

NATIONAL OPEN UNIVERSITY OF NIGERIA

SCHOOL OF ARTS AND SOCIAL SCIENCES

COURSE CODE: ECO 346

COURSE TITLE: FINANCIAL INSTITUTIONS

COURSE GUIDE

**Course Developers:
Jelil Sufiyan**

**Inabo Abel, OBAKA
Ganiyat A. Adesina-Uthman, ACMA, FMNES, PHD**
Economics Unit,
National Open University of Nigeria

NATIONAL OPEN UNIVERSITY OF NIGERIA

National Open University of Nigeria

Headquarters

14/16 Ahmadu Bello Way

Victoria Island

Lagos

Abuja Annex

245 Samuel Adesujo Ademulegun Street

Central Business District

Opposite Arewa Suites

Abuja

e-mail: centralinfo@nou.edu.ng

URL: www.nou.edu.ng

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Introduction

The course, Financial Institution is an elective course which carries two credit units for third year economics students in the School of Arts and Social Sciences at the National Open University of Nigeria (NOUN). It is prepared and made available to all undergraduate students in B.Sc. Economics programme. The course is very useful to you in your academic pursuit and will help you to gain an in-depth knowledge of the Nigerian financial system. This course is aimed at exposing the students to financial institutions with particular reference to Nigeria.

This Course Guide tells you what the financial institutions entails. It also provides you with the necessary information about the course, the nature of the materials you will be using and how to make the best use of them towards ensuring adequate success in your programme. Also included in this Course Guide are instructions on how to make use of your time and instructions on how to tackle the tutor-marked assignment (TMA). There will be tutorial session during which your facilitator will take you through your difficult areas and at the same time have meaningful interaction with your fellow learners.

What you will learn in this Course

The course is made up of fifteen units, covering areas such as:

- The meaning of the financial system
- The money market
- The capital market
- Organization and functions of commercial banks
- How to operate bank account

- The merchant banks and development banks
- The microfinance banks insurance companies
- The central banks
- Comparative banking and financial system
- International financial institutions
- The International Monetary Fund (IMF)
- The African Development Bank (ADB)
- The IBRD/World Bank
- The World Bank Group

Course Content

This course introduces students to the theory and practices of financial system or financial markets which comprise capital market and money market. It covers contemporary topics like the financial system, the money market, the capital market, organization and functions of commercial banks, operating bank account, the merchant banks and development banks, the microfinance banks and insurance companies. Other topics include, the central banks, comparative banking and financial system, international financial institutions, The International Monetary Fund (IMF), The African Development Bank (ADB), The IBRD/World Bank and the World Bank Group

Course Aims

This course recognizes that graduates of B.Sc. Economics Program will be required to function as managers/decision-makers in financial markets. The purpose of this course is to provide these potential managers and decision-makers with tools to solve practical problems.

Course Objectives

There are fifteen study units in the course and each unit has its own objectives. You should read the objectives of each unit and assimilate them. In addition to the objectives of each unit, the main objective of the course is to equip you with (a) an appreciation of the analytical skills needed in the financial sector and (b) adequate financial and quantitative analytical skills needed to pursue careers in the financial sector. It should be noted that this course also provides an adequate background to students who intend to pursue post-graduate studies in economics, business administration, finance, accounting and management.

The objectives of the course will be achieved by:

- Explaining the meaning of the financial system
- Discussing the money market
- Analyzing the capital market
- Illustrating the organization and functions of commercial banks
- Elucidating how bank account is operated
- Describing the merchant banks and development banks
- Discussing the microfinance banks
- Explaining the insurance companies
- Explaining the central banks
- Undertaking an analysis of comparative banking and financial system
- Analyzing international financial institutions
- Examining the International Monetary Fund (IMF)
- Describing the African Development Bank (ADB)
- Describing the IBRD/World Bank
- Discussing the World Bank Group

Working through the Course

To successfully complete this course, you are required to read the study units, referenced books and other materials on the course.

Each unit contains self-assessment exercises in addition to Tutor Marked Assessments (TMAs). At some points in the course, you will be required to submit assignments for assessment purposes. At the end of the course there is a final examination. This course should take about 15 weeks to complete and some components of the course are outlined under the course material subsection.

Course Materials

The major component of the course, what you have to do and how you should allocate your time to each unit in order to complete the course successfully on time are listed follows:

1. Course Guide
2. Study Units
3. Textbooks
4. Assignment File
5. Presentation schedule

Study Units

There are three modules of 15 units in this course, which should be studied carefully. These are:

MODULE 1

Unit 1: The meaning of the financial system

Unit 2: The money market

Unit 3: The capital market

Unit 4; Organization and functions of commercial banks

Unit 5: Operating bank account

MODULE 2

Unit 1: The merchant banks and development banks

Unit 2: The microfinance banks insurance companies

Unit 3: Insurance Companies

Unit 4: The central banks

Unit 5: Comparative banking and financial system

MODULE 3

Unit 1: International financial institutions

Unit 2: The International Monetary Fund (IMF)

Unit 3: The African Development Bank (ADB)

Unit 4: The IBRD/World Bank

Unit 5: The World Bank Group

References and Other Resources

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

Assignment File

There are many assignments in this course and you are expected to do all of them by following the schedule prescribed for them in terms of when to attempt the homework and submit same for grading by your Tutor.

Presentation Schedule

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

Assessment

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

Tutor-Marked Assignments (TMAs)

Assignment questions for the 15 units in this course are contained in the Assignment File. You will be able to complete your assignments from the information and materials contained in your set books, reading and study units. However, it is desirable that you demonstrate that you have read and researched more widely than the required minimum. You should use other references to have a broad viewpoint of the subject and also to give you a deeper understanding of the subject.

When you have completed each assignment, send it, together with a TMA form, to your tutor. Make sure that each assignment reaches your tutor on or before the deadline given in the Presentation File. If for any reason, you cannot complete your work on time, contact your tutor before the assignment is due to discuss the possibility of an extension. Extensions will not be granted after the due date unless there are exceptional circumstances. The TMAs usually constitute 30% of the total score for the course.

Final Examination and Grading

The final examination will be of two hours' duration and have a value of 70% of the total course grade. The examination will consist of questions which reflect the types of self-assessment practice exercises and tutor-marked problems you have previously encountered. All areas of the course will be assessed

You should use the time between finishing the last unit and sitting for the examination to revise the entire course material. You might find it useful to review your self-assessment exercises, tutor-marked assignments and comments on them before the examination. The final examination covers information from all parts of the course.

Course Marking Scheme

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

Assessment	Marks
Assignment (Best three assignment out of the four marked)	30%
Final Examination	70%
Total	100%

Course Overview

The Table presented below indicate the units, number of weeks and assignments to be taken by you to successfully complete the course, Financial Institutions (ECO 316).

Unit	Title of Work	Weekly Activity	Assessment End of Unit
1.	Course Guide	1	
2.	The meaning of the financial system		
3.	The money market		
4.	The capital market		
5.	Organization and functions of commercial banks		
6.	Operating bank account		1 ST Assignment
7.	The merchant banks and development banks		
8.	Comparative banking and financial system		
9.	The microfinance banks insurance companies		
10.	Insurance Companies		
11.	The central banks		
12.	Comparative banking and financial system		2 nd Assignment

13.	International financial institutions		
14.	The International Monetary Fund (IMF)		
15.	The African Development Bank (ADB)		
16.	The IBRD/World Bank		
16.	The World Bank Group		3 rd Assignment

How to Get the Most from This Course

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

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

The main body of the unit guides you through the required reading from other sources. This will usually be either from your set books or from a readings section. Self-assessments are interspersed throughout the units, and answers are given at the ends of the units. Working through these tests will help you to achieve the objectives of the unit and prepare you for the assignments and the examination. You should do each self-assessment exercises as you come to it in the study unit. Also, ensure to master some major historical dates and events during the course of studying the material.

The following is a practical strategy for working through the course. If you run into any trouble, consult your Tutor. Remember that your Tutor's job is to help you. When you need help, don't hesitate to call and ask your Tutor to provide the help.

1. Read this Course Guide thoroughly.
2. Organize a study schedule. Refer to the 'Course overview' for more details. Note the time you are expected to spend on each unit and how the assignments relate to the units. Important information, e.g. details of your tutorials, and the date of the first day of the semester is available from study centre. You need to gather together all this information in one place, such as your diary, a wall calendar, an iPad or a handset. Whatever method you choose to use, you should decide on and write in your own dates for working each unit.
3. Once you have created your own study schedule, do everything you can to stick to it. The major reason that students fail is that they get behind with their course work. If you get into difficulties with your schedule, please let your Tutor know before it is too late for help.
4. Turn to Unit 1 and read the introduction and the objectives for the unit.
5. Assemble the study materials. Information about what you need for a unit is given in the 'Overview' at the beginning of each unit. You will also need both the study unit you are working on and one of your set books on your desk at the same time.
6. Work through the unit. The content of the unit itself has been arranged to provide a sequence for you to follow. As you work through the unit you will be instructed to read sections from your set books or other articles. Use the unit to guide your reading.
7. Up-to-date course information will be continuously delivered to you at the study centre.
8. Work before the relevant due date (about 4 weeks before due dates), get the Assignment File for the next required assignment. Keep in mind that you will learn a lot by doing the assignments carefully. They have been designed to help you meet the objectives of the course and, therefore, will help you pass the exam. Submit all assignments no later than the due date.
9. Review the objectives for each study unit to confirm that you have achieved them. If you feel unsure about any of the objectives, review the study material or consult your Tutor.
10. When you are confident that you have achieved a unit's objectives, you can then start on the next unit. Proceed unit by unit through the course and try to space your study so that you keep yourself on schedule.
11. When you have submitted an assignment to your Tutor for marking, do not wait for its return before starting on the next units. Keep to your schedule. When the assignment is returned, pay particular attention to your Tutor's comments, both on the tutor-marked assignment form and also written on the assignment. Consult your Tutor as soon as possible if you have any questions or problems.

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

Tutors and Tutorials

There are some hours of tutorials (2-hours sessions) provided in support of this course. You will be notified of the dates, times and location of these tutorials, together with the name and phone number of your Tutor, as soon as you are allocated a Tutorial group.

Your tutor will mark and comment on your assignments, keep a close watch on your progress and on any difficulties you might encounter, and provide assistance to you during the course. You must mail your tutor-marked assignments to your tutor well before the due date (at least two working days are required). They will be marked by your Tutor and returned to you as soon as possible.

Do not hesitate to contact your Tutor by telephone, e-mail, or discussion board if you need help. The following might be circumstances in which you would find help necessary. Contact your Tutor if.

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

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

Conclusion

On successful completion of the course, you would have developed critical thinking and analytical skills (from the material) for efficient and effective discussion of financial system. However, to gain a lot from the course please try to apply everything you learn in the course to term paper writing in other related courses. We wish you success with the course and hope that you will find it both interesting and useful.

ECO 346: Financial Institutions

This course is aimed at exposing the students to financial institutions with particular reference to Nigeria. Topics to be covered include functions and organization of commercial Banks, Merchant Banks, Universal Banking, Development Banks, Central Bank, other financial intermediaries, international financial institutions such as IMF, ADB, IBRD and World Bank among others.

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MODULE 1

- Unit 1: Meaning of the Financial System**
- Unit 2: The Money Market**
- Unit 3: The Capital Market**
- Unit 4: Organization and Functions of Commercial Banks**
- Unit 5: Operating Bank Account**

UNIT 1: MEANING OF FINANCIAL SYSTEM

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- 1.0 Introduction**
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 - 3.1 The Meaning of Financial System**
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 - 3.2 The Nature of Financial Institution**

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3.3.1	Classification of Financial Markets			
4.0	Conclusion			
5.0	Summary			
6.0	Tutor Marked Assignment			
7.0	References and Further Reading			

1.0 INTRODUCTION

This is the first unit among the 15 units that made up the course; Financial Institutions. This unit introduces you to the subject. You are going to spend at least two hours to go through it. This unit defines and explains the meaning of financial system, financial institutions and financial markets. You should note that the financial system comprises of financial institutions and the financial market.

While reading the unit, there are exercises designed to make you pause and reflect on what you are studying. By so doing, you will understand the topics being presented to you. At the end of the unit, there are again tutor-marked questions which are meant for you. Try your hands on them so as to be self-assured that you have a mastery of the points raised in the unit, as indicated in the objectives stated below.

2.0 OBJECTIVES

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

- Explain the meaning of financial system
- Discuss the nature of financial institutions
- List and explain the meaning of financial markets

3.0 MAIN CONTENT

3.1 The Meaning of Financial System

The domestic financial system of any country refers to a set of instructional and other arrangements that transfer savings from those who generate them to those who ultimately use them for investment or consumption. It is made up of a mechanism for organizing and managing the payments for current and capital transactions; a mechanism for the

collection and transfer of savings by banks and other depository institutions; arrangements covering the activities of capital markets with respect to the issue and trading of marketable and transferable long-term securities; arrangements covering the workings of money and credit markets dealing with short-term financial instruments; and arrangements covering the activities of financial market complementary to the capital market, credit and money markets, which in essence provide hedging (or risk insurance) facilities, such as the new futures markets.

The financial system is complex, comprising many different types of private-sector financial institutions, including banks, insurance companies, mutual funds, finance companies, and investment banks- all of which are heavily regulated by the government. The Nigerian banking industry which is regulated by the Central Bank of Nigeria, is made up of; deposit money banks referred to as commercial banks, development finance institutions and other financial institutions which include; micro-finance banks, finance companies, bureau de changes, discount houses and primary mortgage institutions. Essentially the industry consists of 24 commercial banks, 5 discount houses, 5 development finance institutions, 50 class A bureau de change, 598 bureau de change, 98 Primary Mortgage Institutions, 84 finance companies and 914 Micro-finance institutions (ICR, 2010).

If you wanted to make a loan to Dangote Group or MTN, for example, you would not go directly to the Chief Executive of the company and offer a loan. Instead, you would lend to such companies indirectly through financial intermediaries, institutions such as commercial banks, savings and loan associations, mutual savings banks, credit unions, insurance companies, mutual funds, pension funds and finance companies that borrows fund from people who have saved and in turn make loans to others (Mishkin and Eakins, 2012).

At international level, world financial system consists of a set of institutional and other arrangements governing the transfer of savings from those generating them to those wishing to use them, across national frontiers.

The flowchart bellow illustrates Nigerian financial system;

3.1.1 Basic Attributes of an Ideal Financial System

An ideal financial system is characterized by the following closely inter-connected attributes: it should be stable, efficient, competitive, flexible and balanced.

a. Stability

It is imperative for confidence to be maintained in the financial system, especially in times of financial panic. It must be able to absorb shocks arising from the greater-than-anticipated and allowed for risks, and hence to contain a contractionary impact on activity, and trade, as well as any inflationary effect on prices.

b. Efficiency

An efficient financial system directs savings to investments with the highest rate of return, allowing for risk. This consists of allocative, operating, and dynamic efficiency.

c. Competitiveness

A good financial system must have an adequate number of participants.

d. Flexibility

The instruments employed and the methods of operation must be able to adapt to changes in the economic and financial structure.

e. Balanced

A balanced financial system requires that there should be an optimal mix of various types of financial system with respect to both transfer of current savings and the stock of past savings. The optimal mix would be such that changes in any one component could be absorbed by changes in another without having excessive impact on the providers and users of saving, while allowing both an adequate period of adjustment. It is important to note that the ideal combination of these closely inter-connected attributes will change as the process of economic growth proceeds.

3.2 The Nature of Financial Institutions

A financial institution is an establishment that conducts financial transactions such as investments, loans and deposits. Almost everyone deals with financial institutions on a regular basis. Everything from depositing money to taking out loans and exchanging currencies must be done through financial institutions. According to Mishkin and Eakins (2012:46), “Financial institutions are what make financial markets work. Without them, financial markets would not be able to move funds from people who save to people who have productive investment opportunities. They thus play a crucial role in improving the efficiency of the economy.”

In financial economics, a financial institution is an institution that provides financial services for its clients or members. Probably the most important financial service

provided by financial institutions is acting as financial intermediaries. They are responsible for transferring funds from investors to companies in need of those funds. Financial institutions facilitate the flow of money through the economy. Most financial institutions are regulated by the government.

3.2.1 Types of Financial Institutions

There are three major types of financial institutions (Siklos, 2001, Robert, E. W. and Quadrini, V. (2012)

1. **Depository Institutions** : Deposit-taking institutions that accept and manage deposits and make loans, including banks, building societies, credit unions, trust companies, and mortgage loan companies
2. **Contractual Institutions** : Insurance companies and pension funds; and
3. **Investment Institutions**: Investment Banks, underwriters, brokerage firms.

You should note that some experts see a tendency of global homogenization of financial institutions, which means that institutions tend to invest in similar areas and have similar investment strategies. The reason for this tendency says economist Jayati Gosh in financial deregulation, has some consequences which might be that there will be no banks that serve specific target groups such as small scale producers who could be left behind (Gosh, 2013).

However, financial institutions can be broadly classified into two: banks or bank financial institutions in the banking sector, and non- bank financial institutions. Commercial bank, Central bank, Merchant bank and Development bank are institutions in the banking sector while building societies, hire purchase companies, insurance companies, pension funds, and investment trusts are non-bank financial institutions. Whilst liabilities of banks form part of the money supply, the liabilities of non-bank financial institutions do not; for they are referred to as near money. In Nigeria, the following types of financial institutions can be classified:

- a. Traditional financial institutions
- b. Commercial Banks
- c. Central Bank
- d. Development Banks
- e. Merchant Banks
- f. Insurance Companies

Self Assessment Exercise 1.1

What do you understand by the term, Financial Institution?

3.3 Meaning of Financial Markets

Financial markets (money and capital markets) consist of institutions, agents, brokers and intermediaries (banks, insurance companies, pension funds) transacting purchases and sales of securities. Financial markets facilitate the movement of funds from those who save to those who invest in capital markets. The persons and institutions operate in the friendships, contracts and communications networks which form an external visible financial structure.

Financial markets are divided into two: investors and financial institutions. These financial institutions are organizations which act as intermediaries, agents and brokers in financial transactions. Financial intermediaries purchase securities for their own account and sell their own liabilities and ordinary shares etc, agents' and brokers' contract on behalf of others.

You should note that in practice, financial markets and financial institutions are inseparable since financial markets are often created and operated by financial institutions.

3.3.1 Classification of Financial Markets

Financial markets are made up of:

- i.** Financial intermediaries
- ii.** Agents and brokers
- iii.** Investors and borrowers

You should note that financial intermediaries, agents and brokers make up financial institutions. Thus one can say that financial markets are made up of financial institutions, investors and borrowers.

4.0 CONCLUSION

The study of financial markets and institutions will reward you with an understanding of many exciting issues. In this unit, we provided a road map of the course by discussing these exciting issues and exploring why they are worth studying.

Financial markets facilitate the transfer of funds from people who have an excess of available funds to people who have a shortage.

5.0 SUMMARY

This is our first unit to the course: Financial Institutions. While reading the unit, you were made to understand the meaning of financial system, the nature of financial institutions and the functions of financial markets.

The ground is now prepared to sow the seeds of functions and organization of commercial banks in the next unit.

6.0 TUTOR-MARKED ASSIGNMENT

1. Define financial institutions. Name five financial institutions in Nigeria.
2. What are the basic attributes of an ideal financial system?

7.0 REFERENCES

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UNIT 2: THE MONEY MARKET

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2.0 Objective

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3.3 Features of A Developed Money Market

3.4 Reasons for the Establishment of the Nigerian Money Market

3.5 Functions of the Money Market

3.6 Common Money Market Instruments

4.0 Conclusion**5.0 Summary****6.0 Tutor Marked Assignment****7.0 References and Further Reading****1.0 INTRODUCTION**

In the preceding unit which was our first to this course, we learnt the meaning of financial system, the nature of financial institutions and the functions of financial markets.

In the present unit, we shall study the money market. Our discussion on money market shall take us to the consideration of the participants in money markets, features of a developed money market, and reasons for the establishment of the Nigerian money market, functions of the money market and common money market instruments.

2.0 OBJECTIVES

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

- Define and explain money market.
- Analyze features of a developed money market.
- Give reasons for the establishment of the Nigerian money market.
- List and explain functions of the money market.
- Expatriate on common money market instruments.

3.0 MAIN CONTENT**3.1 The Money Market**

As money became a commodity for exchange, the money market became a component of the financial markets for assets involved in short-term borrowing, lending, buying and selling with original maturities of one year or less. Trading in the money markets is done over the counter and is wholesale. Various instruments exist, such as Treasury bills, commercial paper, bankers' acceptances, deposits, certificates of deposit, bills of exchange, repurchase agreements, federal funds, and short-lived mortgage-, and asset-backed securities (Fabozzi, 2002). Money market provides liquidity funding for the global financial system. You should remember that money markets and capital markets are parts of financial markets. You should also bear in mind that the instruments bear differing maturities, currencies, credit risks, and structure. Therefore they may be used to distribute the exposure.

Money market refers to a collection or group of financial institutions or exchange system set up for dealing in short-term credit instruments of high quality, such as treasury bills, treasury certificates, call money, commercial paper, Bankers' unit Fund, ways and means advances, as well as the dealing in gold and foreign exchange. These short-term instruments involve a small risk due to loss, because they are issued by obligors of the highest credit rating and they mature within one year.

While denoting trading in money and other short-term financial assets, the money market comprises of all the facilities of the country for the purchase and sale of money for intermediate and deferred delivery and for the borrowing and lending of money for short periods of time. It is a manifestation of dealing in short-term financial instruments (their sale and purchase, as also borrowing and lending for short periods) on the one hand, and a collection of the dealers in these assets on the other. It is thus a collection of financial institutions set up for the granting of short-term loans and dealing in short-term securities, gold and foreign exchange.

3.2 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 lags. To meet this definition, a money market should possess the following features:

- a. **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.
- b. **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.
- c. **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.
- d. **Presence of Well-Developed Sub-Markets:** The existence of well-developed sub-markets and their adequate responsiveness to small changes in interest and developed money market. If the demand and supply of certain instruments dominate, the interaction between different interest rates will be limited
- e. **Existence of Specialized Institutions:** For competitiveness and efficiency, there must exist specialized institutions in particular types of assets, e.g., specialized discount houses, accepting bills, or specialized dealers in government securities.
- f. **Existence of Contributory Legal and Economics:** 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.

3.3 Reasons for the Establishment of the Nigerian Money Market

The following are the reasons for the establishment of the Nigerian Money Market:

- i.** To provide the machinery needed for government's short-term financing requirements.
- ii.** As an essential step on the path to independent nationhood, hence it was part of a modern financial and monetary system which was to enable the nation to establish the monetary autonomy which is part and parcel of the workings of an independent, modern State.
- iii.** To Nigerianize the credit base by providing local investment outlets for the retention of funds in Nigeria and for the investment of funds repatriated from abroad as a result of government persuasions to that effect.
- iv.** To perform for the country all the functions which money market traditionally performs, such as the provision of the basis for operating and executing an effective monetary policy.
- v.** To effectively mobilize resources for investment purposes.

3.4 Functions of the Money Market

The money market performs the following functions:

- a.** It provides the basis for operating and executing an effective monetary policy.
- b.** To promote an orderly flow of short-term funds.
- c.** To ensure supply of the necessary means of expanding and contracting credit.
- d.** It is a central pool of liquid financial resources upon which it can make payments when it holds funds surplus to its needs.
- e.** It provides the mechanism through which the liquidity of the banking system is maintained at the desired level.
- f.** To provide banks with the basic financial requirements for effective management of their resources. Thus, helps them to universalize their assets holding by providing a forum for investment of their surplus cash.
- g.** To provide the machinery needed for government's short-term financial requirements, hence, achieving even seasonal variation in the normal flow of revenue.
- h.** Mobilization of funds from savers (lenders) and transmission of such funds to borrowers (investors).

- i. It provides a channel for the injection of Central Bank cash into the system or the economy.
- j. To maintain stable cash and liquidity ratios as a base for the operation of the open market operation (OMO).
- k. It helps commercial banks to lower cash reserves through the provision of first line of defence for cash shortages through bills. If banks are threatened with cash shortages and if their cash balances at the Central Bank falls below the statutory minimum, they can draw on call money and if need be, they discount bill for cash balances at the Central Bank.

Self-Assessment Exercises

Which mechanism of the money market is used to maintain the liquidity of the banking system at the desired level?

3.5 Common Money Market Instruments

The followings are common money market instruments:

- a. **Treasury bills** – They are short-term debt obligations of a national government that are issued to mature in three to twelve months. In other words, treasury bills are money market (short-term) securities issued by the Federal government of Nigeria. They are sold at a discount (rather than paying coupon interest) and mature within 91 days of the day of issue and are default-free. These instruments are promissory notes to pay the bearer, 91 days from the date of issue. They provide the government with a highly flexible and relatively cheap means of borrowing cash. They also provide a sound security for dealings in the money market, and the Central Bank of Nigeria in particular, can operate on that market by dealing in treasury bills. Thus, Treasury Bill, mere IOUs, are used by the Federal Government to borrow for short periods of about three months, pending the collection of its revenues. Their issue for the first time in Nigeria (in April 1960) was provided for under the Treasury Bill ordinance of 1959.
- b. **Treasury Certificates**- These are similar to Treasury Bills. Treasury Certificate which was introduced in 1968 to replace commercial bill has a maturity between one and two years. The amount paid on the purchase of the certificate is usually less than the discount on the bill but the actual amount is repaid by the CBN at maturity.
- c. **Commercial Bill**- This was introduced in 1962 and it is usually used by commodity board and it is rediscountable by the CBN. It was, however, abolished in 1968 when banks refused to continue with their participation in the World Cocoa Market.

- d. Certificate of deposit** – It is a time deposit, commonly offered to consumers by banks, thrift institutions, and credit unions. It was introduced in Nigeria in 1985 to channel commercial banks surplus funds into merchant banks issued in multiple of N50,000 and rediscountable by the CBN in case the issuing bank cannot redeem them at maturity. You should note that the maturity period ranges between 3 and 36 months. For those with maturity of less than 18 months, the discounts may be used in required ratio of the holding bank.
- e. Call Money-** This was introduced in 1962. This instrument guarantees the payment of money on demand to the issuing bank. This also allows commercial banks and non-banking financial institutions to keep their temporary surplus cash with the CBN who in turn invest the fund. It was abolished in 1974 but banks do operate it among themselves till date.
- f. Stabilization Security-** This is an effective monetary policy introduced in 1976 to mop up banks' excess liquidity with an empowerment of CBN to issue the security and sell them by allocation to banks and other financial institution who are in turn compelled by law to take up any allocated amount in which failure to do so leads to imposition of stiff penalty.

