CENTRAL BANK OF NIGERIA

CBN BRIEFS
2006 - 2007 EDITION

RESEARCH AND STATISTICS DEPARTMENT
2006 - 2007

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PREFACE TO 2006-2007 EDITION

As in previous years, the activities in the 2006 - 2007 CBN Briefs are designed to present an overview of major functions and activities of the Central Bank of Nigeria, especially with respect to the conduct of monetary policy and key developments in the financial system. Since the series are intended for general readership, conscious efforts have been made to make them factual, informative and useful, while minimizing complexities of presentation, statistical and rigorous quantitative analysis. This approach has, to a large extent, contributed to the increasing popularity of the BRIEFS, which in turn, has encouraged us not only to review and update the contents periodically, but also to include important developments in the financial system and the Nigerian economy for continued relevance.

In this respect, the 2006-2007 Series were developed against the background of recent developments in the economy, including Financial System Strategy 2020 (FSS 2020), which is a sub-component of the Vision 2020 a plan to position Nigeria among the top 20 largest economies in the world by the year 2020, microfinance policy and inflation targeting framework of monetary policy management which is expected to commence on January 1, 2009.

Editorial Committee,
CBN BRIEFS
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THE CENTRAL BANK OF NIGERIA: ITS FUNCTIONS AND ACTIVITIES

The principal role of a central bank in an economy is to nurture an efficient financial system through the application of appropriate instruments to influence the levels of the monetary and credit aggregates in the pursuit of low inflation, economic growth and balance of payments viability. In developing economies, central banks usually go beyond these traditional roles to engage in developmental activities in order to speed up the economic development process and enhance the environment for the performance of their primary role.

This Brief highlights the functions and activities of the Central bank of Nigeria (CBN), from its inception to date with particular emphasis on recent developments.

1. EVOLUTION OF THE CENTRAL BANK OF NIGERIA

The earliest support for the establishment of the Central Bank of Nigeria dates back to the period of the bank failures of the early 1950s, following which the power of supervision of banks was vested in the Financial Secretary. Many nationalist leaders at that time advocated for the establishment of a central bank to perform the traditional functions of a central bank which the then colonial administration resisted on the pretext of the absence of a highly organized money market. Apparently, the desire of the colonial administration was to sustain the monetary role that the British Bank for West Africa (BBWA) was playing at that time. The spirited agitations by the nationalists led to the institution of several commissions to examine the desirability and feasibility of establishing a central bank in Nigeria as an instrument for promoting the economic development of the country. In this regard, Mr. Fisher, an adviser to the Bank of England in 1952 and the International Bank for Reconstruction and Development (IBRD) Mission in 1953 considered the establishment of a central bank in Nigeria as premature. However, Mr. Loynes, another adviser to the Bank of England, in his own report in 1957 favoured the idea of establishing a central bank in Nigeria. The report formed the basis for the draft legislation for the establishment of

the Central Bank of Nigeria, which was presented to the House of Representatives in March, 1958. The Act was fully implemented on 1st July, 1959 when the CBN came into full operation with an initial capital of £17.0 million.

2. CBN's MANDATE

The core mandate of the CBN, as spelt out in the new Central Bank of Nigeria Act (2007), include:

(a) Ensuring monetary and price stability;

(b) Issuance of legal tender currency in Nigeria;

(c) Maintenance of Nigeria's external reserves to safeguard the international value of the legal currency;

(d) Promotion of a sound financial system in Nigeria; and

(e) Acting as banker and providing economic and financial advise to the Federal Government.

The CBN in addition to its core functions, like central banks in other developing economies, has over the years performed some major developmental functions, focused on all the key sectors of the Nigerian economy (financial, agricultural and industrial sectors). Overall, these mandates were carried out by the Bank through its various departments as shown in the organizational structure (Figure 1).

3. CORE FUNCTIONS OF THE CENTRAL BANK OF NIGERIA

a) Ensuring Monetary and Price Stability

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 deposit money banks' activities with the overall target.

b) Issuance of Legal Tender Currency

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 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 denominations note ₦20 joined the currency profile. In 1984, a currency exchange was carried out whereby, the colours 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 2 kobo and 5 kobo coins, while the 1 kobo, 10 kobo and 25 kobo coins were redesigned. In addition, the 50 kobo and ₦1 notes were coined, while the ₦50 note was put in circulation. In the quest to enhance the payments system and substantially reduce the volume and cost of production of “legal tender notes”, the ₦100, ₦200 and ₦500 notes were issued in December, 1999, November, 2000, and 2001 respectively. In February, 2007 a redesigned lower denominations of ₦5, ₦10, ₦20 and ₦50 notes as well as redesigned coins of 50kobo, ₦1 and a new coin of ₦2 were introduced.

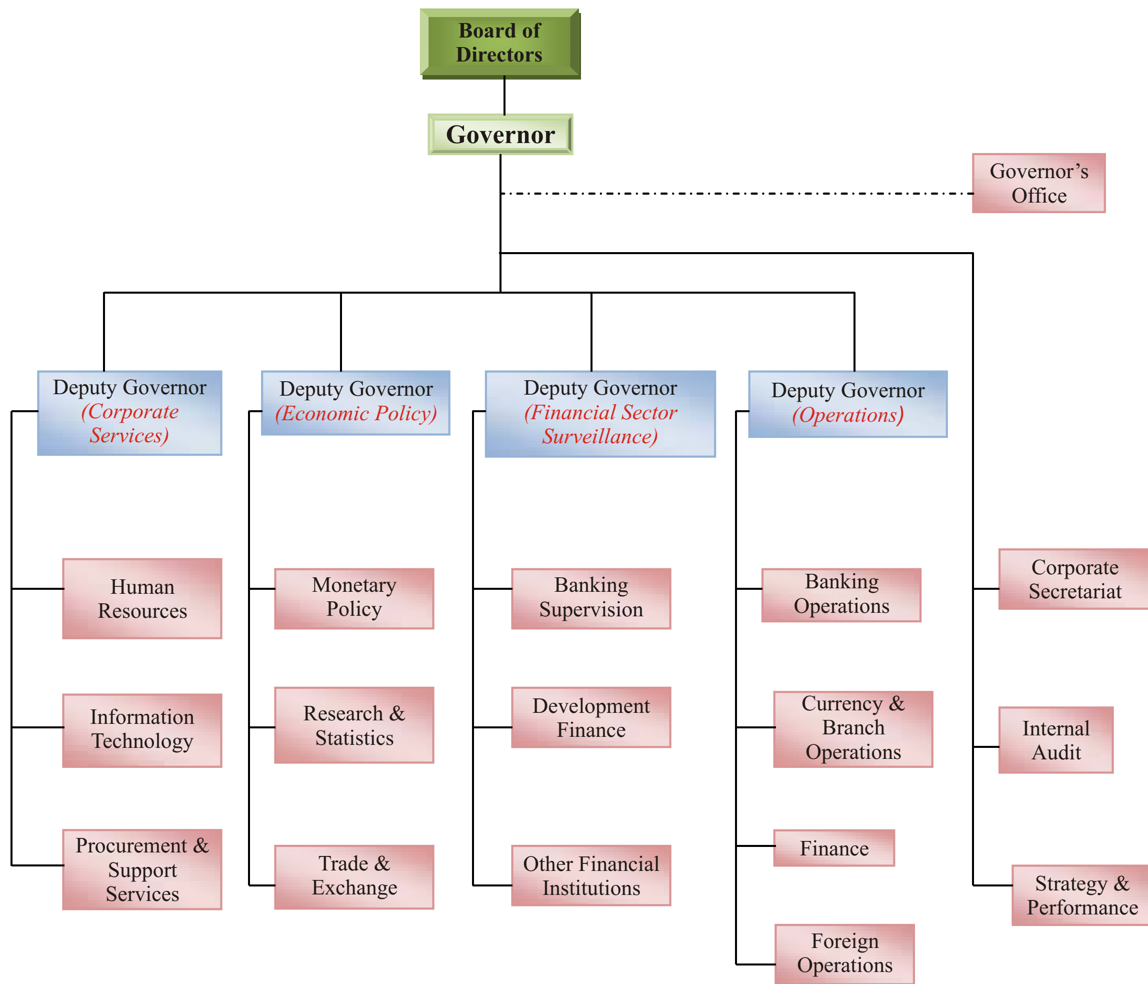
c) Maintenance of Nigeria's External Reserves

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.

