the fact that the people employed in a bank or company are resources which at least as important as financial material resources and must be given careful expert attention.

Personal Management is the responsibility of all those who manage people, as well as being a description of the work of those who are employed as specialist (Nmadu, 1991:1). It is the part of management which is concerned with people at work and with their relationships within a bank or an enterprise. Through human resources management, banks seeks to bring together and develop into effective organization the men and women who make up an enterprise, enabling each to make his own best contribution to its success both as an individual and as a member of a working group. It seeks to provide fair terms and conditions of employment, and satisfying work for those employed. In managing human resources in the bank, it requires that employees be treated as important resources to be invested in prudently, to be used productively, and from a return can be expected, a return that should be monitored wisely. Human resources management plans, develops and administers policies and programmes to make expeditious use of the banks human resources.

The major role that human resource management plays in the management of banks includes planning, staffing, development and maintenance. In the aspect of planning, human resource management in banks involves the planning of organizational goals and objectives, job analysis and human resources. In the area of staffing, it recruits and select staff. Besides, development in this respect, involves activities like orientation, training and development, performance appraisal, carrier planning etc. Finally, the activities that are involved in maintenance include compensation, benefits, safety and Health, labour relations etc.

3.1.2. Working Capital Management

Working capital can be defined as the excess of current assets over current liabilities. It is the same as net current assets. It represents the investments of a company's medium and long-term funds in assets which are expected to be realized within the years trading. It is not permanent investment, but as the name implies is continually in use, being turn over many times in a year. It is used to finance production, to invest in stock and to provide credit for customers. The more of a business finance invested in working capital, the less is available for investing in long-term assets such as buildings, plant and machinery.

In the management of working capital, at least three questions need to be considered. First, what size of investment should be allocated to the different forms of current assets? Second, what proportions of these current assets should be financed respectively by short-term and long-term funds? Third, what proportion of the total assets should be in the form of current assets, and what proportion in fixed asset? The successful control of working capital or cash depends on detailed budgets, which must be as accurate as possible. These are needed for planning balance sheets and profits and loss accounts, and consequently it is common practice for the conventional budgetary system to include estimates of the component parts of working capital. All that is needed for the management of working capital as a whole is that the parts should be put together. The size of the cash balance that a company might need depends on the nearness or availability of other sources of funds at short notice, on the control of debtors and creditors – a crucial factor for short-term financial planning.

3.1.3. Cash Management

There are no simple rules to govern decisions concerning the amount of cash a firm should have on hand or short call at a bank. Part of the difficulty is that such decisions involve management's subjective attitude to the risks ahead. The more cash that is on hand, the more easily the company can meet its bills when they are due for payment. By carrying a quantity of cash or processing securities at short call, the company is buying peace of mind. On the other hand, the more cash the company can invest or put to work within the business, the greater will be the profits it earns. However, if it does not retain a sufficient amount of liquidity, the company can lose the opportunities to take advantage of discounts and perhaps, because of late payments, lose suppliers. Management must therefore balance liquidity with profitability.

There are three basic reasons why a company would wish to hold some of its assets in the form of cash or cash equivalent. These reasons according to economic theory are; the transaction motive, precaution motive, and the speculative motive. One explanation often given for holding cash is that any profitable opportunities that arise can be met immediately. This motive may be strong in the case of a company that exists primarily for speculative purposes. To hold cash or near cash has a cost, which is the earnings that could have been obtained through using the funds elsewhere. The company has to ensure that the gains from the possible speculative opportunities are greater than the earnings from normal investment opportunities. Determining the amount of cash a firm needs at a point in time is not an easy matter. As already explained, if a bank has too little cash, it can run into liquidity difficulties, if it has too much cash, it will be missing opportunities to earn profits. The problem is to determine how much cash is too much cash. The key statements by which management can be kept informed about the cash position of the company are the cash budget and the cash -flow statement. It is necessary to have these informative statements as quick as possible and as up to date as possible, so that action can be

taken on the figures. The cash budget involves estimating what the inflow and outflow of cash will be at fixed intervals over the next planning period.

3.1.4 Credit Management

Credit management is an important part of financial management. The credit issuing policy of a company should answer several questions. For instance, whom should credit be extended to? How much credit should be allowed (at individual level and in total), how long should the credit be for? And what is to be done about defaulting debtors? The objective of the company is assumed to be to choose the credit policy that, taken into conjunction with its other policy decisions, maximizes the expected profits of the company. It may well be that the credit policy cannot be formulated without reference to constraints. The liquidity position of the company presents an obvious constraint, and production capacity, management capacity, and risk may define others. The problem is thus a programming problem in form, but it is, even in principle, so involved that a complete vigorous and general formalization would not be useful from the operational point of view. Some of the data that would be required for such model illustrates this difficulty. The company need to know the probability of sale to each potential customer as a function of the credit terms offered to him and the expected timing of the payments received from the customers. The choice of which customers to advance credit to, is really a question of the level of risk of non-payment that is considered acceptable. With every credit or sale, there is some risks that the customers will not be able to pay, but with most large banks or companies, the risk may be small. But with small illiquid banks or companies, the risks of non-payment might be so high.

3.1.5. Inventory Management

An inventory policy is a set of decision rules which determine the size and timing of replenishment orders and what to do in a stock out situation. The policy issue here is that an order for replenishment is placed when inventory fell to or below the re-order level and the size of replenishment is fixed. The re-order level policy calls for continuous monitoring of inventory level. The periodic review policy retains the concept of a re-order level but stock on hand is not constantly known, there are periodic stock takings. If at the time of stocktaking inventory is at or below the re-order level a replenishment order, of fixed size, is placed. Otherwise there is no re-ordering.

An efficient inventory policy is always an important requirement for the successful management of banking, manufacturing and distributing enterprise. Usually a fraction of the total assets of these companies are in the form of stock, so that improvement in stock control policy can bring major benefits for companies.

Any idle resource may be thought of as an inventory. Rather more vividly, stocks have been described as “money in disguise”. Indeed the stock may be of money itself, as in the case of holdings of cash. In terms of physical goods, it is conventional to distinguish three types of inventory.

- i. Pre-production inventory
- ii. In- process inventory
- iii. Finished goods inventory

Pre- production inventory is a raw material or other inputs secured from outside the firm.
In-process inventory is work-in-progress (Possibly at several stages in the production process)

and finished goods are the products of the enterprise awaiting sale. The purpose of inventory is to allow each stage of the production and distribution system to operate economically by insulating it from different or varying rates of activity at other stages.

The most obvious illustration of this is the role that finished goods inventory plays as a cushion between production and sales. Even if the rate of sales is predictable and steady, it may be uneconomical to produce continually at just that rate while if demand is erratic it would be nonsense to keep changing the rate of production. The entire production process usually needs insulating from irregularities in the arrival of suppliers. This is the main function of pre-production or raw material inventory. In times of inflation, there may be a speculative role too.

Self-Assessment Exercise 1

Discuss how human Resources, Working Capital, Cash and Credit are managed by banks

3.2. Bank Regulations in Nigeria

3.2.1. The Concept of Bank Regulation

It refers to the supervision and control of the banking sector by government in the interest of economic efficiency, fairness, healthy and safety of the banking system in the country. Regulation may be imposed simply by enacting laws and leaving their supervision to the normal process of the law, by setting up special regulatory agencies or by encouraging self-regulation by recognizing, and in some cases delegating powers to bodies or agencies. Regulation in the banking sector is ultimately aimed at the “safety and soundness” of the banking institutions, the protection of depositors’ money, the shareholders’ investments and the effective implementation of government monetary and other policies in the economy.