4.0 CONCLUSION

It is a fact that a well-developed market for money market instruments makes the money market an ideal place for a firm or financial institution to “warehouse” surplus funds until they are needed. Similarly, the money market provides a low-cost source of funds to firms, the government, and intermediaries that need a short-term infusion of funds. The development of the Nigerian money market should be encouraged in order to fast tract the economic growth of the country.

5.0 SUMMARY

You learnt in this unit the money market, the participants in money markets, features of a developed money market, reasons for the establishment of the Nigerian money market, functions of the money market and common money market instruments.

Of course, we are now ready to discuss capital market in the next unit, that is, Unit three.

6.0 TUTOR-MARKED ASSIGNMENTS

1. Analyze the features of a developed capital market.
2. List and explain Common Money Market Instruments.

7.0 REFERENCES

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UNIT 3: THE CAPITAL MARKET

CONTENT

1.0 Introduction

2.0 Objectives

3.0 Main Content

3.1 Evolution of the Capital Market

3.2 Meaning of the Capital Market

3.3 Segment of the Capital Market

3.4 Functions of Active Capital market

3.5 Reasons for the Establishment of the Nigerian Capital Market

3.6 Organs of the Market

3.6.1 The Nigerian Securities and Exchange Commission (NSEC)

3.6.2 The Nigerian Stock Exchange (NSE)

3.6.2.1 Functions of the Nigerian Stock Exchange (NSE)

4.0 Conclusion

5.0 Summary**6.0 Tutor Marked Assignment****7.0 References and Further Reading****2.0 INTRODUCTION**

In the preceding unit which was our second to this course, we learnt the money market, the participants in money markets, features of a developed money market, reasons for the establishment of the Nigerian money market, functions of the money market and common money market instruments.

In the present unit, we shall discuss the capital market.

2.0 OBJECTIVES

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

- Trace the evolution of the capital market
- Explain the meaning of the capital market
- Clarify the segment of the capital market
- Explain the functions of an active capital market
- Give reasons for the establishment of the Nigerian capital market
- List the organs of the capital market
- Discuss the Nigerian Securities and Exchange Commission (NSEC)
- Discuss the Nigerian Stock Exchange (NSE)
- Explain the functions of the Nigerian Stock Exchange (NSE)

3.0 MAIN CONTENT**3.1 Evolution of the Nigeria Capital Market**

At the time Nigeria had her independence in 1960, there was nothing like the capital market, instead, what was in existence was a financial system which was totally monopolized by expatriate commercial banks. These commercial banks were only involved in the provision of short-term credit for commercial trade. The absence of a capital market in Nigeria as at that period hindered economic development. The non-existence of this market meant that Nigerians who had surplus funds had no such market to invest them in Nigeria. They had to repatriate such funds for investment overseas, especially in London; thus resulting to export of capital (capital flight) which could have been used in the economic development of Nigeria. This in addition, resulted to lack of a market where Nigerian industrialists and businessmen could raise capital for the

operation and construction of their business. On the government's side, there was no effective tool for monetary policy control.

With the above situation, there was an obvious need to provide a local market for the borrowing and lending of long-term funds for economic development of Nigeria. To achieve this objective, the Central Bank of Nigeria (CBN) went into operation on 1st July, 1959 and that same year, the Nigerian Industrial Development Bank (NIDB) and the Nigerian Stock exchange (NSE) were established. With these institutions, some key financial instrument, which included government development stocks and some industrial shares were floated. Then in 1973, some fourteen years later, other financial institutions were established. These were the Nigerian Agricultural and Co-operative Bank established in 1973 and the Capital Issues Commission (today known as the Nigerian Securities and Exchange Commission (established by the Securities and Exchange Commission (SEC) Act of 27th September, 1979). Subsequently, many other financial institutions were established. Such institutions include the State-owned development finance companies (and recently private finance companies), insurance companies, pension and provident funds and stock broking firms. As at December 2013, the number of finance companies stood at..., registered Stockbrokers ..., while the number of insurance companies increased to ... To these institutions named above, we also have to include commercial and merchant banks which have tremendously witnessed massive increase. Commercial banks have increased both in numbers and in branches from 14 and 273 respectively in 1970 to 65 banks and 2023 branches in 1991 and now respectively.

3.2 Meaning of the Capital Market

The capital market refers to a collection of financial institutions set up for the purpose of granting long-term loans. It is a market for long-term instrument which include market for government securities, market for corporate bonds, market for corporate shares (stocks) and market for the mortgage loans. That is to say that, it is the market for the mobilization and utilization of long-term funds for development of the financial system.

You should note that the capital market is composed of the inner capital market (market for new securities) and the outer capital market (including insurance companies, building societies, saving banks and other bodies not directly concerned with the issue of new securities, but which are engaged in the business of long-term borrowing and lending upon which the issue of new securities depends). Included in the outer capital market are the special financial companies set up to help in providing medium and long-term capital for industry. Consequently, the capital market embraces both the new issues (primary) market and the secondary (seasoned securities) market, whether such securities are raised

in an organized market such as the Stock Exchanges or not. In this sense, it involves consortium underwriting, syndicated loans and project financing; it involves formal stock exchanges and the unlisted securities market. Thus, it is the mechanism whereby economic units desirous to invest their surplus funds, interact directly or through financial intermediaries with those who wish to procure funds for their businesses. In the Nigerian Stock Exchange, Discount Houses, Development Banks, Investment Banks, Building Societies, Stock Broking Firms, Insurance and Pension organizations, quoted companies, the government, individuals and the NSEC.

3.3 Segment of the Capital Market

You should note that there are two segments of the capital markets. These are primary and secondary markets, which are discussed briefly as follows;

- i. Primary Market:** This is a market that deals with issue and sales of new securities of companies which are not previously quoted on the stock exchange market. The instruments used in the primary market are:
 - a. Offer for sale
 - b. Offer for subscription
 - c. Right issue
 - d. Private placing
 - e. Issue by tender
 - f. Stock exchange introduction

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

Self Assessment Exercise

If Benue Cement Plc wants to give right issues to its Shareholders, which market will it go?

3.4 Functions of Active Capital market

The following are functions of an active capital market:

- a. The promotion of rapid capital formation.
- b. The provision of sufficient liquidity for any investor or group of investors.
- c. The creation of built-in operational and allocational efficiency within the financial system to ensure that resources are optimally utilized at relatively little costs.
- d. The mobilization of savings from numerous economic units for economic growth and development.

- e. The encouragement of a more efficient allocation of new investment through the pricing mechanism.
- f. The provision of alternative sources of fund other than taxation for government.
- g. The broadening of the ownership base of assets and the creation of healthy private sector.
- h. The encouragement of a more efficient allocation of a given amount of tangible wealth through changes in wealth ownership and composition.
- i. Provision of an efficient mechanism for the allocation of savings among competing productive investment projects.
- j. It is machinery for mobilizing long-term financial resources for industrial development.
- k. It is an avenue for effecting payments on debts.
- l. it is a necessary liquidity mechanism for investors through a formal market for debts and equity securities.

3.5 Reasons for the Establishment of the Nigerian Capital Market

The followings are the reasons for establishing the Nigerian capital market:

- i. To introduce code of conduct, check abuses and regulate the activities of operators in the market.
- ii. To provide local opportunities for borrowing and lending for long-term purposes.
- iii. To enable the authorities to mobilize long-term capital for the economic development of the country.
- iv. To provide facilities for the quotation and ready marketability of shares and stocks and opportunities and facilities to raise fresh capital in the market.
- v. To provide foreign businesses with the facilities to offer their shares, and the Nigeria public an opportunity to invest and participate in the shares and ownership of foreign businesses.
- vi. Through participation and ownership, to provide 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..

3.6 Organs of the Market

From the galaxy of institutions mentioned above, the key organs of the market are the Central Bank of Nigeria (CBN), the Nigerian Securities and Exchange Commission (NSEC), the Nigerian Stock Exchange (NSE), and the Stock Brokers.

We are going to discuss only the Nigerian Securities and Exchange Commission (NSEC), the Nigerian Stock Exchange (NSE), and the Stock Brokers in this sub-section because the Central Bank of Nigeria (CBN) will be treated as a unit.

3.6.1 The Nigerian Securities and Exchange Commission (NSEC)

The Nigerian Securities and Exchange Commission (NSEC) is next key institution in the capital market after the CBN. Formerly called the Capital Issues Committee (1962-1972), and the Capital Issue Commission (1973-1979), NSEC was established by the NSEC Act of 27th September, 1979 which was re-enacted by the NSEC Decree of 1988. The NSEC as an apex regulatory organ of the capital market has the objectives of promoting an orderly and efficient capital market in Nigeria by providing a conducive environment for savings and investment necessary for economic development; ensuring fair and appropriate price for stocks and shares; and ensuring adequate protection of the investing public. Mention must however, be made that unlike the CBN, NSEC does not participate in the capital market as a buyer or seller of securities. Generally, NSEC's primary functions include:

- i. The determination of price and time at which companies' securities are to be sold ;
- ii. Registering all securities proposed to be offered privately with the intention that they would be held ultimately other than by those to whom the offers were made;
- iii. Registering all securities dealers (stockbrokers), investment adviser, registrars and market places in the industry such as Stock Exchange branches with a view to maintaining proper standards of conduct and professionalism in the securities business;
- iv. Maintaining overall surveillance of the market to ensure orderly, fair and equitable dealings and to forestall or take steps to forestall illegal and unethical dealings, such as insider trading at the expense of the public;
- v. Determining the basis for allotment of securities offered to the market to ensure spread and equity; and
- vi. Determining the volume of issue coming to the market with a view to preventing the market from being over flooded with issues.

3.6.2 The Nigerian Stock Exchange (NSE)

While the NSEC is the apex regulatory body for the capital market, the Nigerian Stock Exchange (NSE) is the hub. The NSE is a secondary market while the NSEC is a primary market in the sense that while the NSEC acts as the new issue market, concerned with the issue and sale of new securities, the NSE acts as the market for sale and purchase of existing securities. In the new issues market, the operators are the issuing houses such as the Stockbrokers, Merchant Banks, Commercial Banks, Central Bank of Nigeria, the Government, etc. On the other hand, in the existing securities market by the Nigerian

Stock Exchange (NSE), the main participants are the Stockbrokers as the dealing members with the CBN acting as the buyer of last resort of government's securities not absorbed in the market.

Established in 1961 by the Lagos Stock Exchange Act, the Lagos Stock exchange was reconstituted into the Nigerian Stock Exchange (NSE) in 1977, and today has six trading floors in Lagos, Port Harcourt, Kano, Kaduna, Onitsha and Ibadan.

In terms of organization, the NSE comprises of the following:

- i. Council members responsible for the day-to-day management of the Exchange and
- ii. Dealing members who are the Stockbrokers licensed by the Council to deal in government and industrial securities quoted on the Exchange and whose conduct are guided by the Exchange's rules and regulations.

3.6.2.1 Functions of the Nigerian Stock Exchange (NSE)

The Nigerian Stock Exchange (NSE) was established to perform the following functions:

- a. To provide the machinery for mobilizing private and public saving and making them available for productive investment through stocks and shares.
- b. To provide a meeting place for dealing members to buy and sell existing stocks and shares, as well as provide opportunities for raising new capital.
- c. To facilitate the purchase and sale of securities.
- d. To facilitate dealings in government securities and thus provide to government with funds for development purpose.
- e. To protect the public from shady deals and practices through its rules, regulations, and operating codes, with the objectives of ensuring fair dealing.

4.0 CONCLUSION

The capital markets are the complex institutions mechanisms whereby intermediate-term funds (loans of up to 10 years maturity for example) and long-term (longer-maturity loans and corporate stocks) are pooled and made available to business, governments and individuals, and whereby instruments already outstanding are transferred (Dougal, 1970). As such, the importance of an active capital market for the economic development of Nigeria cannot be over-emphasized.

5.0 SUMMARY

You learnt in this unit the evolution of the capital market, the meaning of the capital, the segment of the capital market and the functions of an active capital market. You also learnt the reasons for the establishment of the Nigerian capital market, the organs of the

capital market, the Nigerian Securities and Exchange Commission (NSEC) and the Nigerian Stock Exchange (NSE).

In the next unit which is four, we shall discuss the organization and function of commercial banks.

6.0 TUTOR-MARKED ASSIGNMENT

- i. Trace the evolution of the evolution of the Nigerian capital market.
- ii. List and explain the functions of an active capital market.

7.0 REFERENCES

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UNIT 4: ORGANIZATION AND FUNCTIONS OF COMMERCIAL BANKS

CONTENT

- 4 Introduction
- 5 Objectives
- 6 Main Content
 - 3.1 Meaning of Commercial Banks
 - 3.2 Organization and Structure of Commercial Banks
 - 3.2.1 Unit Banking
 - 3.2.2 Branch Banking System
 - 3.3 Functions of Commercial Banks
 - 3.3.1 Primary Functions of Commercial Banks
 - 3.3.2 Secondary Functions of Commercial Banks
- 4.0 Conclusion
- 5.0 Summary

6.0 Tutor Marked Assignment

7.0 References and Further Reading

3.0 INTRODUCTION

In the preceding unit which was our third to this course, we learnt the evolution of the capital market, the meaning of the capital, the segment of the capital market and the functions of an active capital market. We also learnt the reasons for the establishment of the Nigerian capital market, the organs of the capital market, the Nigerian Securities and Exchange Commission (NSEC) and the Nigerian Stock Exchange (NSE).

In the present unit which is four, we shall discuss the organization and function of commercial banks.

OBJECTIVES

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

- Define commercial banks
- Explain organization and structure of commercial banks
- Clarify functions of commercial banks

3.0 MAIN CONTENT

3.1 Meaning of Commercial Banks

The word 'bank' is derived from the Italian word 'banco' meaning bench (de Albuquerque, 1855). The Jews in Lombardy, the early bankers, conducted their business at benches in the market place. The Italian word *banco* "desk/bench" was used during the Renaissance era by Florentine bankers, who used to make their transactions above a desk covered by a green tablecloth (Matyszak, 2007). However, traces of banking activity can be found even in ancient times.

Some have suggested, the word traces its origins back to the Ancient Roman Empire, where moneylenders would set up their stalls in the middle of enclosed courtyards called *macella* on a long bench called a *banco*, from which the words *banco* and *bank* are derived. As a moneychanger, the merchant at the *banco* did not so much invest money as merely convert the foreign currency into the only legal tender in Rome – that of the Imperial Mint (Matyszak, 2007).

A commercial bank is a type of bank that provides services such as accepting deposits, making business loans, and offering basic investment products. Commercial bank can also refer to a bank or a division of a bank that mostly deals with deposits and loans from corporations or large businesses, as opposed to individual members of the public (retail banking).

3.2 Organization and Structure of Commercial Banks

Commercial banks vary in their organization and structure from country to country. The two main banking systems are the unit banking and the branch banking. The unit banking is peculiar to the USA. Branch banking, on the other hand, is found in the majority of countries such as England, Australia, Canada, New Zealand, and of course, Nigeria. Two other important types are the group banking and the chain banking which are also found in the USA. We discuss below these different systems of banking.

3.2.1 Unit Banking

Unit banks are independent, one-office banks. Their operations are confined in general to a single office. 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. The unit banks operate in small towns and cities in the USA and are called county banks and city banks respectively. All unit banks are linked together by a correspondent bank relationship. A county bank has deposits in city banks, and city banks have deposits in branch banks in the same and other big cities like New York and Chicago (Jhingan, 2004).

3.2.2 Branch Banking System

The branch banking is the most prevalent banking system in the majority of countries. Under this system, a big bank has a number of branches in different parts of the country and even many branches within a cosmopolitan city like Lagos, Ibadan, Abuja, Enugu, Port Harcourt, Kaduna, Kano and Jos. In Nigeria, banks like First Bank Nigeria Plc, Union Bank Nigeria Plc, United Bank for Africa Plc and many commercial banks have branches spread all over the country.

Small commercial banks also carry on branch banking operations within a State or a region. In the USA for instance, branch banking is confined to the States. Accordingly, a number of banks have merged under a holding company to carry on branch business efficiently and profitably.

Self Assessment Exercise 2.1

Choose an old generation commercial bank and discuss how it is organized

3.3 Functions of Commercial Banks

Commercial bank being the financial institution performs diverse types of functions. It satisfies the financial needs of the sectors such as agriculture, industry, trade, communication, etc. That means they play very significant role in a process of economic social needs. The functions performed by banks are changing according to change in time and recently they are becoming customer centric and widening their functions. Generally the functions of commercial banks are divided into two categories viz. primary functions and the secondary functions. The following chart simplifies the functions of banks.

There are two essential functions that a financial institution must perform to become a bank. These are: primary and secondary functions.

Functions of commercial banks

Primary functions	Secondary functions
1. Accepting Deposits	Clearance of cheque
2. Making Advances	Sale/purchase of shares/bonds
3. Credit Creation	Transfer of money
	To work as trusty
	To work as a representative
	To give/accept money
	To provide letter of credit

3.3.1 Primary Functions of Commercial Banks

Commercial Banks performs various primary functions some of them are given below

1. Accepting Deposits: Commercial bank accepts various types of deposits from public especially from its clients. It includes saving account deposits, recurring account deposits, fixed deposits, etc. These deposits are payable after a certain time period.

2. Making Advances: The commercial banks provide loans and advances of various forms. It includes an overdraft facility, cash credit, bill discounting, etc. They also give demand and demand and term loans to all types of clients against proper security.

3. Credit creation: It is most significant function of the commercial banks. While sanctioning a loan to a customer, a bank does not provide cash to the borrower Instead it opens a deposit account from where the borrower can withdraw. In other words, while sanctioning a loan a bank automatically creates deposits. This is known as a credit creation from commercial bank.

3.3.2 Secondary Functions of Commercial Banks

Along with the primary functions each commercial bank has to perform several secondary functions too. It includes many agency functions or general utility functions. The secondary functions of commercial banks can be divided into agency services and general utility services.

i. Agency Services

A commercial bank provides a range of investment services. Customers can arrange for dividends to be sent to their bank paid directly into their bank accounts, or for the bank to detach coupons from bearer bonds and present them for payment and to act upon announcements in the press of drawn bonds, coupons, payable, etc. Orders for the purchase or sale of stock exchange securities are executed through the banks brokers who will also give their opinions on securities or list of securities. Similarly, banks will make applications on behalf of their customers for allotments arising from new capital issues, pay calls as they fall due and ultimately obtain share certificates or other documents of title. On certain agreed terms the banks will allow their names to appear on approved prospectus or other documents as bankers for the issue of new capital, they will receive applications and carry out their instructions.

A commercial bank undertakes the payment of subscriptions, premium, rent, etc., on behalf of its customers. Similarly, it collects cheques, bills of exchange, promissory notes, etc., on behalf of its customers. It also acts as a correspondent or representative of its customers, other banks and financial corporations.

Most of the commercial banks have an 'Executor and Trustee Department'; some may have affiliated companies to deal with this branch of business. They aim to provide a complete range of trustee, executor or advisory services for small charge. The business of banks acting as trustees, executors, administrators, etc has continuously expanded with considerable usefulness to their customers.

Most banks will undertake on behalf of their customers the preparation of income tax returns and claims for the recovery of overpaid tax; they also assist the customers in checking the assessments. In addition to the usual claims involving personal allowances and reliefs, claims are prepared on behalf of residents abroad, minors, charities, etc.

ii. General Utility Services

These services are those in which the banks position is not that of an agent for his customer. They include the issue of credit instruments like letters of credit and travellers cheques, the acceptance of bills of exchange; the safe custody of

valuables and documents; the transaction of foreign exchange business; acting as a referee as to the respectability and financial standing of customers; providing specialized advisory service to customers; etc.

iii. Bankers Draft and Letter Of Credit

By selling drafts or orders and by issuing letters of credit, circular notes, travellers cheques, etc., a commercial bank is discharging a very important function. A bankers draft is an order, addressed by one office of a bank to any other of its branches or by any one bank to another, to pay a specified sum to the person concerned.

A 'letter of credit' is a document issued by a banker, authorizing some other bank to whom it is addressed, to honour the cheques of a person named in the document, to the extent of a stated amount in the letter and charge the same to the account of the grantor of the letter of credit. A letter of credit includes a promise by the issuing banker to accept all bills of exchange to the limit of credit.

iv. Circular Notes, Travellers Cheques, Circular Cheques

'Circular Notes' are cheques on the issuing banker for certain round sums in his own currency. On the reverse side of the circular note is a letter addressed to the agents specifying the nature of the holder and referring to a letter of indication in his hands, containing the specimen signature of the holder. The note will not be honoured unless the letter of indication is presented. 'Travellers Cheques' are documents similar to circular notes with the exception that they are not accompanied by any letter of indication. 'Circular Cheques' are issued by banks in certain countries to their agents abroad. These agents sell them to intending visitors to the country of the issuing bank.

v. Safe Custody of Valuables

Another important service rendered by a modern commercial bank is that of keeping in safe custody valuables such as negotiable securities, jewellery, documents of title, wills, deed-boxes, etc. Some branches are also equipped with specially constructed strong rooms, each containing a large number of private steel safes of various sizes. These may be used for a small fee. Each user is provided with the key of an his/her valuables but also retains full personal control over them. The safes are accessible at any time during banking hours and often longer.

vi. Night Safes

For shopkeepers and other customers who handle large sums of money after banking hours, 'night safes' are available at many banks. Night safe takes the form of a small metal door on the outside wall of the bank, accessible from the street, behind which there is a chute connecting with the bank's strong room. Customers who require this service are provided with a leather wallet, which they lock before placing in the chute. The wallet is opened by the customer when he calls at the bank the next day to get the contents credited to his account.

vii. Referee as to the Responsibility and Financial Status of the Customer

Another function of great value, both to banks and businessmen, is that of the bank acting as referee as to the responsibility and financial status of the customer.

3.4 Balance Sheet of Commercial Bank - Liabilities and Assets

Commercial bank's balance sheet has two main sides i.e. the liabilities and the assets. From the study of the balance sheet of a bank we come to know about a system which a bank has followed for raising funds and allocation of these funds in different asset categories. Bank can have others money with it. It can be in terms of shareholders share capita, or depositors deposits. This money is the bank's liabilities. On the other hand bank's own sources of income leads to generation of assets for bank.

i. Unsecured loan

Unsecured loans are monetary loans that are not secured against the borrower's assets (i.e., no collateral is involved). There are small business unsecured loans such as credit cards and credit lines to large corporate credit lines. These may be available from financial institutions under many different guises or marketing packages:

ii. Bank overdrafts

An overdraft occurs when money is withdrawn from a bank account and the available balance goes below zero. In this situation the account is said to be "overdrawn". If there is a prior agreement with the account provider for an overdraft, and the amount overdrawn is within the authorized overdraft limit, then interest is normally charged at the agreed rate. If the POSITIVE balance exceeds the agreed terms, then additional fees may be charged and higher interest rates may apply.

- * Corporate bonds
- * Credit card debt
- * Credit facilities or lines of credit
- * Personal loans

Balance Sheet of a Commercial Bank**Liabilities**

- a. Share Capital
- b. Reserve Funds
- c. Deposits
 - i. Fixed Deposits
 - ii. Saving Deposits
 - iii. Current Deposits
 - iv. Other Deposits
- d. Borrowings
- e. Other liabilities

Assets

- a. i. Cash in Hand
- ii. Cash with the Central Bank (RBI)
- iii. Cash with the other banks
- b. Money at short
- c. Bills and securities discounted
- d. Investment of bank
- e. Loans and Advances given
- f. Other Assets

Bank's Liabilities

Bank's liabilities constitute five major items: The share capital, the contribution which shareholders have contributed for starting the bank. Reserve funds are the money, which the bank has accumulated over the years from its undistributed profits. Deposits are the money owned by customers and therefore it is a liability of a bank. There can be various kinds of deposits and recurring deposits. Apart from these items a bank can borrow from central and other commercial banks. These borrowings are also treated as bank's liabilities.

Bank's Assets

Bank's asset comprises cash, money at short notice, bills and securities discounted, bank's investments, loans sanctioned by the bank, etc. Bank's cash in hand, cash with other banks and cash with central bank (RBI) are its assets. When a bank makes money available at short notice to other banks and financial institutions for a very short period of 1-14 days it is also treated as bank's asset. Apart from these items bank always make money available to people on the form of loans and advances. They are also become bank's assets.

4.0 CONCLUSION

As financial institutions, commercial banks play an important role in financial intermediation. As such, 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.

4.0 SUMMARY

You learnt in this unit, the meaning of commercial banks as well as the organization and functions of commercial banks.

In the next unit, that is Unit 5 which is the last in Module 1, we shall discuss how to operate a bank account.

6.0 TUTOR-MARKED ASSIGNMENTS (TMAs)

1. How are commercial banks organized in Nigeria?
2. List and explain primary functions of commercial banks.

7.0 REFERENCES

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UNIT 5: OPERATING BANK ACCOUNT

CONTENT

1.0 Introduction

2.0 Objectives

3.0 Main Content

3.1 Seven (7) Steps to Open Bank Account

3.2 The Advantages of Opening Bank Account

3.3 Types of Bank Account

3.3.1 Saving Account in Bank:- Meaning, Features, Advantages

3.3.2 Current Account in Bank:- Meaning, Features and Advantages

3.3.3 Fixed Deposit Account of Bank:- Meaning, Features, Advantages

3.3.4 .Recurring Deposit Account of Bank:-Meaning, Features, Advantages

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

3.4.1 Different Kinds / Types of Cheques

3.4.2 Crossing of Cheque:- Different Types of Check Crossing

3.4.3 Different Types of Crossing

4.0 Conclusion

5.0 Summary

6.0 Tutor Marked Assignment

7.0 References and Further Reading

0.0 INTRODUCTION

We learnt in the preceding unit, the meaning of commercial banks as well as the organization and functions of commercial commercial banks.

In the present unit, that is Unit 5 which is the last in our Module 1, we shall discuss how to operate a bank account.

2.0 OBJECTIVES

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

- Explain how to open bank account
- List seven (7) steps to open bank account
- Discuss the advantages of opening bank account
- Name types of Bank Account
- Discuss the meaning, features, advantages of saving account in bank
- Interpret the meaning, features, advantages current account in bank
- Discuss the meaning, features, advantages fixed deposit account of bank
- Discuss the meaning, features, advantages recurring deposit account of bank
- Define a Cheque and explain different kinds and types of cheques

3.0 MAIN CONTENT

3.1 Seven (7) Steps to Open Bank Account

- i. **Decide the type of Bank Account you want to open:** There are several types of bank accounts such as Saving Account, Recurring Account, Fixed Deposit Account and Current Account. So, a decision regarding the type of account to be opened must be taken.
- ii. **Approach any Bank of choice & meet its Bank Officer:** Once the type of account is decided, the person should approach a convenient bank. He has to meet the bank officer regarding the opening of the account. The bank officer will provide a proposal form (Account Opening Form) to open bank account.