(i) Debt Management:

In addition to its function of mobilizing funds for the Federal Government, the CBN

Organizational Structure of the CBN



In 2004, the number of departments was reduced from 23 to 17.

manages 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. The primary responsibility for debt management was formally transferred to the Debt Management Office (DMO) in 2000.

d) Promotion of a Sound Financial System

The CBN through its surveillance activities over banks and non-bank financial institutions seeks to promote a sound and efficient financial system in Nigeria.

e) 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 corporations set up by Federal, State and Local Governments. The CBN also finances government in periods 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 instrument to be issued, while it acts as the issuing house on behalf of government for the short, medium and long-term instruments. The Bank coordinates the financial needs of government in collaboration with the Treasury to determine appropriately the term, timing of issues and volume of instruments to raise funds for government.

DEVELOPMENTAL FUNCTIONS OF THE CBN

Consistent with its support for growth and development in the Nigeria economy, the Central Bank of Nigeria has been involved in developmental activities since its inception to date in all the sectors of the economy. Some of these activities are:

(a) Promotion of the Growth of Financial Markets

A major function of the Bank is the promotion of the growth of the financial markets, which comprise the money, capital and foreign exchange markets. In order to develop the money market, which is the market for mobilizing short-term funds, the CBN initiated money instruments such as Treasury Bills (TBs), Treasury Certificates (TCs), and Eligible Development Stocks (EDS). To deepen the activities of the money market, particularly the secondary segment, the CBN granted licenses to five discount houses to participate in trading in government securities.

The CBN also fostered the growth of the capital market, which deals in long-term funds. Although, the first development stock was issued in 1946 before the establishment of the CBN, the Bank issued subsequent Federal Government development stocks to stimulate the market for enhanced patronage and accommodate government longer-term financial requirements. Initially, the Bank provided a secondary market in development stocks, where potential buyers and sellers could strike bargains. With the establishment of the Lagos Stock Exchange in 1961 in which the CBN played a significant role, secondary market transactions in government stocks were transferred to the Exchange.

The deregulation of the exchange rate of the Naira since 1986 has fostered the development of an active foreign exchange market in Nigeria in which the Central Bank of Nigeria is a major player.

Further more, the CBN has greatly influenced the development of the Nigerian financial system through the promotion of and continued assistance to development finance institutions. These include the Nigerian Agricultural Cooperative and Rural Development Bank (NACRDB), the Bank of Industry (BOI), The Nigerian Agricultural Insurance Company (NAIC), Federal Mortgage Bank of Nigeria (FMBN), and the Nigerian Export-Import Bank (NEXIM).

(b) Other Promotional Activities of the Bank

Through its regulatory activities and monetary policy, the CBN has promoted growth in various sectors of the economy since the early 1970s to date. These include the

promotion of wholly owned Nigerian enterprises, as well as agricultural and manufacturing activities nationwide.

(c) Establishment of Special Schemes and Funds

The Bank has been very active in the promotion of special schemes and funds to enhance economic development. These are in the areas of agriculture, export promotion, small and medium scale enterprises, and collaborative research/services to third parties.

(i) The Agricultural Credit Guarantee Scheme Fund (ACGSF):

The Agricultural Credit Guarantee Scheme Fund (ACGSF) was established by Act 20 of 1977 to encourage banks to increase lending to the agricultural sector. It took off in April 1978 under the management of the CBN, with a Board of Directors constituted for policy making. The guarantee instrument itself is a pledge by the Fund to the banks that it would repay 75.0 per cent of any net default, which could arise in their agricultural loans. The Federal Government and the CBN own the Fund in the ratio of 3:2. In pursuit of its developmental function and to ensure the sustenance of the ACGSF and flow of credit to the agricultural sector, the authorized share capital of the scheme was reviewed upward from ₦100.0 million to ₦1.0 billion in 1999. Following the increase, the loan limits under the scheme were raised from ₦5, 000.00 to ₦20, 000.00 for unsecured loans, and from ₦100, 000.00 to ₦500, 000.00 for secured loans to individuals as well as from ₦1.0 million to ₦5.0 million for corporate borrowers. In 2000, the capital base of the fund was further increased from ₦1.0 billion to ₦3.0 billion.

(ii) The Refinancing and Rediscounting Facility (RRF) and the Foreign Input Facility (FIF)

The CBN introduced the Refinancing and Rediscounting Facility (RRF) in April 1987 to encourage banks to undertake export finance. The scheme involved rediscounting and refinancing of pre-and post-shipment activities at preferential rates. Increased awareness about the advantages of the RRF has led to greater participation by both exporters and banks in the scheme. The Foreign Input Facility (FIF) was introduced

by the CBN in May 1989 to facilitate the importation of raw materials and capital goods that are needed to produce for exports. The programme was supported by a loan from the African Development Bank (ADB). The loan, which amounted to about US$245 million, was disbursed in three tranches to stimulate non-oil exports. The RRF and FIF facilitates were, however, transferred to NEXIM in 1991. In its effort to strengthen the operation of the NEXIM, the CBN increased its contribution to the paid-up capital by ₦450 million to ₦1.4 billion.

(iii) The Small and Medium-Scale Enterprises (SME) Apex Unit Loan Scheme

In order to increase access to credit by the SMEs, the CBN and the Federal Ministry of Finance, on behalf of the Federal Government, obtained a World Bank Loan for SMEs. The total project cost was US$451.8 million, of which the World Bank provided US$270 million or 64 per cent. The CBN established an SME Apex Unit in the Bank in 1990 to administer the credit components and other related activities of the World Bank loan in order to facilitate project implementation. Loans disbursement under the Scheme ceased in 1996.

(iv) Small and Medium Enterprises Equity Investment Scheme (SMEEIS)

Bothered by the persistent decline in the performance of the industrial sector and with the realization of the fact that the small and medium scale industries hold the key to the revival of the manufacturing sector and the economy, the Bankers' Committee in 1999, initiated the Small and Medium Industries Equity Investment Scheme (SMIEIS) aimed at ensuring assistance to small-scale industries. Under this new scheme, banks are required to set aside 10.0 per cent of their profit before tax for investment in small-scale industries in the country. A bank's investment in the scheme is conceived to be in the form of equity participation, project packaging/monitoring, advisory services and nurturing of specific industries to maturity. The SMIEIS was renamed Small and Medium Equity Investment Scheme (SMEEIS) in March 2005, to broaden the scope of activities that can be funded under it. As at 30 May 2006, the total fund set aside by banks was ₦40.735 billion. During the same period, 16 projects

valued at ₦2, 665,781,000.00 were verified and confirmed. The cumulative investment made by the banks in 225 projects was ₦14.768 billion. On sectoral basis, the total value of investments recorded in the real sector amounted to ₦7.5 billion (50.79 per cent) in 145 projects, while service related sector accounted for investments amounting to ₦7.268 (49.21 per cent) in 80 projects.

(v) Refinancing Scheme for Medium and Long Gestation Agricultural Projects

The Refinancing Scheme for medium and long gestation agricultural projects is an initiative of the Central Bank of Nigeria, aimed at providing funds for extending credit for the establishment and sustenance of medium and long gestation agricultural projects whose moratorium and financing requirements have hitherto been unattractive to banks. Under the scheme, a fund from which the banks will draw for lending to these agricultural projects would be set-up. Some of the enterprises covered by the scheme include cocoa, rubber, oil palm, coffee, gum arabic, cashew, tea, fish capture, trawling, etc. The modalities for the operations of the scheme was prepared with inputs from stakeholders through series of workshops held all over the country by the Bank in 2000.

The Monetary Policy Forum

In 2000, the CBN established the Monetary Policy Forum in order to create a channel for public enlightenment and cross fertilization of ideas between the monetary authorities and other stakeholders. The forum was created in recognition of the fact that monetary policy works best in an environment where the views of the key stakeholders are taken into consideration in both its formulation and implementation. This initiative is consistent with the general move towards greater transparency and openness in monetary policy making by central banks worldwide. The Forum also serves as a medium for educating the public on the statutory functions of the Bank, which is necessary for the sustenance of its autonomy and credibility.

(d) Collaborative Research/Service to Third Parties

The Bank's services to third parties are largely routine, interspersed with ad-hoc/special studies directed at addressing specific and contemporary economic problems. The routine services include organizing/participating at seminars, data gathering through surveys and releases of the Banks' publications comprising weekly, monthly, quarterly, half-yearly and Annual Reports. In addition, papers are presented by the Governors and other top officials of the Bank on topical economic issues to enlighten the public. The outcome of the studies and collaborative research work with other institutions also inform the design and implementation of economic policies in the country.