In Nigeria, there is evidence that over the years, the banking laws and regulations tended to make operations of commercial and merchant banks uniform. For example, while in 1979, the amendment to the repealed 1969 Decree made wholesale banking and medium-term lending as the main functions of merchant banks, the Banks and other Financial Institutions Decree of 1991 was silent on the role of merchant banks in wholesale banking and medium to long-term lending. Furthermore, the prescribed proportion of loans to medium and long-term enterprises was reduced from 50% in 1979 to 20% in 1991 and was abolished in 1996. Similarly, the prescribed minimum deposit accepted by merchant banks was reduced from N50,000 in 1992 to N10,000 since 1994. These legal and regulatory changes continued in the banking sector until the adoption of universal banking in 1999 and subsequently bank consolidation in 2004.

The changes in the laws and regulations were responses to the pressures mounted by the banking institutions to be allowed to expand the scope of their activities. Since the establishment of the CBN in 1958, the other major regulatory measure that had been taken was the establishment of the NDIC in 1988.

3.2.2. Objectives of Regulation of the Nigerian Banking System

The objectives of bank regulation and the emphases, varies from one country to another. In Nigeria, some of the objectives of regulating the banking sector include the following:

- i. To achieve public policy objectives of financial stability, high economic growth, price stability, full employment levels of output, and a balance of payments equilibrium position.

- ii. To ensure that adequate services are provided at reasonable costs to the public and that the services reach the people at reasonable low costs.
- iii. To provide safety for depositors.
- iv. To protect investors from fraud and deceit.
- v. To limit the risk taken by banking financial institutions.
- vi. To preserve the liquidity and ensure the solvency of the banks.
- vii. To built up confidence in the public and hence promote savings mobilization and investment.
- viii. To promote a highly competitive financial market.
- ix. To prevent unhealthy proliferation of banking institutions.
- x. To prevent bank failure and help built up confidence in the public.
- xi. To ensure that resources are allocated into their most efficient and profitable uses.
- xii. To improve the flexibility of financial institutions to respond to the challenging needs of individuals and businesses.
- xiii. To preserve a sound and resilient financial system.
- xiv. To maintain a base for effective monetary policy.
- xv. To promote a stable and growing standard of living.

3.2.3. Some Laws and Regulations in Nigeria

Some of the regulations/ legislations affecting the Nigerian banking system are enumerated below. You should note that by this enumeration, these bank laws and legislations in Nigeria are not exhaustive. These include:

1. The banking ordinance of 1952; which provided for the licensing of banks and prescribed a mandatory minimum capital requirement of N25,000 for the banks to operate in the country.
2. The Central Bank of Nigeria, Act 1958; this provided for the establishment of the CBN as an apex financial institution to regulate and control the commercial banks and other banks or financial institutions.
3. Banking Decree of (Acts), 1969; this provided for the regulation and control of the monetary and financial system. It made provision for the grant of licenses to banks before they can carry on banking business in the country and also imposed restriction on certain activities of licensed banks. It also empowered the CBN, among other things, to prescribe the licensed banks' minimum holding of cash reserves, specified liquid assets, specified deposits and stabilization securities.
4. Banking (Amendment) Act, 1970; this provided sundry amendments to the CBN Act of 1958, including approval required before the award of certain banking activities and the determination of the salaries and allowances of the employees of the CBN.
5. Banking (Amendment) Act, 1972; This further amended the CBN Act of enable the CBN to grant advances to commercial banks which incur deficits in their clearing operations.

Some of the Nigerian banking laws and regulations are listed below to include:

- i. Money Laundering Act (PROHIBITION) Act No.7, 2003.
- ii. Banks and other financial institutions Decree 25, 1991 Act CAP. B3 L. F. N.
- iii. Nigerian Bank for commerce and industry Act CAP. 296 L.F. N 1990 Act CAP. N92, L. F. N 2004.
- iv. Peoples Bank of Nigeria Decree No. 22 1990 Act CAP. P7 L.F.N 2004.
- v. Revocation of Banking license S. I 1 2003.

- vi. Nigerian Education Bank Decree No. 50 1993 Act CAP. N104 L.F.N 2004.
- vii. Urban Development Bank of Nigeria Act. U16 L. F. N 2004.
- viii. Community Banks Decree No.46 1992 Act CAP. C18 L. F. N 2004.
- ix. Nigerian Export Import Bank Decree No. 38 1991 Act CAP. No.106 L. F. N 2004.
- x. Federal Savings Bank Act CAP. 142, L. N. F 1990 Act CAP F20 L. F. N 2004.

3.2.4. Benefits of Bank Regulations in Nigeria

Banking regulation is expected to yield some benefits not only to the banking industry, but to the entire economy. Some of the benefits of bank regulation in Nigeria include the following:

- i) It prevents bank runs and avoidance of the resulting losses to depositors and to bank institutions.
- ii) Reduction of fraud, gross mismanagement, and excessive risk-taking by some managers of banks.
- iii) Reduction of some possible aspects of centralized power and self-dealing should this occur were banks unconstrained as to location and products offered to the public.
- iv) Greater and efficient allocation of resources than in the absence of laws and regulations.
- v) Enhances bestow confidence in the banking system.

3.2.5. Problems of Bank Regulation in Nigeria

- i) Consumers tend to be major losers since they bear the cost of reduced competition in the form of higher prices and or worse services.
- ii) The regulated institutions bear costs also from two sources; first, the cost of complying with the regulations such as supervision and examination, and second, the cost of being prevented from organizing their activities efficiently and offering products that customers want.
- iii) It entails movement away from free competition and toward greater costs or suboptimal portfolio.
- iv) It limits innovations in the banking system and banks also attempt measures to evade the supervisory/ regulatory structures.

Self-Assessment Exercise2

Define and explain the concept of bank regulation.

3.2. Bank Fraud

3.3.1. What is Bank Fraud?

Fraud, generally, refers to an act or course of deception deliberately practiced to gain unlawful or unfair advantage; such deception directed to the detriment of another. It therefore suggests unfair dealing and could be against the customer by the bank officers, or against the bank by its officers, or by the customers against the bank, etc. What constitutes fraud in banking practice has to do with some elements of deception, misrepresentation and the intent to obtain some unjustifiable advantage. Such act is generally perceived professionally unethical, legally unjust, and morally wrong.

3.3.2. Types of Bank Frauds

a). Forged cheques: This is perpetrated in a number of ways depending on the type of cheque. Any type of cheque, be it personal cheque, government cheque or travellers cheque, has its unique and peculiar characteristics and vulnerability. Compared to corporate cheques, individual cheques are more vulnerable to theft and fraud since they do not necessarily require confirmation as in the case of corporate cheques.

b). Cash fraud: This includes suppressing and converting customers' cash lodgements by fraudulent bank cashiers. Bank depositors who are illiterate are always victims of this kind of bank fraud.

c). Cross firing of cheques or kiting: This involves using bank funds without proper authority, whereby the customer usually has two or more accounts at two or more different banks or branches. He draws a cheque on his account in bank A, (knowing fully well that there are no funds in that account) and deposits the cheque into his account with Bank B. He then draws on the uncollected funds at bank B and immediately deposits in bank A another cheque drawn on non-existing funds in his account at Bank B.

d). Foreign exchange malpractices: These involve unlawful trafficking in foreign exchange and non-adherence to official guidelines on foreign exchange transactions.

e). Printing of Bank Stationary and Carving of bank Rubber Stamps: These forged papers and stamps are usually used by unscrupulous people to prepare forged letters of and other international trade instruments which are circulated all over the world with a view to obtaining goods worth millions of naira under pretence.

f). Spurious letters of Credit: This kind of letters of credit are usually accompanied with spurious "bank drafts" on the reserve of which are fake endorsements which guarantee payment.