- iii. **Fill up Bank Account Opening Form - Proposal Form:** The proposal form must be duly filled in all respects. Necessary details regarding name, address, occupation and other details must be filled in wherever required. Two or three specimen signatures are required on the specimen signature card. If the account is opened in joint names, then the form must be signed jointly. Nowadays the banks ask the applicant to submit copies of his latest photograph for the purpose of his identification.
- iv. **Give References for Opening your Bank Account:** The bank normally required references or introduction of the prospective account holder by any of the existing account holders for that type of account. The introducer introduces by signing his specimen signature in the column meant for the purpose. The reference or introduction is required to safeguard the interest of the bank.
- v. **Submit Bank Account Opening Form and Documents:** The duly filled in proposal form must be submitted to the bank along with necessary documents. For e.g. in case of a joint stock company, the application form must accompany with the Board's resolution to open the account. Also certified copies of articles and memorandum of association must be produced.
- vi. **Officer will verify your Bank Account Opening Form:** The bank officer verifies the proposal form. He checks whether the form is complete in all respects or not. The accompanying documents are verified. If the officer is satisfied, then he clears the proposal form.
- vii. **Deposit initial amount in newly opened Bank Account:** After getting the proposal form cleared, the necessary amount is deposited in the bank. After depositing the initial money, the bank provides a pass book, a cheque book and pay in slip book in the case of savings account. In the case of fixed deposits, a fixed deposit receipt is issued. In the case of current account, a cheque book and a pay in slip book is issued. For recurring account, the pass book and a pay in slip book is issued.

Self Assessment Exercise

Dr. Adesina-Uthman Ganiyat wants to open a current account with WEMA Bank Plc. Advise her on the steps to take.

3.2 The Advantages of Opening Bank Account

- i. **Bank account facilitates a safe custody of money:** The bank is the custodian of cash. As and when the account holders needs the money can withdraw the same depending upon the type of account.
- ii. **Bank account helps in making payments:** The bank account holder can make payment to third parties through the savings and current account. The payment may be regarding electricity bills, insurance premium, etc. The

bank also makes direct payment on the standing instructions of the customer.

- iii. **Bank account helps in collection of money:** The bank can directly collect money of the customer in respect of dividend, salary pension or from debtors. The collected money is then deposited in customer's bank account.
- iv. **Bank account holders get advances and loans:** The current account holder can obtain an overdraft facility from his bank. The recurring and fixed deposit account holders can get a loan upto 75% of the amount to their credit. The savings account holders can also obtain loans to purchase computers and such other equipments.
- v. **Bank account helps in smooth transactions:** The bank account makes it possible for the businessmen to conduct their business operations smoothly not only in the domestic trade but also in the foreign markets.
- vi. **Bank account holders get a safe deposit locker:** The bank provides safe deposit locker facility to its account holders to keep their valuables like gold jewellery, share certificates, property documents, etc.

3.3 Types of Bank Account

The four different types of bank accounts are:

3.3.1 Saving Account in Bank:- Meaning, Features, Advantages

The 'saving account' is generally opened in bank by salaried persons or by the persons who have a fixed regular income. This facility is also given to students, senior citizens, pensioners, and so on. Saving accounts are opened to encourage the people to save money and collect their savings.

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

a. Features of Saving Account

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

- i. The main objective of saving account is to promote savings.
- ii. There is no restriction on the number and amount of deposits
- iii. Withdrawals are allowed subject to certain restrictions.

- iv. The money can be withdrawn either by cheque or withdrawal slip of the respective bank.
- v. The rate of interest payable is very nominal on saving accounts.
- vi. Saving account is of continuing nature. There is no maximum period of holding.
- vii. A minimum amount has to be kept on saving account to keep it functioning.
- viii. No loan facility is provided against saving account.
- ix. Electronic clearing System (ECS) or E-Banking are available to pay electricity bill, telephone bill and other routine household expenses.
- x. Generally, equated monthly installments (EMI) for housing loan, personal loan, car loan, etc., are paid (routed) through saving bank account.

b. Advantages of Saving Account

The advantages of saving account are as follows:

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

3.3.2 Current Account in Bank:- Meaning, Features and Advantages

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

Current account can be opened in co-operative bank and commercial bank. In current account, amount can be deposited and withdrawn at any time without giving any notice. It is also suitable for making payments to creditors by using cheques. Cheques received from customers can be deposited in this account for collection.

a. Features of Current Account

The main features of current account are as follows:-

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

b. Advantages of Current Bank Account

The advantages of current account are as follows:-

- i. Current account enables businessmen to conduct his business transactions smoothly.
- ii. The businessmen can withdraw any amount at any time from their current accounts. There are also no restrictions on withdrawals.
- iii. The businessmen can make direct payment to their creditors with the help of cheques.
- iv. The bank collects money on behalf of its customers and credits the same to their accounts.
- v. Current account enables the account holder to obtain overdraft facility.
- vi. The creditors of the account holder can get credit-worthiness information of the account holder through interbank connection.
- vii. Current account facilitates the industrial progress of the country. Without the help of this account, businessmen would have difficulties in running their business.

3.3.3 Fixed Deposit Account of Bank:- Meaning, Features, Advantages

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

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

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

a. Features of Fixed Deposit Account

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

- i. The main purpose of fixed deposit account is to enable the individuals to earn a higher rate of interest on their surplus funds (extra money).
- ii. The amount can be deposited only once. For further such deposits, separate accounts need to be opened.
- iii. The period of fixed deposits range between 15 days to 10 years.
- iv. A high interest rate is paid on fixed deposits. The rate of interest may vary as per amount, period and from bank to bank.
- v. Withdrawals are not allowed. However, in case of emergency, banks allow to close the fixed account prior to maturity date. In such cases, the bank deducts 1% (deduction percentage may vary) from the interest payable as on that date.
- vi. The depositor is given a fixed deposit receipt, which depositor has to produce at the time of maturity. The deposit can be renewed for a further period.

b. Advantages of Fixed Deposit Account

The advantages of fixed deposit account are as follows:-

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

3.3.4. Recurring Deposit Account of Bank:- Meaning, Features, Advantages

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

a. Features of Recurring Deposit account:

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

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

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

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

"Cheque is an instrument in writing containing an unconditional order, addressed to a banker, sign by the person who has deposited money with the banker, requiring him to pay on demand a certain sum of money only to or to the order of certain person or to the bearer of instrument."

3.4.1 Different Kinds / Types of Cheques

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

- payable to the person specified therein as the payee, or to any one else to whom it is endorsed (transferred).
- iii. **Uncrossed / Open Cheque:** When a cheque is not crossed, it is known as an "Open Cheque" or an "Uncrossed Cheque". The payment of such a cheque can be obtained at the counter of the bank. An open cheque may be a bearer cheque or an order one.
 - iv. **Crossed Cheque:** Crossing of cheque means drawing two parallel lines on the face of the cheque with or without additional words like "& CO." or "Account Payee" or "Not Negotiable". A crossed cheque cannot be cashed at the cash counter of a bank but it can only be credited to the payee's account.
 - v. **Anti-Dated Cheque:** If a cheque bears a date earlier than the date on which it is presented to the bank, it is called as "anti-dated cheque". Such a cheque is valid upto six months from the date of the cheque.
 - vi. **Post-Dated Cheque:** If a cheque bears a date which is yet to come (future date) then it is known as post-dated cheque. A post-dated cheque cannot be honoured earlier than the date on the cheque.
 - vii. **Stale Cheque:** If a cheque is presented for payment after six months from the date of the cheque it is called stale cheque. A stale cheque is not honoured by the bank.

3.4.2 What are the Features of and Characteristics of Cheque

- i. Cheque is an instrument in writing: A cheque must be in writing. It can be written in ink pen, ball point pen, typed or even printed. Oral orders are not considered as cheques.
- ii. Cheque contains an unconditional order: Every cheque contains an unconditional order issued by the customer to his bank. It does not contain a request for payment. A cheque containing conditional orders is dishonoured by the bank.
- iii. Cheque is drawn by a customer on his bank: A cheque is always drawn on a specific bank mentioned therein. Cheque drawn by stranger is of no meaning. Cheque book facility is made available only to account holder who are supposed to maintain certain minimum balance in the account.
- iv. Cheque must be signed by customer: A cheque must be signed by customer (Account holder). Unsigned cheques or signed by persons other than customers are not regarded as cheque.
- v. Cheque must be payable on demand: A cheque when presented for payment must be paid on demand. If cheque is made payable after the expiry of certain period of times then it will not be a cheque.

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

3.4.3 Crossing of Cheque:- Different Types of Check Crossing

A cheque is a negotiable instrument. During the process of circulation, a cheque may be lost, stolen or the signature of payee may be done by some other person for endorsing it. Under these circumstances the cheque may go into wrong hands.

Crossing is a popular device for protecting the drawer and payee of a cheque. Both bearer and order cheques can be crossed. Crossing prevents fraud and wrong payments. Crossing of a cheque means "Drawing Two Parallel Lines" across the face of the cheque. Thus, crossing is necessary in order to have safety. Crossed cheques must be presented through the bank only because they are not paid at the counter.

3.4.4 Different Types of Crossing

1. General Crossing

Generally, cheques are crossed when;

- i. There are two transverse parallel lines, marked across its face or
- ii. The cheque bears an abbreviation "& Co." between the two parallel lines or
- iii. The cheque bears the words "Not Negotiable" between the two parallel lines or
- iv. The cheque bears the words "A/c. Payee" between the two parallel lines.

A crossed cheque can be made **bearer cheque** by cancelling the crossing and writing that the crossing is cancelled and affixing the full signature of drawer. In addition to the word bank, the words "A/c. Payee Only", "Not Negotiable" may also be written. The payment of such cheque is not made unless the bank named in crossing is presenting the cheque.

The effect of special crossing is that the bank makes payment only to the banker whose name is written in the crossing. Specially crossed cheques are safer than generally crossed cheques.

4.0 CONCLUSION

Today Banks have emerged as important financial institutions. Banks provide a safe environment and help us manage our financial transactions. To avail professional banking service it is mandatory for every individual to open a bank account. Opening a bank account is not a difficult task. It takes only seven easy steps to open a bank account. This article has helped us understand these seven simple steps or procedures to open a bank account.

4.0 SUMMARY

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

This is the last unit of our Module 1. We will start the first unit of our next Module 2 with a discussion about the organization and functions of merchant banks and development banks.

5.0 TUTOR-MARKED ASSIGNMENT

1. Mr. Obaka Abel is a Lecturer while Alhaji Alhaji Muhammed Jibrin is a multi-millionaire businessman. Advise both Mr. Obaka and Alhaji Ahmed the types of account they can operate.
2. Write on 4 of the following terms;
 - a. Bearer cheque
 - b. Order cheque
 - c. Crossed cheque
 - d. Anti-dated cheque
 - e. Post-dated cheque
 - f. Stale cheque
 - g. Drawer
 - h. Drawee
 - i. Payee

7.0 REFERENCES

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

MODULE 2

Unit 1: Organization and Functions of Merchant Banks and Development Banks

Unit 2: The Microfinance Banks

Unit 3: Insurance Companies

Unit 4: The Central Banks

Unit 5: Comparative Banking and Financial System

UNIT 1: ORGANIZATION AND FUNCTIONS OF MERCHANT BANKS AND DEVELOPMENT BANKS

CONTENT

1.0 Introduction

2.0 Objectives

3.0 Main Content

3.1 The Meaning of Merchant Bank

3.1.1 Development of Merchant Banking in Nigeria

- 3.1.2** The Functions of Merchant Bank
 - 3.2** The Meaning of Development Banks
 - 3.2.1** Evolution of Development Banks in Nigeria
 - 3.2.2** Functions of Development Banks
 - 3.2.3** History of Nigerian Industrial Development Bank
 - 3.4** Federal Mortgage Bank of Nigeria (FMBN)
 - 3.5** Nigerian Agriculture and Cooperative Bank (NACB)
 - 3.6** Functions of Nigerian Agriculture and Cooperative Bank
- 4.0** Conclusion
- 5.0** Summary
- 6.0** Tutor Marked Assignment
- 7.0** References and Further Reading

1.0 INTRODUCTION

In the preceding unit which was the last of our Module 1, we learnt the seven steps to opening bank account, the advantages of opening bank account as well as the different types of bank account. We also learnt the meaning, features and advantages of operating saving account, current account, fixed deposit account, recurring deposit account and cheque.

We are starting the first unit of our Module 2 with a discussion about the organization and functions of merchant banks and development banks.

2.0 OBJECTIVES

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

- Explain the Meaning of Merchant Bank
- Trace development of merchant banking in Nigeria
- Analyze the functions of merchant bank
- Explain the meaning of development banks
- Trace the evolution of development banks in Nigeria
- Analyze the functions of development banks
- Trace the history of Nigerian Industrial Development Bank
- Discuss the Federal Mortgage Bank of Nigeria (FMBN)
- Discuss the Nigerian Agriculture and Cooperative Bank (NACB)
- Analyze the functions of Nigerian Agriculture And Cooperative Bank

2.0 MAIN CONTENT

3.1 The Meaning of Merchant Bank

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

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

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

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

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

3.1.1 Development of Merchant Banking in Nigeria

Merchant banking will rightly be said to have started in Nigeria with the registration of Nigerian Acceptance on 25th November, 1960, and the Philip Hills (Nigeria) Limited on 14th September, 1960. Between 1960 and 1969, these two banks operated in Nigeria as the only licensed merchant banks. In 1969, the two merged to form the Nigerian

Acceptances Limited now called NAL Merchant Bank Limited. The merger was resorted to due to limited activities of the two banks. NAL Merchant Bank remained the only operating merchant bank in Nigeria until 1973. The indigenization Decree requires 40:60 percent -expatriate/indigenous equity ownership in the banking industry. The oil boom of the 1970s and the Third National Development Plan helped to increase the activities of the merchant bank. This also led to an upsurge in the merchant banking industry in Nigeria. The second merchant bank to enter the market was the United Dominion Trust Bank (Nigeria) Limited, which was licensed in July 1973. Following its licensing as a merchant bank, it changed its name to UDT (Nigeria) Limited in April, 1974. Today, it answers the Nigerian Merchant Bank.

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

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

3.1.2 The Functions of Merchant Banking

The Functions of Merchant Banking are listed as follows:

- i. **Raising Finance for Clients:** Merchant Banking helps its clients to raise finance through issue of shares, debentures, bank loans, etc. It helps its clients to raise finance from the domestic and international market. This finance is used for starting a new business or project or for modernization or expansion of the business.
- ii. **Broker in Stock Exchange:** Merchant bankers act as brokers in the stock exchange. They buy and sell shares on behalf of their clients. They conduct research on equity shares. They also advise their clients about which shares to buy, when to buy, how much to buy and when to sell. Large brokers,

- Mutual Funds, Venture Capital companies and Investment Banks offer merchant banking services.
- iii. **Project Management:** Merchant bankers help their clients in many ways. For e.g., advising about location of a project, preparing a project report, conducting feasibility studies, making a plan for financing the project, finding out sources of finance, advising about concessions and incentives from the government.
 - iv. **Advice on Expansion and Modernization:** Merchant bankers give advice for expansion and modernization of the business units. They give expert advice on mergers and amalgamations, acquisition and takeovers, diversification of business, foreign collaborations and joint-ventures, technology upgrading, etc.
 - v. **Managing Public Issue of Companies:** Merchant bank advise and manage the public issue of companies. They provide the following services related to public issue of securities:
 - a. Advise on the timing of the public issue.
 - b. Advise on the size and price of the issue.
 - c. Acting as manager to the issue, and helping in accepting applications and allotment of securities.
 - d. Help in appointing underwriters and brokers to the issue.
 - e. Listing of shares on the stock exchange, etc.
 - vi. **Handling Government Consent for Industrial Projects:** A businessman has to get government permission for starting of the project. Similarly, a company requires permission for expansion or modernization activities. For this, many formalities have to be completed. Merchant banks do all this work for their clients.
 - vii. **Special Assistance to Small Companies and Entrepreneurs:** Merchant banks advise small companies about business opportunities, government policies, incentives and concessions available. It also helps them to take advantage of these opportunities, concessions, etc.
 - viii. **Services to Public Sector Units:** Merchant banks offer many services to public sector units and public utilities. They help in raising long-term capital, marketing of securities, foreign collaborations and arranging long-term finance from term lending institutions.
 - ix. **Revival of Sick Industrial Units:** Merchant banks help to revive (cure) sick industrial units. It negotiates with different agencies like banks, term lending institutions, etc. It also plans and executes the full revival package.
 - x. **Portfolio Management:** A merchant bank manages the portfolios (investments) of its clients. This makes investments safe, liquid and profitable for the client. It offers expert guidance to its clients for taking investment decisions.

- xi. **Corporate Restructuring:** It includes mergers or acquisitions of existing business units, sale of existing unit or disinvestment. This requires proper negotiations, preparation of documents and completion of legal formalities. Merchant bankers offer all these services to their clients.
- xii. **Money Market Operation:** Merchant bankers deal with and underwrite short-term money market instruments, such as:
 - a. Government Bonds.
 - b. Certificate of deposit issued by banks and financial institutions.
 - c. Commercial paper issued by large corporate firms.
 - d. Treasury bills issued by the Government (Here in Nigeria by CBN).
- xiii. **Leasing Services:** Merchant bankers also help in leasing services. Lease is a contract between the lessor and lessee, whereby the lessor allows the use of his specific asset such as equipment by the lessee for a certain period. The lessor charges a fee called rentals.
- xiv. **Management of Interest and Dividend:** Merchant bankers help their clients in the management of interest on debentures / loans, and dividend on shares. They also advise their client about the timing (interim / yearly) and rate of dividend.

Self Assessment Exercise

What is the most familiar role of the merchant bank?

3.2 The Meaning of Development Banks

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

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

3.2.1 Evolution of Development Banks in Nigeria

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

Apart from providing medium and long-term loans for capital projects in specific areas as already mentioned, development banks render ancillary services like providing technical advice on new and existing projects to their customers, engaging in promotional activities to stimulate interests among their customers on new projects which the banks consider necessary and profitable. The commercial banks in operation provided short-term funds which were as a result of the nature of funds available to them. Occasionally, they provided medium-term funds and long-term basis. Development banks perform this function by providing long-term loans for capital projects in specific areas.

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

Following the reconstruction of the Nigerian Industrial Development Bank Limited, NIDB in 2001, which incorporated the mandate of the Nigerian Bank of Commerce and Industry (NBCI), the (NBCI) appear to have lost its identify. Today you may not discuss

the NBCI without seeing it as a part of NIDB. Nevertheless, since NBCI, is still in existence, having not been swallowed by the NIDB, it can still be referred to. The NBCI was established through Decree 22 of 5th May 1973 by the Federal Government of Nigeria. The bank which is believed to be a child of circumstance because it came up after the Nigeria's civil when the Indigenization Decree was set up. It started its operation on 4th October, 1974. The bank's authorized capital at inception was N50 million with N35 million of this fully paid up and subscribed by the Federal Government with 60% contribution and the Central Bank of Nigeria, which contributed the remaining 40%.

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

3.2.2 Functions of Development Banks

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

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

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

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

ii. Development of Housing Sector: Development banks provide finance for the development of the housing sector. The FGN started the National Housing Fund (NHF) through the National Housing Fund Act 1992. The Federal Mortgage Bank of Nigeria Act

of 1993 also came into being to provide long-term credit facilities to mortgage institutions in Nigeria and encourage and promote the development of mortgage institutions at the rural, local, State and Federal levels.

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

- a. provide long-term credit facilities to mortgage institutions in Nigeria at such rates and such terms as may be determined by the Board in accordance with the policy directed by the Federal Government, being rates and terms designed to enable the mortgage institutions to grant comparable facilities to Nigerian individuals desiring to acquire houses of their own;
- b. license and encourage the emergence and growth of the required number of viable secondary mortgage institutions to service the need of housing delivery in all parts of Nigeria;
- c. encourage and promote the development of mortgage institutions at rural, local, State and Federal levels;
- d. supervise and control the activities of mortgage institutions in Nigeria
- e. collect, manage and administer the National Housing Fund in accordance with the provisions of the National Housing Fund Act;
- f. do anything and enter into any transaction which in the opinion of the Board is necessary to ensure the proper performance of its functions under this Act

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

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

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

vi. Review of Sick Units: Development banks help to revive (cure) sick-units. Federal Government of Nigeria (FGN) started NBCI to help sick units. NBCI is the main credit

and reconstruction institution for revival of sick units. It facilitates modernization, restructuring and diversification of sick-units by providing credit and other services.

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

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

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

3.2.3 History of Nigerian Industrial Development Bank

NIDB came into existence in 1964 after the restructuring of ICON. The new company was chartered to provide medium and long-term credit to existing and emerging industrial and mining firms in Nigeria. A reconstruction of ICON to NIDB brought in the Federal Government of Nigeria and the World Bank/International Finance Corporation as partners. Originally, the firm had 42 Lagos shareholders holding about 20% of the equity and 56 foreign shareholders holding about 80% of the company. The company originally had a paid-up capital of 1 million pounds. After the restructuring, NIDB had an authorized capital of 5 million pounds with about 20% of the shares of the bank held by Nigerians and about 10% each held by the Central Bank of Nigeria and the International Finance Corporation (IFC). A few international finance houses also held shares, banks such as Chase International Investment Corporation, Bank of America, Irving International Financing Corporation, IBEC, Northwest International Bank and Chemical Overseas Financial Corporation expanded their overseas risk portfolio and might have invested in the bank as a result of its relationship with Nigerian Stock Exchange.

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

3.4 Federal Mortgage Bank of Nigeria (FMBN)

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

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

In 1994, the Federal Mortgage Bank of Nigeria, with the promulgation of the FMBN Act 82 [1993] and the Mortgage Institutions Act 53 [1989] was accorded the status of the apex mortgage institution and thus ceded its retail function to an autonomous company, Federal Mortgage Finance Limited (FMFL) which was carved out of the FMBN, itself fully owned by the Federal Government of Nigeria.

Under the reform of the housing sector based on the Federal Government's 2002/2006 National Policy on Housing and Urban Development, the FMBN was restructured into a Federal Government-Sponsored Enterprise (FGSE) with more focus on secondary mortgage and capital market functions. It plays the critical role of developing a robust mortgage finance system for the country. To meet its mandate, the FMBN has shifted operational emphasis to expand its functions from only social housing on-lending under the NHF to include commercial on-lending for housing, commercial mortgages refinancing, mortgage purchasing and warehousing and Mortgage-Backed Securitization. Under this mandate, it finances mortgages created by primary mortgage institutions (PMI) under the National Housing Fund Scheme and also gives estate development loans (EDL) to real estate developers. The bank's overall mandate is to promote the delivery of affordable and modern houses to Nigerians.

3.5 Nigerian Agriculture and Cooperative Bank (NACB)

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

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

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

3.6 Functions of Nigerian Agriculture and Cooperative Bank (NACB)

The followings are functions of NACB:

- a.** Work with cooperative groups at the States and Local Government level to prepare development action plans for themselves;
- b.** Enter into collaborative or on-lending MOU with State governments and cooperative associations and microfinance banks, specifying their respective obligations to improve the affairs of the groups and banks within a stipulated timeframe;
- c.** Monitor implementation of development action plans of cooperative associations and micro-finance banks and fulfillment of obligations under MOUs;
- d.** Provide financial assistance to cooperatives and micro-finance banks for establishment of technical, monitoring and evaluations cells;
- e.** Provide Organization Development Intervention (ODI) through reputable training institutes like Federal Cooperative Colleges, Universities of Agriculture, and Departments of Agriculture of various universities in Nigeria;
- f.** Provide financial support for Federal Cooperative Colleges and Departments of Cooperative Studies in various universities and polytechnics;
- g.** Provide training for senior and middle level executives of local commercial bank branches, micro finance banks and cooperative associations;
- h.** Create awareness among the borrowers on ethics of repayment through local debt collectors and cooperative marshals that enforce timely repayment and prompt remittance of same to the lending institution;

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

4.0 SUMMARY

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

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

4.0 CONCLUSION

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

In the next unit we shall discuss the microfinance banks.

6.0 TUTOR-MARKED ASSIGNMENT

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

7.0 REFERENCES

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

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UNIT 2: THE MICROFINANCE BANKS

CONTENT

1.0 Introduction

2.0 Objectives

3.0 Main Content

3.1 Meaning of Microfinance

3.2 European Origin of Microfinance

3.3 African Origins of Microfinance

3.4 Emergence of Microfinance Banks in Nigeria

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3.6 Objectives of the Microfinance Policy

3.7 The Stakeholders in the Microfinance Subsector in Nigeria

3.8 The Impact of the Microfinance Subsector in Promoting Financial Inclusion in Nigeria

3.9 Access to Funding

3.10 Operational Challenges of Microfinance Banks in Nigeria

3.11 Reform of the Microfinance Bank Subsector in Nigeria

4.0 Conclusion

5.0 Summary

6.0Tutor-Marked Assignment

7.0References and Further Reading

3.0 INTRODUCTION

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

In the present unit which is Unit 2 of Module 2, we shall discuss the microfinance banks.

2.0 OBJECTIVES

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

- Discuss the meaning of microfinance;
- Trace the European origin of microfinance;
- Trace the African origins of microfinance;
- Explain the emergence of microfinance banks in Nigeria;
- Give reasons for the formulation of the national microfinance policy;
- Explain the objectives of the microfinance policy;
- Name the stakeholders in the microfinance subsector in Nigeria;
- Analyze the impact of the microfinance subsector in promoting financial inclusion in Nigeria;
- Explain access to funding;
- Discuss operational challenges of microfinance banks in Nigeria; and
- Explain reform of the Microfinance Bank Subsector In Nigeria;

3.0 MAIN CONTENT

3.1 Meaning of Microfinance

Microfinance involves the provision of financial services to the poor and the low income segment of society. Worldwide, microfinance has been identified as a potent instrument for promoting financial inclusion and consequently, poverty alleviation. In 2005, the Central Bank of Nigeria (CBN) formulated the National Microfinance Policy along the

objectives of the Millennium Development Goals and the National Economic Empowerment and Development Strategy (NEEDS) and thus was born, the formal microfinance subsector in Nigeria. The CBN had since undertaken a comprehensive review of the Policy to address the identified challenges of the emergent subsector and leverage on its achievements.