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THE NIGERIAN FINANCIAL SYSTEM

The financial system plays fundamental role in the growth and development of an economy, particularly by serving as the fulcrum for financial intermediation between the surplus and deficit units in the economy. The financial system refers to the set of institutions, instruments, markets, the rules and regulations as well as the mechanism by which they interrelate to one another within the economic system. Thus, the financial system is the hub of productive activities, as it performs the vital role of financial intermediation, anchors payment services and is the bedrock of monetary policy implementation. The development of the financial system changes in tandem with the developments in the economy. The Nigerian financial system has continued to transform in character, ownership structure, depth and extent of the instruments, number of institutions and regulatory framework.

This Brief is aimed at enlightening the readers on the structure, operations and recent developments in the financial system.

THE STRUCTURE OF THE NIGERIAN FINANCIAL SYSTEM

Besides the regulatory and supervisory bodies, the institutions operating in the financial system can be grouped into money market, capital market, development finance institutions and other financial institutions.

[1] THE REGULATORY AND SUPERVISORY AUTHORITIES

The regulatory and supervisory authorities are very crucial for the efficient functioning and orderly development of the financial system because their surveillance role engender the soundness and efficiency of the financial institutions as well as enhance the stability of the system.

(A) CENTRAL BANK OF NIGERIA (CBN)

The Central Bank of Nigeria is the apex regulatory authority in the Nigerian financial system. It was established by the CBN Act of 1958 and commenced operations on 1st

July 1959. Among its primary functions, the Bank issues legal tender currency notes and coins, maintain the external reserves to safeguard the international value of the currency and promotes monetary stability and efficient financial system. Other functions include banker and financial adviser to the Federal Government and the lender of last resort to banks in the financial system. It also promotes the development of money and capital markets through the establishment of relevant institutions and has responsibility for formulating and implementing monetary and exchange rate policies. The CBN Act 1958 and the Banking Act 1969 were the precursors of the Bank's legal authority and subsequent legislation/amendments contained in the CBN Act 24 of 1991 (amended in 1997, 1998 and 1999) as well as the Banks and Other Financial Institutions (BOFI) Act No. 25 of 1991 (amended in 1997, 1998 and 1999) gave the CBN greater flexibility in regulating and supervising the banking sector and other financial institutions, particularly incorporating those that hitherto operated outside its purview. These include: primary mortgage institutions, finance companies and development finance institutions. With this development, the CBN became the overall regulator of all financial institutions in the system. In addition, the new mandate of the Central Bank of Nigeria (CBN) as contained in the new CBN Act (2007) reinforced its mandate to ensure monetary and price stability.

(B) NIGERIA DEPOSIT INSURANCE CORPORATION (NDIC)

The NDIC which was established by Decree No. 28 of 1988 and effectively commenced operations in 1989 was set up primarily as part of the financial safety net in the regulation of the banking system and to complement the CBN in the regulatory and supervisory role of deposit money banks as well as strengthening the banking system and promoting financial stability. It was set up to provide deposit insurance and related services for banks in order to engender confidence in the banking industry and provide safety net for depositors in case of unforeseen crisis. The NDIC was empowered to examine the books and operations of insured banks and deposit taking institutions. The NDIC operates funded deposit insurance system (DIS) which involves regular contributions in the form of premium which is payable by the entire member banks in the country. The mechanism adopted by NDIC in determining the

premium to be contributed to the funded DIS is uniform premium for all dmbs and is as a percentage of the deposits mobilized. Under the present arrangement, licensed deposit money banks are required to contribute 15/16 of 1 per cent or 0.937 per cent of their total deposit liabilities excluding foreign currency liabilities and inter-bank funds as insurance premium to the NDIC. With the recent amendments to the NDIC Act, depositor's maximum claim in event of a bank failure which hitherto stood at ₦50,000.00 was raised to ₦100,000.00 to address the observed inadequacy of the amount and to reflect developments in the financial system. In recent years, the NDIC has worked relentlessly with the CBN to curtail the problems of bank distress and the subsequent consolidation of the banking industry. Also, in collaboration with the CBN it has commenced the implementation of the new supervisory and regulatory framework based on risk management strategy which seeks to seek to encourage banks to develop and continuously update their internal risk management system to ensure that they are commensurate with the scope of their operations. The NDIC Act was amended in 1997 making the corporation to report to the Federal Ministry of Finance as against the previous position where it reports to the CBN.

(C) SECURITIES AND EXCHANGE COMMISSION (SEC)

The SEC is the apex regulatory/supervisory authority in the Capital market. It was established by the Securities and Exchange Commission Act of 1979, and was further strengthened by the SEC Act of 1989. The enactment of the Investment and Securities Act of 1999 repeal the former legislation and conferred on the Commission wide range regulatory powers over institution operating in the capital market. It also licensed stock exchanges and capital trading points all over the country as well as stipulated operational guidelines for institutions in the market. The SEC is responsible for registering all eligible securities offered in the capital market as well as stock exchanges, issuing houses, and stock brokers. It also registers over-the-counter transactions, futures, options other derivatives and other registered investment exchanges. The SEC maintains surveillance on the securities market to ensure strict compliance with the requirements of "just and equitable dealings". Since 1999, when the SEC stipulated minimum paid-up capital for all capital market

operators, efforts had been geared towards restructuring the Nigeria Capital Market. For instance, minimum paid-up capital for stock brokerage firms was fixed at N20.0 million, Issuing Houses N40.0 million, Brokers N10,000.00 million and N5.0 million for Registrars. Overall, the activities of SEC have continued to impact positively on the developments of the Nigerian financial system.

(D) FEDERAL MINISTRY OF FINANCE (FMF)

The FMF is the apex fiscal authority, responsible for the formulation and regulation of fiscal operations in Nigeria, particularly, fiscal policy of the federal government. It co-ordinates it's activities with those of the CBN to minimize conflicts and work in tandem with the monetary authority to ensure the achievement of macroeconomic goals of the government. It is pertinent to note that fiscal policy matters is at the core of all the financial policies and the FMF has immense responsibility in the management of the financial system. Fiscal policies have considerable impact on monetary policy through the actions of government in the money and capital markets. The FMF is the supervisory authority for SEC, NDIC and the National Insurance Commission among others as well as the CBN until it was granted autonomy in 1998.

(E) NATIONAL INSURANCE COMMISSION (NAICOM)

The National Insurance Commission (NAICOM) was established in 1987 as the regulatory authority for the insurance industry. It replaced the Nigerian Insurance Supervisory Board (NISB) which was established by the Insurance Special Supervision Fund (amendment) Act No. 62 of 1992 to take-over the regulation and supervision of insurance business from the FMF. The NAICOM is charged with the effective administration, supervision, regulation and control of business of insurance in Nigeria. Its functions include establishing standards for the conduct of insurance business, protection of insurance policy holders and establishment of a bureau to which complaints could be made against erring insurance companies and other intermediaries by the members of the public. It also has responsibilities for ensuring adequate capitalization and reserves as well as implementing capital restructuring for insurance business in Nigeria. Currently, in line with developments in the financial

system the NAICOM has concluded the consolidation of insurance companies in order for them to effectively and efficiently participate in the global business environment.

(F) FINANCIAL SERVICES REGULATION COORDINATING COMMITTEE

The Financial Services Regulation Coordinating Committee (FSRCC) was set up by the Central Bank of Nigeria (amendment) Decree No. 37 of 1998 to coordinate and harmonize the supervisory efforts of all regulatory institutions in the country. It comprises of the CBN, with the Governor as the Chairman, a representative from FMF not below the rank of a Director, Managing Director, NDIC, Director General, SEC, Commissioner for Insurance, NAICOM and the Registrar General, Corporate Affairs Commission (CAC). The committee also has responsibility for coordinating the supervision of financial conglomerates. The Committee meets regularly to coordinate its activities so as to minimize areas of conflicts and regulatory arbitrage that could result from the lack of proper coordination among the regulatory institutions.