4.0. CONCLUSION

While managing the resources of a bank prudentially and in the most efficient way enhances the attainment of the bank's basic objectives with less time and efforts and at minimal cost, bank regulations keep the banking system under check and guides the back staff, its shareholders, customers and all who are involved in the system from any form of irregularity for the smooth operation of the system. On the other hand, bank fraud is a very serious cankerworm that has caused failure in many banks in Nigeria and it requires all hands on deck to fight the menace to a halt and total elimination for economic development.

5.0. SUMMARY

In this unit, we have learned about;

- i. Managing the available resources in a bank
- ii. Bank regulation in Nigeria
- iii. Bank fraud in Nigeria.

6.0. TUTOR-MARKED ASSIGNMENT

Discuss the objectives of bank regulation in Nigeria

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UNIT 12: MONEY

CONTENT

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- 2.0. Objectives
- 3.0. Main Content
 - 3.1. What is Money?
 - 3.2. Attributes of Money
 - 3.3. Functions of Money
 - 3.4. Demand for Money
 - 3.4.1. The concept of Demand for Money
 - 3.4.2. Motives for holding Money
 - 3.4.2.1. Transactions Motives
 - 3.4.2.2. Precautionary Motives
 - 3.4.2.3. Speculative Motives
 - 3.4.3. Determinants of the Demand for Money
 - 3.5. Money Supply
 - 3.5.1. The concept of Money Supply
 - 3.5.2. Determinants of Money Supply
- 4.0. Conclusion
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- 6.0. Tutor – Marked Assignment
- 7.0. Reference / Further readings

1.0. INTRODUCTION

Money is a difficult concept to define, partly because it fulfils not just one but various functions, each of them providing a criterion of moneyness. There has been lots of controversy and debate over the right definition of money, because people have defined it base on the functions it performs in an economy. In this unit, you shall learn about what money is, and its function in the economy.

2.0. OBJECTIVES

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

- Define money
- List and explain the attributes of money
- Define and explain the concept of demand for money
- Define and explain the concept of supply of money
- Identify and explain the determinants of demand for money and the determinants of supply of money

3.0. MONEY

7.1. What is Money?

Money has been defined by many people in different way base on the functions which money perform in an economy. So of the definition of money given by different scholars include the ones below.

- i. Money may be defined in a functional sense as anything generally used in the purchase of goods and services and in the discharge of debts.
- ii. Money can be regarded as anything that is commonly accepted as a medium of exchange and as an instrument for the final settlement of a debt.
- iii. Money is any commodity that is generally accepted in a locality as a means of payments for goods and services and in settlement of debt.

The above definitions are all functional definitions of money because they define money in terms of the function it performs. One common feature in the definition of money is its general acceptability by a particular society as a means of payment for goods and services and settlement of debts.

3.2. Attributes of Money

General acceptability: This means that the commodity used as money must be generally accepted by people of a locality. If money possesses other qualities without being generally acceptable, it cannot function as a medium of exchange. The acceptability is the most essential feature of money.

Portability: The commodity to serve as money should be such that it could be carried along with ease or transferred from place to place without difficulty.

Divisibility: It must be capable of being divided into small units or denominations to allow for exchange of small quantity of goods.

Durability: The commodity should be capable of being kept for a long time without deteriorating easily, else, it may not be a good store of value.

Stability: Stability in the value of money is also essential if money is to perform its functions satisfactorily. It is important that since money performs the function of a store of value or a standard of deferred payments, its value must not fluctuate excessively.

Homogenous: This implies that the commodity must be identical in all respects to allow smooth exchange transactions take place. For example, a five naira note in Lagos should be an exact replica of another five naira in Jos.

Scarcity: For money to have value and therefore be acceptable, it must be relatively limited in supply relative to demand and the productive capacity of the country. In other words, to be generally acceptable, the supply of anything being used as money must be restricted. It must neither be too plentiful, nor too scarce.

Recognizability: For anything to serve as money, it has to be easily recognized. If it is not easily recognized, market participants will find it difficult to determine whether they are dealing with money or some inferior assets like a counterfeit.

It must be a legal tender: The commodity must be backed by law so that debtors could compel their creditors to accept the commodity as a means of payment and in settlement of debt.

3.3. Functions of Money

Money performs the following functions in an economy.

Medium of exchange: This is one of the primary functions of money. It is said to be a primary function in the sense that out of this function, other functions are derived. To say that money serves as a medium of exchange means that market participants (buyers and sellers) will accept it as payment. That means that it is generally acceptable and therefore, affords the freedom of choice. As a medium of exchange, individuals can sell their output for money and use that money to make purchases in the future. In this process, money facilitates exchange through specialization and division of labour. Money, as servicing as a medium of exchange also eliminates the inconveniences and difficulties of barter, especially the need for double coincidence of wants.

Money as a store of value: As a store of value, money enable us preserve wealth in a more durable form, without having to keep bulky inventories. To do this, money material should be durable and value of money itself be relatively stable. But we know that value of money depends on price so that money cannot perform this function of store of value well in a period of inflation. However, it is because money can store value that we can defer payment.

Money as a unit of account: Money as unit of account serves as a unit

In terms of which the value of all goods and services are measured and expressed. That is, as a unit of account, money is used to express prices or values in exchange of commodities. For instance, in Nigeria, the exchange price of goods and services is expressed in naira and kobo. The use of money in this manner promotes orderly pricing system for rational choice in production and consumption.

Put in another way, money serves as a unit in terms of which values of goods and services are measured and expressed. It is a unit in which people express debt, values of goods and in which wealth is measured and compared. In other words, money is a common denominator which determines the rate of exchange between goods and services which applies in terms of monetary units.

Money as a standard for deferred payment: Money as a standard for

deferred payment has made it possible for us to buy something today and pay tomorrow. You know that a lot of transactions and contracts take place on the understanding that the payments will be done in the future. This is possible because money not only serves as medium of exchange but also as a unit of value hence future payments are stated in monetary unit provided its value of purchasing power is stable overtime.

Self-Assessment Exercise1

Define Money and explain its major functions in an economy

3.4. Demand for Money

3.4.1. What is Demand for Money?

Demand for money refers to the total amount of money balances that people want to hold for certain purposes. This refers to the desire to hold money in its liquid form (i.e. cash) instead of investing it in a business. According to Lord John Maynard Keynes there are three reasons for holding money in cash form, Transaction, and Precautionary and Speculative motives for holding money.

3.4.2. Motives for holding Money

3.4.2.1. The Transaction motive:

This refers to the desire to hold cash for day-to-day buying and selling of goods and services. This quantity of money to be held depends on an individual's income and the interval between one pay day and the next. Generally, the higher the income, the greater the amount of money held for this purpose, all things being equal. Again, the longer the interval between one pay-day and the next, the higher the amount of cash held all things being equal.

3.4.2.2. Precautionary motive

Money is also demanded to cater for emergencies or to provide for unseen expenditures. Individuals and businesses also desire to hold cash in order to take care of emergencies, such as sicknesses, entertainment of unexpected guests, unplanned repairs of factory equipments, accidents, etc. Again, how much is to be held for this purpose depends largely on one's income. Higher income earners are likely to hold more money for precautionary purpose than the lower income earners.