3.2 European Origin of Microfinance

Revolutions in rural and microfinance seem to be recurrent events. One such revolution started in the 1970s, when Shaw and McKinnon (1973) at Stanford University propagated, pertaining to financial systems, the crucial importance of Money and Capital in Economic Development; and a group of scholars around Dale Adams (1984) at Ohio State University, pertaining to rural financial systems, exposed the dangers of Undermining Rural Development with Cheap Credit. An earlier revolution, truly in microfinance, urban and rural, started in Germany some 150-200 years ago from small informal beginnings as part of an emerging self-help movement: with the first thrift society established in Hamburg in 1778; the first community bank in 1801; and the first urban and rural cooperative credit associations in 1850 and 1864, respectively. The provision of legal status, prudential regulation and effectively delegated supervision played a crucial role in their further development, starting with the Prussian Savings Banks Decree in 1838 and the Cooperative Act of the German Reich in 1889, the first cooperative law in the world. Their success has been spectacular. With 39,000 branches, these two types of (micro-) finance institutions now comprise 51.5% of all banking assets in Germany (Dec. 1997 data) and seem far healthier than the big national banks. (Seibel 2003a).

The story of Germany is preceded by the earlier, but sadder, story of the Irish charities which emerged in the 1720s in response to a tremendous increase in poverty. They started with interest-free loans from donated resources. After a century of slow growth, a boom was initiated a special law in 1823, which turned the charities into financial intermediaries by allowing them to collect interest-bearing deposits and to charge interest on loans. Around 1840, around 300 funds had emerged as self-reliant and sustainable institutions, with high interest rates on deposits and loans. They were so successful that they became a threat to the commercial banks, which acted with financial repression: getting the government to put a cap on interest rates in 1843. The Loan Funds lost thus their competitive advantage, which caused their gradual decline, until they finally disappeared in the 1950s. (Seibel 2003a)

Microfinance is thus not a recent development, and it is not just a temporary solution for poor countries. Every now developed country has its own history of microfinance. It is important to recognize this because it presents a view different from that of many in the microfinance community who associate microfinance with credit NGOs and believe that microfinance was invented in Bangladesh some 20-odd years ago. Attributing the origin

of microfinance to recent initiatives misses not only the historical depth and scale of microfinance, but also centuries of experience, which means: learning from trial and error, failure and success. The beginnings in Europe and Africa, notably in Nigeria, were all informal and small-scale. What distinguishes a country like Germany from many developing countries is not the prevalence of self-help and informal finance at an earlier time. Community- and member-based as well as other informal financial institutions are exceedingly widespread throughout the world. The major difference seems to be the legal recognition given to informal finance in Germany and the protection of the institutions through prudential regulation and effective supervision: an issue which is still controversial in the microfinance community.

3.3 African Origins of Microfinance

Turning now to another world of microfinance, our journey back in history takes us to Nigeria: to a microfinance revolution, centuries ago. The earliest evidence of financial institutions in Africa dates back to the 16th century: to *esusu*, a rotating savings and credit association (**RoSCA**) among the Yoruba. As a form of social capital, the *esusu* as a financial self-help group was transported during the slave trade to the Caribbean islands (Bascom 1952:69), where both the institution and the term still exist today and are now carried by a new wave of migrants to major American cities. Its origin were probably rotating work associations, in which labour as a scarce commodity was accumulated and allocated to one member at a time; and then, with the spreading of commercial transactions, replaced by money, such as cowries, pounds and Naira.

Nigeria is one of the countries where informal financial institutions continue to play an important role. There may be only few Nigerians who are not a member in one or several of them. Numerous adaptations and innovations have sprung from the **RoSCAs**: one is the transformation into non-rotating savings associations with a permanent loan fund. Both the name, *esusu*, and the institution have spread as far as Liberia as the only effective financial institutions existing in the countryside (Seibel 1970; Seibel & Massing 1974) and Congo, or Zaire. The other one is daily deposit collection at doorsteps or market stalls. It seems to have originated among the Yoruba (where it is known as *ajo*) from where it has spread all over West Africa during the past 50 years. These informal financial institutions are immensely popular in Nigeria. Virtually every ethnic group has its own institutions and proper names (*adashi*, in Hausa, perhaps the best-known besides *esusu*); and most adults are members in one or several. Yet their importance and potential have been controversially discussed. In 1934 C.F. Strickland, a British cooperative expert, examined the *esusu* as a possible basis for modern cooperative societies in Western Nigeria. Having previously worked on the rotating chit funds in India, he speculated that the *esusu* must have been imported from India at some unknown time, found them “improvident” and “fraudulent”, and concluded that he was “not hopeful of the reform of the *esusu*.” (Strickland, 1934:14). The consequences of his judgment were far-reaching: the Co-operative Societies Ordinance, introduced in 1935 and modeled after

British-Indian cooperatives, became the blueprint for the British colonies in Africa. However, informal financial institutions of various types continued to be rediscovered in Nigeria by scholars (e.g, Green, 1947/64; Bascom, 1952; Ardener, 1953, 1964; Isong, 1958; Seibel, 1967; Seibel & Marx, 1984; Ottenberg, 1968, 1973; Okorie & Miller, 1976; Chukwu, 1976) and practitioners, who were intrigued by their development potential. At various times, two approaches were tested: (i) upgrading informal rotating or non-rotating savings and credit associations to registered cooperatives and linking them to banks; and (ii) Transforming indigenous savings and credit associations into cooperatives. In Eastern Nigeria, in the 1940s colonial officers with an anthropological background recommended the transformation of *esusu* or *isusu* (the Igbo term) to financial cooperatives as well as the continuation of *isusu* practices within modern cooperatives (i.e., those registered under cooperative law). In 1954, the Eastern Region Cooperative Department (1954) stated in its annual report: Financial institutions accumulate scarce resources and make them available in lump sums: either as one's savings at the end of a period of depositing small amounts; or as a loan at the beginning of a period of (usually) small payments; or as a mixture of both, savings and credit, somewhere during that period. In the process, financial institutions manage risks, decrease the costs of transaction between individuals, and increase efficiency. Historically, labour has been a scarce resource in Africa. Rotating group work has been one of the forms of accumulating and allocating that scarce resource. With the emergence of a cash economy, money was gradually substituted for labour: a process which is still going on in some countries. (Seibel & Damachi 1982). "The *Isusu (Esusu, Susu, Osusu)* is a widespread indigenous system of thrift and credit... On the whole, the *Esusu* seems to be fairly well managed; although in some areas... the *Isusu* has degenerated into a notorious money-lender-controlled 'racket'. There are vast numbers of *Isusu* Clubs in the region and the total amount of money involved must be very large. Some local Government Bodies have recently instituted a system of registration of *Isusu* Clubs."

During the 1950s, when self-government was introduced, definitions of what constitutes "development" changed; and so did attitudes to local culture and institutions. This is indicated by the "modernization" of one *esusu* in Ondo Province initiated in 1952 by a Nigerian civil servant, J.T. Caxton-Idowu. He prepared bye-laws, "regularized" its activity, imparted cooperative education, and registered the *esusu* as a proper cooperative society. At that time, there existed four Cooperative Thrift & Credit Societies of the type imported by the British, to which the *esusu* was added as a fifth cooperative, but of indigenous origin. Within a ten-year period, the number of such cooperatives grew from 5 in 1952 to 94 in 1962, including converted *esusu*. Their proportion in terms of number of cooperatives had risen from 20% in 1952 to 44% in 1962; their working capital and savings from 20% to 52%, and their membership from 23% to 58%. Adeyeye (1970), a learned observer, concluded: "... the Ondo experiment has demonstrated... that the '*Esusu*' may yet represent a source of immeasurable strength... With the renewed pride in our traditional heritage, we in the developing nations will definitely find the idea of

institutional adaptation a most welcome experiment. It will offer opportunities to modernize without necessarily destroying the essentially indigenous character.”

In the early 1980s, donor countries realized that capital transfer through development banks had failed to bring about the desired modernization and shifted their interest to the domestic resource mobilization. As a contribution to the Third International Symposium on the Mobilization of Personal Savings in Developing Countries, 1984 in Yaoundé, the Federal Ministry of Economic Cooperation (BMZ) commissioned a study of modern cooperatives as well as indigenous savings and credit associations in Nigeria. At the time, cooperatives in Nigeria had 1.6 million members. There were no figures on the membership in *esusu*-type groups; but membership was conservatively estimated at 12-25 million.

At a time when Nigeria had a differentiated banking sector and a booming oil industry, the question came up again whether traditional and modern cooperatives had a major role to play in financial sector development; and what had happened to the earlier approach of converting indigenous to modern cooperatives. Was it a thing of the past, or did it still have promise? In Eastern Nigeria, it was estimated at the same that approximately 40% of all cooperatives had been established on the basis of pre-existing *esusu*, the majority of which had previously evolved from rotating to non-rotating associations with permanent loan funds. In 1984, Seibel & Marx studied a total of 64 cooperatives in five states in Nigeria: Anambra, Imo, Cross River, Oyo and Benue, comparing cooperatives with and without *esusu* origin. The case studies are not statistically representative; and the results can only be indicative. There are two striking results: one concerning the difference between cooperatives with and without an indigenous *esusu* origin; the other concerning the difference between cooperatives and unconverted *esusu*.

Self-Assessment Exercise

Explain the words *Isusu* (*Esusu*, *Susu*, *Osusu*) and *Adashi*.

3.4 Emergence of Microfinance Banks in Nigeria

The Central Bank of Nigeria formulated the National Microfinance Policy in December 2005 in order to deepen the access of micro entrepreneurs to financial services. A liberal access of micro entrepreneurs to financial services is expected to boost, expand and modernize the operations of their businesses so that this class of entrepreneurs can be economically empowered and thus be able to contribute to national economic growth and development.

The Microfinance policy presented a blueprint for the emergence of a regulated Microfinance subsector in Nigeria under the supervisory purview of the CBN and with deposit insurance cover provided by the Nigeria Deposit Insurance Corporation. Inter

alia, the policy provided guidelines for the establishment of de novo Microfinance Banks, as well as migration of the existing Community Banks and NGO- MFIs to Microfinance Banks. The policy also directed Community Banks that were unable to convert to MFBs to close shop. Furthermore, the Policy provided for the emergence of two types of Microfinance Banks namely: Unit MFBs with a minimum paid up capital of N20million and operational outreach not beyond a state of the Federation and State MFBs with a minimum paid up capital of N1billion and operational outreach across the states of the Federation.

3.5 Reasons for the Formulation of the National Microfinance Policy

The apex bank gave the following reasons for the formulation of the National Microfinance Policy:

- i. **Weak Institutional and Network Capacity:** The prolonged sub optimal performance of many erstwhile community banks, microfinance and development finance institutions is as a result of incompetent management, weak internal controls and lack of deposit insurance schemes. Other factors include poor corporate governance, lack of well defined operations and restrictive regulatory / supervisory requirements.
- ii. **Weak Capital Base:** The weak capital base of the existing microfinance institutions could not adequately provide a cushion for the risk of lending to micro enterprises.
- iii. **The Existence of a Huge Un served Market:** The size of the un-served market by the existing financial institutions is large. For instance in 2005, the aggregate microcredit facilities in Nigeria accounted for about 0.2 percent of Gross Domestic Product (GDP) and less than one percent of total credit to the economy. This revealed the existence of a huge gap in the provision of financial services to a large number of the active poor and low income groups.
- iv. **Poor Banking Culture and Low level of Financial Literacy:** The primary target of microfinance initiative includes people who have never had any banking relationship in their lives either due to poor financial literacy, remoteness from bank locations or complete ignorance of what banking entail. Most of these people equate microfinance with micro credit see banks and other fund providers not as partners in business but mere sources of loans and advances.
- v. **Economic Empowerment of the Poor:** Globally, micro small and medium enterprises (MSMEs) are known to contribute to poverty alleviation through their employment generating potentials. As people become gainfully employed they are able to earn some income from which basic needs of life are met. In Nigeria, however, the employment generation potentials of small businesses have been seriously constrained by lack of access to fiancé either to start, expand or re-

- engineer their present scope of economic activities in order to generate employment.
- vi. The increasing interest of local and international investors in Microfinance: Many local and international investors have expressed interest in investing in the country's microfinance sector.
 - vii. Urban Bias in Banking Services: Most of the existing banks are located in urban centres and several attempts in the past at encouraging them to open branches in the rural areas did not produce the desired results. With a high proportion of the Nigerian population still living in the rural areas, it has become absolutely imperative to develop an institutional framework to reach the hitherto unserved population with banking services..

3.6 Objectives of The Microfinance Policy

The main objectives of the Microfinance Policy are:

- i. Provision of diversified affordable and dependable financial services to the economically poor which otherwise would have been excluded in a timely and constructive to enable them undertake and develop long term sustainable entrepreneurial activities.
- ii. Creation of employment opportunities and increase in the productivity of the active poor in the country thereby enhancing their individual household income and uplifting their standard of living.
- iii. Promotion of synergy and mainstreaming of the informal Microfinance subsector into the formal financial system, thereby ensuring effective systematic and focused participation of the poor in socio economic development and resource allocation.
- iv. Enhancement of service delivery by all microfinance institutions to MSMEs and rendering of specialized services such as payment of salaries, gratuities and pensions licensed by the CBN.
- v. Mobilization of savings for intermediation and contribution to rural transformation.
- vi. Promotion of linkage programmes between MFIs on one hand and DMBs, DFIs and specialized funding institutions on the other.
- vii. Provision of sustainable avenues for the administration of the micro credit programmes of government and high net worth individuals on a non recourse basis, and promotion of an enabling platform for microfinance service providers to network and exchange views and experiences on their products and processes

3.7 The Stakeholders in the Microfinance Subsector in Nigeria

The stakeholders in the microfinance subsector in Nigeria can be classified as government regulatory authorities, investors, development partners, financial institutions, technical assistance providers and donor agencies. These are;

- i. Regulatory Environment Stakeholders comprising the CBN, the NDIC, Securities and Exchange Commission, Federal and State Departments of Cooperatives, and apex associations like the National Association of Microfinance Banks.
- ii. Donor Agencies and Funds Providers like Human Rights Organizations and Corporate Establishments using microfinance to achieve their corporate social responsibility objectives.
- iii. Microfinance Institutions and Operators which comprise Microfinance Banks, NGO-MFIs, Cooperative Societies, Community Based Development Institutions, Deposit Money Banks offering microfinance services, Development Banks, Government Intervention Programmes and Trade Associations.
- iv. Microfinance Support institutions comprising professional service providers in accounting, audit law and technology, and
- v. Microfinance Beneficiaries or Microfinance Clients who are basically low income people and micro entrepreneurs.

3.8 The Impact of the Microfinance Subsector in Promoting Financial Inclusion in Nigeria

Targets set for the subsector at inception in 2005 included the following:

- i. To cover the majority of the poor but economically active population by 2020 thereby creating millions of jobs and reducing poverty.
- ii. To increase the share of micro credit as a percentage of total credit to the economy from 0.9 percent in 2005 to at least 20 percent in 2020 and the share of micro credit as a percentage of GDP from 0.2 percent in 2005 to at least 5 percent in 2020
- iii. To promote the participation of at least two thirds of the states and local governments in micro credit financing by 2015
- iv. To eliminate gender disparity by improving women's access to financial services by 5% annually
- v. To increase the number of linkages among universal banks, developmental banks specialized finance institutions and microfinance banks by 10% annually.
- vi. The impact of the subsector in promoting financial inclusion in Nigeria can be discussed under the following broad headings: Access to funding, Social impact/Social Mission of Poverty reduction, Gender Equality and Financial Literacy.

3.9 Access to Funding

With 877 Microfinance Banks in operation in Nigeria as at present even after the liquidation of 103 of them in September, 2010, it is in order to aver that microfinance banking has taken firm roots in Nigeria even if the locations of the institutions are not evenly spread across the country. For instance, a review of the distribution of Microfinance Banks in the twelve most populous states of the Federation as at 31st Oct, 2011 revealed that while the most populous state in the Federation, Kano State (population : 9.38m, 2006 census) had just 7 Microfinance Banks, the second most populous state, Lagos State with 9.01m inhabitants had 178 Microfinance Banks and while the 11th most populous state, Borno State with a population of 4.15 had only 4 Microfinance Banks, Delta State which was the twelfth most populous state with 4.10m had 39 Microfinance Banks. Notwithstanding the uneven distribution of the Microfinance Banks in the country, the astronomical increases in their numbers had led to heightened awareness of the potentials that microfinance banking holds for economic growth and development amongst stakeholders such as government regulatory authorities, investors, development partners, financial institutions, technical assistance providers and donor agencies.

Furthermore and perhaps, more importantly, economically active poor and micro entrepreneurs, the primary foci of MFBs, are now taking advantage of the large numbers of MFBs by increasingly demanding for microfinance services such as credit, savings, financial advice and payment services. For instance, although the statistics for total deposit mobilized and total credit created by MFBs at inception are not available to facilitate inter-temporal comparisons, the total deposit mobilized and total loans created by the 596 MFBs who rendered returns to the NDIC as at March 2011 (representing about 60% of total MFBs in operation) were N326.85 billion and N251.96 billion respectively. These absolute figures indicate that the microfinance subsector in Nigeria is being patronized by the citizens. Furthermore, although there were no data of Nigerians who were served by the informal microfinance subsector pre 2005 to facilitate comparison over time, a study conducted by EFinA (Enhancing Financial Innovation and Access) in 2010 revealed that 3.2 million Nigerians (representing 3.8% of the adult population) had a Microfinance bank of which 57.9% were males and 42.1% were females while 1.8 million Nigerians (2.1% of the adult population) used their MFB account as their main bank account.

3.10 Operational Challenges of Microfinance Banks in Nigeria

A number of challenges had been identified as constraining MFBs from fulfilling their potentials as financial inclusion instruments and economic growth drivers. We have already alluded to the uneven distribution of MFBs in the country. The skewed distribution of MFBs in Nigeria is capable of limiting access of a vast majority of the economically active poor to credit. Even in those parts of the country with sizable

numbers of MFBs, most of the institutions are located in urban places to the neglect of the rural areas because of pure profit making considerations

Another challenge of the subsector is lack of relevant skills. Microfinance banking is different from conventional banking. As earlier indicated, microfinance banking involves the provision of financial services to the lower segment of the market. Microfinance banking, therefore, requires specialized skills which are presently lacking in the country.

Many operators with community banking background still run their businesses as if they were community banks while quite a number of them also see themselves as competitors to Deposit Money Banks. Consequently, they dissipate both depositors' funds and loanable funds by acquiring expensive infrastructure.

It is also noteworthy that there are still inadequate funds in the sector for intermediation owing to lack of aggressive savings mobilization, inability to attract commercial capital and the non-establishment of Microfinance Development Funds.

It is a matter for concern that most of the weaknesses that characterized the operations of community banks and which led to the sub optimal performance of the institutions have started to rear their ugly heads in the MFB subsector so much that by December, 2010, five years after the formulation of the Microfinance Policy, the apex bank had to revoke the operating licences of one hundred and one (101) Microfinance Banks. In announcing the withdrawal of the licenses, the apex bank catalogued the weaknesses of the MFBs whose licenses were revoked. In the words of the apex bank : 'the MFBs whose licenses were revoked were found to have suffered total erosion of their capital base and dissipation of depositors' funds resulting from very high levels of non-performing loans(NPLs) and or insider abuse which culminated in negative shareholders' funds unimpaired by losses and negative capital Adequacy ratio(CAR) which were far below the prescribed minimum levels, in violation of the BOFIA and in contravention of the Regulatory and Supervisory Guidelines for MFBs in Nigeria. In addition, many of the MFBs were unable to meet matured obligations and had closed shop, a situation which had jeopardized depositors' funds in the affected institutions and was capable of ultimately eroding the safety and credibility of the microfinance sub sector, if allowed to remain unchecked.

3.11 Reform of the Microfinance Bank Subsector In Nigeria

Efforts to reform and reposition the subsector for enhanced service delivery include:

- i. Withdrawal of the operating licenses of 103 MFBs in 2010.
- ii. Proposed criminal prosecution of errant directors and management staff found culpable for the mismanagement of the affected banks.

- iii. Intensified on site routine examination
- iv. Continuous sanitization/revocation of licences of failed MFBs
- v. Zero tolerance for regulatory infractions
- vi. Implementation of stiffer sanctions and penalty regime.
- vii. The review of the Microfinance Policy framework
- viii. The establishment of the Microfinance Certification Programme to build capacity in the subsector.
- ix. Facilitation of the establishment of an apex association for the subsector; the National Association of Microfinance Banks in Nigeria.
- x. The adoption of Risk Based supervision in the subsector.

4.0 CONCLUSION

There should be faithful and diligent implementation of the Revised Microfinance Policy and other reform initiatives already put in place. In addition, mergers and acquisitions as opposed to outright liquidation should be encouraged in the subsector as obtains in other jurisdictions like Germany where no Cooperative Bank (equivalent of an MFB) has failed in the past 50 years).

4.0 SUMMARY

In this unit, you learnt the meaning of microfinance, the European origin of microfinance, the African origins of microfinance and the emergence of microfinance banks in Nigeria. You also learnt the formulation of the national microfinance policy, the objectives of the microfinance policy, the stakeholders in the microfinance subsector in Nigeria and the impact of the microfinance subsector in promoting financial inclusion in Nigeria. Finally, you learnt the access to funding, the operational challenges of microfinance banks in Nigeria and reform of the microfinance bank subsector in Nigeria.

In the next unit, that is, Unit 3 of module 2 we shall discuss insurance companies.

6.0 TUTOR MARKED ASSIGNMENT

1. Trace the emergence of Microfinance banks in Nigeria.
2. Analyze the operational challenges of Microfinance banks in Nigeria.

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UNIT 3: THE INSURANCE COMPANIES

CONTENT

1.0 Introduction

2.0 Objectives

3.0 Main Content

3.1 Meaning of Insurance

3.2 Development of Insurance business in Nigeria

3.3 Classes of Insurance in Nigeria

3.4 Functions/Roles of Insurance Companies

3.5 Number of Licensed Insurance Companies in Nigeria

3.6 Number of Licensed Insurance Practitioners in Nigeria as at February 2014

3.7 The Impact of Insurance Practice on Economic Growth

3.8 The Regulatory Role of NAICOM

4.0 Conclusion

5.0 Summary

6.0 Tutor Marked Assignment

7.0 References and Further Reading

1.0 INTRODUCTION

In the preceding unit, we learnt the meaning of microfinance, the European origin of microfinance, the African origins of microfinance and the emergence of microfinance banks in Nigeria. We also learnt the formulation of the national microfinance policy, the objectives of the microfinance policy, the stakeholders in the microfinance subsector in Nigeria and the impact of the microfinance subsector in promoting financial inclusion in Nigeria. Finally, we concluded our discussion on Microfinance bank with the consideration of access to funding, the operational challenges of microfinance banks in Nigeria and reform of the microfinance bank subsector in Nigeria.

In the present unit, which is Unit 3 of Module 2 we shall discuss insurance companies.

2.0 OBJECTIVES

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

- Explain the meaning of insurance;
- Trace the development of insurance business in Nigeria;
- List classes of insurance in Nigeria;
- Analyze functions/roles of insurance companies;
- List the number of licensed companies in Nigeria;
- List the number of licensed insurance practitioners in Nigeria;
- Analyze the impact of insurance practice on economic growth; and
- Examine the regulatory role of NAICOM.

3.0 MAIN CONTENT

3.1 Meaning of Insurance

Insurance refers to a contract to pay a premium in return for which the insurer (insurance company) will pay compensation in certain eventualities such as death, fire, theft, motor accident, etc. Premiums are calculated so that in total they are sufficient to pay compensation for the policy-holders who will make claims together with a margin to cover administrative costs and profit. Risk, the uncertainty of loss, is an uncomfortable part of life which we must cope with. Such risks and misfortunes that occur in our daily lives cannot in many instances be borne by the individual and so an insurer is prepared to shoulder the burden of these consequences in exchange for an assessed payment for the risk undertaken.

3.2 Development of Insurance business in Nigeria

The first insurance company to have a full branch office in Nigeria was the Royal Exchange Assurance. It opened its first office in Lagos in 1921 and until 1949, it practically dominated insurance business in the country. In 1949, three other British-owned insurance companies entered the insurance industry in Nigeria. By the time of independence in 1960 there were about 25 insurance companies in the country. At the end of 1989, 98 insurance companies were operating as registered companies in Nigeria and most of them are indigenous. The leading indigenous insurance company in Nigeria is the National Insurance Corporation of Nigeria (NICON) which was fully owned by the Federal Government of Nigeria and which underwrites about 25 per cent of the total insurance business in Nigeria.

The Nigerian insurance industry is a dynamic and rapidly growing one. It is supervised by the National Insurance Commission (NAICOM), which is poised to ensure that the market grows to a level commensurate with contemporary economies. The number of policyholders has increased from 500,000 in 2010 to 1,500,000 in 2012. During that period, the ratio of premium income to GDP increased from 0.5 per cent to 0.7 per cent (Thisday Newspaper, 14 Aug 2013)

3.3 Classes of Insurance in Nigeria

According to the Insurance Act of 1976, insurance in Nigeria is divided into two main classes: life insurance business (life assurance) and non-life insurance business (general insurance). General or non-life insurance business is a contract between an insurer (i.e. the insurance company) and the insured whereby the insurer undertakes to indemnify the assured against losses, which may result from the occurrence of specified events within specified periods. General insurance business can be sub-divided into: fire, accident, oil and gas, contractors' all risks and engineering risks; marine and Credit insurance, bond and surety ship etc.

Life assurance business is a contract between the assurer (the company) and the assured (i.e. the policy holder) whereby the assurer undertakes to pay benefits to the policy holder on the attainment of a specified event. This type of insurance is long-term in nature. It comprises individual life business, group life insurance and pension business, health insurance business and annuities.

Self Assessment Exercise

What do you understand by the word 'Annuity'?

3.4 Functions/Roles of Insurance Companies

The following are functions of insurance companies:

- a. Insurance companies provide the most effective method of handling many of the pure risks encountered by individuals and firms;
- b. Insurance companies facilitate risk transfer;
- c. They accumulate substantial funds which are used for long-term investment;
- d. Through their life and pension businesses they help to develop the financial market;
- e. They help to mobilize national resource by encouraging individuals to save;
- f. They operate pension schemes on behalf of companies;
- g. They grant loans on mortgages;
- h. They act as underwriters in the capital market;
- i. Insurance policies are used as collateral securities for bank loans; and
- j. They help to improve the balance of payments position of the country by insuring imports and exports and through re-insurance. Their major problem in \Nigeria is the non-application of modern techniques through research.