(G) NATIONAL PENSION COMMISSION

The Pension Reform Act 2004, established the National Pension Commission (PenCom) as the body to formulate the overall pension policy, regulate, supervise and ensure the effective administration of pension matters in Nigeria. To strengthen the Commission's ability to effectively discharge its responsibilities, the Act empowered it to request for information from any employer, pension administrator or custodian or any institution on matters relating to retirement benefits. It is also charged with the responsibility of issuing guidelines for the investment of pension funds, establishment of standards and rules for the management of pension funds, as well as approving and licensing pension fund administrators, custodians and other institutions relating to pension matters. In addition, Pencom is responsible for the industry oversight functions such as investigating all parties involved in the management of pension funds.

[2] THE FINANCIAL MARKETS

These are markets where financial assets are traded. Generally, these markets deal-in short and long term securities and debt instruments to meet the broad spectrum of market financial requirements. These include stock exchanges for trading company shares and government debt, the money market for trading short-term loans, the foreign exchange market for trading currencies, and a number of specialized markets trading financial derivatives.

(A) MONEY MARKET AND ITS INSTITUTIONS

The major function of the money market is to facilitate the intermediation of short term funds from the surplus to deficit units of the economy. The deficit units which could be public or private, source funds from the market to bridge budgetary gaps by trading in short-term securities in the market. The institutional players in the money market which is the fulcrum of the financial sector include, deposit money banks and discount houses. The primary money market instruments comprises of Treasury Bills, Certificate of Deposits, Call Money, Commercial Papers, Investment Funds, Bankers Acceptances and Repurchase Agreement.

(i) DEPOSIT MONEY BANKS (DMBs)

Following the adoption of the Universal Banking System in January 2001, the dichotomy between the erstwhile commercial and merchant banks in Nigeria was removed, thus paving the way for banks to effectively play their intermediation role and provide level playing ground for operators in the banking industry. Consequently, the banks were able to pursue the business of receiving deposits, provide finance, consultancy and advisory services unhindered. However, the persistence of structural rigidities including low capital base, declining ethics and huge non-performing loans, weak corporate governance and overdependence on public sector deposits precipitated the reform that led to the banking system consolidation in the first quarter of 2006. Under the reform, the minimum capitalization for each bank was raised to ₦25.0 billion to be met by end-December 2005 and banks were encouraged to consolidate through mergers and acquisitions. At the conclusion of the exercise, 25

banks emerged out of the previous 89 that existed prior to the consolidation. Furthermore, with the recently concluded merger 2 of the recently consolidated banks, there are currently 24 deposit money banks on the financial landscape. Generally, the activities of deposit money banks impact on the soundness and the stability of the financial system hence the unique attention accorded them by the regulatory authority.

(ii) DISCOUNT HOUSES (DHs)

Discount houses were established at inception as financial intermediaries between the Central Bank and other financial institutions. They are specialized non-bank financial institutions which engage in mobilizing funds from the surplus sectors and channeling the mobilized funds to the deficit sector. They mobilize funds for investment in securities by providing (re) discounting facilities in government short-term securities. The operation of the discount houses have effectively assisted in deepening the money market and has also facilitated the use of Open Market Operations (OMO) in monetary management. The number of discount houses in existence remained unchanged at five in December 2006 with total assets/liabilities amounting to N185.5 billion.

(B) THE CAPITAL MARKET AND ITS INSTITUTIONS

The capital market which is the long end of the financial market is the channel for mobilizing long-term funds for investment in capital projects. The major capital market institutions in Nigeria include the Securities and Exchange Commission (SEC) which is the apex regulatory institutions, other are the Nigerian Stock Exchange (NSE); Nigerian Commodity Exchange (NCE); Stock Brokers; Issuing Houses and the Registrars.

(i) THE NIGERIAN STOCK EXCHANGE (NSE)

The NSE evolved from the Lagos Stock Exchange, which was incorporated as a limited liability company to provide the mechanism for mobilizing public and private savings for productive investment in the economy. The functions of the Exchange include: provide the medium for bringing market participants together for the

purchase and sales of stocks and shares, granting of quotation on the Exchange in respect of the shares and stocks under the listing requirements of the NSE. In order to bring its services nearer to the investing public, the Nigerian Stock Exchange has since 1977 extended its trading floors to Port Harcourt, Kano, Kaduna, Ibadan, Onitsha Yola and Abuja. Also, in recognition of the crucial role of small and medium scale enterprises, the NSE introduced the Second-Tier Securities Market (SSM) for the quotation and listing of small and medium enterprises which often cannot meet its stringent listing requirements. In 1998, the Central Securities Clearing System (CSCS) was introduced to facilitate trading through enhanced processing and settlement of transactions and the Automated Trading System (ATM) was introduced in 1999 to enhance automation on the Exchange. These efforts were geared toward improving the efficiency of the capital market and encourage foreign capital inflows into the economy. In the same year, the effort resulted in the cross-border listing of Mnet/Supersports on the floors of the exchange, concurrently with the listing of the company on the Johannesburg Stock Exchange (JSE). in the same year. The NSE also entered into a memorandum of Understanding (MOU) with the Ghanaian and the Nairobi Stock Exchanges. In 2004, the Nigeria Stock Exchange implemented a remote trading process which was a multi-pronged market development strategy and automation of the bond market. The NSE also adopted a zero tolerance policy on market malpractices in 2005 and consequently introduced the Trade Alert system primarily to secure the market against unethical practices of unauthorized sales of shares. The system was also meant to promptly communicate market related information to subscribers.

(ii) The Primary Market

This is the market where financial assets are sold for the first time usually in the form of new issues of securities. The mode of offer for the securities traded in this market includes; offer for subscription, rights issue, offer for sale and private placement. In 2006, the Exchange approved 62 applications for both new issues and mergers/acquisitions valued ₦1.4 trillion, compare with 52 applications valued at ₦730.5 billion. There were also the FGN Bonds issues which amounted to ₦155.0 billion during the year.

(iii) The Secondary Market

This is the market where existing securities are traded and consists of the stock exchanges and Over-the-Counter (OTC) markets, where securities are bought and sold after their issuance in the primary market. Activities in the secondary market are carried out on the floors of the stock exchange, where investors and sellers of securities meet to consummate deals through their stock brokers who are the dealing members of the Exchange. Activities in the secondary market have increased substantially over the years resulting in increase in trading floors as well as the number of stock brokers. The performance of the market was enhanced by the increased awareness of the opportunities in the stock market, improved result of the quoted companies as well as the mandatory investment of 25.0 per cent of pension funds in the market.

(iii) The Unit Trust Scheme

The scheme is a mechanism for mobilizing financial resources from small and big savers and managing such funds to achieve maximum returns with minimum risks, especially, through portfolio diversification. If effectively managed, unit trust schemes offer the advantages of low costs, liquidity and high returns. Activities in this area however remained grossly inadequate.

(C) THE DEVELOPMENT FINANCE INSTITUTIONS (DFIs)/SPECIALIZED BANKS

These institutions were established primarily the address the slow pace of development and economic growth by mobilizing enormous resources for investment in the critical sector of the economy. This led to the establishment of the erstwhile Nigeria Industrial Development Bank (NIDB) set up in 1964 to harness local and foreign skills as well as provide capital for the development of industries. Also, the Nigeria Bank for Commerce and Industry (NBCI) was set up in 1973 to provide equity capital and funds to small and medium industrialists. Similarly, the former Nigerian Agricultural and Co-operative Bank (NACB) was established to finance viable agricultural projects to enhance the level and quality of agricultural production

in the country. These institutions had been restructured owing to poor assets quality and low capital base and merged with other development agencies to form new institutions. Specifically, the NIDB, NBCI and the National Economic Reconstruction Fund (NERFUND) were merged to form the Bank of Industry (BOI), while the NACB, Peoples Bank of Nigeria (PBN) and the Family Economic Advancement Programme (FEAP) became the Nigeria Agricultural Cooperative and Rural Development Bank (NACRDB), respectively. The restructuring of these various institutions into two was intended to achieve sharper focus and to address the issue of development financing from a holistic perspective. Other specialized institutions also set up to address development issues included the Nigeria Export-Import Bank (NEXIM), Federal Mortgage Bank of Nigeria (FMBN), Urban Development Bank and the Nigeria Education Bank (NEB), formerly Students Loans Board.

(i) Urban Development Bank (UDB)

The UDB was established by Decree No. 51 of 1992 to create a greater capital for dealing with the problems of inadequate housing, transportation, electricity and water supply. The bank commenced business with an authorized equity capital of ₦800 million, of which ₦543.6 was subscribed by the three tiers of government and the Nigeria Labour Congress. The bank operates on a profit making basis and provides financial services to both the public and private sectors of the economy for the development of urban houses, provision of mass transportation systems and other public utilities.