3.4.2.3. Speculative motive

This refers to the desire to hold cash to take advantage of profitable investment opportunities. It has to do with money held for the purpose of avoiding capital losses in a decline securities market. This arises out of uncertainty. Due to changing or fluctuating interest rates, the individual may decide to hold money in cash or in bonds or equities, etc. This varies inversely with the rate of interest. The strength of the desire for liquidity is called liquidity-preference. It is this that helps to decide what proportion of individual's assets will be held in the form of money.

3.4.3. Determinants of Demand for Money

Factors such as the price level, the rate of change of prices or inflation, real permanent income or wealth and return on bonds and equities have been identified by Keynes and Friedman as the determinants of money demand in an economy. These are explained below:

Income: Demand for money varies directly with the level of income, that is, the higher the level of income, the higher the level of money demand.

Interest rate: Demand for money varies inversely with the interest rate i.e. the higher the interest rate, the lower the demand for money and the lower the interest rate, the higher the demand for money.

Price level: There is direct positive relationship between money and price level.

The rate of price changes: Demand for money varies inversely with inflation rate. This is said to be a weak determinant of the demand for money.

Real permanent income: Money demand varies directly with permanent income or wealth. The higher the return on bonds and equities the lower the demand for money

3.4.3. Money Supply

This refers to the total quantity of money in circulation at any point in time. It comprises currency (i.e. naira and kobo) and demand deposit (Bank Money). The level of money supply depends on the monetary and credit policies pursued by a country at any given period of time. If a country through its monetary authorities (i.e. Central Bank) pursues a contractionary or tight money policy, the level of supply of money will be small. But if on the other hand, an expansionary or loose or easy monetary policy is pursued, size of supply of money will be large.

3.4.3.1. Determinants of Money Supply

Money supply is generally determined by the Central Bank behaviour, the behaviour of non-bank public, and the behaviour of the commercial banks in an economy. More specifically, money supply is determined by the following factors.

Total reserves supplied by the Central Bank: If the total reserves supplied by the Central Bank are high, money supply will be high.

Reserve requirement: If the reserve requirement (percentage of commercial banks' deposit legally required to be kept with the central bank) is high, money supply will be low.

Demand for currency: If the non-bank public increases its demand for currency, money supply will increase.

Demand for time Deposits: If the non- bank public increase its demand for time deposits, money supply increases.

Demand for excess reserves: If commercial banks demand for excess reserves increases, currency supply increases.

Interest Rates: There is a positive relationship between money supply and interest rates. That is, the higher the interest rate, the higher the money supply.

The bank rate: If the rate at which commercial banks borrow from the Central Bank or discount bills rises, money supply falls.

Self-Assessment Exercise2

Define the concept of Money supply and explain its determinants

4.0. CONCLUSION

Money is anything that is generally acceptable in a society for exchange of goods and services and for the settlement of debts in that society. It facilitates economic development of nations. This unit discusses money, its functions and its determinants in respect of its supply and demand.

5.0. SUMMARY

In this unit, we have learned about;

- Money, its attributes and functions
- The demand for money
- The supply of money
- The determinants of the demand and supply of money.

6.0. TUTOR-MARKED ASSIGNMENT

Identify and explain the motives for holding money in an economy.

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UNIT 13: MONETARY POLICY

CONTENT

1.0. Introduction

2.0. Objectives

3.0. Main Content

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3.2. Objectives of Monetary Policy

3.3. Instruments of Monetary Policy

3.3.1. Quantitative Instruments of monetary Policy

3.3.2. Qualitative Instruments of Monetary Policy

3.4. The role of monetary Policy in developing economies

3.5. Limitations of monetary Policy in developing economies

4.0. Conclusion

5.0. Summary

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1.0. INTRODUCTION

One of the functions of the Central Bank of Nigeria (CBN) is to formulate and execute monetary policy to promote monetary stability and sound financial system in Nigeria. The authority to formulate and implement monetary policy is vested in the CBN as outlined in the Central Bank Act of 1958 (and subsequent amendments), the CBN Decree No. 24 of 1991 and the Banks and other Financial Institutions Decree No. 25 of 1991. These laws, enjoin the CBN to promote monetary stability and sound financial system in Nigeria under the overall guidance of the Federal Government. In this unit, you shall learn about the concept of monetary policy and its objectives, Instruments and role in economic development. You shall also learn about the limitations of monetary policy in developing economies in this unit.

2.0. OBJECTIVES

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

- Define and explain the concept of monetary policy
- Identify and discuss the objectives of monetary policy
- Identify and explain the Instruments of monetary policy
- Describe the role of monetary policy in developing economies
- Discuss the limitations of monetary policy in developing economies.

3.0. MONETARY POLICY

3.1. The Concept of Monetary Policy

Monetary policy is a major economic stabilization weapon which involves measures designed to regulate and control the volume, cost, availability and direction of money and credit in any economy to achieve some specified macroeconomic policy objectives. It is a deliberate effort by the monetary authorities (The CBN) to control the money supply and credit condition for the purpose of achieving certain broad economic objectives.

The monetary policy in the Nigerian context encompasses actions by the CBN that affect the availability and cost of commercial and merchant banks reserve balances and thereby, the overall monetary and credit conditions in the economy. The main objective of such action is to ensure that overtime, expansion of money and credit will be adequate for the long-run needs of the economy.

3.2. Objectives of Monetary Policy

Monetary authorities charged with the responsibility to administer monetary policy are normally concerned with the selection of some economic objectives. Such economic objectives must be such that are in the general interest of the society. The objectives of monetary policy in any economy may include the following:

Attainment of a high rate or full employment: Full employment has been

ranked among the foremost objectives of monetary policy. It is an important goal not only because unemployment leads to wastage of potential output, but also because of the loss of social standing and self-respect and more so, it breeds poverty. Full employment according to Keynes means the absence of involuntary unemployment. In other words, full employment is a situation in which everybody who wants to work, get work. This does not mean zero unemployment since there is always a certain amount of frictional, voluntary or seasonal unemployment. Thus, what most policy makers aim at is actually minimum unemployment and the percentage varies among countries.

Maintenance of relative stability in domestic prices: One of the objectives of monetary policy is to stabilize domestic price levels in an economy. This policy is favoured by many economies because fluctuations in prices bring uncertainty and instability to the economy. Besides, rising and falling prices are both bad because they bring unnecessary loss to some and undue advantage to others. So a policy of price stability keeps the value of money stable, eliminates cyclical fluctuations, brings economic stability, helps in reducing inequalities of income and wealth, secures social justice and promotes economic welfare.

Achievement of a high and sustainable economic growth: One of the most

important objectives of monetary policy is to achieve rapid economic growth of an economy. Economic growth refers to the process whereby the real per capita income of a country increases over a long period of time. Economic growth is measured by the increase in the amount of goods and services produced in a country. A growing economy produces more goods and services in each successive time period. Thus, growth occurs when an economy's productive capacity increases which, in turn, is used to produce more goods and services. The attainment of high economic growth refers to maximum sustainable high output, that is, the most possible output with all resources employed to the greatest possible extent, given the general social and

organizational structure of the society at any given time. In its wider perspective, economic growth implies raising the standard of living of the people, and reducing inequalities of income distribution.

Maintenance of Balance of payments equilibrium: The achievement of this goal has been necessitated by the phenomenal growth in the world trade as against the growth of international liquidity. It is also recognized that deficit in the balance of payments will retard the attainment of other objectives, especially the objective of rapid economic growth. This is because a deficit in the balance of payments leads to sizeable out flow of gold. The maintenance of balance of payments equilibrium therefore involves keeping international payments and receipts in equilibrium. That is, avoiding fundamental or persistent disequilibrium in the balance of payments position.