3.5 Number of Licensed insurance Companies in Nigeria

According to National Insurance Commission (NAICOM) which is the apex regulatory authority for insurance business in Nigeria, there are presently 59 licensed insurance companies in Nigeria (NAICOM, 2014). These are presented in table 1 below;

Table 1: Number of Licensed Companies in Nigeria as at February 2014

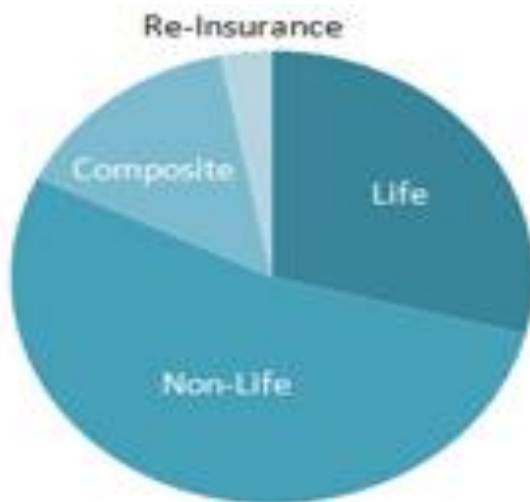
S/No.	Type	Share	% Share
1.	Life	16	27.12
2.	Non-Life	30	50.85
3.	Composite	11	18.64
4.	Re-Insurance	2	3.39
Total		59	100.00

Source: NAICOM and computed by the Researcher

From the above table, Non-life insurance has the greatest share of the insurance companies in Nigeria with 30 companies out of the total of 59 or about 50.85% of the total number of insurance companies in Nigeria as at February 28, 2014. Life insurance was second with 16 companies or 27.12%. Third was composite with 11 companies or

18.64%. Last but not the least was Re-Insurance with only 2 out of a total of 59 insurance companies which represents a mere 3.39%. The above data is diagrammatically represented as pie-chart in Diagram 1 below.

Diagram 1: Number of Licensed Companies in Nigeria as February 2014



Source: NAICOM

3.6 Number of Licensed Insurance Practitioners in Nigeria as at February 2014

Bellow is the current list of the number of licensed insurance practitioners in Nigeria as given by NAICOM:

Table 2: Number of Licensed Insurance Practitioners in Nigeria as at February 2014

S/No.	Type	Share (Numerical)	Share (%)
1.	Reinsurers	2	0.08
2.	Underwriters	57	2.20
3.	Brokers	577	22.28
4.	Loss Adjusters	54	2.08
5.	Agents	1,900	73.36
Total		2,590	100

Source: NAICOM and computed by the Researcher

From the table 2 above, it can be seen that Agents have the highest number of 1,900 out of the total of 2,590 insurance practitioners in Nigeria, which represents 73.36%. This is a proof that the Nigerian insurance industry is dominated by agency. After Agents, the next was Brokers with 577 number or 22.28%. This shows that brokerage is second in terms of the prevalence of insurance practitioners in Nigeria. Underwriters that are 57 in number or 2.20% are third in hierarchy in terms of numerical strength. Loss Adjusters who are 54 in number and which represents 2.08% are fourth. Finally, Reinsurers with only 2 members and a mere 0.08% share of total insurance practitioners came in the rear.

The above data is diagrammatically represented as pie-chart in Diagram 2 below.

Table 2: Number of Licensed Insurance Practitioners in Nigeria as at February 2014



Source: NAICOM

3.7 The Impact of Insurance Practice on Economic Growth

Insurance companies' practice would affect economic growth through the channels of marginal productivity of capital, protection, technological innovations and savings rate. Insurance companies indemnify the ones who suffer a loss and stabilize the financial position of individuals and firms with possibility of transfer of different kinds of risks to insurance companies. Again, firms exposed to various risks of their liability, property, illness and disability of their employees and life of key employees, have the possibility of managing those risks by transfer to insurance companies. This allows firms to concentrate their attention and resources on their core business which can lead to willingness and ability to take real investment which will help to generate higher level of economic growth (Oke, 2012). This means that without pooling and transferring of risk which insurance companies provide, part of the economic activities would not take place and positive effects on social welfare would fail. In other words, by creating an environment of greater security, insurance fosters investment and innovation or economic growth. Insurance increases marginal productivity of capital also in a way that it makes no need for high liquid contingency funds of firms which results in more funds available for financing high-return projects. Without insurance coverage, large contingency funds would be needed to protect firms against risk. Increasing availability of funds could result from kind of insurance products by which insurance companies provide protection from credit risk to other financial intermediation. In that way, financial intermediaries are more willing to lend funds for financing real investments which encourage economic growth.

NAICOM (2014) listed insurance contribution to the Nigerian Economy as follows:

Total Net Premium (N)185BN

Total Gross Premium..... (N) 234BN

+Increase / -Decrease

TGP..... (%) +16.7

3.8 The Regulatory Role of NAICOM

There were some initiatives introduced by NAICOM in its bid to drive growth in the industry. The Market Development and Restructuring Initiative (MDRI) by NAICOM is a template for enforcing the compulsory insurance of public buildings and buildings under construction. MDRI also seeks to put in place adequate insurance protection for liabilities associated with use of such buildings and increase the number of insurance agents to introduce insurance products to drive the mass market. The insurance regulator is also enforcing the compulsory professional indemnity insurance for Health Management Organization (HMOs) and property insurance cover for hospitals under the National Health Insurance Scheme (NHIS). The regulator in addition enforces the mandatory group life assurance for all employees as prescribed by the Pension Reform Act, 2004 in addition to making annuities as veritable means of paying pension to retirees.

NAICOM is engaging stakeholders on the compulsory aviation insurance as mandated by the Nigerian Civil Aviation Act, 2006 while enforcing the Nigerian Oil and Gas Industry Content Development Act, 2010. You should note that the law provides that all assets, operations and liabilities of companies operating in the Nigerian oil and gas industry must be insured by a Nigerian insurance company through a Nigerian registered insurance broker, he recalled. This has resulted in an increase from 10 per cent retention of oil and gas risk to about 70 per cent currently. Besides these, there are the legacy mandatory insurance covers of motor vehicle and marine. The market is so attractive that between 2011 and 2013 the number of insurance companies with foreign equity has increased from 3 to 10 (Thisday Newspaper 14 Aug 2013).

4.0 CONCLUSION

There are better prospects for the insurance industry because of the fact that the industry would be called upon to cover some of the risks associated with economic growth and development in the country, going forward.

The Nigerian economy, according to experts, is expected to grow appreciably and this will be led by infrastructural development and the private sector investments. This will drive purchase of insurance products to secure investment and protect against liabilities.

6.0 SUMMARY

In this unit, you learnt the meaning of insurance, the development of insurance business in Nigeria, classes of insurance in Nigeria and the functions/roles of insurance companies. You also learnt the number of licensed insurance companies in Nigeria, the number of licensed insurance practitioners in Nigeria, the impact of insurance practice on economic growth as well as the regulatory role of NAICOM.

In the next unit, that is Unit 4 of our module 2 we shall discuss the central banks.

6.0 TUTOR-MARKED ASSIGNMENT

1. Analyze the impact of insurance practice on economic growth.
2. List and explain the roles and functions of insurance.

7.0 REFERENCES

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UNIT 4: THE CENTRAL BANK OF NIGERIA

CONTENT

- 1.0** Introduction
- 2.0** Objectives
- 3.0** Main Content
 - 3.1** History of Central Bank of Nigeria
 - 3.1.1** Authorizing legislation
 - 3.1.2** The Origin of Central Bank of Nigeria
 - 3.2** Functions of Central Bank of Nigeria
 - 3.3** Policy Implementation and Criticism
- 4.0** Conclusion
- 5.0** Summary
- 6.0** Tutor Marked Assignment
- 7.0** References and Further Reading

4.0 INTRODUCTION

In the preceding unit, we learnt the meaning of insurance, the development of insurance business in Nigeria, classes of insurance in Nigeria and the functions/roles of insurance companies. We also learnt the number of licensed insurance companies in Nigeria, the number of licensed insurance practitioners in Nigeria, the impact of insurance practice on economic growth as well as the regulatory role of NAICOM.

In the present unit, that is Unit 4 of our Module 2, we shall discuss the central banks.

2.0 OBJECTIVES

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

3.0 MAIN CONTENT

3.1 History of Central Bank of Nigeria

The history of Central Bank of Nigeria includes its authorizing legislation and its origin which are discussed in the following subsections.

3.1.1 Authorizing legislation

In 1948, an inquiry under the leadership of G.D. Paton was established by the colonial administration to investigate banking practices in Nigeria. Prior to the inquiry, the banking industry was largely uncontrolled. The G.D Paton's Report, an offshoot of the inquiry became the cornerstone of the first banking legislation in the country: the Banking Ordinance of 1952. The ordinance was designed to prevent non-viable banks from mushrooming, and to ensure orderly commercial banking. The banking ordinance triggered a rapid growth in the industry, with growth also came disappointment. By 1958, a few numbers of banks had failed. To curtail further failures and to prepare for indigenous control, in 1958, a bill for the establishment of Central Bank of Nigeria was presented to the House of Representatives of Nigeria. The Act was fully implemented on July 1, 1959, when the Central Bank of Nigeria came into full operation. In April 1960, the Bank issued its first treasury bills. In May 1961 the Bank launched the Lagos Bankers Clearing House, which provided licensed banks a framework in which to exchange and clear checks rapidly. By July 1, 1961 the Bank had completed issuing all denominations of new Nigerian notes and coins and redeemed all of the West African Currency Board's previous money.

3.1.2 The Origin of Central Bank of Nigeria

In 1892, Nigeria's first bank, the African Banking Corporation, was established. No banking legislation existed until 1952, at which point Nigeria had three foreign banks (the Bank of British West Africa, Barclays Bank, and the British and French Bank) and two indigenous banks (the National Bank of Nigeria and the African Continental Bank) with a collective total of forty branches. A 1952 ordinance set standards, required reserve funds, established bank examinations, and provided for assistance to indigenous banks. Yet for decades after 1952, the growth of demand deposits was slowed by the Nigerian propensity to prefer cash and to distrust checks for debt settlements.

British colonial officials established the West African Currency Board in 1912 to help finance the export trade of foreign firms in West Africa and to issue a West African currency convertible to British pounds sterling. But colonial policies barred local investment of reserves, discouraged deposit expansion, precluded discretion for monetary management, and did nothing to train Africans in developing indigenous financial institutions. In 1952, several Nigerian members of the Federal House of Assembly called for the establishment of a central bank to facilitate economic development. Although the motion was defeated, the colonial administration appointed a Bank of England official to study the issue. He advised against a central bank, questioning such a bank's effectiveness in an undeveloped capital market. In 1957, the Colonial Office sponsored another study that resulted in the establishment of a Nigerian central bank and the introduction of a Nigerian currency. The Nigerian pound (see Glossary), on a par with the pound sterling until the British currency's devaluation in 1967, was converted in 1973 to a decimal currency, the naira (N), equivalent to two old Nigerian pounds. The smallest unit of the new currency was the kobo, 100 of which equaled 1 naira. The naira, which exchanged for US\$1.52 in January 1973 and again in March 1982 (or N0.67=US\$1), despite the floating exchange rate, depreciated relative to the United States dollar in the 1980s. The average exchange rate in 1990 was N8.004=US\$1. Depreciation accelerated after the creation of a second-tier foreign exchange market under World Bank structural adjustment in September 1986. As 2014, the Naira further depreciated to N166 per \$1.

The Central Bank of Nigeria, which was statutorily independent of the Federal Government until 1968, began operations on July 1, 1959. Following a decade of struggle over the relationship between the government and the Central Bank, a 1968 military decree granted authority over banking and monetary policy to the Federal Executive Council. The role of the Central Bank, similar to that of central banks in North America and Western Europe, was to establish the Nigerian currency, control and regulate the banking system, serve as banker to other banks in Nigeria, and carry out the government's economic policy in the monetary field. This policy included control of bank credit growth, credit distribution by sector, cash reserve requirements for commercial banks, discount rates and interest rates the Central Bank charged commercial and merchant banks and the ratio of banks' long-term assets to deposits. Changes in Central Bank's restrictions on credit and monetary expansion affected total demand and income. For

example, in 1988, as inflation accelerated, the Central Bank tried to restrain monetary growth. During the civil war, the government limited and later suspended repatriation of dividends and profits, reduced foreign travel allowances for Nigerian citizens, limited the size of allowances to overseas public offices, required official permission for all foreign payments, and, in January 1968, issued new currency notes to replace those in circulation. Although in 1970, the Central Bank advised against dismantling of import and financial constraints too soon after the war, the oil boom soon permitted Nigeria to relax restrictions. The three largest commercial banks held about one-third of total bank deposits. In 1973, the Federal Government undertook to acquire a 40-percent equity ownership of the three largest foreign banks. In 1976, under the second Nigerian Enterprises Promotion Decree requiring 60 percent indigenous holdings, the Federal Government acquired an additional 20 percent holding in the three largest foreign banks and 60 percent ownership in the other foreign banks. Yet, indigenization did not change the management, control, and lending orientation toward international trade, particularly of foreign companies and their Nigerian subsidiaries of foreign banks.

At the end of 1988, the banking system consisted of the Central Bank of Nigeria, forty-two commercial banks, and twenty-four merchant banks, a substantial increase since 1986. Merchant banks were allowed to open checking accounts for corporations only and could not accept deposits below N50,000. Commercial and merchant banks together had 1,500 branches in 1988, up from 1,000 in 1984. In 1988, commercial banks had assets of N52.2 billion compared to N12.6 billion for merchant banks in early 1988. In 1990, the government put N503 million into establishing community banks to encourage community development associations, cooperative societies, farmers' groups, patriotic unions, trade groups, and other local organizations, especially in rural areas.

Other financial institutions included government-owned specialized development banks: the Nigerian Industrial Development Bank, the Nigerian Bank for Commerce and Industry, and the Nigerian Agricultural Bank, as well as the Federal Savings Banks and the Federal Mortgage Bank. Also active in Nigeria were numerous insurance companies, pension funds, and finance and leasing companies. Nigeria also had a stock exchange (established in Lagos in 1961) and a number of stockbrokerage firms. The Securities and Exchange Commission (SEC) Decree of 1988 gave the Nigerian SEC powers to regulate and supervise the capital market. These powers included the right to revoke stockbroker registrations and approve or disapprove any new stock exchange. Established in 1988, the Nigerian Deposit Insurance Corporation increased confidence in the banks by protecting depositors against bank failures in licensed banks up to N50,000 in return for an annual bank premium of nearly 1 percent of total deposit liabilities.

Finance and insurance services represented more than 3 percent of Nigeria's GDP in 1988. Economists agree that services, consisting disproportionately of nonessential items, tend to expand as a share of national income as a national economy grows. However,

Nigeria lacked comparable statistics over an extended period, preventing generalizations about the service sector. Statistics indicate, nevertheless, that services went from 28.9 percent of GDP in 1981 to 31.1 percent in 1988, a period of no economic growth. In 1988, services comprised the following percentages of GDP: wholesale and retail trade, 17.1 percent; hotels and restaurants, less than 1 percent; housing, 2.0 percent; government services, 6. percent; real estate and business services, less than 1 percent; and other services, less than 1 percent.

Self Assessment Exercise

List the first 2 foreign-owned commercial banks and the first 2 locally-owned commercial banks in Nigeria.

3.2 Functions of Central Bank of Nigeria

The functions of CBN are;

- a. Issuance of Legal Tender Currency Notes and coins:** The Central Bank of Nigeria engages in currency issue and distribution within the economy. The Bank assumed these important functions since 1959 when it replaced the West African Currency Board (WACB) pound then in circulation with the Nigerian pound. The decimal currency denominations, Naira and Kobo, were introduced in 1973 in order to move to the metric system, which simplifies transactions. In 1976, a higher denomination note – N20 joined the currency profile. In 1984, a currency exchange was carried out whereby, the colors of existing currencies were swapped in order to discourage currency hoarding and forestall counterfeiting. In 1991, a currency reform was carried out which brought about the phasing out of 2kobo and 5kobo coins, while the 1k, 10k and 25k coins were redesigned. In addition, the 50k and N1 notes were coined, while the N50 note was put in circulation. In the quest to enhance the payments system and substantially reduces the volume and cost of production of “legal tender notes”, the N100 and N200 notes were issued in December 1999 and November 2000, respectively. Similarly, the N500 note was issued in 2001;
- b. Maintenance of Nigeria’s External Reserves:** In order to safeguard the international value of the legal tender currency, the CBN is actively involved in the management of the country’s debt and foreign exchange;
- c. Debt Management:** In addition to its function of mobilizing funds for the Federal Government, the CBN in the past managed its domestic debt and services external debt on the advice of the Federal Ministry of Finance. On the domestic front, the Bank advises the Federal Government as to the timing and size of new debt instruments, advertises for public subscription to new issues, redeems matured stocks, pays interest and principal as and when due, collects

- proceeds of issues for and on behalf of the Federal Government, and sensitizes the Government on the implications of the size of debt and budget deficit, among others. On external debt service, the CBN also cooperates with other agencies to manage the country's debt. In 2001, the responsibility of debt management was transferred to Debt Management Office (DMO);
- d. Foreign Exchange Management:** Foreign Exchange management involves the acquisition and deployment of foreign exchange resources in order to reduce the destabilizing effects of short-term capital flows in the economy. The CBN monitors the use of scarce foreign exchange resources to ensure that foreign exchange disbursements and utilization are in line with economic priorities and within the annual foreign exchange budget in order to ensure available balance of payments position as well as the stability of the Naira;
 - e. Promotion and Maintenance of Monetary Stability and a Sound and Efficient Financial System:** The effectiveness of any central bank in executing its functions hinges crucially on its ability to promote monetary stability. Price stability is indispensable for money to perform its role of medium of exchange, store of value, standard of deferred payments and unit of account. Attainment of monetary stability rests on a central bank's ability to evolve effective monetary policy and to implement it effectively. Since June 30, 1993 when the CBN adopted the market-based mechanism for the conduct of monetary policy, Open Market Operations (OMO) has constituted the primary tool of monetary management supported by reserve requirements and discount window operations for enhanced effectiveness in liquidity management. Specifically, liquidity management by the Central Bank of Nigeria involves the routine control of the level of liquidity in the system in order to maintain monetary stability. Periodically, the CBN determines target growth rates of money supply, which are compatible with overall policy goals. It also seeks to align commercial and merchant banking activities with the overall target. The CBN, through its surveillance activities over banks and non-bank financial institutions seeks to promote a sound and efficient financial system in Nigeria.
 - f. Banker and Financial Adviser to the Federal Government:** The CBN as banker to the Federal government undertakes most of Federal Government banking businesses within and outside the country. The Bank also provides banking services to the State and Local Governments and may act as banker to institutions, funds or corporation set up by the Federal, State and Local Governments. The CBN also finances government in period of temporary budget shortfalls through Ways and Means Advances subject to limits imposed by law. As financial adviser to the Federal Government, the Bank advises on the nature and size of government debt instruments to be issued, while it acts as the issuing house on behalf of government for the short, medium and long-term debt instruments. The Bank coordinates the financial needs of

government in collaboration with the treasury to determine appropriately the term, timing of issue and volume of instruments to raise funds for government financing.

- g. Banker and Lender of Last Resort to Banks:** The CBN maintains current account for deposit money banks. It also provides clearing house facilities through which instruments from the banks are processed and settled. Similarly, it undertakes trade finance functions on behalf of banks' customers. Finally, it provides temporary accommodation to banks in the performance of its functions as lender of last resort.

3.3 Policy Implementation and Criticism

The CBN's early functions were mainly to act as the government's agency for the control and supervision of the banking sector, to monitor the balance of payments according to the demands of the Federal Government and to tailor monetary policy along the demands of the federal budget. The central bank's initial lack of financial competence over the finance ministry led to deferment of major economic decisions to the finance ministry. A key instrument of the bank was to initiate credit limit legislation for bank lending. The initiative was geared to make credit available to the neglected national areas such as agriculture and manufacturing. By the end of 1979, most of the banks did not adhere to their credit limits and favoured a loose interpretation of CBN's guidelines. The central bank did not effectively curtail the prevalence of short-term loan maturities. Most loans given out by commercial banks were usually set within a year. The major policy to balance this distortion in the credit market was to create a new Bank of Commerce and Industry, a universal bank. However, the new bank did not fulfill its mission.

Another policy of the bank in concert with the intentions of the government was direct involvement in the affairs of the three major expatriate commercial banks in order to forestall any bias against indigenous borrowers and consumers. By 1976, the Federal Government had acquired 40% of equity in the three largest commercial banks. The bank's slow reaction to curtail inflation by financing huge deficits of the Federal Government has been one of the sore points in the history of the central bank. Coupled with its failure to control the burgeoning trade arrears in 1983, the country was left with huge trade debts totaling \$6 billion.

4.0 CONCLUSION

The Central Bank of Nigeria (CBN) plays a prominent role in economic development. It plays a promotional, financial, operational, regulatory and participatory role in the money market and the capital market.

There is the need for close integration between the CBN's policies and those of the Federal Government in order to achieve macro-economic stability. There is also the need to guarantee CBN autonomy and should be insulated from interference by the government.

5.0SUMMARY

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

In the next unit which is Unit 5 and the last in our Module 2, we shall discuss comparative banking and financial system.

6.0TUTOR MARKED ASSIGNMENT

1. Analyze the functions of the Central Bank of Nigeria.
2. Undertake a critique of the policy implementation of the Nigerian apex bank.

7.0 REFERENCES AND FURTHER READING

Jhingan, M.L. (2004). *Monetary Economics*. Delhi: Vrinda publications (P) Ltd

UNIT 5: COMPARATIVE BANKING SYSTEM

CONTENT

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3.5.1 Advantages of Universal Banking**3.5.2 Disadvantages of Universal Banking****4.0 Conclusion****5.0 Summary****6.0 Tutor Marked Assignment****7.0 References and Further Reading****1.0 INTRODUCTION**

In the preceding unit, we learnt the history of Central Bank of Nigeria, its authorizing legislation and origin. The discussion on CBN also led us to the consideration of its functions, its policy implementation and criticism.

In the present unit which is Unit 5 and the last in our Module 2, we shall discuss comparative banking system.

2.0 OBJECTIVES

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

- Discuss unit banking
- Explain Advantages and disadvantages of unit banking
- Discuss branch banking
- Explain the advantages and disadvantages of branch banking
- Discuss group banking
- Explain the advantages and disadvantages of group banking
- Discuss chain banking
- Discuss universal banking
- Explain the advantages and disadvantages of universal banking

3.0 MAIN CONTENT**3.1 Unit Banking**

In most cases, banking systems are classified in terms of their structure as unit banking, branch banking, or hybrids of the two. However, multi-office banking may occur in any of three forms: branch, group, or chain banking.

Unit banking refers to a system in which each banking firm has only one office. The United States banking system can be characterized as a Unit Banking System though recently there has been expansion in multiple-office banking which may occur in any of

three forms: branch banking, group banking, and chain banking. It is important to state that the American legal framework contributed to the tendency towards unit banking.

3.1.1 Advantages of Unit Banking

Unit banking has the following advantages:

- a.** It is a reliable method of ensuring that the savings of a locality are more or less utilized in the investment ventures of the same area. In this way, savers find that their efforts provide a stimulus to production and employment in the neighbourhood itself.
- b.** It is able to meet specific requirements of borrowers since the management of the bank is in a better position to appreciate the problems and difficulties of borrowers. The management is also better able to evaluate the profit prospects of different investment ventures, as also the credit worthiness of the borrowers; hence it can adopt suitable criteria of judging credit worthiness and viability of the projects.
- c.** The possibility of fraudulent practices is very low in unit banking since the bank owners themselves will not be tempted to cheat the depositors and will be able to maintain a strict vigil on the activities of the managers and other officials of the bank.
- d.** The management does not suffer from laxity of supervision or top heavy expensive management. Thus, unit banks are able to economize in their operating costs. However, low operating costs is a function of the efficiency of management.
- e.** It prevents centralization of credit-power in the hand of monopolistic groups.

3.1.2 Disadvantages of Unit Banking

The following are disadvantages of unit banking;

- a.** A unit bank tends to rely upon the prosperity of a small area for its own prosperity and success. This tends to hinder its progress and development.
- b.** There is a very low capacity to weather crisis since unit banks are more liable to rush and ill- equipped to face it.
- c.** Due to their relatively small scale of operations and total resources, unit banks are not able to acquire the services of specialists and are therefore not able to judge the viability of many projects.
- d.** Thus in many cases, unit banks might miss the opportunities of financing sound proposals, or might undertake to finance unduly risky projects.
- e.** Due to the absence of competition in most cases, local communities suffer from local unit banking monopoly.

3.2 Branch Banking

Branch banking is the act of doing one's banking business at a location that is separate from the bank's central business location. Many large and small banks use branch banking in order to extend the reach of their services to different locations in a community, state, or country. Smaller branches are also less expensive to operate, and often easier for customers to access, while providing all of the features of a larger bank. Historically, branch banks were part of a larger building, often found in strip malls or even in grocery stores or discount stores, sharing the location with another business. Today, however, branch banking can take place at a number of different locations, and many banks build individual branch locations that are independent of other businesses. Each type of location is still considered a branch bank.