(ii) The Federal Mortgage Bank of Nigeria (FMBN)

The FMBN was established by Decree No. 7 of 1997 with the mandate of providing banking and advisory services as well as research activities pertaining to housing development in the country. Following the promulgation of Decree No. 3 of 1991 that set up the National Housing Fund (NHF), the FMBN was empowered to coordinate contributions to the fund and manage the NHF. Other mandates included licensing and regulating mortgage institutions in Nigeria and acting as the apex body for the

entire mortgage industry. The Federal Mortgage Finance was, however, carved out of FMBN in 1993 with its financing functions transferred to the new agency, while it retained its regulatory functions of the primary mortgage institutions and also serves as the apex body.

(iii) Nigerian Export-Import Bank (NEXIM)

The Nigerian Export-Import Bank (NEXIM) Decree 38 of 1991 to provide finance, risk mitigating facilities and trade information as well as advisory services to the Nigeria export community established the NEXIM. The bank commenced operations 2nd January, 1991 with facilities covering: trade finance, project finance, treasury operations, export advisory service and market information. The Rediscounting and Refinancing Facilities (RRF) which was created by the CBN was transferred to NEXIM to assist banks provide pre and post shipment finance in local currency to support non-oil exporters. Similarly, under the Foreign Input Facility (FIF) the Federal Government sourced resources from the African Development Bank (ADB) for NEXIM to provide the export sector with foreign exchange for raw materials and machinery to produce goods for export. In addition, NEXIM introduced the Stocking Facility in local currency to enable manufacturer of exportable goods to procure adequate stock of local raw materials to keep production at optimal levels at all times. Under its treasury operations, funds are placed with banks that are active in export finance in order to encourage them to continue supporting exports. The export advisory and market information services disseminate information and provide guidance to the export community on a wide range of issues bordering on finance and trade.

(D) OTHER FINANCIAL INSTITUTIONS (OFIs)

These are non-bank financial institutions within the financial system that play important financial intermediary roles as discussed below:

(i) Finance Companies (FCs)

Finance Companies are non-bank financial intermediaries involved in funds mobilization particularly short-term fund, placement and funds management, project

financing, equipment leasing, debt factoring and granting credit. Finance companies are statutorily barred from accepting deposits and undertaking foreign exchange transactions as stipulated in the guidelines for their operations. The CBN is responsible for monitoring finance companies operations to ensure that they conform with specified regulations to avoid financial distress in the sub-sector. At end-December 2006, there were 112 finance companies in operation with total capitalization amounting to ₦11.4 billion.

(ii) Primary Mortgage Institutions (PMIs)

The PMIs were established with the enactment of Decree No 53 of 1989 to mobilize savings for the development of the housing sector. Mortgage financing received a boost with the establishment of the National Housing Fund in 1992 with contributions to the fund made mandatory through deductions from the monthly salaries of formal sector employees. At end-December 2006, there were 91 PMIs in operations with a total capitalization of ₦15.6 billion.

(iii) Bureaux De Change (BDCs)

To broaden the foreign exchange market, the CBN introduced the BDCs to enhance accessibility of foreign exchange by small end-users. They act as dealers in the spot market and buy/sell foreign currency with small margin as returns. Following the liberalization of both the foreign exchange market and BDCs sub-sector during the first-quarter of 2006, the number of BDCs in operation rose to 322 by end-December, 2006.

RECENT DEVELOPMENTS IN NIGERIA'S PAYMENTS SYSTEM

The Nigeria's payments system (NPS) has been significantly influenced by financial liberalization and deregulation across international borders as well as the remarkable progress made in information and communication technology (ICT). Given the crucial role of the payments system as a channel through which financial resources flow from one segment of the economy to the other, the CBN accorded the payments system due priority in the reform agenda of the financial system. Thus, the Bank in conjunction with other stakeholders channeled resources towards its transformation and modernization to enhance the safety, efficiency and reliability of the payments system in Nigeria. This effort culminated in the introduction of institutional arrangements, operational mechanisms, interrelated IT infrastructure and instruments that are widely gaining acceptability among service consumers in the banking industry.

Accordingly, this BRIEF reviews the transformation which has occurred in the NPS in the pre and post banking sector consolidation era.

2. OBJECTIVES OF THE NPS

The first major step towards reforming the NPS by the CBN was the evolvement of a set of national policy objectives which provided the framework and the guidelines for all payment systems initiatives. The goal was to ensure that the system is available without interruption, meet as much of the users' needs as possible, and operate at minimum risk and reasonable cost.

Specifically, the objectives of the NPS reforms as articulated include:

- Promoting efficiency and effectiveness through transparency, flexibility and reliability;
- Ensuring integration/interoperability of the sub-systems;

- Speeding up exchange and settlement of funds and securities;
- Promoting safety and protecting systemic risks by:
  - i. Containing credit, legal, liquidity and operational risks.
  - ii. Compliance with international standards and recommendations
  - iii. Compliance with national standards and recommendations e.g. Cheque and electronic banking standards;
- Migration to cash-less modes of payments, such as electronic debit/credit instruments, credit/debit cards, ATM-sharing and Electronic Fund Transfer at Point Of Sales and Real-Time Gross Settlement System (RTGS);
- Operating the NPS system in a transparent manner to spearhead procedures and technology that perform end-to-end audit-ability, full transaction reporting to regulatory and reporting authorities.
- Initiating the channels for effective information dissemination, customer convenience orientation and total quality delivery. In particular, the NPS would ensure widespread use of payment solutions for government payments and inspire public confidence and acceptance. The NPS would ensure that the legal and institutional arrangement is favorable to the achievement of its goals.
- Integration with the financial infrastructure to ensure that financial value flows from one market to the other in a seamless manner.

Therefore, the NPS would be a major driver of changes in the financial markets, and encourage collaboration and cooperation as Nigeria moves towards a common monetary zone with five other West African countries.

3.0 MILESTONES IN THE NPS

The major developments that have taken place so far in the payments system can be broadly classified into three, viz: infrastructural, institutional and instruments. These are discussed in details as follows;

3.1 INFRASTRUCTURAL DEVELOPMENTS

3.1.1 National Automated Clearing System

Concrete steps towards modernizing the payment system began with the introduction of the National Automated Clearing System (NACS) based on the magnetic ink character recognition (MICR) technology. A centralized automated clearing process was established and became operational in the Lagos clearing zone in October 2002 and was later extended to Abuja in March 2005. Hitherto, the processing of cheques and computations of the net settlement position of banks were done manually. Enabled by MICR reader sorters, necessary information on cheques were captured, built into clearing files and electronically transmitted to the clearing house, from where the net settlement position of participating banks were automatically computed and also electronically transmitted to the CBN for final settlement. Thus, automation revolutionized the cheque clearing system and provided the veritable platform for the development of electronic payments and settlement, such as electronic card transactions as well as paper based instruments. Furthermore, since the adoption of the new system, the clearing cycle for local and up-country instruments was reduced from 9 and 5 days to 6 and 3 days, respectively.

3.1.2 CBN Inter-bank Funds Transfer System (CIFTS)

The CIFTS is a Real Time Gross Settlement (RTGS) in which the continuous settlement (real-time) of funds or securities transfers is individually done on an order by order basis (without netting). It was introduced to deal with the risks associated with the earlier net settlement system, particularly in large volume transactions. The system which went live in December 2006 interfaces with the core banking application, the Temenos 24 system and has all the twenty five (25) DMBs and five (5) Discount Houses as direct participants. Through the CIFTS, participants are able to perform a number of transactions such as inter-bank and third party fund transfers, balance enquiry, reconciliation, etc from their offices electronically using Terminal Access Device. In addition to reducing systemic risk and elimination of settlement risk as payment messages are irrevocable, the system also enhances the implementation of monetary policy.

3.1.3 National Central Switch (NCS)

In a bid to further enhance the efficiency of the electronic payment system in the country, the Bankers' Committee through the initiative of the CBN, approved the establishment of a NCS in 2006. It was meant to facilitate interoperability and interconnectivity between electronic funds transfer switches. In addition to its primary function of providing interconnectivity and interoperability between EFT switches, the NCS would be used for switching transactions between other third party processors. Furthermore, it would serve as a platform for supporting the integration of the Nigerian retail payment system with that of the West African Monetary Zone (WAMZ).