Exchange Rate Stability: This objective involves avoiding excessive, undue and unnecessary fluctuations in the currency exchange rate. This is meant to help in protecting and promoting foreign trade which ultimately enhances economic growth and development.

3.3. Instruments of Monetary Policy

The instruments or tools of monetary policy are broadly classified into two, first, the quantitative or indirect instruments; and second, the qualitative, selective or direct instruments. The instruments affect the level of aggregate demand through the supply of money, cost of money and availability of credit. The instruments of monetary policy are discussed below:

3.3.1. Quantitative instruments

These are instruments or tools of monetary policy which operate primarily by influencing the cost, volume and availability of bank reserves. They lead to the regulation of the supply or credit and cannot be used effectively to regulate the use of credit in particular areas or sectors of the credit market. These instruments include bank rate variation, open market operations and changing reserve requirements and liquidity ratio. They are meant to regulate the overall level of credit in the economy through commercial banks.

Bank rate or rediscount rate policy: Bank rate is the minimum lending rate of the Central Bank at which it rediscounts first class bills of exchange and government securities held by the commercial banks. This discount rate is the rate of interest rate the monetary authorities (as lenders of last resort) charge the commercial banks on loans extended to them. When the Central Bank finds that inflationary pressures have started emerging within the economy, it raises the bank rate. Borrowing from the Central Bank then becomes costly and commercial banks borrow less from it. The commercial banks, in turn, raise their lending rates to the business community and borrowers borrow less from the commercial banks. This therefore, contracts credit and prices are checked from rising further. On the contrary, when prices are depressed, the central bank lowers the bank rate. It becomes cheaper now to borrow from the Central Bank by the commercial banks. The latter also lower their lending rates which encourage the business community to borrow more and investment is encouraged. By this, output, employment, income and demand will start rising and down ward movement of prices are checked.

Open Market Operations (OMO): Open Market Operations refers to the sale and purchase of government securities in the money market by the central bank depending on whether the economy is inflationary or deflationary respectively. When prices are rising and there is need to control them, the Central Bank sells securities. This will lead to the reduction of the reserves of commercial banks and therefore, they will not be in a position to lend more to the business community, hence investment is discouraged and the rise in prices is checked. On the other hand, when recessionary forces start in the economy, the Central Bank buys securities from the commercial banks and the reserve of the commercial banks are raised and they lend more. This will lead to increase in investment, output, employment, income in the economy and subsequently fall in price is checked.

Liquidity Ratio: Every commercial bank is required by law to keep a certain percentage of its total deposits in the form of a reserve fund in its vaults. This is in order to control their liquidity and influence their credit operations. This ratio is usually expressed as a percentage of customers' deposits and it can be manipulated by the central bank to vary the ability of commercial banks to make loans to the public by simply increasing or decreasing the ratio. The central bank imposes upon the banks a minimum liquidity ratio, being varied according to the needs of the situation. It is designed to enhance the ability of the banks to meet cash withdrawals on them by their customers. When prices are rising, the central bank raises the liquidity ratio. Banks are by this, required to keep more with themselves in from of this ratio without lending it out to the public and therefore lending is reduced. The volume of investment, output and employment are adversely affected. On the other hand, when the ratio is lowered, the reserves of the commercial banks are raised and they lend more and the economic activities are favourably affected.

Cash reserve requirements: This refers to the cash reserves or balances held by banks with Central Bank and which the Central Bank has authority to vary according to the exigencies of the credit control. These are usually certain percentage of the total deposits of commercial banks kept in form of reserve fund with the central bank by law. This is in order to control their liquidity and influence their credit operations. Such deposits with the central bank must not be less than a prescribed portion of the banks' deposit liabilities. It is more effective than OMO, since it acts directly and has no effect on the prices of government securities or on interest rates. The central bank increases or decreases the rate during inflationary periods and depression periods in the economy respectively depending on the prevailing situation in the economy.

3.3.2. Qualitative or selective instruments

Selective credit controls are used to influence specific types of credit for particular purposes. They confer on the monetary authorities the power to regulate the terms on which credit is granted in specific sectors. These powers or controls involve the official interference within the volume and directions of credit into those sectors of the economy which planners believe are of crucial importance to economic development. These instruments include moral suasion and selective credit controls or guidelines.

Moral Suasion: At times, the monetary authorities attempt to affect both the total and the mix of credit by appeal and voluntary response rather than by regulation and authority. Moral suasion is a process by which the monetary authorities through informal discussion make known to

commercial banks the direction in which monetary policy and the contribution which are expected on the part of the commercial banks. This instrument tends to be effective in the short term and in periods in which the basis for the appeal are both visible and meaningful to the institutions involved. There is no legal basis for forcing commercial banks to meet their commitments. However, monetary authorities have frequently found it necessary either to replace voluntary compliance with enforced compliance or to introduce threats of retaliation for failure to comply.

Selective credit control or guidelines: This is an instrument of monetary policy used specifically to direct credit to sectors that are favoured at certain periods. This tool involve administrative orders whereby the central bank, using guidelines, instructs banks on the cost and volume of credit to specified sectors depending on the degree of priority of each sector. Thus, selective credit controls are examples of the use of monetary policy to influence directly the allocation of resources, indicating a lack of faith in the working of the free market. Here, the Central Bank may resort to “Credit Rationing” by prescribing absolute limits up to which specified sectors of the economy may be authorized to get credit from the banking system or from particular types of banks.

Self-Assessment Exercise1

Identify and discuss the Instrument of monetary policy in Nigeria.

3.4. The Role of monetary policy in Developing Economies

Monetary policy in a developing country like Nigeria plays an important role in increasing the growth rate of the economy by influencing the cost and availability of credit, by controlling inflation and maintaining equilibrium in the balance of payments. Some of the roles that monetary policy plays in the development of the Nigerian economy and other developing economies of the world are discussed below:

Control of inflation: Inflation is a serious economic problem that causes excessive and undue fluctuations in the price levels in an economy which are highly upsetting to the economy. Not only do such wide price gyrations produce windfall profits and losses, but they also introduce uncertainties into the market that make it difficult for businesses to plan a head. However, monetary policy is an important economic policy in the control of inflationary pressures in developing economies including Nigeria. In controlling inflationary pressures arising from the process of development in the developing countries, monetary authorities have been using both quantitative and qualitative instruments of credit control. In the use of both quantitative and qualitative instruments of monetary policy in the control of inflation, the qualitative credit control measures are however been said to be more effective in developing countries than the quantitative measures in influencing the allocation of credit, and thereby the pattern of investment. They prove more useful in controlling “sectoral inflation” in an economy. The selective credit controls are more appropriate for controlling and limiting credit facilities to the productive sectors like agricultural, mining, industrial sectors, etc.

Achievement of price stability: Monetary policy is an important instrument for achieving price stability. It brings a proper adjustment between demand for and supply of money. An imbalance between the two will be reflected in the price level. A shortage of money supply will retard

growth while an excess of it will lead to inflation. As the economy develops the demand for money increases due to the gradual monetization of the non-monetized sector, and the increase in agricultural and industrial production. These will lead to increase in the demand for the transactions and speculative motives. So the monetary authorities will have to raise the money supply more than proportionate to the demand for money in order to avoid inflation.