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

3.2.1 Advantages of Branch Banking

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

a. Economies of Large Scale Operations: Under the branch banking system, the bank with a number of branches possesses huge financial resources and enjoys the benefits of large-scale operations such as;

- i. Highly trained and experienced staff is appointed which increases the efficiency of management,
- ii. Division of labour is introduced in the banking operations which ensure greater economy in the working of the bank. Right persons are appointed at the right place and specialization increases,
- iii. Funds are made available liberally and at cheaper rates,
- iv. Foreign exchange business is done economically,
- v. Large financial resources and wider geographical coverage increases public confidence in the banking system.

b. Spreading of Risk: Another advantage of the branch banking system is the lesser risk and greater capacity to meet risks. This is because;

- i. Since there is geographical spreading and diversification of risks, the possibility of the failure of the of the bank is remote,
- ii. The losses incurred by some branches may be offset by the profits earned by other branches,

- iii. Large resources of branch banks increase their ability to face any crisis.
- c. **Economy in Cash Reserves:** Under the branch banking system, a particular branch can operate without keeping large amounts of idle reserves. In time of the need, resources can be transferred from one branch to another.
- d. **Diversification on Deposits and Assets:** There is greater diversification of both deposits and assets under branch banking system because of wider geographical coverage, which leads to;
 - i. Deposits are received from the areas where savings are in plenty,
 - ii. Loans are extended in those areas where funds are scarce and interest rates are high. The choice of securities and investments is larger in this system which increases the safety and liquidity of funds.
- e. **Cheap Remittance Facilities:** Since bank branches are spread over the whole country, it is easier and cheaper to transfer funds from one place to another. Inter-branch indebtedness is more easily adjusted than inter-bank indebtedness.
- f. **Uniform Interest Rates:** Under branch banking system, mobility of capital increases, which in turn, brings about equality in interest rates. Funds are transferred from areas with excessive demand for money to areas with deficit demand for money. As a result, the uniform rate of interest prevails in the whole area; it is prevented from rising in the excessive demand area and from falling in the deficit demand area.
- g. **Proper Use of Capital:** There is proper use of capital under the branch banking system. If a branch has excess reserves, but no opportunities for investment, it can transfer the resources to other branches which can make most profitable use of these resources.
- h. **Better Facilities to Customers:** The customers get better and greater facilities under the branch banking system. It is because of the small number of customers per branch and the increased efficiency achieved through large scale operations.
- i. **Banking Facilities in Backward Areas:** Under the branch banking system, the banking facilities are not restricted to big cities. They can be extended to small towns and rural as well as underdeveloped areas. Thus, this system helps in the development of backward regions of the country.
- j. **Effective Control:** Under the branch banking system, The Central bank has a more efficient control over the banks because it has to deal only with few big banks and not with each individual branch. This ensures better implementation of monetary policy.

3.2.2 Disadvantages of Branch Banking

The following are the main disadvantages and limitations of branch banking system:

- a. **Problem of Management:** Under the branch banking system a number of difficulties as regards management, supervision and control arise. These are:
 - i. Since the management of the bank gets concentrated at the head office, the managers can afford to be lax and indulgent in their duties and are often involved in serious irregularities while using the funds.

- ii. Since the branch manager has to seek permission from the head office on each and every matter, this results in unnecessary delay and red-tapism in the banking business.
- b. Lack of Initiative:** Branch managers generally lack initiative on all-important matters; they cannot take independent decisions and have to wait for the clearance signal from the head office.
- c. Monopolistic Tendencies:** Branch banking encourages monopolistic tendencies in the banking system. A few big banks dominate and control the whole banking system of the country through their branches. This can lead to the concentration of resources into a few hands.
- d. Regional Imbalances:** Under branch banking system, the financial resources collected in the smaller and backward regions are transferred to the bigger industrial centres. This encourages regional imbalances in the country.
- e. Adverse Linkage Effect:** Under branch banking system, the losses and weaknesses of some branches also have their effect on other branches of the bank.
- f. Inefficient Branches:** In this system, the weak and unprofitable branches continue to operate under the protection cover of the large and more profitable branches.
- g. Other Defects:** Other defects of branch banking system are as follows:
 - i. Preferential treatment is given to the branches near the head office,
 - ii. Higher interest rates are charged in the developed area to compensate for the lower rates charged in the backward areas,
 - iii. There is concentration and unhealthy competition among the branches of different banks in big cities,
 - iv. Many difficulties are faced when a bank opens branches in foreign countries.

Self Assessment Exercise

List the names and number of branches of banks in your place of residence.

3.3 Group Banking

Group banking can refer either to banking provided to a specific group of people with customized services for their needs or to the formation of a holding company in control of several banks. The type of banking is usually evident from the context, as the two concepts are very different.

In the first sense, group banking often comes up in the context of employees who join a bank or credit union together. The employer works with the bank to create an incentive program encouraging people to sign up. Members of the group may get discounts on fees, access to special services, and greater control over retirement accounts along with offers for insurance and other products. While people are not required to participate in group banking, the benefits of the program are often a compelling argument to join. For banks, group banking provides a ready-made group of customers, a distinct benefit. The bank

does not have to recruit customers, because they sign up on their own. In addition, bureaucratic costs associated with things like direct deposit of paychecks are greatly reduced when employers and employees bank in the same location. Banks get access to capital through the deposits of group banking participants and the participants get benefits like special interest rates, account features like free traveler's checks, and so forth.

Group banking in the sense of holding companies in control of banks consists of a holding company with a majority share in two or more banks. The banks have their own boards and are run as independent entities, but the holding company controls their activities and has the power to outvote other shareholders. Depending on regional laws and the percentage of shares owned, the holding company's ownership may need to be approved by government regulators to address concerns about the potential for creating a banking monopoly, where free market competition is limited by having a single company control the bulk of the companies offering banking services.

3.3.1 Advantages of Group Banking

The following are the advantages of the Group Banking System:

- (i) **Centralized Administration:** The participating banks enjoy the benefits of centralized administration.
- (ii) **Enhancement of operational efficiency:** Because of Group banking system, the operational efficiency of participant banks is enhanced through shared knowledge and experience.
- (iii) **Broader market:** Group Banking offers broader market to the small banks for their excess resources. Thus, their earning capacity and network improved.
- (iv) **Mobility and transfer of resources:** In the case of crisis, the funds are transferred among participating banks. This helps them to face the financial crisis if any, more effectively
- (v) **Large-scale operation:** Group banking paves the way for large scale operation. The member banks can get the economies of large scale operation.
- (vi) **Other Benefits:** The holding company offers the following services to the participating banks:
 - a. Guidance of experts
 - b. Auditing
 - c. Investment counseling
 - d. Combined Purchase of stationery and office equipments
 - e. Insurance cover on deposits
 - f. Advertising and publicity
 - g. Tax guidance

- h. Other advisory services.

3.3.2 Disadvantages of Group Banking

The disadvantages of the Group Banking System are as follows:

- (i) **Lack of effective management and control:** Under Group banking system the control and management is not effective because the control is indirect and more flexible. It cannot offer specialized management.
- (ii) **Inefficiency of member banks protected:** The inefficiency of one participating bank affects the other participating banks.
- (iii) **Fewer facilities:** This system cannot provide all the facilities offered by branch banking.
- (iv) **Cannot mobilize funds:** Group banking does not have the capacity to mobilize funds as in the case with branch banking. Hence, it cannot offer the same economy of operations as are offered by branch banking.

3.4 Chain Banking

Chain banking is a situation in which three or more banks that are independently chartered are controlled by a small group of people. The mechanisms used to establish this type of arrangement normally involve securing enough stock between the individuals to have a controlling interest in each of the bank corporations involved. The arrangement can also be managed with the establishment of interlocking directorates or boards of directors that effectively create a network between the banks without the need for some type of central holding company.

The concept of chain banking is different from group banking, in that the entities involved in the chain bank arrangement remain autonomous and are not owned by a single holding company. By contrast, the group banking model requires a holding company to own all the banks involved, effectively creating an umbrella under which all the banks operate. Chain banking is also different from branch banking, a situation where all local branches of a bank are owned by a single banking institution.

In years past, chain banking afforded several benefits for investors. The strategy made it possible to earn steady returns from several banks that operated in the same community, without any fears of a great deal of competition from other banks in the area. The network approach made it possible for investors to use their cumulative influence to keep bank services and their attendant fees similar from one enterprise to another, thus ensuring that returns remained consistent. The chain banking process also made it possible for investors to create a network where each bank in the chain served a different part of the market within the area. For example, one bank may focus on business

accounts while another specialize in personal accounts, and the third bank in the chain provided services related to the purchase and sale of securities.

Over time, the chain banking approach has become less popular in a number of nations. This is due to changes in banking laws in many places that helped to redefine the process of interstate banking as well as international banking. This redefinition has made it possible for some banks that were once somewhat restricted in what they could offer customers to be able to offer a wider range of services. With more liberalized banking laws in many jurisdictions, the benefits afforded by the chain banking model can now be realized using other approaches, sometimes with a greater degree of efficiency and without the need for establishing this type of investor network.

3.5 Universal Banking

There is no universally accepted definition of ‘Universal Banking’. A ‘Universal Bank’ refers to a bank which offers a wide variety of financial services beyond the strict traditional boundaries of a commercial bank. According to the traditional description of a commercial bank, it confines itself to the core business of accepting deposits and providing working capital finance to industry, trade, commerce and agriculture. If this could be considered as one extreme, universal banking is the other extreme. It would not be an exaggeration to state that universal bank is “financial services supermarket”, since universal banking is a combination of commercial banking, investment banking and various other activities including insurance. A universal bank offers this entire range of financial services within the bank or through subsidiaries.

Most countries permit universal banking, although it is common in European countries. Universal banking is set to dominate world financial scene. It is set to take off in a major way in the global market. It may be mentioned in this connection that in the USA, the Glass Steagall Act which had imposed severe restrictions on commercial banks, investment banks and insurance companies has been scrapped, thus enabling possible mergers and acquisitions in this field, resulting in universal banking in a big way. The term **Glass–Steagall Act** usually refers to four provisions of the U.S. Banking Act of 1933 that limited commercial bank securities activities and affiliations between commercial banks and securities firms. Universal banking has its own advantages while one cannot deny the fact that it has its own disadvantages also.

3.5.1 Advantages of Universal Banking

The benefits or advantages of universal banking are:-

- i. **Investors Trust:** Universal banks hold stakes (equity shares) of many companies. These companies can easily get other investors to invest in their business. This is because other investors have full confidence and

faith in the Universal banks. They know that the Universal banks will closely watch all the activities of the companies in which they hold a stake.

- ii. **Economies of Scale:** Universal banking results in economic efficiency. That is, it results in lower costs, higher output and better products and services. In Nigeria, RBI is in favour of universal banking because it results in economies of scale.
- iii. **Resource Utilization:** Universal banks use their client's resources as per the client's ability to take a risk. If the client has a high risk taking capacity then the universal bank will advise him to make risky investments and not safe investments. Similarly, clients with a low risk taking capacity are advised to make safe investments. Today, universal banks invest their client's money in different types of Mutual funds and also directly into the share market. They also do equity research. So, they can also manage their client's portfolios (different investments) profitably.
- iv. **Profitable Diversification:** Universal banks diversify their activities. So, they can use the same financial experts to provide different financial services. This saves cost for the universal bank. Even the day-to-day expenses will be saved because all financial services are provided under one roof, i.e. in the same office.
- v. **Easy Marketing:** The universal banks can easily market (sell) all their financial products and services through their many branches. They can ask their existing clients to buy their other products and services. This requires less marketing efforts because of their well-established brand name. For e.g. WEMA may ask their existing bank account holders in all their branches, to take house loans, insurance, to buy their Mutual funds, etc. This is done very easily because they use one brand name (WEMA) for all their financial products and services
- vi. **One-stop Shopping:** Universal banking offers all financial products and services under one roof. One-stop shopping saves a lot of time and transaction costs. It also increases the speed or flow of work. So, one-stop shopping gives benefits to both banks and their clients.

3.5.2 Disadvantages of Universal Banking

The limitations or disadvantages of universal banking are:-

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

- ii. Effect of failure on Banking System:** Universal banking is done by very large banks. If these huge banks fail, then it will have a very big and bad effect on the banking system and the confidence of the public. For e.g. Recently, Lehman Brothers a very large universal bank failed. It had very bad effects in the USA, Europe and even in India.
- iii. Monopoly:** Universal banks are very large. So, they can easily get monopoly power in the market. This will have many harmful effects on the other banks and the public. This is also harmful to economic development of the country.
- iv. Conflict of Interest:** Combining commercial and investment banking can result in conflict of interest. That is, Commercial banking versus Investment banking. Some banks may give more importance to one type of banking and give less importance to the other type of banking. However, this does not make commercial sense.

3.0 CONCLUSION

Commercial banks differ in their organization and structure from country to country. The two principal banking systems are the unit banking and the branch banking. The unit banking is peculiar in the USA. Branch banking, on the other hand, is found in England, Australia, Canada, New Zealand and Nigeria. Two other important types are the group banking and the chain banking which are also found in the USA.

4.0 SUMMARY

In this unit, you learnt unit banking and its advantages and disadvantages, branch banking and its advantages and disadvantages as well as group banking and its advantages and disadvantages. You also learnt chain banking, universal banking and its advantages and disadvantages.

This Unit 5 concludes our Module 2. We shall start Module 3 with a discussion of international financial institutions in the next unit.

6.0 TUTOR-MARKED ASSIGNMENT

1. The concept of chain banking is different from group banking. Discuss
2. Define and explain universal banking

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MODULE 3

Unit 1: International Financial Institutions

Unit 2: The International Monetary Fund (IMF)

Unit 3: The African Development Bank (AfDB)

Unit 4: The IBRD/World Bank

Unit 5: The World Bank Group

UNIT 1: INTERNATIONAL FINANCIAL INSTITUTIONS

CONTENT

1.0 Introduction

2.0 Objectives

3.0 Main Content

3.1 Meaning of International Financial Institutions

3.2 Multilateral development bank

3.3 Bretton Woods institutions

3.4 Regional development banks

3.4.1 Other regional financial institutions

- 3.5 Bilateral development banks and agencies
- 4.0 Conclusion
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4.0 INTRODUCTION

In the preceding unit, which was the last in our Module 2, we learnt unit banking and its advantages and disadvantages, branch banking and its advantages and disadvantages as well as group banking and its advantages and disadvantages. We also discussed chain banking, universal banking and its advantages and disadvantages.

In the present unit which is first in our Module 3, we shall discuss international financial institutions.

2.0 OBJECTIVES

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

- Explain the meaning of international financial institutions
- Describe a multilateral development bank
- List the Bretton Woods institutions
- Describe Regional development banks and other regional financial institutions
- Explain Bilateral development banks and agencies

3.0 MAIN CONTENT

3.1 Meaning of International Financial Institutions

International financial institutions (IFIs) are financial institutions that have been established (or chartered) by more than one country, and hence are subjects of international law. Their owners or shareholders are generally national governments, although other international institutions and other organizations occasionally figure as shareholders. The most prominent IFIs are creations of multiple nations, although some bilateral financial institutions (created by two countries) exist and are technically IFIs. Many of these are multilateral development banks (MDBs).

3.2 Multilateral development bank

A multilateral development bank (MDB) is an institution, created by a group of countries that provides financing and professional advising for the purpose of development. MDBs have large memberships including both developed donor countries and developing borrower countries. MDBs finance projects in the form of long-term loans at market rates, very-long-term loans (also known as credits) below market rates, and through grants.

The followings are usually classified as the main MDBs:

- World Bank
- European Investment Bank(EIB)
- Asian Development Bank (ADB)
- European Bank for Reconstruction and Development (EBRD)
- Inter-American Development Bank Group (IDB, IADB)
- African Development Bank (AfDB)
- Islamic Development Bank (IsDB)

There are also several "sub-regional" multilateral development banks. Their membership typically includes only borrowing nations. The banks lend to their members, borrowing from the international capital markets. Because there is effectively shared responsibility for repayment, the banks can often borrow more cheaply than could any one member nation. These banks include:

- CAF - Latin America Development Bank (CAF)
- Caribbean Development Bank (CDB)
- Central American Bank for Economic Integration (CABEI)
- East African Development Bank (EADB)
- West African Development Bank (BOAD)
- Black Sea Trade and Development Bank (BSTDB)
- Eurasian Development Bank (EDB)

There are also several multilateral financial institutions (MFIs). MFIs are similar to MDBs but they are sometimes separated since they have more limited memberships and often focus on financing certain types of projects.

- European Commission (EC)
- International Finance Facility for Immunisation (IFFIm)
- International Fund for Agricultural Development (IFAD)
- Nordic Investment Bank (NIB)
- OPEC Fund for International Development (OPEC Fund)
- Nederlandse Financieringsmaatschappij voor Ontwikkelingslanden NV (FMO)

3.3 Bretton Woods institutions

The best-known International Financial Institutions (IFIs) were established after World War II to assist in the reconstruction of Europe and provide mechanisms for international cooperation in managing the global financial system. They include the World Bank, the IMF, and the International Finance Corporation. Today, the largest IFI in the world is the European Investment Bank which lent 61 billion Euros to global projects in 2011. According to (Mishkin and Eakins, 2012), “The Bretton Woods system and the IMF were established to promote a fixed exchange rate system in which the U.S. Dollar, the reserve currency, was convertible into gold. The Bretton Woods system collapsed in 1971. We now have an international system that has elements of a managed float and fixed exchange rate system. You should note that some exchange rates fluctuate from day to day, although central banks intervene in the foreign exchange market while, while other exchange rates are fixed.” The Bretton Woods institutions are:

Founded	Name	www Address	Notes	HQ
1944	IMF International Monetary Fund	http://www.imf.org	Specialised agency of the UN	Washington (District of Columbia)
1944	IBRD International Bank for Reconstruction and Development	http://www.worldbank.org	World Bank Group, Specialised agency of the UN	Washington (District of Columbia)
1956	IFC International Finance Corporation	http://www.ifc.org	World Bank Group	Washington DC
1960	IDA International Development Association	http://www.worldbank.org/ida	World Bank Group	Washington DC

1966	ICSID, International Centre for Settlement of Investment Disputes	http://icsid.worldbank.org/ICSID/Index.jsp	World Bank Group	Washington DC
1988	MIGA Multilateral Investment Guarantee Agency	http://www.miga.org	World Bank Group	Washington DC
30/10/47	GATT General agreement on tariffs and trade, basis for the creation of World Trade Organization (WTO) in 1995	http://www.wto.org/english/docs_e/legal_e/06-gatt_e.htm http://wto.org	The GATT is not an organisation. The WTO is not a United Nations agency	Geneva for the WTO

Source: Wikipedia: International Financial Institutions (2014)

Self Assessment Exercise

Why did the Bretton Woods system collapsed in 1971?

3.4 Regional development banks

The regional development banks consist of several regional institutions that have functions similar to the World Bank group's activities, but with particular focus on a specific region. Shareholders usually consist of the regional countries plus the major donor countries. The best-known of these regional banks cover regions that roughly correspond to United Nations regional groupings, including the Inter-American Development Bank, the Asian Development Bank; the African Development Bank; and the European Bank for Reconstruction and Development. These are:

Founded	Name	www Address	Notes	HQ
1959	IDB Interamerican Development Bank	http://www.IADB.org	Works in the Americas, but primarily for development in Latin America and the Caribbean	Washington
1964	AFDB African Development Bank	http://www.afdb.org	Africa	Abidjan
1966	ADB Asian Development Bank	http://www.adb.org	Asia	Manilla
29/5/91	EBRD European Bank for Reconstruction and Development	http://www.ebrd.com		London
16/4/56	CEB Council of Europe Development Bank	http://www.coebank.org	Coordinated organisation	Paris
14/11/73	BOAD Banque ouest-africaine de développement West African Development Bank	http://www.boad.org	Union économique et monétaire ouest-africaine, Cf. BCEAO Banque centrale des États de l'Afrique de l'Ouest	Lomé
1975	BDEAC Banque de développement des États de l'Afrique Centrale, DBCAS Development Bank of Central African States	http://www.bdeac.org	Communauté économique et monétaire de l'Afrique centrale (CEMAC), Cf. BEAC Banque des États de l'Afrique centrale	Brazzaville, Congo

3.4.1 Other regional financial institutions

Financial institutions of neighboring countries established themselves internationally to pursue and finance activities in areas of mutual interest; most of them are central banks, followed by development and investment banks. The table below lists some of them in chronological order of when they were founded or listed as functioning as a legal entity. Some institutions were conceived and started working informally 2 decades before their legal inception (e.g. the South East Asian Central Banks Centre)

Founded	Name	www Address	Notes	HQ
17/5/1930	BIS Bank of International Settlements	http://www.bis.org	The bank of all central banks, 60 members	Basle, Basel, Bâle
1958	EIB European Investment Bank	http://www.eib.org	Created by European Union member states to provide long-term finance, mainly in the EU	Luxembourg
2/15/1965	AACB African Association of Central Banks, ABCA Association des Banques Centrales Africaines	http://www.aacb.org/	consists of 40 African central banks	Dakar, Senegal.
10/7/1970	International Investment Bank of Comecon		established by 7 countries of the former Soviet Union and Eastern Europe ^[4] -no longer functioning	Moscow
1975	IDB Islamic Development Bank	http://www.isdb.org	56 members, established by the Conference of Finance Ministers of Muslim Countries held in Jeddah, December 1973	Jeddah, Saudi Arabia
8/1976	NIB Nordic Investment Bank ^[5]	http://www.nib.int	Lending operations in its 8 member countries and emerging markets on all continents. ^[6]	Helsinki, Finland
3/2/1982	SEACEN South East Asian Central Banks Centre	http://www.seacen.org	19 Asian central banks	Kuala Lumpur, Malaysia
24/1/1997	BSTDB Black Sea Trade and Development Bank	http://www.bstdb.org	11 member countries, corresponding to the Organization of the Black Sea Economic Cooperation	Thessaloniki, Greece
1998	ECB European Central Bank	http://www.ecb.int	Central bank of 18 EU countries that have adopted the euro	Frankfurt am Main

Source: Wikipedia: International Financial Institutions (2014)

3.5 Bilateral development banks and agencies

A bilateral development bank is a financial institution set up by one individual country to finance development projects in a developing country and its emerging market, hence the term bilateral, as opposed to multilateral. Examples include:

- the Netherlands Development Finance Company FMO, headquarters in The Hague; one of the largest bilateral development banks worldwide.
- the DEG German Investment Corporation or Deutsche Investitions- und Entwicklungsgesellschaft,^[2] headquartered in Köln, Germany.
- the French Development Agency Agence Française de Développement, and Caisse des dépôts, founded 1816, both headquartered in Paris, France.

4.0 CONCLUSION

The International Financial Institutions or IFIs—the IMF, World Bank, multilateral development banks, and other international development agencies—can become more responsive to the needs of developing countries and ensure that growth opportunities they promote reach the world's poorest people.

The IFIs are major sources of financial and technical support for developing countries. While their influence on development outcomes is often less than their more virulent critics contend, it can be quite substantial, especially in smaller low-income countries. Yet the policies of these institutions are largely determined by the major shareholders—the rich countries that provide most of the capital—rather than by the borrowers. This lopsidedness should be addressed so that borrowers can have their say in the operation of the IFS.

5.0 SUMMARY

In this unit which is the first in our Module 3, you learnt the meaning of international financial institutions, the multilateral development banks, the Bretton Woods institutions, the regional development banks as well as bilateral development banks and agencies.

With this background we will now proceed to the next unit to discuss International Monetary Fund (IMF).

6.0 TUTOR-MARKED ASSIGNMENT

1. With at least 5 examples, define a multilateral development bank.
2. List 4 Regional Development Banks and 4 Bretton Woods Institutions.

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UNIT 2: THE INTERNATIONAL MONETARY FUND (IMF)

CONTENT

1.0 Introduction

2.0 Objectives

3.0 Main Content

3.1 Meaning of International Monetary Fund (IMF)

3.2 Functions of International Monetary Fund (IMF)

3.3 Surveillance of the global economy

3.4 Structural adjustment

3.5 Benefits of IMF loan conditions

3.6 Criticisms of IMF Conditionalities

3.7 Qualifications for Membership

3.8 Leadership of IMF

3.8.1 Board of Governors

3.9 Voting Power

3.9.1 Effects of the quota system

4.0 Conclusion

5.0 Summary

6.0Tutor Marked Assignment**7.0**References and Further Reading**1.0 INTRODUCTION**

In the preceding unit which was the first in our Module 3, we learnt the meaning of international financial institutions, the multilateral development banks, the Bretton Woods institutions, the regional development banks as well as bilateral development banks and agencies.

With that solid background, we will now proceed to the present unit to discuss International Monetary Fund (IMF).

2.0 OBJECTIVES

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

- Explain the meaning of international monetary fund (IMF);
- Analyze the functions of International Monetary Fund (IMF);
- Explain IMF surveillance of the global economy;
- Analyze structural adjustment;
- List benefits of IMF loan conditions;
- Do a critique of IMF conditionalities;
- State the qualifications for IMF membership;
- Describe the leadership of IMF;
- Explain IMF Board of Governors;
- Describe the voting power of IMF members; and
- Effects of the quota system;

3.0 MAIN CONTENT**3.1 Meaning of International Monetary Fund (IMF)**

The International Monetary Fund (IMF) is an international organization that was initiated in 1944 at the Bretton Woods Conference and formally created in 1945 by 29 member countries. The IMF's stated goal was to assist in the reconstruction of the world's international payment system post–World War II. Countries contribute money to a pool through a quota system from which countries with payment imbalances can borrow funds temporarily. Through this activity and others such as surveillance of its members' economies and the demand for self-correcting policies, the IMF works to improve the economies of its member countries (Escobar, 1980).

The IMF describes itself as “an organization of 188 countries, working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world.” (IMF, 2012). The organization's stated objectives are to promote international economic co-operation, international trade, employment, and exchange rate stability, including by making financial resources available to member countries to meet balance of payments needs. Its headquarters are in Washington, D.C., United States.

3.2 Functions of International Monetary Fund (IMF)

The IMF works to foster global growth and economic stability. It provides policy advice and financing to members in economic difficulties and also works with developing nations to help them achieve macroeconomic stability and reduce poverty. The rationale for this is that private international capital markets function imperfectly and many countries have limited access to financial markets. Such market imperfections, together with balance of payments financing, provide the justification for official financing, without which many countries could only correct large external payment imbalances through measures with adverse effects on both national and international economic prosperity (Isard, 2005). The IMF can provide other sources of financing to countries in need that would not be available in the absence of an economic stabilization program supported by the Fund.

Upon initial IMF formation, its two primary functions were: to oversee the fixed exchange rate arrangements between countries, thus helping national governments manage their exchange rates and allowing these governments to prioritize economic growth, and to provide short-term capital to aid balance-of-payments. This assistance was meant to prevent the spread of international economic crises. The Fund was also intended to help mend the pieces of the international economy post the Great Depression and World War II.

The IMF's role was fundamentally altered after the floating exchange rates post 1971. It shifted to examining the economic policies of countries with IMF loan agreements to determine if a shortage of capital was due to economic fluctuations or economic policy. The IMF also researched what types of government policy would ensure economic recovery (Jensen, April 2004). The new challenge is to promote and implement policy that reduces the frequency of crises among the emerging market countries, especially the middle-income countries that are open to massive capital outflows. Rather than maintaining a position of oversight of only exchange rates, their function became one of “surveillance” of the overall macroeconomic performance of its member countries. Their role became a lot more active because the IMF now manages economic policy instead of just exchange rates.