3.1.4 T24 System

The T24 System was introduced in 2006 as a core banking application of the CBN to automate trading in securities. The system allows banks and discount houses to conduct transactions from their offices through of internet rather than by submitting written bids to the CBN.

3.1.5 Retail Payments System

To enhance the efficiency of cheque clearing and settlement activities, the CBN reduced the clearing cycles for up-country cheques from T + 5 to T+ 3, while the clearing cycle for local cheques remained at T + 2. The reduction was to step-up the harmonization of the clearing cycles between up-country and local cheques.

3.2 INSTITUTIONAL DEVELOPMENTS

3.2.1 Payments System Division

The laws and organizational arrangements required to ensure the seamless operation of the payments systems constitute the institutional framework. Towards this end, the CBN in the exercise of its mandate, created a full fledged Payments System Division in the Banking Operations Department of the CBN with oversight function over the NPS. The Division has, therefore, assumed full responsibility for ensuring the effectiveness and efficiency of the NPS. The need for oversight derives from the

associated risk and constraints connected with payment issues which if not identified, monitored and controlled in a timely manner, may adversely affect the smooth functioning of the entire system.

3.2.2 National Payments System Committee

Inaugurated on May 2005, the National Payments System Committee (NPSC) serves to provide strategic direction for the development of the Payment System. Its membership consists of CBN Governor as chairman, DMBs, core government agencies, regulators as well as other stakeholders in the financial service industry. To effectively deal with the various ramifications of the subject matter, six technical Sub-Committees of the NPSC were created on September, 2005 as follows; Large Value Payments, Retail Payments, Securities Clearing and Settlement, Regulations and Supervision, Legal and Institutional Framework, Standards and Information Technology, and Publicity and Public Enlightenment. Some notable initiatives of these Sub-Committees include; the linking of the CIFTS with the CSCS, issuance of electronic payments standard, guidelines on transaction switching and card issuance.

3.2.3 Nigeria Cheque Printers Accreditation Scheme (NICPAS)

The NICPAS was instituted following approval for the implementation of the Nigerian Cheque Standard. The Scheme was meant to produce standardized cheques to be used within the economy. Eleven printing firms were accredited, consisting of nine foreign and two local. With the completion of all necessary arrangements, the implementation of NICPAS was scheduled for commencement in January, 2007.

3.3 INSTRUMENTS

Generally, payments system instruments can be categorized into four; namely, currency or cash, paper-based instruments, paperless or electronic instruments and other instruments. Currency or cash includes bank notes and coins. Paper-based instruments are cheques, bank drafts, and travelers' cheque while the paper-less or electronic instruments are essentially computer-based technology payment instruments like the automated teller machines (ATMs), automated clearing houses (ACHs), point-of-sale terminals (POSTs), internet payments, mobile telephones and

wire transfers. Other instruments include: postal orders, money orders, vouchers and pre-paid cards,

In Nigeria, the most significant changes have occurred with the paper-less or electronic instruments and would, therefore, de discussed in greater detail as follows. It is also pertinent to mention that the driving forces in the progress so far made include the deregulation and liberalization in the financial system, consumers' changing needs, technological innovations as well as competition among banks.

3.3.1 Automatic Teller Machines (ATMs)

The ATM is an electronic cash dispenser which allows account holder 24 hours access to their funds. The entire system is leveraged upon a complex network of ICT system to verify online, information contained in a card before cash request is honoured. It has been generally found to be highly reliable and very convenient for users.

In the Nigerian environment, Societe Generale Bank blazed the trail in the provision of ATMs in 1984. Currently, practically all of the deposit money banks offer ATM services either on stand-alone basis or as part of a network arrangement, and in some cases on both platforms, on and off-site, particularly at hotels and commercial centres. Evidence has shown the growing awareness and acceptability of its usage. Available statistics show that the total number ATMs available in the country increased from 184 in 2004 through 425 in 2005 to 776 in 2006. Similarly, the volume and value of transactions rose steadily from 1,017,576 and ₦4.34 billion in 2004, through 3,489,843 and ₦17.31 billion in 2005 to 12,138,019 and ₦63.24 billion in 2006, respectively.

3.3.2 Debit and Credit Cards

Otherwise known as plastic money, debit and credit cards are electronic cards which carry monetary value and so could be used to settle financial obligations. With debit cards, purchases and cash withdrawals are charged directly to the accounts of holders. Worldwide examples of debit cards include VISA, MasterCard, Euro card and American Express etc. Some local variants of debit cards in Nigeria include; Valucard, Smart pay, EasyCash Card etc.

International card companies particularly, VISA and MasterCard are expanding their presence in Nigeria. VISA had Nigerian bank membership of thirteen while MasterCard had four banks in its scheme as at end 2005. Owing to growing public awareness, the volume and value of dollar denominated transactions through electronic cards in Nigeria rose significantly from 40,843 and US$10.74 million respectively, in 2005 to 139,011 and US$36.29 million in 2006

Credit cards on the other hand, allow the holder to undertake purchases and/or make cash withdrawals up to an agreed limit. The credit is later settled partially or in full depending on the terms of the contract. MasterCard in partnership with Cards Technology Limited and Ecobank introduced credit card in Nigeria in 2004. Ecobank again introduced the Naira Credit Card in 2006.

3.3.3 Mobile Phone and Internet Payments

Payments through the internet and mobile phones have gained a lot of prominence with the widespread use of the GSM and the adoption of internet banking operations. Banks now partner with telecommunications companies to offer mobile payments services. Services such as balance enquiry and funds transfer, have become common feature. Similarly, internet payments were encouraged by agencies such as the Joint Admission Matriculation Board (JAMB) which started e-registration using single purpose stored value card, also the Lagos State Water Corporation initiated payment of water bills through the web. Currently, airlines, businesses, corporations/MDAs such as Corporate Affairs Commission (CAC), Nigerian Immigration Service etc accept payments through the web.

4.0 FUTURE OUTLOOK: NPS VISION 2012

The NPSC has recognized the need for and consequently, initiated a strategic vision document for the development of the NPS. Thus, the NPS Vision 2012 draft document had being completed for implementation in order to enhance collaborative development of the System. The Vision aims to create an electronic payments infrastructure that would be nationally utilized by all sectors of the economy as well as being internationally recognized.

The specific objectives are; to facilitate economic activities, provide safe and efficient means of non-cash payments, minimize risks to users, provide coverage for all sectors and regions and, ensure conformity to internationally accepted standards. The expected outcomes include; low usage of cash for transactions which would enhance the implementation of monetary policy, greater access to means of payments irrespective of location and promote economic efficiency.

The prospects for the development of the NPS are very bright, given the above initiatives, the rapid transformation taking place in the Nigerian banking industry, and the ongoing efforts to position the country as the financial hub of Africa by the year 2020. In addition, the capital market is gradually becoming internationalized with implications on the NPS. Finally, the monetary integration efforts in the West African sub-region would be an added impetus as this would mean integrating the NPS with that of the WAMZ.

CBN BRIEFS
SERIES NO. 2006 - 2007/04
RESEARCH AND STATISTICS DEPARTMENT

NIGERIA'S FINANCIAL SYSTEM STRATEGY 2020 (FSS 2020)

The Financial System Strategy 2020 (FSS 2020) is a blueprint initiated by the Central Bank of Nigeria (CBN) for achieving the goals of developing and transforming Nigeria's financial sector into a growth catalyst which, would propel the country into an international financial center, and provide the safest and fastest-growing financial system amongst emerging economies. The strategy was predicated on Nigeria's goal to become one of the top economies in the world by the year 2020, and to successfully develop the financial sector, such that Nigeria would be the choice destination in West Africa for financial products and services as well as the gate-way for channeling investments to other parts of the continent. The FSS 2020 would be fully integrated with the ongoing economic reforms and harness the gains, to ensure that Nigeria realizes the underlying objective of becoming a financial hub as well as joining the league of top 20 economies in the world by 2020.

The project commenced in August 2006 with the constitution of a steering committee with membership drawn from key stakeholder including: CBN, Nigerian Deposit Insurance Corporation (NDIC), National Insurance Commission (NAICOM) and other key industry players. Consultants/subject matter experts were also appointed to facilitate the development of the strategic plan.

The objective of this BRIEF is to provide a general overview of the Financial System Strategy 2020 Project.