Bridging of balance of payments deficit: Monetary policy in the form of interest rate policy plays an important role in bridging the balance of payments deficit. Developing countries develop serious balance of payments difficulties to fulfill planned targets of development. It is a fact that developing countries depend on the industrially developed countries for capital goods such as capital equipments, machines, iron and steel, spare parts and components, etc for infrastructural development thereby raising their imports. On the other hand, exports are almost stagnant and are high-priced due to inflation. As a result, an imbalance is created between imports and exports which lead to disequilibrium in the balance of payments. Monetary policy can help in narrowing the balance of payments deficit through high rate of interest. A high rate attracts the inflow of foreign investments and helps in bridging the balance of payments gap.

Incentives to higher savings in the economy: A policy of high interest rate in developing countries also acts as an incentive to higher savings, develops banking habits, and speed up the monetization of the economy which are essential for capital formation and economic growth. A high interest rate policy is also anti-inflationary in nature, for it discourages borrowing and investment for speculative purposes in foreign countries. Further, it promotes the allocation of scarce capital resources in more productive channels. However, it is advisable for the monetary authorities in developing countries to follow a policy of discriminatory interest rate, charging high interest rates for non-essential and unproductive uses and low interest rates for productive uses.

Self-Assessment Exercise2

Discuss the role of monetary policy in developing Economies.

3.5. Limitations of Monetary policy in Developing Economies

The experience of developing countries reveals that monetary policy plays a limited role in such countries. Some of the limitations of monetary policy in developing countries are explained below.

Underdeveloped money and capital markets: The money and capital markets of these countries are underdeveloped so much so that these markets lack in Bills, Stocks and Shares which limits the success of monetary policy

Large amount of money outside banking system: Most rural dwellers in the developing countries have little or no habit of depositing money in the banks. They prefer to keep huge sums of money in their houses as their wealth. Besides, some well-to-do people in the urban areas do not deposit money in the bank but use it for buying jewelleries, gold, real estate etc in speculation. Monetary policy is also not successful in such countries because bank money comprises a small proportion of the total money supply in the country. As a result, the central bank is not in position to control credit effectively.

Large non-monetized sector: There is a large non-monetized sector which hinders the success of monetary policy in developing countries. People mostly live in rural areas where there are no banks and also, money is not always used for exchange. As a result of the absence of banks and inadequate use of money for transaction in the economy, monetary policy fails to influence this large segment of the economy.

High liquidity: Most commercial banks possess high liquidity so that they are not influenced by the credit policy of the central bank. This also makes monetary policy less effective.

10.0. CONCLUSION

This unit discusses monetary policy, its objectives, instruments and limitations especially in developing countries.

11.0. SUMMARY

In this unit, we have learned about;

- The concept of monetary policy
- The objectives of monetary policy
- The instruments of monetary policy
- The role of monetary policy in developing economies
- The limitations of monetary policy in developing economies.

12.0. TUTOR-MARKED ASSIGNMENT

Identify and discuss the objectives of monetary policy in Nigeria.

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UNIT 14: MONEY AND CAPITAL MARKETS

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1.0. INTRODUCTION

Financial markets are broadly categorized into money and capital markets. The structure of a country's financial markets is dictated by the economic and financial development of its economy. As a country experiences growth in its wealth and income, its financial structure also becomes richer in assets, institutions and markets. In this unit, you shall learn about money and capital markets, the stock exchange and their functions respectively.

2.0. OBJECTIVES

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

- Define money market
- Identify and explain the instruments of money market
- Identify and discuss the functions of money market
- Define capital market
- List and explain the instruments of capital market
- Enumerate and discuss the functions of capital market
- Define stock exchange market
- Identify and explain the functions of the stock exchange

3.0. MONEY AND CAPITAL MARKETS

3.1. Money market

3.1.1. What is Money Market?

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

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

3.1.2. Instruments of Money Market

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

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

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

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

a first line defence against cash since they can always be drawn up immediately to meet pressing cash shortages.

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

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

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

Self-Assessment Exercise1

Define Money Market and discuss its instruments

3.1.3. Functions of Money Market

Money market performs the under listed functions in Nigeria:

- i. Promotion of an efficient allocation and utilization of funds in the economy, thus ensuring non-existence of idle fund.
- ii. Helps the commercial banks to hold lower cash reserve through provision of numerous investment outlets – treasury bills, call money, treasury certificates etc.
- iii. Acts as an important source for short-term borrowing to the government.
- iv. Helps to indigenize the credit base of the economy through provision of Nigeria securities.
- v. Provision of an avenue or way for the implementation of government monetary policy.
- vi. Provision of forum for fund mobilization and allocation in the economy.
- vii. Provision of opportunity for investment in fairly liquid and riskless assets.
- viii. Help banks to invest their surplus funds in earning assets and thus minimizing their cash holding.
- ix. It promotes liquidity and safety of financial assets since through the forum of money market one can easily convert an undesired short-term security into cash.
- x. Gives the central bank signals with respect to shortages/ surpluses of funds in the economy through preventing interest rate.

3.1.4. Features of a Developed Money Market

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

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

Presence of a developed commercial banking system: A well developed money market should be characterized by the presence of a developed commercial banking system, along with a wide-spread banking habit on the part of the public.

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

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

Existence of specialized institutions: For competitiveness and efficiency, there must exist specialized institutions in particular types of assets, e.g. specialized discount houses, acceptance houses specializing in accepting bills, or specialized dealers in government securities.

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

3.2. Capital market

3.2.1. What is a Capital Market?

A capital market is the market for buying and selling of long-term securities. Alternatively, it is the market for long-term credit or loanable funds. Thus, while those who are short of funds and need to borrow for short-term purposes borrow from the money market, those who are short of funds and are desirous of borrowing for long-term go to the capital market. Similarly, whereas those who have funds surplus to their immediate requirements and wish to lend or invest these funds for short-term periods do so in the money market, those who have such funds and wish to lend them for long periods, invest or lend these funds to the capital market.

The market is the source from which industry obtains its capitals for establishment, expansion and modernization and from which the government borrows on long-term basis for development purposes. It offers access to a variety of financial instruments that enables economic agents to pool, price, and exchange risk. Through assets with attractive yields, liquidity and risks characteristics, it encourages savings in financial form. This is very important for governments and other institutions in need of long-term funds who because of the nature of their liabilities, undertake to maintain part of their assets in relatively illiquid form.

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

The capital market is divided into two:

- i. The primary (or New issue) market which deals with the selling of fresh or new securities; and
- ii. The secondary (Stock exchange) which is concerned with the resale of old or second-hand securities.

3.2.2. Capital Market Instruments

The following instruments are traded in the capital market.

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

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

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

3.2.3. Functions of Capital Markets

The capital market performs the following functions:

- i. It provides local opportunities for borrowing and lending for long-term purposes.
- ii. Enables the authorities to mobilize long-term capital for the economic development of the country.
- iii. Provides foreign business with the facility to offer their shares, and the Nigerian public an opportunity to invest and participate in the shares and ownership of foreign businesses.
- iv. Provide facilities for the quotation and ready marketability of shares and stocks, and opportunities and facilities to raise fresh capital in the market.

- v. Maintains discipline in the market through introduction of a code of conduct, checking abuses and regulating the activities of the operators in the market.
- vi. Provides a healthy and mutually acceptable environment for participation and co-operation of indigenous and expatriate capital in the joint effort to develop the Nigerian Economy to the mutual advantage of both parties through participation and ownership.