In addition, the IMF negotiates conditions on lending and loans under their policy of conditionality, which was established in the 1950s. Low-income countries can borrow on concessional terms, which mean there is a period of time with no interest rates, through the Extended Credit Facility (ECF), the Standby Credit Facility (SCF) and the Rapid Credit Facility (RCF). Non-concessional loans, which include interest rates, are provided mainly through Stand-By Arrangements (SBA), the Flexible Credit Line (FCL), the Precautionary and Liquidity Line (PLL), and the Extended Fund Facility. The IMF provides emergency assistance via the newly introduced Rapid Financing Instrument (RFI) to all its members facing urgent balance of payments needs.

3.3 Surveillance of the global economy

The IMF is mandated to oversee the international monetary and financial system and monitor the economic and financial policies of its 188 member countries. This activity is known as surveillance and facilitates international co-operation. Since the demise of the Bretton Woods system of fixed exchange rates in the early 1970s, surveillance has evolved largely by way of changes in procedures rather than through the adoption of new obligations. The responsibilities of the Fund changed from those of guardian to those of overseer of members' policies.

The Fund typically analyses the appropriateness of each member country's economic and financial policies for achieving orderly economic growth, and assesses the consequences of these policies for other countries and for the global economy.

3.3 Conditionality of loans

IMF conditionality is a set of policies or conditions that the IMF requires in exchange for financial resources. The IMF does not require collateral from countries for loans but rather requires the government seeking assistance to correct its macroeconomic imbalances in the form of policy reform. If the conditions are not met, the funds are withheld. Conditionality is perhaps the most controversial aspect of IMF policies. The concept of conditionality was introduced in an Executive Board decision in 1952 and later incorporated in the Articles of Agreement.

Conditionality is associated with economic theory as well as an enforcement mechanism for repayment. Stemming primarily from the work of Jacques Polak in the Fund's research department, the theoretical underpinning of conditionality was the "monetary approach to the balance of payments." (Chorev and Babb, June 2009)

3.4 Structural adjustment

Some of the conditions for structural adjustment can include:

- Cutting expenditures, also known as austerity.
- Focusing economic output on direct export and resource extraction,
- Devaluation of currencies,
- Trade liberalisation, or lifting import and export restrictions,
- Increasing the stability of investment (by supplementing foreign direct investment with the opening of domestic stock markets),
- Balancing budgets and not overspending,
- Removing price controls and state subsidies,
- Privatization, or divestiture of all or part of state-owned enterprises,
- Enhancing the rights of foreign investors vis-a-vis national laws,
- Improving governance and fighting corruption.

These conditions have also been sometimes labelled as the Washington Consensus.

3.5 Benefits of IMF loan conditions

These loan conditions ensure that the borrowing country will be able to repay the Fund and that the country won't attempt to solve their balance of payment problems in a way that would negatively impact the international economy. The incentive problem of moral hazard, which is the actions of economic agents maximizing their own utility to the detriment of others when they do not bear the full consequences of their actions, is mitigated through conditions rather than providing collateral; countries in need of IMF loans do not generally possess internationally valuable collateral anyway.

Conditionality also reassures the IMF that the funds lent to them will be used for the purposes defined by the Articles of Agreement and provides safeguards that country will be able to rectify its macroeconomic and structural imbalances. In the judgment of the Fund, the adoption by the member of certain corrective measures or policies will allow it to repay the Fund, thereby ensuring that the same resources will be available to support other members.

Self Assessment Exercise

Why did Nigeria opt for structural adjustment instead of IMF loan during IBB regime?

3.6 Criticisms of IMF Conditionalities

In some quarters, the IMF has been criticized for being 'out of touch' with local economic conditions, cultures, and environments in the countries they are requiring policy reform. The Fund knows very little about what public spending on programs like public health and education actually means, especially in African countries; they have no feel for the impact that their proposed national budget will have on people. The economic advice the

IMF gives might not always take into consideration the difference between what spending means on paper and how it is felt by citizens.

It has been said that the IMF's role as a generalist institution specializing in macroeconomic issues needs reform. Conditionality has also been criticized because a country can pledge collateral of "acceptable assets" to obtain waivers on certain conditions. However, that assumes that all countries have the capability and choice to provide acceptable collateral.

One view is that conditionality undermines domestic political institutions. The recipient governments are sacrificing policy autonomy in exchange for funds, which can lead to public resentment of the local leadership for accepting and enforcing the IMF conditions. Political instability can result from more leadership turnover as political leaders are replaced in electoral backlashes. IMF conditions are often criticized for their bias against economic growth and reduce government services, thus increasing unemployment.

Another criticism is that IMF programs are only designed to address poor governance, excessive government spending, excessive government intervention in markets, and too much state ownership. This assumes that this narrow range of issues represents the only possible problems; everything is standardized and differing contexts are ignored. A country may also be compelled to accept conditions it would not normally accept had they not been in a financial crisis in need of assistance.

It is claimed that conditionalities retard social stability and hence inhibit the stated goals of the IMF, while Structural Adjustment Programs lead to an increase in poverty in recipient countries. The IMF sometimes advocates "austerity programmes," cutting public spending and increasing taxes even when the economy is weak, to bring budgets closer to a balance, thus reducing budget deficits. Countries are often advised to lower their corporate tax rate. In *Globalization and Its Discontents*, Joseph E. Stiglitz, former chief economist and senior vice-president at the World Bank, criticises these policies (Stiglitz, 2002). He argues that by converting to a more monetarist approach, the purpose of the fund is no longer valid, as it was designed to provide funds for countries to carry out Keynesian reflations, and that the IMF "was not participating in a conspiracy, but it was reflecting the interests and ideology of the Western financial community." (Friedman, 2002)

3.7 Qualifications for Membership

Any country may apply to be a part of the IMF. Post-IMF formation, in the early postwar period, rules for IMF membership were left relatively loose. Members needed to make periodic membership payments towards their quota, to refrain from currency restrictions unless granted IMF permission, to abide by the Code of Conduct in the IMF Articles of

Agreement, and to provide national economic information. However, stricter rules were imposed on governments that applied to the IMF for funding.

The countries that joined the IMF between 1945 and 1971 agreed to keep their exchange rates secured at rates that could be adjusted only to correct a fundamental disequilibrium in the balance of payments, and only with the IMF's agreement. Some members have a very difficult relationship with the IMF and even when they are still members they do not allow themselves to be monitored. Argentina for example refuses to participate in an Article IV Consultation with the IMF.

In terms of benefit, member countries of the IMF have access to information on the economic policies of all member countries, the opportunity to influence other members' economic policies, technical assistance in banking, fiscal affairs, and exchange matters, financial support in times of payment difficulties, and increased opportunities for trade and investment.

3.8 Leadership of IMF

IMF organs consist of Board of Directors, Executive Board and the Managing director.

3.8.1 Board of Governors

The Board of Governors consists of one governor and one alternate governor for each member country. Each member country appoints its two governors. The Board normally meets once a year and is responsible for electing or appointing executive directors to the Executive Board. While the Board of Governors is officially responsible for approving quota increases, special drawing right allocations, the admittance of new members, compulsory withdrawal of members, and amendments to the Articles of Agreement and By-Laws, in practice it has delegated most of its powers to the IMF's Executive Board.^[43]

The Board of Governors is advised by the International Monetary and Financial Committee and the Development Committee. The International Monetary and Financial Committee has 24 members and monitors developments in global liquidity and the transfer of resources to developing countries. The Development Committee has 25 members and advises on critical development issues and on financial resources required to promote economic development in developing countries. They also advise on trade and global environmental issues.

3.8.2 Executive Directors

24 Executive Directors make up Executive Board. The Executive Directors represent all 188 member-countries. Countries with large economies have their own Executive

Director, but most countries are grouped in constituencies representing four or more countries.

Following the 2008 Amendment on Voice and Participation, eight countries each appoint an Executive Director: the United States, Japan, Germany, France, the United Kingdom, China, the Russian Federation, and Saudi Arabia. The remaining 16 Directors represent constituencies consisting of 4 to 22 countries. The Executive Director representing the largest constituency of 22 countries accounts for 1.55% of the vote.

3.8.3 Managing Director

The IMF is led by a managing director, who is head of the staff and serves as Chairman of the Executive Board. The managing director is assisted by a First Deputy managing director and three other Deputy Managing Directors. Historically the IMF's managing director has been European and the president of the World Bank has been from the United States. However, this standard is increasingly being questioned and competition for these two posts may soon open up to include other qualified candidates from any part of the world.

In 2011 the world's largest developing countries, the BRIC nations, issued a statement declaring that the tradition of appointing a European as managing director undermined the legitimacy of the IMF and called for the appointment to be merit-based. The head of the IMF's European department is António Borges of Portugal, former deputy governor of the Bank of Portugal. He was elected in October 2010.

3.9 Voting Power

You should note that voting power in the IMF is based on a quota system. Each member has a number of "basic votes" (each member's number of basic votes equals 5.502% of the total votes), plus one additional vote for each Special Drawing Right (SDR) of 100,000 of a member country's quota. The Special Drawing Right is the unit of account of the IMF and represents a claim to currency. It is based on a basket of key international currencies. The basic votes generate a slight bias in favour of small countries, but the additional votes determined by SDR outweigh this bias.

3.9.1 Effects of the quota system

The IMF's quota system was created to raise funds for loans. Each IMF member country is assigned a quota, or contribution, that reflects the country's relative size in the global economy. Each member's quota also determines its relative voting power. Thus, financial contributions from member governments are linked to voting power in the organization. This system follows the logic of a shareholder-controlled organization: wealthy countries

have more say in the making and revision of rules. Since decision-making at the IMF reflects each member's relative economic position in the world, wealthier countries that provide more money to the fund have more influence in the IMF than poorer members that contribute less; nonetheless, the IMF focuses on redistribution.

4.0 CONCLUSION

The IMF is only one of many international organizations and it is a generalist institution for macroeconomic issues only; its core areas of concern in developing countries are very narrow. One proposed reform is a movement towards close partnership with other specialist agencies to better productivity. The IMF has little to no communication with other international organizations such as UN specialist agencies like UNICEF, the Food and Agriculture Organization (FAO), and the United Nations Development Program (UNDP).

International institutions like the International Monetary Fund (IMF) and the World Bank have the brightest economists and the lead in advising poor countries on how to break out of poverty, but the problem is development economics. Development economics needs the reform, not the IMF. It should also be noted that IMF loan conditions need to be partnered with other reforms such as trade reform in developed nations, debt cancellation, and increased financial assistance for investments in basic infrastructure to be effective. IMF loan conditions cannot stand alone and produce change; they need to be partnered with other reforms or other conditions as applicable.

6.0 SUMMARY

In this unit, you learnt the meaning of international monetary fund (IMF), its functions and its surveillance of the global economy. You also studied the structural adjustment, the benefits of IMF loan conditions, a critique of IMF conditionalities and the qualifications for IMF membership. Other sub-topics covered by you in this unit were the leadership of IMF, its Board of Governors, the voting power of IMF members and effects of the quota system;

With the discussion of IMF in this unit, the study of the African Development Bank will be the focus of the next unit.

6.0 TUTOR MARKED ASSIGNMENT

1. Why IMF does provides policy advice and financing to members in economic difficulties and also works with developing nations to help them achieve macroeconomic stability and reduce poverty?

2. IMF conditions are often criticized for their bias against economic growth and reduce government services. Discuss.

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UNIT 3: THE AFRICAN DEVELOPMENT BANK (AfDB)**CONTENT****1.0** Introduction**2.0** Objectives**3.0** Main Content**3.1** The African Development Bank Group (AfDB)**3.2** History of the African Development Bank (AfDB)**3.3** Group entities of the African Development Bank Group (AfDB)**3.3.1** African Development Fund**3.3.2** Nigeria Trust Fund**3.4** Management and Control of the African Development Bank (AFDB)**3.5** Functions of the African Development Bank (AFDB)**3.6** Status of the African Development Bank (AFDB)**3.7** Recent Trends and Directions of the African Development Bank (AFDB)**3.7.1** The AfDB's Support of RMCs through the Fight against HIV/AIDS.**3.8** Membership of AfDB**4.0** Conclusion**5.0** Summary**6.0** Tutor Marked Assignment**7.0** References and Further Reading

7.0 INTRODUCTION

In the preceding unit, we learnt the meaning of international monetary fund (IMF), its functions and its surveillance of the global economy. We also studied the structural adjustment, the benefits of IMF loan conditions, a critique of IMF conditionalities and the qualifications for IMF membership. Other sub-topics covered by us were the leadership of IMF, its Board of Governors, and the voting power of IMF members and effects of the quota system;

In the present Unit 3 of our Module 3, we shall discuss the African Development Bank.

2.0 OBJECTIVES

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

- Discuss the African Development Bank Group (AfDB);
- Trace the history of the African Development Bank (AfDB);
- Describe the group entities of the African Development Bank Group (AfDB);
- Explain the African Development Fund;
- Explain the Nigeria Trust Fund;
- Analyze management and control of the African Development Bank (AFDB);
- Analyze functions of the African Development Bank (AFDB);
- Examine the status of the African Development Bank (AFDB);
- Trace the recent trends and directions of the African Development Bank (AFDB);
- Discuss the AfDB's support of RMCs through the fight against HIV/AIDS; and
- List the membership of AfDB.

3.0 MAIN CONTENT

3.1 The African Development Bank Group (AfDB)

The African Development Bank (AfDB) Group is a regional multilateral development finance institution established to contribute to the economic development and social progress of African countries that are the institution's Regional Member Countries (RMCs). The AfDB was founded following an agreement signed by member states on August 14, 1963, in Khartoum, Sudan, which became effective on September 10, 1964. The AfDB comprises three entities: the African Development Bank (ADB), the African Development Fund (ADF) and the Nigeria Trust Fund (NTF).

As the premier development finance institution on the continent, the AfDB's mission is to help reduce poverty, improve living conditions for Africans and mobilize resources for the continent's economic and social development. The AfDB headquarters is officially in Abidjan, Côte d'Ivoire. However, due to recent events in Côte d'Ivoire, the institution's activities have temporarily been relocated to Tunis, Tunisia (AfDB, 2014).

3.2 History of the African Development Bank (AfDB)

At the end of the colonial period in Africa, a growing desire for more unity within the continent led to the establishment of two draft charters, one for the establishment of the Organization of African Unity (established in 1963, later replaced by the African Union), and for a regional development bank.

A draft agreement was submitted to top African officials, then to African Ministers, before being cosigned by twenty-three African governments on August 4, 1963, in the form of an agreement establishing the African Development Bank. The agreement came into force on 10 September 1964. Although established officially in under the auspices of the Economic Commission for Africa, the AfDB began operation in 1966. Although originally only African countries were able to join the bank, since 1982 it has allowed the entry of non-African countries as well. During its forty years of operations, AfDB has financed 2,885 operations, for a total of \$47.5 billion. In 2003, it received an AAA rating from the major financial rating agencies and had a capital of \$32.043 billion.

A development bank's mission is to promote the investment of public and private capital in projects and programmes that are likely to contribute to the economic development of its stakeholders. The bank therefore finances projects run either by the government or the private sector. The AfDB is one of the five major multilateral development banks in the world that provides assistance to its regional member countries with a view to helping them achieve their development goals.

The AfDB's primary objective is to assist African countries – individually and collectively - in their efforts to achieve economic development and social progress. To this end, the institution's main challenge is to reduce poverty on the continent.

Combating poverty is at the heart of the continent's efforts to attain sustainable economic growth. The Bank therefore seeks to stimulate and mobilize internal and external resources to promote investments as well as provide RMCs with technical and practical assistance. In partnership with various international and development organizations, including the United Nations, the World Bank, and the International Monetary Fund, the AfDB has, since 2000, undertaken to support RMCs in their efforts to attain the Millennium Development Goals (MDGs).

3.3 Group entities the African Development Bank Group (AfDB)

The African Development Bank Group has two other entities: the African Development Fund (ADF) and the Nigeria Trust Fund (NTF).

3.3.1 African Development Fund

Established in 1972, the African Development Fund started operations in 1974. It provides development finance on concessional terms to low-income RMCs which are unable to borrow on the non-concessional terms of the AfDB. In harmony with its lending strategy, poverty reduction is the main aim of ADF activities. Twenty-four non-African countries along with the AfDB constitute its current membership. The largest ADF shareholder is the United States with approximately 6.5 percent of the total voting shares, followed by Japan with approximately 5.4 percent. The Federal Reserve Bank of New York was designated as the depositor bank for the fund according to telegraphs sent from the U.S. Embassy in Abidjan in 1976.

The ADF's general operations are decided by a Board of Directors, six of which are appointed by the non-African member states and six designated by the AfDB from among the bank's regional Executive Directors. The ADF's sources are mainly contributions and periodic replacements by non-African member states. The fund is usually replenished every three years, unless member states decide otherwise. The total donations, at the end of 1996, amounted to \$12.58 billion. The ADF lends at no interest rate, with an annual service charge of 0.75%, a commitment fee of 0.5%, and a 50-year repayment period including a 10-year grace period. The tenth United Kingdom replenishment of the ADF was in 2006.

3.3.2 Nigeria Trust Fund

The Nigeria Trust Fund (NTF) was established in 1976 by the Nigerian government with an initial capital of \$80 million. The NTF is aimed at assisting in the development efforts of the poorest AfDB members. The NTF uses its resources to provide financing for projects of national or regional importance which further the economic and social development of the low-income RMCs whose economic and social conditions require financing on non-conventional terms. In 1996, the NTF had a total resource base of \$432 million. It lends at a 4% interest rate with a 25-year repayment period, including a five-year grace period.

3.4 Management and Control of the African Development Bank (AFDB)

The AfDB is controlled by a Board of Executive Directors, made up of representatives of its member countries. The voting power on the Board is split according to the size of each

member's share, currently 60%-40% between African (or "regional") countries and "non-regional" member countries ("donors"). The largest African Development Bank shareholder is Nigeria with nearly 9 percent of the vote. All member countries of the AfDB are represented on the AfDB Board of Executive Directors.

Member governments are officially represented at the AfDB by their Minister of Finance, Planning or Cooperation who sits on the AfDB Board of Governors. The AfDB Governors meet once a year (at the Annual Meetings of the AfDB each May) to take major decisions about the institution's leadership, strategic directions and governing bodies. The Governors typically appoint a representative from their country to serve in the offices of the AfDB's Board of Executive Directors.

Day-to-day decisions about which loans and grants should be approved and what policies should guide the AfDB's work are taken by the Board of Executive Directors. Each member country is represented on the Board, but their voting power and influence differs depending on the amount of money they contribute to the AfDB.

3.5 Functions of the African Development Bank (AFDB)

The primary function of AfDB is making loans and equity investments for the socio-economic advancement of the RMC. Second, the bank provides technical assistance for development projects and programs. Third, it promotes investment of public and private capital for development. Fourth, the bank assists in organizing the development policies of RMCs. The AfDB is also required to give special attention to national and multinational projects which are needed to promote regional integration.

3.6 Status of the African Development Bank (AFDB)

The ADB promotes economic development and social progress of its RMCs in Africa and the bank commits approximately 3 billion dollars annually to African countries. Its relatively small lending and tendency to follow in the footsteps of more prominent public institutions like the World Bank, implies that the African Development Bank has been receiving little interest from civil society organizations as well as academia.

AfDB emphasizes the role of women along with education reforms, and lent its support to key initiatives such as debt alleviation for Heavily Indebted Poor Countries and the New Partnership for Africa's Development (NEPAD).

The Bank is currently based in Tunis, Tunisia after relocating from its headquarters in Abidjan, Côte d'Ivoire because of instability there. It employs approximately 1,020 employees as of 2007, and has 78 members: 53 countries in Africa and 25 American, European, and Asian countries.

3.7 Recent Trends and Directions of the African Development Bank (AfDB)

One of emerging views, repeatedly cited by the AfDB's Board of Directors and management, is that the AfDB should be more "selective" and "country-focused" in its operations. Though this policy has still to be clearly defined, it appears to be driving certain lending priorities.

The infrastructure sector, including power supply, water and sanitation, transport and communications, has traditionally received the largest share of AfDB lending. This focus was re-affirmed in the AfDB's 2003-2007 Strategic Plan, which identified infrastructure as a priority area for AfDB lending. In 2005, the AfDB approved 23 infrastructure projects for approximately \$982 million, which totaled 40 percent of AfDB approvals that year. Given the increased attention to infrastructure development in Africa from donors and borrowers, it is likely that AfDB's infrastructure lending will increase significantly in the coming years. In 2007, infrastructure operations accounted for approximately 60 percent of the bank's portfolio.

Regional integration infrastructure projects will also be a key part of the AfDB's future business. According to the AfDB's 2005 Annual Report, regional economic blocs will make Africa "more competitive in the global market", while transport and power interconnections between smaller African economies will help create larger markets within the continent. The AfDB's member countries claim that AfDB, as a multilateral institution, is particularly suited to support regional integration projects.

The AfDB has also been designated the lead agency to facilitate "NEPAD infrastructure initiatives", which are regional integration projects led by African Regional Economic Communities (RECs). Additionally, the AfDB hosts the Infrastructure Consortium for Africa (ICA). The ICA was established by G8 countries to coordinate and encourage infrastructure development in Africa, focusing on regional infrastructure development in particular. The AfDB also helps to prepare projects so they may obtain financing from others sources through an initiative called the Infrastructure Project Preparation Facility (IPPF). So even if the AfDB is not directly involved in financing a particular infrastructure project, it may have helped to make that project possible.

3.7.1 The AfDB's Support of RMCs through the Fight against HIV/AIDS.

Another key area of concentration of the AfDB's support of RMCs is the fight against HIV/AIDS. The AfDB has five policies towards securing Africa's future through health funding:

- Institutional capacity building through assistance of policy/strategy formulation and implementation
- Human capital development to create an environment for the operation of national AIDS strategies through training and technical assistance support
- HIV/AIDS multi-sectoral responses with emphasis on prevention and control interventions that include IEC (Information, Education and Communication), STI (Sexually Transmitted Infections) control, VCT (Voluntary Counseling and Testing), infrastructure support for the establishment of laboratories and blood transfusion facilities, and provision of equipment and supplies, including antiretroviral drugs
- Advocacy through participation in international and regional forums to raise political commitment and leadership towards a collaborative effort in the fight against the pandemic among RMCs and development partners
- Partnership development with a view of forging new alliances and revitalizing existing collaboration to cover critical development concerns such as HIV/AIDS and to bringing partnership activities within the framework of the bank's vision

To date, the bank's contribution in the fight against HIV/AIDS is estimated at over 500 million Dollar. The bank is also among the initiating partners of *AIDS in Africa – Scenarios for the future*, a project whose outcome will enable governments and development partners alike to make strategic choices of current and future development paths and define their activities accordingly in order to face the challenges posed by HIV/AIDS.

Energy projects are likely to become a more important area of the AFDB's infrastructure work, given the lack of access to energy services across Africa and continued high oil prices affecting oil-importing countries. It is not clear if the AFDB's role in the energy sector will prioritize energy projects for domestic consumption or for export, although the AfDB has supported both in the past. The AFDB is currently drafting an energy policy and developing its contribution to the G8-mandated Clean Energy Investment Framework.

Although there is no official statement or consensus to this effect, AFDB lending for agriculture, (non-infrastructure) rural development and social sectors, such as health and education, is reportedly likely to decrease over the coming years.

Self Assessment Exercise

The AfDB has five policies towards securing Africa's future through health. List these policies.

3.8 Membership

All countries in the African Union including Mauritania but excluding the SADR are eligible for NTF benefits. Morocco is also eligible though not a part of the African Union.

Non-African Member countries are:

- Argentina
- Austria
- Belgium
- Brazil
- Canada
- China
- Denmark
- Finland
- France
- Germany
- India
- Italy
- Japan

- Kuwait
- Latvia - over 42.71 billion \$ since 1991.^[citation needed]
- Netherlands
- Norway
- Portugal
- Saudi Arabia
- South Korea
- Spain
- Sweden
- Switzerland
- Turkey
- United Kingdom

- United States

4.0 CONCLUSION

The AfDB's financial standing has been restored from the near collapse of 1995, but its operational credibility remains a work-in-progress. AfDB is still a relatively small source of development finance for Africa. The AfDB management and shareholders should address the urgent task of reforming Africa's development bank to enable it deliver on its mandate especially a strong focus on infrastructure.

5.0SUMMARY

In this unit, you learnt the African Development Bank Group (AfDB), its history, entities, functions, management and control, status, and membership. You also learnt the recent trends and directions of the African Development Bank (AFDB) and its support of Regional Member Countries (RMCs) through the fight against HIV/AIDS.

In the next unit, that is, Unit 4 of our Module 3, we shall discuss the International Bank for Reconstruction and Development otherwise called the World Bank.

6.0TUTOR MARKED ASSIGNMENT

- 1.** Trace the history of the African Development Bank (AfDB)
- 2.** Analyze functions of the African Development Bank (AFDB)

7.0 REFERENCES AND FURTHER READING

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UNIT 4: THE INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT (IBRD) OR THE WORLD BANK

CONTENT

1.0 Introduction

2.0 Objectives

3.0 Main Content

3.1 The Formation of the World Bank or the IBRD

3.2 The Functions of the World Bank

3.3 The Purposes of the World Bank

3.4 Resources of the World Bank

3.5 Lending Procedure of the World Bank

3.6 General Provisions Regarding Loans and Guarantees

3.7 The World Bank Structural Adjustment Loans

3.8 Criticism against the World Bank

4.0 Conclusion

5.0 Summary

6.0 Tutor Marked Assignment

7.0 References and Further Reading

4.0 INTRODUCTION

In the preceding unit, we learnt the African Development Bank Group (AfDB), its history, entities, functions, management and control, status, and membership. You also learnt the recent trends and directions of the African Development Bank (AFDB) and its support of Regional Member Countries (RMCs) through the fight against HIV/AIDS.

In the present unit, that is, Unit 4 of our Module 3, we shall discuss the International Bank for Reconstruction and Development otherwise called the World Bank. You should note that the World Bank is different from the World Bank Group which we shall discuss in the last unit of this course, that is, Unit 5.

2.0 OBJECTIVES

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

- Discuss the formation of the World Bank or the IBRD;
- Analyze the functions of the World Bank;
- State the purposes of the World Bank;
- Describe the resources of the World Bank;
- Describe the lending procedure of the World Bank;
- Give a general provisions regarding World Bank loans and guarantees;
- Describe the World Bank structural adjustment loans; and
- Undertake a critique against the World Bank policies.