THE VISIONING PROCESS OF THE FSS 2020

The overall vision guiding the FSS 2020 defines the desired end-state for the Nigeria's financial system in 2020. The visioning process was influenced by several factors, including the nation's economic trends, the character and the dynamics of the local economy. Based on these, the crafting of the desired end-state of the Nigerian financial system was guided by the following:

- **Vision Time Frame:** A target date of 2020 was chosen based on the desire to fast track the nation's development process.
- **Geographic Dimension:** In arriving at the geographical scope of the strategy, emerging markets were chosen as the geographical dimension. The choice was influenced by, amongst other factors, Goldman Sachs' assertion that Nigeria could be placed among the "next 11" after Brazil, Russia, India, and China (BRICs) by 2025. Based on this premise, Nigeria would be one of the emerging market economies by 2020.
- **Scope of Offerings:** A generalist option that would focus on asset management, banking, capital markets and technology-backed office operations was chosen.
- **Size of Economy:** The desire was to become one of the 20 largest economies by 2020.
- **Growth Rate:** The economy was expected to be the fastest growing economy among emerging market economies.
- **Role of Financial System:** The financial system was expected to drive and sustain economic growth and development in Nigeria. It would, therefore, be positioned as a catalyst for the economic advancement of the country.
- **Sector Target:** The financial system strategy aimed at leveraging on the gains from the oil sector to significantly impact on the non-oil sector of the economy. It was expected that this would further diversify the economy and create the desired positive ripple effect.

The strategy was designed to ensure that efficiency and safety were not compromised within the financial system despite the impending changes in the financial system.

THE VISION, MISSION AND ASPIRATIONS OF THE FSS 2020

- **The Vision Statement:**

"To be the safest and fastest growing financial system amongst emerging market countries"

- **An explanation to the vision statement**

"Safest" The Nigeria financial system would be modeled to provide unparalleled safety in order to mitigate the perception usually associated with emerging economies. The financial system would be re-configured with shock-recovery capabilities and sensitivity.

"Fastest Growing" The rate of growth would be measured by clearly defined parameters that would enable the country to become one of the 20 largest economies through the strengthening of the country's financial system.

"Emerging Markets" The country intended to conquer and use the key emerging markets as the initial benchmark.

- **The Mission Statement**

"To drive rapid and sustainable economic growth in Nigeria and Africa"

The plan was for the Nigerian financial system to serve as a catalyst for the growth of the economy, as opposed to "supporter of economic growth". It was also to build size in order to create momentum by straddling the entire Africa after leveraging the West African sub-region. Nigeria currently constitute 70 per cent of the West African economy, thus, creating a highly integrated sub-regional economy would increase the relative market size.

THE OBJECTIVES OF THE FSS 2020

The broad objectives of the FSS2020 included:

- Developing a shared vision and an integrated strategy for the nation's financial system.
- Developing market and infrastructure strategies that would align fully with the strategic intent of the overall system.
- Creating a performance management framework and building a partnership with all key stakeholders to implement the strategy.
- Establishing a harmonious and collaborative environment for the development and delivery of the strategy.

THE SCOPE OF THE FSS 2020

In developing the strategic plan, the CBN and other stakeholders identified the following sectors as the 'drivers" whose immediate development would enable the financial sector to catalyze growth:

- The financial system in general
- Money market
- Capital market
- Insurance market
- Credit market
- Mortgage finance industry
- Information and communication technology
- Legal framework
- Regulatory framework

THE STRUCTURE FOR THE ACTUALISATION OF THE FSS 2020

In order to produce a blueprint which would ensure that the FSS 2020 had buy-in from stakeholders and the general public, and that it was also, generally accepted in Nigeria, the following structure was put in place: Steering Committee which at as the approving body that takes the final decision; Technical Committee responsible for harmonizing teams output; Project Management Office that coordinates all project activities to minimize project risks; Quality Assurance Team that ensures consistency and quality of output in all deliverables; Communication & Branding Team that creates the right visibility for the project; and the various Sector Teams, which conduct in-depth research, carry out diagnostic reviews of sectors and develop sector visions, strategies, and implementation plans.

The identified sectors for the various teams were money market, foreign exchange, capital market, regulation, central banking, mortgage, legal, insurance, credit, small and medium enterprises, information & communication technology, and human capital development.

THE GROWTH STRATEGY FOR THE FSS 2020

To accomplish the goals of the project, the plan was to concurrently strengthen the domestic financial markets; enhance integration with external financial markets; and engineer Nigeria's evolution into an international financial centre. The improved financial system would then be used to catalyze growth in other parts of the economy.

Strengthening the Domestic Financial Markets

The first prong of the strategy focuses on strengthening the domestic financial markets. It was believed that a strengthened financial sector would act as a catalyst that would drive growth in the real sector. To develop the financial sector, efforts would be made to:

- Develop competence and skills in the financial services industry
- Leverage on oil and gas sector to develop the non-oil sectors
- Integrate the informal financial sector into the formal financial sector
- Revolutionize access to finance;
- Build an integrated infrastructure for the financial industry; and
- Optimise data management in the evaluation, monitoring and promotion of a sound financial sector

Enhancing Integration with External Financial Markets

The second prong of the strategy focuses on integration with external financial markets (concurrently with strengthening the domestic financial markets). The plan was to focus on initiatives that would enable the financial sector to reinforce the expansion of the export base. Simultaneously, there was a plan to adopt initiatives that would support exchange rate stability, create an environment that attracts foreign direct investments as well as drive integration with external markets. Integration with external markets, would first start with the regional bloc, then expand to other global economic blocs. These would be done through the creation of a platform for seamless linkages with international markets. It would entail the following: pursuing currency convertibility, while maintaining macroeconomic stability; maintaining a healthy

foreign reserves level; ensuring the progressive unification of trade and commercial laws amongst ECOWAS and AU countries; and creating an environment that would attract global financial services firms and enable Nigerian financial institutions to export their products and services.

Building an International Financial Centre

The third prong in the financial system strategy would focus on engineering Nigeria's evolution into an international financial centre in the medium-to long-term. This would entail weaving into the other two prongs the necessary ingredients for building a successful international financial centre.

Other issues for consideration towards the success of the FSS 2020 include:

- Openness trade restrictions still existed. Major steps would be taken towards address this;
- Stable macroeconomic environment(fiscal, monetary and exchange rate management);
- Double digit GDP growth;
- Single-digit interest rate to stimulate productive capacity and growth of the real sector;
- Fully functional infrastructure facilities with adequate security of life and property;
- Effective judicial system that would guarantee property rights;
- Market-driven and harmonized supervisory and regulatory regime;
- Single-digit inflation (to encourage savings);
- Best practice corporate governance and transparent reporting standards in line with international accounting standards; and
- Qualitative education (Human capital development).

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POST CONSOLIDATION CHALLENGES IN NIGERIA'S BANKING SECTOR

The banking sector reforms which started in 2004 and focused on strengthening and consolidating the banking system, ended on December 31, 2005. The major emphasis of the reforms on recapitalization and proactive regulation under a risk-based or risk-focused supervision, framework has ensured competition and safety of the system; and has proactively positioned the industry to perform its role of intermediation and economic development. Specifically, the successful consolidation of the industry has ushered in a number of positive developments to the banking sector in particular and the economy at large.

The consolidation exercise, however, has thrown up some challenges which require sustained policy actions so as not to compromise with the gains already recorded.

This Brief reviews the outcome of the Banking Sector Consolidation in Nigeria, with particular focus on post consolidation challenges.

OUTCOME OF BANKING SECTOR CONSOLIDATION IN NIGERIA

At the expiration of the deadline on 31st December 2005, set for the recapitalization of banks, twenty-five (25) groups made up of seventy-five (75) banks emerged out of the eighty-nine (89) banks that existed at end-December 2004. The successful banks accounted for 93.5 per cent of the total deposit liabilities of the banking system. Fourteen (14) banks, which neither met the minimum capital of N25.0 billion nor found merger partners, had their licenses revoked by the CBN. Consequently, the Nigerian Deposit insurance Corporation (NDIC) obtained court approval to commence the process of liquidation of the affected banks. The component members of the twenty-five consolidated banks are as contained in Table 1 (below).