3.2.4. Differences between Money and Capital Markets

- i. Whereas the capital market provides opportunities for sourcing medium and long-term loans and avenues for medium and long-term investments, the money market offers opportunities for sourcing short -term loans and making short-term investments.
- ii. Whereas the capital market instruments mature as from three years and above, money market instruments mature within one year mainly.
- iii. Whereas the participants in the capital market are mainly those that lend long, e.g. Development Banks, Merchant Banks, Finance Corporations, Stock Exchange and the Central Bank, the participants in the money market are largely those institutions that lend short e.g. the commercial banks, discount houses and acceptance houses.

Self-Assessment Exercise2

Identify and discuss the instruments of Capital Market in Nigeria.

3.3. The Stock Exchange Market

3.3.1. What is stock Exchange market?

The stock exchange is an organized market for buying and selling of secondary, existing, old or second-hand securities (i.e. existing shares, stocks and bonds). The Nigerian Stock Exchange was founded in 1960 as Lagos Stock exchange through the inspiration of the Federal Government, the NIDB, the CBN and the business community. Backed by the Lagos Stock Exchange Act of 1961, the exchange commenced business in June of the same year.

As contained in the memorandum of association of the organization, the objectives of the Nigerian Stock Exchange (NSE) include:

- i. The creation of an appropriate mechanism for capital formation and efficient resource allocation among competing projects.
- ii. The provision of special financing strategies for those projects with long – term gestation periods.
- iii. Maintenance of fair prices for securities.
- iv. Maintenance of discipline in the capital market.
- v. To spread share ownership among Nigerians.

3.3.2. Functions of the Stock Exchange

The Nigerian Stock Exchange performs the following functions.

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

- ii. It is a source of capital to government and companies.
- iii. It helps to maintain prices of securities by controlling the flow of stocks and shares into the market.
- iv. It provides information on the value and prices of securities to investors.
- v. It protects the investor / public against fraudulent practice since the participants in the market are known-licensed dealers.
- vi. It stimulates inflow of foreign exchange into the economy by promoting issuance and sale of non – voting shares to foreign investors.
- vii. It helps to maintain discipline in the capital market.
- viii. It controls the activities of jobbers and brokers.

4.0. CONCLSION

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

5.0. SUMMARY

In this unit, you have learned about;

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

6.0. TUTOR-MARKED ASSIGNMENT

Define Stock Exchange Market and explain its functions.

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UNIT 15: INTERNATIONAL FINANCIAL ORGANIZATIONS

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1.0. INTRODUCTION

The three International Financial Organizations that you will study in this unit are the World Bank- the International Bank for Reconstruction and Development (IBRD); the International Monetary Fund (IMF); and the African Development Bank (ADB).

The World War II had disastrous impact on most European countries. Most of the industrial centres in Europe were damaged and excessive imports and borrowings to prosecute the war led to prolong deficits in the balance of payment accounts of most countries. A meeting then was held in Breton Wood, U.S.A in 1944 to find solution to these problems and at the end of this meeting, two institutions emerged. These were the International Bank for Reconstruction and Development (IBRD) World Bank; and the International Monetary Fund (IMF). In this Unit, you shall learn about the objectives, functions and the sources of funds of these international financial institutions, and also the functions and sources of funds of the African Development Bank (ADB).

2.0. OBJECTIVES

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

- Describe how the World Bank Originated;
- Discuss the Functions/ purpose of the World Bank;
- Explain the main sources of funds of the world Bank;

- Describe the IMF
- Discuss the objectives and functions of the IMF
- Discuss the functions and sources of funds of the ADB

3.0. INTERNATIONAL FINANCIAL ORGANIZATIONS

3.1. The World Bank -The International Bank for Reconstruction and Development (IBRD)

The Bank came into existence in 1945, following the deliberations of the representatives of the 44 nations assembled at Breton Woods, New Hampshire, and U.S.A. in 1944. The participants at the Breton Woods conference realized that at the end of the World War II, there was a pressing need for international capital to finance the reconstruction of productive facilities destroyed by the war and to increase productivity and living standard of the underdeveloped countries of the world in accelerating the pace of economic growth. By 2009, the banks membership stood at over 151 countries with Headquarters still at Washington D. C, U.S.A.

3.1.1. Functions /purpose of the World Bank

The major functions or purpose of establishing the World Bank are enumerated below:

- i. Reconstruction of the war-devastated economies and development of economically backward countries through investment and capital accumulation and through the use of productive capacity for production of goods and services.
- ii. To promote long-term balanced growth of international trade and maintenance of equilibrium in the balance of payments by encouraging international investment for the development of productive resources of the members, thereby assisting in raising the standard of living.
- iii. To assist in bringing out a smooth transaction from a war – time to a peaceful time economy.
- iv. To underwrite loans to developing nations who are members.
- v. Renders technical assistance to less developed countries who are members.
- vi. It can also borrow money from member-nations (advanced, rich nations) to finance its own loans.
- vii. It also comments on the financial buoyancy and credit – worthiness of a borrowing nation through its expertise and understanding of financial matters. It issues certificates of credit worthiness and those are acceptable and respectable the world-over.

3.1.2. The main sources of funds of the World Bank

The World Bank has three main sources of funds. These are outlined and explained below:

Its own capital: This refers to its authorized capital. This is made up of subscribed capital, paid-in capital and amounts subject to call.

Retained Earnings: A proportion of the Bank's retained earnings (net) are transferred in the form of grants to one of its affiliates, International Development Association (IDA), and the balance transferred to the general special resources.

Borrowings: This forms the largest sources of the Banks funds for lending and the major sources of borrowing are the international capital markets of the capital-rich members.

3.1.3 The General Provisions regarding Loans and Guarantees by the World Bank

The banks provisions regarding loans and guarantees are outlined below. That is, the bank can make loans or guarantee subject to the following conditions.

- i. The World Bank ensures that the borrowers and the guarantor have the paying capacity.
- ii. With the exception of loans given to the International Finance Corporation (IFC), every loan must be made to or guaranteed by the member-government (Or other competent authority) on its behalf acceptable to the World Bank, in whose territory the project to be finance is located.
- iii. It lends only for productive purposes and in non- military projects.
- iv. It must ensure that the project to be financial will be able to provide a return commensurate with the amount of investments, that is, return must be enough to service its debt obligations and show a surplus thereafter.
- v. Except in special circumstances, the World Bank Loans are for specific projects.
- vi. A loan made for a project cannot be diverted to any other use.
- vii. Only economic considerations inform the bank's decision to give loans.
- viii. There must be a written report, prepared by a competent committee after careful study of the merits of the proposal, recommending the project.
- ix. The World Bank deals only with member governments, their Central Banks or some other component agencies.
- x. A project slated for financing must be able to contribute to the economic development of the borrowing member nation.
- xi. The bank has the right to determine the loan amount and conditions though it has to satisfy itself that the interest rate and other charges are reasonable and appropriate to the project.
- xii. The loan amount or guarantee is not limited by the members subscribed capital.
- xiii. The interest on the loan must be paid in currencies in which the loan was made.

3.2. The International Monetary Fund (IMF)

The International Monetary Fund (IMF) is an intergovernmental monetary and financial organization. The IMF, as a Breton Woods institution, is an intergovernmental pillar supporting the structure of the World's economic and financial order. The IMF was formed in reaction to the unresolved financial problems instrumental in initiating and protracting the Great Depression of the 1930: Sudden, unpredictable variations in the exchange values of national currencies and a widespread-disinclination among governments to allow their national currency to be exchanged for foreign currency. The IMF came into existence on 27 December, 1945 when 29 countries signed the articles of agreement. The inaugural meeting of the Board of Governors was held in Savannah, Georgia, U.S.A on 8 March, 1946, and the first meeting of the executive Board took place at the funds headquarters in Washington D.C. on 6 May, 1946. The fund then started financial operations on 1st March, 1947 with 39 members but have over 151 members by 2009. Its policies and activities are guided by its charter known as the "Article of agreement".