3.0 MAIN CONTENT

3.1 The Formation of the World Bank or the IBRD

Like the International Monetary fund (IMF), the International Bank for Reconstruction and Development (IBRD) or simply the World Bank was also formed at the United Nations Monetary and Financial Conference held at Bretton Woods, New Hampshire, U.S.A. 1-22 July 1944. The Bank was meant to take care of the long-term economic problems of member-nations. Such aims for its creations are:- to help the war-torn nations in the reconstruction of their economies, and to help the vast underdeveloped world in accelerating the pace of economic growth. By 1988, the Bank's membership stood at 151 countries. Its headquarters is in Washington D.C. and maintains 40 offices throughout the world.

The five institutions of the World Bank are the International Bank for Reconstruction and Development (IBRD), International Development Association (IDA), International Finance Corporation (IFC), Multilateral Guarantee Agency (MIGA), and International Centre for the Settlement of Investment Disputes (ICSID).

The World Bank's projects and operations are designed to support low-income and middle-income countries' poverty reduction strategies. The Bank provides low-interest loans, interest-free credits and grants to developing countries for a wide array of purposes that include investments in disaster recovery and risk mitigation, education, health, infrastructure, financial and private sector development, and environmental and natural resource management. Although the World Bank has traditionally played a key role in post-disaster recovery and reconstruction, it has been increasing its involvement in longer term disaster risk reduction. The overarching objective is to mainstream disaster risk reduction and climate change adaptation in country development strategies.

The World Bank supports country development strategies, such as Poverty Reduction Strategies (PRSP), Country Assistance Strategies (CAS), United Nations Development Assistance Frameworks (UNDAFs), and National Adaptation Programmes of Action (NAPAs), to reduce vulnerabilities to natural hazards. This is done through providing analytical, technical and operational support to countries for disaster risk reduction.

3.2 The Functions of the World Bank

The functions of the World Bank are:

- a.** Reconstruction of the war-devastated economies and development of economically backward countries through investment and capital accumulation and through use of productive capacity for production of civilian goods and services.
- b.** To achieve the above objective through promotion of foreign private investment by means of guarantees or participation in loans and other investments made by private investors; and in case of non-availability of private capital at reasonable terms, to supplement private investment by providing, on suitable conditions, finance for productive purposes out of its own resources.
- c.** To promote long-term balanced growth of international trade and maintenance of equilibrium in balance of payments by encouraging international investment for the development of productive resources of the members, thereby assisting in raising the standard of living.
- d.** To assist in bringing about a smooth transition from a war-time to a peace-time economy.
- e.** To encourage that the more useful and urgent projects are dealt with first.
- f.** To underwrite loans to developing nations.

- g.** Renders technical assistance to LDCs.
- h.** To comment on the financial buoyancy and credit-worthiness of a borrowing nations through its expertise and understanding of financial matters. It issues certificates of credit-worthiness and these are acceptable and respectable the world-over.
- i.** It can also borrow money from member nations (advanced, rich nations) to finance its own loans.

3.3 The Purposes of the World Bank

It is important to note that the Bank has certain regional offices to serve the following purposes:-

- a.** To help the Bank in maintaining and improving the effectiveness of its development assistance.
- b.** To bring the 'sectors experts' and 'country experts' closer to each other thus helping the Bank in better understanding of the needs, opportunities and problems of the member countries.
- c.** To permit an optimum utilization of the Bank staff in preparing, appraising and implementing projects. Its loans are medium- and long-term in nature.

3.4 Resources of the World Bank

The World Bank has three main sources of funds viz:-

- a.** Its own capital (i.e authorized capital):- This is made up of subscribed capital, paid-in capital, and amounts subject to call. Thus, it is divided into three parts:
 - (i)** 2 per cent of the subscribed capital is payable by the subscriber in the form of U.S. dollars or gold and is available to the Bank for lending other uses.
 - (ii)** 18 per cent of subscription is payable in member's own currency and is available to the Bank for lending with the consent of the member whose currency is involved.
 - (iii)** The remainder (80 per cent) is not payable for lending, rather it can be called only for meeting the obligations of the Bank arising out of its borrowing or guaranteeing of loans.
- b.** Retained Earnings:- A proportion of the Bank's retained earnings (net) is transferred in the form of grants to one of its affiliates, IDA, and the balance transferred to the General and Special Resources.
- c.** Borrowings:- This forms the largest sources of the Bank's funds for lending and the major sources of borrowing are the international capital markets of the capital-rich members (through the issue of AAA rating bonds)

3.5 Lending Procedure of the World Bank

Loans rather than grants are given to needy member-nations at rates close to the market interest rates. Such loans come in the following forms:-

- a. The IBRD may give loans out of its own paid-in capital and retained earnings.
- b. The Bank can guarantee in whole or in part loans made by private investors through the usual investment channels. Such guarantees attract a guarantee commission to the Bank.
- c. The Bank may borrow from the capital markets of the world on the strength of its own credit-worthiness and in turn give loans to its borrowers. In this way, it acts as a bridge between the capital-surplus and capital-deficit areas of the world.

3.6 General Provisions Regarding. Loans and Guarantees

The Bank can make loans or can guarantee them subject to the following conditions:

- a. With the exception of loans given to the 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 financed is located.
- b. The World Bank ensures that the borrower and the guarantor have the paying capacity.
- c. It lends only for productive purposes and in non-military projects.
- d. It must ensure that the project to be financed will be able to provide a return commensurate with the amount of investment, i.e, its return must be enough to service its debt obligations and show a surplus thereafter.
- e. Except in special circumstances, the World Bank loans are for specific projects.
- f. A loan made for a project cannot be diverted to any other use.
- g. Only economic considerations inform the Bank's decision to give loans.
- h. The World Bank satisfies itself that in the prevailing market conditions the borrower would be unable otherwise to obtain loans under conditions which in the opinion of the Bank are reasonable for the borrower.
- i. There must be a written report, prepared by a competent committee after careful study of the merits of the proposal, recommending the project.
- j. The World Bank normally gives a loan only to cover the foreign exchange component of the project, though in special circumstances a part of the local cost may also be financed by the Bank's loan.
- k. The World Bank deals only with member governments, their Central Banks or some other competent agency.
- l. The loan must be spent in the economies of member-nations.
- m. A project slated for financing must be able to contribute to the economic development of the borrowing member- nation.

- n. 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.
- o. The loan amount or guarantee is not limited by the member's subscribed capital.
- p. Amortization and interest must be paid in currencies in which the loan was made.

3.7 The World Bank Structural Adjustment Loans

The World Bank began a policy of structural adjustment lending in 1979-80 in response to the markedly deteriorating prospects that were then foreseen for developing nations in the 1980s. Such structural adjustment lending was designed within the staff and financing levels available to the Bank and within its mandate, to those governments that had requested such support and that had recognized the need to formulate and introduce, as a matter of urgency, a set of comprehensive measures designed to adjust the structure of productive activities of their economies to the markedly deteriorating external situation (World Bank, 1982). The objective here is to provide quick disbursing finance to support measures, specifically designed to strengthen country balance of payments within 5-10 years without restricting imports in a manner that would adversely affect its economic and social development. Such loans which are generally medium-term in nature, are in the Bank's view directed to achieve the following:

- a. To support a programme to specific policy changes and and institutional reforms so that the productive resources of the economy can be put to a better use in the sense of improving the balance of payments in medium and long-run, and to simultaneously help in the maintenance of economic growth.

- b. To act as a catalyst for the inflow of other external capital to ease the balance of payments situation.

To extend such loans, the Bank insists on a high degree of conditionality, imposed upon LDCs only, leading to their bearing the cost resource-reallocation and consequent hardships.

Such conditionality imposed includes:

- a. A set of pricing policies including tariff reforms, fiscal incentives, budget subsidies, and interest rate charges;

- b. Revised public investment priorities;

- c. Improved budget and debt management and

- d. A policy for strengthening institutions particularly public enterprises.

Nigeria has benefitted from this scheme in her SAP which began in July 1986.

Self-Assessment Exercise

During the regime of Chief Olusegun Obasanjo, Nigeria exited most of her debts with the Paris Club and the London Club of Creditors. How much did Nigeria pay?

3.8 Criticism against the World Bank

The World Bank has long been criticized by non-governmental organizations, such as the indigenous rights group Survival International, and academics, including its former Chief Economist Joseph Stiglitz, Henry Hazlitt and Ludwig Von Mises (Stiglitz, 2003, 2007). Henry Hazlitt argued that the World Bank along with the monetary system it was designed within would promote world inflation and "a world in which international trade is State-dominated" when they were being advocated (Hazlitt, 1984). Stiglitz argued that the so-called free market reform policies which the Bank advocates are often harmful to economic development if implemented badly, too quickly ("shock therapy"), in the wrong sequence or in weak, uncompetitive economies (Stiglitz, 2003; Schneider, 2002).

One of the strongest criticisms of the World Bank has been the way in which it is governed. While the World Bank represents 188 countries, it is run by a small number of economically powerful countries. These countries (which also provide most of the institution's funding) choose the leadership and senior management of the World Bank, and so their interests dominate the bank. Titus Alexander argues that the unequal voting power of western countries and the World Bank's role in developing countries makes it similar to the South African Development Bank under apartheid, and therefore a pillar of global apartheid (Alexander, 1996). In the 1990s, the World Bank and the IMF forged the Washington Consensus, policies which included deregulation and liberalization of markets, privatization and the downscaling of government. Though the Washington Consensus was conceived as a policy that would best promote development, it was criticized for ignoring equity, employment and how reforms like privatization were carried out. Joseph Stiglitz argued that the Washington Consensus placed too much emphasis on the growth of GDP, and not enough on the permanence of growth or on whether growth contributed to better living standards (Stiglitz, 2007).

The United States Senate Committee on Foreign Relations report criticized the World Bank and other international financial institutions for focusing too much "on issuing loans rather than on achieving concrete development results within a finite period of time" and called on the institution to "strengthen anti-corruption efforts".

Criticism of the World Bank often takes the form of protesting as seen in recent events such as the World Bank Oslo 2002 Protests, the October Rebellion, and the Battle of Seattle. Such demonstrations have occurred all over the world, even amongst the Brazilian Kayapo people.

Another source of criticism has been the tradition of having an American head the bank, implemented because the United States provides the majority of World Bank funding. "When economists from the World Bank visit poor countries to dispense cash and advice," observed *The Economist* in 2012, "they routinely tell governments to reject cronyism and fill each important job with the best candidate available. It is good advice. The World Bank should take it." (*The Economist*, Mar 31st 2012). You should note that Jim Yong Kim was the most recently appointed president of the World Bank.

4.0 CONCLUSION

The World Bank is a United Nations international financial institution that provides loans to developing countries for capital programs. The World Bank's official goal is the reduction of poverty. According to its Articles of Agreement, all its decisions must be guided by a commitment to the promotion of foreign investment and international trade and to the facilitation of capital investment.

The World Bank is the world's premier development institution. For almost 70 years, the leadership of the IMF and World Bank has been subject to an indefensible carve-up. The head of the IMF is European; the World Bank, American. This shabby tradition has persisted because it has not been worth picking a fight over. It is long overdue for the headship of the World Bank and the IMF be opened to candidates from the rest of the world

5.0 SUMMARY

In this unit, you learnt how the World Bank or the IBRD was formed as well as its functions, purposes, resources and lending procedure. You also learnt the general provisions regarding the World Bank loans and guarantees, the Bank's structural adjustment loans and a critique of its operation.

In the next unit, that is, Unit 5, which is the last of our Module 3, we shall conclude the study with a discussion about the World Bank Group, which as stated in the introductory section of this unit, is different from the World Bank or IBRD.

6.0 TUTOR-MARKED ASSIGNMENT

1. Analyze the functions of the World Bank.
2. Undertake a critique of the policies of IBRD

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UNIT 5: THE WORLD BANK GROUP CONTENT

1.0 Introduction

2.0 Objectives

3.0 Main Content

3.1 World Bank Group Agencies

3.2 International Finance Corporation (IFC): Meaning and Formation

3.2.1 Purpose and Objectives of IFC

3.2.2 Membership of IFC

3.2.3 Organization of IFC

3.2.4 Resources of IFC

3.2.5 Activities of IFC

3.3 International Development Association (IDA): Meaning and Formation

3.3.1 Membership of IDA

3.3.2 Organization of IDA

3.3.3 Resources of IDA**3.3.4 Problems faced by IDA****3.3.5 Operations of IDA****4.0 Conclusion****5.0 Summary****6.0 Tutor Marked Assignment****7.0 References and Further Reading****8.0 INTRODUCTION**

In the preceding unit, we learnt how the World Bank or the IBRD was formed as well as its functions, purposes, resources and lending procedure. We also learnt the general provisions regarding the World Bank loans and guarantees, the Bank's structural adjustment loans and a critique of its operation.

In the present unit, that is, Unit 5, which is the last of our Module 3, we shall conclude the study with a discussion about the World Bank Group, which as earlier stated in the introductory section of Unit 4, is different from the World Bank or IBRD. The IBRD or the World Bank itself is part of the World Bank Group. We have discussed the IBRD or the World Bank in the preceding unit. Other agencies of the World Bank Group are the International Finance Corporation (IFC), the International Development Association (IDA), the International Centre for Settlement of Investment Disputes (ICSID), the Multilateral Investment Guarantee Agency (MIGA). We shall discuss the first two; the International Finance Corporation (IFC) and the International Development Association (IDA).

2.0 OBJECTIVES

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

- Discuss agencies of the World Bank Group;
- Explain the meaning and formation of the International Finance Corporation (IFC);
- State the purpose and objectives of IFC;
- List the membership of IFC;
- Describe the organization of IFC;
- Explain the resources of IFC;
- Analyze the activities of IFC;
- Explain the Meaning and Formation of International Development Association (IDA);
- List the membership of IDA;

- Describe the organization of IDA;
- Explain the resources of IDA;
- State the problems faced by IDA; and
- Analyze the operations of IDA.

3.0 MAIN CONTENT

3.1 World Bank Group Agencies

The World Bank Group consists of

- the International Bank for Reconstruction and Development (IBRD), established in 1945, which provides debt financing on the basis of sovereign guarantees;
- the International Finance Corporation (IFC), established in 1956, which provides various forms of financing without sovereign guarantees, primarily to the private sector;
- the International Development Association (IDA), established in 1960, which provides concessional financing (interest-free loans or grants), usually with sovereign guarantees;
- the International Centre for Settlement of Investment Disputes (ICSID), established in 1966, which works with governments to reduce investment risk;
- the Multilateral Investment Guarantee Agency (MIGA), established in 1988, which provides insurance against certain types of risk, including political risk, and primarily to the private sector.

The term "World Bank" generally refers to just the IBRD and IDA, whereas the term World Bank Group or WBG is used to refer to all five institutions collectively. The World Bank Institute is the capacity development branch of the World Bank, providing learning and other capacity-building programs to member countries. The activities of the IFC and MIGA include investment in the private sector and providing insurance respectively.

3.2 International Finance Corporation (IFC): Meaning and Formation

The IFC is the second affiliate of the World Bank set up in July 1956 to supplement the efforts of World Bank in its provision of development funds to private enterprises (mainly industrial) of the less-developed nations of the world. That is, it was established to supplement the IBRD's efforts at accelerating the economic development of its less developed member-nations. IFC, a member of the World Bank Group, is the largest global development institution focused exclusively on the private sector in developing countries.

IFC is owned by 184 member countries, a group that collectively determines their policies. Their work in more than a 100 developing countries allows companies and financial institutions in emerging markets to create jobs, generate tax revenues, improve corporate governance and environmental performance, and contribute to their local communities. IFC's vision is that people should have the opportunity to escape poverty and improve their lives.

Three basic propositions were behind the concept of IFC, viz:

- a. The claim that the private sector is better suited than the public sector in certain areas of economic activity essential for economic growth;
- b. The claim that in actual practice, the private sector was not playing as active a role as it could and should; and
- c. That the private sector has an inherent tendency to be located in those areas where the rate of return is high and safety of capital is more.

A report prepared by the staff of the World Bank in 1952 incorporated the above arguments and proposed the creation of IFC as an affiliate of the World Bank to stimulate productive private enterprises in the territories of members of the IBRD and the flow of private international investment. Thus, in July 1956, IFC materialized after prolonged discussions of 3 years amongst governments, the World Bank and the investors in the developed nations.

3.2.1 Purpose and Objectives of IFC

IFC's purpose is to further economic development by encouraging the growth of productive private enterprise in member nations, especially in the LDCs, thus supplementing the activities of the IBRD. Its role is not limited to direct equity capital but extends into mobilization of finance from other sources. It must be noted that as an inter-governmental organization, IFC is immune from taxation on income earned on its investments.

The objectives, in conjunction with its purpose are:

- a. In association with private investors, it shall assist in financing the establishment, improvement and expansion of productive private enterprise which would contribute to the development of its member countries by making investments, without guarantee of repayment by the member government concerned, in cases where sufficient private investment is not available on reasonable terms;
- b. To bring together investment opportunities, domestic and foreign private capital, and experienced management and

- c. To stimulate and to help create conditions conducive to the flow of private capital, domestic and foreign, into productive investment in member nations.
- d. IFC also provides financial, legal and technical advice to enterprise sponsors.

3.2.2 Membership of IFC

Membership of the World Bank is a prerequisite for membership of the IFC. In the same way, once a member country ceases to be a member of the World Bank (voluntarily or by suspension), she also ceases to be a member of IFC. IFC arranges to repurchase the capital stock of a government relinquishing membership as part of the settlement of the accounts with the government. However, if a government ceases to be a member, she remains liable for all amounts due from her to IFC.

3.2.3 Organization of IFC

The general organizational structure of IFC resembles that of the IBRD and IDA. The powers of IFC management are vested in the Board of Governors to which each country nominates one member. Each member has 250 votes plus one for each \$1,000 of capital subscribed. IBRD's President is the ex-officio Chairman of the IFC Board of Directors. The Chief Executive handles IFC's internal administration, i.e., conducts the day-to-day affairs of the Corporation.

IFC has a diversified organization, having eight departments. The four departments of Capital Markets, Finance and Management, Legal matters and Engineering, operate on functional lines. The four departments of Investment operate on geographical basis.

3.2.4 Resources of IFC

The resources of the IFC are made up of the:-

- a. Authorized capital (which stood at \$392 million by 1980-81);
- b. Borrowed funds from the IBRD (which stood at \$509 million by June 1982); and
- c. Retained accumulated earnings (which stood at \$159 million in June 1982).

3.2.5 Activities of IFC

a. Investment: Investments are mostly in the industrial sector and productive investment is promoted in three ways, viz: by direct investment, by securing additional foreign and local capital, and by providing guidance and technical assistance. The investments which are only in Less Developed Countries (LDCs) where sufficient private capital is not available on reasonable terms, the projects satisfy the criteria of both economic priority and reasonable commercial return.

The loans are generally long-term while the interest rates are determined by existing commercial rates, though repayment is normally with a grace period.

b. Promotion: The IFC, through its specialized staff, undertakes activities to identify the type of projects which have a potential of making a major contribution to economic development of the host country and which has commercial viability. This promotion is strengthened by ensuring and insisting on adequate participation by the chief sponsor in the capital of the enterprise, so as to ensure that a proper long-term incentive exists, just as there should be a provision for immediate or eventual local participation. The IFC, apart from engaging in equity and/or loan investment in its own identified projects, also undertakes promotion of projects identified by the host governments themselves which satisfy the IFC's investment criteria. In addition, IFC undertakes studies with respect to technologies best suited to the host country.

c. Capital Markets: The IFC through its capital markets Department takes various measures to develop capital markets and money markets in LDCs where these are lacking or underdeveloped. For example, IFC acts as an underwriter of share capital thus helping the sale of shares of projects, it also sells its share to local investors when projects succeed and stand on their own feet, in addition to helping in establishing financial institutions for domestic resource/savings mobilization. Furthermore, IFC advises on ways to encourage wider share ownership and to increase the choice of debt and equity instruments available to local investors. It also helps to strengthen existing capital markets through its investment in development finance companies and other financial institutions. The spread of its own operating standards and requirements also helps in creating financial institutions.

d. Syndication: The IFC arranges for the financing of projects by consortia of other financial institutions such as commercial banks and other private investors. It sells participations in IFC loan either at the time of investment or shortly thereafter. An overall agreement of loan is concluded between the IFC and the borrower and the IFC in turn issue other financial institutions participation certificates corresponding to their respective shares of financing.

e. Technical Assistance: The IFC undertakes financial studies and analysis on the effects of various policies on private sector and then advise governments on their suitable reformulation so as to aid in the creation of a proper atmosphere conducive to the promotion of private enterprise and investment,

3.3 International Development Association (IDA): Meaning and Formation

IDA is an affiliate of the World Bank (IBRD) (though legally and financially the two are totally separate entities), established in September 1960 to assist the World Bank in its efforts to promote economic development of the less developed nations. It does this by making available additional capital on a low interest rate basis, that is, by providing 'soft

loans, especially to the poor developing nations of the world. In other words, the IDA is the 'soft' loan window of the World Bank and its terms of loans are highly concessional. The idea underlying the setting up of IDA was to have an international agency for financing the development of underdeveloped nations on exceptionally favourable terms. Given the infrastructural needs, poverty, low savings, and high and growing population of these nations, there was need to obtain loans that can be repaid on easy terms. Such funds cannot come from the World Bank whose loans are conditioned by acceptable commercial rates of return.

Thus, the first formal proposal for IDA's establishment was made in the form of a Resolution introduced in the U.S. Senate in February 1958 by Senator Mike Monroney of Oklahoma. In July 1958, the U.S. Senate passed a Resolution asking the U.S. National Advisory Council on International and Financial Affairs (NAC) to study the feasibility of setting up IDA. The task of the proposed body was to arrange multilateral development loans at highly liberal terms than were hitherto available. The U.S. Senate Resolution also proposed that IDA should be an affiliate of the IBRD. The NAC made a favourable report in August 1959 and an Annual Meeting of the Board of Governors of the IBRD followed in October 1959 during which the Board adopted a Resolution accepting the idea of IDA and thus asked the Executive Directors to formulate its Articles of Agreement and in September 1960 the dream materialized.

Its creation highlights three key points:

- a. It institutionalized the concessional finance for development purposes.
- b. It made poverty a major concern for the rich nations of the world.
- c. It is a step towards the promotion of a system of multilateral trade and payments.

3.3.1 Membership of IDA

IDA started with 15 member countries but by June 1985 the number had risen to 135. Membership of IBRD is a prerequisite for IDA's membership. Suspension/termination from the IBRD's membership means automatic suspension/termination from IDA though does not free that country from its obligations to IDA prior to suspension/termination.

IDA members are divided into two groups:

- a. Part I, made up of developed nations (22 as at June 1985) and
- b. Part II, made up of developing nations (111 as at June, 1985).

Part I members' subscriptions are fully convertible and available to the IDA for use in its lending. Part II members provide only 10 percent of their subscriptions in convertible form and the balance in their own currencies.

The non-convertible portions cannot be used by IDA without the consent of the concerned member. Part I members command 62.98 per cent of voting rights while Part II members command only 37.02 per cent.

Self Assessment Exercise

List the agencies of the World Bank Group;

3.3.2 Organization of IDA

The organization of IDA is essentially similar to that of IBRD - different only in its source and terms of lending. In other words, officers and staff of IBRD serve IDA also hence the IBRD President is also IDA President.

3.3.3 Resources of IDA

IDA's entire resources consist of grants from members, IBRD and repayment of borrowed refunds extended by it. It can also borrow on its own. Its articles of Agreement provided for initial subscriptions by members and that IDA should review the adequacy of its resources in the light of the schedule of payment of initial subscriptions every five years, and to authorize a general increase in subscriptions if thought desirable. The need for additional subscriptions or replenishments was bound to arise due to the long maturities of IDA loans, long periods of moratoria, the huge needs of the developing nations, and the interest free nature of these loans.

The Articles authorize IDA to receive supplementary resources from any member on terms and conditions to be agreed upon. It also allows it to borrow money and guarantee loans or securities, increases in subscriptions, replenishments in the form of supplementary resources and special contributions to IDA are subject to approvals by the legislatures of the individual member countries. Thus by 1982, there had been seven (7) replenishments leading to IDA's resources aggregating to \$32.817 billion by June 1985.

3.3.4 Problems faced by IDA

One of its problems is the United States' (the largest contributor) reduction in its contributions and lateness/delays in its contributions. Also the entry of China as a borrowing nation has helped to reduce availability of funds for other countries just like the oil glut and tumbling oil prices have not helped OPEC nations to make grants as expected.

3.3.5 Operations of IDA

IDA lends to its developing member-nations on concessional terms. Its loans have a maturity up to 50 years with a grace period of 10 years. Its loans are interest free; only a service charge of 0.75 per cent per annum on disbursed and a 0.5 per cent charge on undisbursed loans is levied.

Concessional loans and long maturities are granted so as not to bear heavily on the balance of payments of the debtor nations. However, the economic criteria for choosing projects to be financed are as rigorous as those of IBRD. The key difference is that IDA loans go to only very poor nations whose per capita income does not exceed \$791 at 1983 prices. Thus, IDA loans go by the criteria of low per capita income of the member-nation, a lack of credit-worthiness and resultant difficult access to commercial borrowing, acceptable economic performance of the borrowing nation and loan worthiness of the projects. When the per capita income of a nation increases above the mark, it ceases to be eligible for IDA loans and 'graduates' out of the need to borrow from IDA. Such a nation may then approach the World Bank or the International Capital market on its own for loans.

By June 1985, IDA loans totalled \$36.68 million covering 1494 projects in 86 nations with South Asia as the main beneficiary due to its high population density. Agriculture and rural development accounted for the largest share in IDA loans, followed by transportation and power. Education has also benefitted substantially.

IDA also assists in the development of institutions, efficiency aid management as well as in cofinancing with other donors. It is important to note that its projects are capable of generating multiplicative effect.

4.0 CONCLUSION

IFC fosters sustainable economic growth in developing countries by financing private sector investment, mobilizing capital in the international financial markets, and providing advisory services to businesses and governments. IFC helps companies and financial institutions in emerging markets create jobs, generate tax revenues, improve corporate governance and environmental performance, and contribute to their local communities. The goal is to improve lives, especially for the people who most need the benefits of growth. IFC should ensure sustainability of all its funding programmes.

5.0 SUMMARY

In this unit which is the 5th of our Module 3 and the last in the entire course, you learnt the agencies of the World Bank Group such as the International Finance Corporation (IFC) and the International Development Association (IDA).

With this Unit 5 of our Module 3, we conclude the course, Financial Institution. You should endeavour to go through the Study guide for this course.

6.0 TUTOR MARKED ASSIGNMENT

1. Explain the meaning and formation of the International Finance Corporation (IFC).
2. Explain the meaning and formation of the International Development Association (IDA).

7.0 REFERENCES

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