3.2.5. Objectives of IMF

Articles of the IMF charter set out its aims as follows:

- i. Promotion of international monetary corporation.
- ii. The expansion and balanced growth of international trade, i.e. to ensure that payment does not constitute an impediment of trade.
- iii. The promotion of exchange rate stability.
- iv. Maintenance of high levels of employment and real income in member countries through gains from trade and necessary assistance.
- v. The encouragements of free exchange arrangement through assisting in ensuring easy convertibility of currency.
- vi. The avoidance of retaliatory or competitive devaluation of currency.
- vii. Providing assistance to a country in solving balance of payment problems, e.g. through provision of advice on fundamental re – structuring of the economy.
- viii. Reduction in balance of payment problems.
- ix. Maintenance of surveillance over exchange rate policies.
- x. Creating a reserve base for members.
- xi. Establishment of multi-lateral payment system.

3.2.6. Functions of the IMF

The functions of the IMF are discussed under three main headings; regulatory functions, financial assistance, and services.

3.2.6.1.Regulatory Functions

Exchange arrangements: Members have a general obligation to collaborate with IMF and with other members to promote orderly exchange arrangements and a stable system of exchange rates. They indeed, have the more specific obligations to pursue economic and financial policies that promote orderly economic growth with reasonable price stability and to foster orderly underlying economic and financial conditions. Members are also required to avoid exchange rate and other policies that prevent effective balance of payments adjustment or provide an unfair competitive advantage over other members.

Surveillance: The IMF is required to oversee both the International Monetary System, to ensure its effective operation, and the observance of by each member of its obligations and to accomplish the later, the fund exercises firm surveillance over the exchange rate policies of members who are required to provide it with the necessary information and to consult with it on their exchange rate policies when the fund requests them to do so. It is also the principle of the fund that members should refrain from manipulating exchange rates or from gaining unfair competitive advantages over other members. Also, the IMF calls on members to intervene in their exchange markets if necessary to counter disorder conditions that may be characterised by among other things disruptive short-term movements in the exchange rate of their currencies. The members, in their intervention policies should take into cognizance the interest of other members, including those countries in whose currencies they intervene.

Exchange rate restriction: Members are to avoid discriminatory currency practices and restrictions on currency payments as well as multiple currency practices. These are meant to foster a multilateral system of payments for current transactions between members and to

contribute to the balance growth of world trade. The IMF is required to prepare annual report on restrictions maintained by members that subscribed to the Article prohibiting same, for publication in the Annual Report on Exchange Arrangements and Exchange Restrictions.

Consultations: The IMF is required to hold regular consultations with each member in order for the fund to obtain the data needed to exercise surveillance over the exchange rate policies of members, and give prompt consideration to request for use of its resources and to changes in exchange practices. Apart from general annual consultations, (e.g. with respect to periodic review of the world economic situation and forecast of anticipated economic developments), and supplemental surveillance (e.g. in case of unanticipated changes in economic policies or conditions).

3.2.6.2.Financial Assistance

The IMF's transactions (exchanges of monetary assets for other monetary assets) and financial operations (other uses or receipts of monetary assets) are carried out through the General Department and the Special Drawing Right (SDR) Department.

The fund provides financial assistance to members by selling to them securities or SDRs in exchange for their own currencies, except for the subsidy account in which assistance is made available in the form of grants. The currencies sold to members are generally those of countries with satisfactory payments and reserve positions. The sources of the Funds general resources are quota subscriptions and borrowing.

The IMF provides balance of payments assistance to members in exchange for their own currency the currencies for other members or SDRs ("Purchases" or "drawings"). Members that purchase from the IMF must subsequently buy back their currencies from the fund with other currencies or SDRs (Re-purchase) (Anyanwu, 1993:380).

3.2.6.3.Services

The IMF, apart from supervising the international monetary system and providing financial support to member countries, also assists its membership by running an educational institution in Washington D. C, by making technical assistance available in member countries in certain specialized areas of its competence and by issuing a wide variety of publications relating to international monetary matters.

In the area of training, the IMF institute since 1964 has offered courses to nearly 6,000 officials (employees of finance ministries, central banks, and other official agencies) from 150 member countries whose work is closely related to the work of the IMF (Anyanwu, 1993: 380). Such training has helped to standardized throughout the world the methods of gathering and presenting BOPs, monetary and financial statistics to the benefit of the entire membership.

Also, in the area of publication access to each member's fiscal policy, monetary and external debt data has made the IMF a unique conduit of such information to the entire membership. Its publication (e.g. international financial statistics) not only keep members countries informed of financial position of their fellow members but also constitute an

unrivalled source of statistical information for universities, research institutions, banks and the media.

In summary, therefore, the IMF oversees the international monetary system, promotes exchange stability and orderly exchange relations among its member countries, assists all members (both industrial and developing countries that find themselves in temporary balance of payments difficulties, by providing short – to medium-term credits, supplements the currency reserves of its members through the allocation of SDRs, draws its financial resources principally from the quota subscription of its members.

Self-Assessment Exercise1

Identify and discuss the objectives and functions of the IMF.

3.3. The African Development Bank (ADB)

The move to establish the ADB was conceived in 1960. ADB became fully operational in 1966 but was established in 1963 at a meeting of 33 African Heads of state in Chartain, Sudan. By 1965, 20 out of the 33 member countries had contributed 65% of the bank's take of capital (Okoji-Ibiayo, 2004: 438).

In order to make the bank to a large extent African in nature, two third of (2/3) of the bank shareholding is reserved for African countries and the Headquarters of the Bank must be in African permanently. Also, the position of chairman of the bank is to be for Africans, and at least two – third (2/3) of members to ratify important decisions of the bank.

3.3.1. Functions of ADB

- i. Mobilising, within and outside, resources for financing development projects in African, in agriculture, infrastructural, manufacturing and water supply etc.
- ii. Financing joint venture projects that relate to the economic and social development of its members. Such projects are usually designed to positively affect the economies of member countries and expand foreign and regional trade.
- iii. Participating in the selection and research and preparation of projects that contribute to the economic development and create large markets for African countries.
- iv. Promoting foreign and local investment in public and private capital projects.

Self-Assessment Exercise2

Discuss the functions and sources of the ADB's Funds.

3.3.2. Source of ADBs Funds

The African Development Bank obtains its funds from the following sources;

- i. Subscriptions by member-countries especially the rich industrialized non-African member nations.
- ii. Borrowing from international organizations and financial markets.
- iii. Operational funds generated from loan repayments and guarantees.
- iv. Operational income.

4.0. CONCLUSION

While the World Bank and the International Monetary Fund are international financial institutions that enhance the economic development of member countries of the world. The African Development Bank on the other hand, plays a restricted role of facilitating the economic development of African member countries. This unit discusses the functions and sources of funds the examined international financial institutions.

5.0. SUMMARY

In this unit, you have learned about;

- i. The World Bank and its functions,
- ii. The sources of funds of the World Bank,
- iii. The IMF and its objectives,
- iv. The functions of the IMF,
- v. The African Development Bank and its functions

6.0. TUTOR-MARKED ASSIGNMENT

Identify and discuss the functions of the World Bank.

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