Table 1 : Component Members of Consolidated Banks

Bank Name		Members of the Group
1	**Access Bank Plc**	Marina Bank, Capital Bank International, Access Bank
2	**Afribank Plc**	Afribank Plc, Afrimerchant Bank
3	**Diamond Bank Plc**	Diamond Bank, Lion Bank, African International Bank (AIB)
4	**EcoBank**	EcoBank
5	**ETB Plc**	Equatorial Trust Bank (ETB), Devcom
6	**FCMB Plc**	FCMB, Co-operative Development Bank, Nig-American Bank, Midas Bank
7	**Fidelity Bank Plc**	Fidelity Bank, FSB, Manny Bank
8	**First Bank Plc**	FBN plc, FBN Merchant Bank, MBC
9	**FirstInland Bank Plc**	IMB, Inland Bank, First Atlantic Bank, NUB
10	**Guaranty Trust Plc**	GT Bank
11	**IBTC-Chartered Bank Plc**	Regent, Chartered, IBTC
12	**Intercontinental Bank Plc**	Global, Equity, Gateway, Intercontinental
13	**NIB**	Nigerian International Bank
14	**Oceanic Bank Plc**	Oceanic Bank, In't Trust Bank
15	**Platinum-Habib Bank Plc**	Platinum Bank, Habib Bank
16	**Skye Bank Plc**	Prudent Bank, Bond Bank, Coop Bank, Reliance Bank, EIB
17	**Springbank Bank Plc**	Guardian Express Bank, Citizens Bank, Fountain Trust Bank, Omega Bank,, Trans International Bank, ACB
18	**Stanbic Bank Ltd**	Stanbic Bank
19	**Standard Chartered Bank Ltd**	Standard Chartered Bank Ltd
20	**Sterling Bank Plc**	Magnum Trust Bank, NBM Bank, NAL Bank, INMB, Trust Bank of Africa
21	**UBA Plc**	STB, UBA, CTB
22	**Union Bank Plc**	Union Bank, Union Merchant Bank, Universal Trust Bank, Broad Bank
23	**Unity Bank Plc**	New Africa Bank, Tropical Commercial Bank, Centre-Point Bank, Bank of the North, NNB, First Interstate Bank, Intercity Bank, Societe Bancaire, Pacific Bank
24	**Wema Bank Plc**	Wema Bank, National Bank
25	**Zenith International Bank Plc**	Zenith International Bank Plc

*Following the merger of IBTC-Chartered Bank Plc and Stanbic Bank Ltd on September, 2007, the number of consolidated banks in Nigeria stood at twenty four (24) at end December, 2007.

In the process of complying with the minimum capital requirement, N406.4 billion was raised by banks from the capital market, out of which N360.0 billion was verified and accepted by the CBN as at end-December 2005. As a result, aggregate capital base of the sector rose from about US$3.0 billion to US$5.9 billion. The programme also attracted ₦350.2 billion (about US$3.0 billion) in new investments and US$500.0 million from foreign direct investment (FDI) inflow.

The banking consolidation programme brought a number of positive developments to the banking sector in particular and the economy in general. These included:

- The emergence of relatively well capitalized banks, which engendered greater public confidence in the system;
- Greater public awareness and the deepening of the capital market, as the aggregate capitalization of banks as a share of the stock market capitalisation rose from 24 per cent to 41.8 per cent in December, 2006;
- A reduction in bank interest rates and other charges induced by significant inflow of funds into the banking system;
- The depth of the financial sector, as measured by the ratio of broad money stock (M2) to GDP increased to 20.3 per cent in December, 2006 as against 18 per cent at end-December, 2005;)
- The intermediation efficiency of the banks as measured by the ratio of currency outside bank (COB) to broad money (M2) supply improved as it fell to 18.8 per cent in December, 2006 from 21.4 per cent at end-December, 2005.
- Increased capacity of banks to finance big ticket transactions with higher single obligor limit;
- Dilution of ownership of banks enhanced corporate governance;

Enhanced regulatory and supervisory oversights with other agencies collaborating with the CBN;

- High level of transparency and adherence to best practices in information disclosure.

EMERGING ISSUES AND POST CONSOLIDATION CHALLENGES

Following the successful consolidation of the Nigerian banking industry, a number of consolidation challenges emerged. These challenges relate to the stakeholders in the industry, particularly the operators, regulatory authorities and the government. Both existing and potential challenges are discussed hereunder.

Operators:

Banks require strong management teams that are committed to bringing about overall performance improvements and capacity enhancements. Paradigm shifts has necessitated the conceptualization and articulation of new strategies to address the complexities arising from the consolidation exercise. Specifically, some considerations has to be given to the industry as follows:

i. Increased Customer Orientation and Focus

In the post-consolidation era, customers' expectations for improved banking services has increased as banking no longer involve providing standard products to customers. In order to remain competitive as financial intermediaries, banking institutions need to be sensitive to customer's needs for greater efficiency and convenience. There is the need for financial products to be customized to the individual needs of corporate and retail clients. Banking institutions therefore need to be more proactive and innovative in products packaging and marketing. While customers expect wider range of products to be offered, the banking institutions ability to provide these products at competitive pricing is of greater importance.

ii. Dearth of Qualified Manpower

Consolidation has engendered a competitive environment that only well motivated and trained employees would effectively contribute to value creation within the banks. However, most banks lack the required manpower to drive the new process in

view of the emergence of big ticket transactions in the market occasioned by the consolidation exercise. There is the need therefore, for banks to channel resources towards manpower development in order to meet the challenge.

iii. Access to Information and Communication Technology (ICT)

The evolving financial landscape requires the development of new financial products and innovations, increased access to information, speed of transactions, and enhanced control and management of finances. The availability of high technology systems would facilitate the integration of these processes and enhance efficiency.

iv. Post-Consolidation Integration in Banks

Integration of processes, people and culture, infrastructure (including rationalization of physical assets), products and branding poses serious challenges to post consolidated banks. Effective service delivery and new orientations are the critical issues that has to be resolved in order to ensure work harmony, planning and repositioning for increased market shares and improved performance.

v. Corporate Governance

Good corporate governance is a critical success factor. The consolidation exercise revealed the pervasiveness of sharp practices in the banking industry including misreporting, mis-representation of facts, insider abuse and poor asset management among others. To address this problem, the CBN in March 2006 issued a new code of corporate governance to the post consolidated banks, which ensured that only "fit and proper" persons were appointed as Chairman and directors of banks.

Regulatory Authorities:

The regulators in the new financial environment need to ensure adequate and effective consumer education and protection as well as prevent any disruption in the level or reliability of services rendered by banks. In addition, customer's protection from potential unfair practices is equally important. Other areas that require effective regulatory action include:

i. Improved Regulatory Framework

The regulatory authorities need to further streamline their regulatory framework as

well as strengthen their supervisory capacity to ensure a smooth operation. In this regard, there is need to adopt strategies and establish appropriate framework in order to properly monitor the activities and performance of the banks to prevent distress and failures in the post-consolidation era. These include:

- Adoption of Risk-based supervision
- Need for greater capacity for supervisors
- Necessary supervisory tools/software
- Adoption of Consolidated Supervision

ii. Liquidation of the Failed Banks

The conclusion of the liquidation of the fourteen (14) failed banks constitutes a major challenge for the CBN, due to litigators' process involving banks that challenged the revocation of their licences. Even when final court order is obtained for their liquidation, the issue of disposal of their assets for the settlement of the depositors constitutes another problem. This brings to fore the issue of expediting action on the establishment of the Assets Management Company (AMC) as well as the revision of the necessary laws that will make it possible for both the CBN and NDIC to liquidate failed bank (s) without litigation by the bank (s) involved.

iii. Provision of Banking Services to the Rural and Semi-Urban Areas

One of the fallout of the banking consolidation is the emergence of mega banks and the arguments that trailed their existence is that they will not be able to provide banking services in the rural and semi-urban areas. The argument is heightened by the fact that the existing institutions established primarily to provide rural banking services are not empowered to provide real banking services. However, this problem is being addressed through the establishment of microfinance banks (MFBs) to offer basic services such as savings, micro-credit, micro-leasing, domestic fund transfer and other financial services that are needed by the economically active poor and low income households.

Government:

i. Legal Reforms

A number of legislative iniatives had been taken during the early reform years to address the problems in the banking sector and the financial sector at large, however, there is still the need for further improvements in order to complement the efforts of the regulatory authorities in realizing a sound and stable banking system. In the wake of growth in the volume and complexity of financial transactions involving both local and foreign investors in the post-consolidation era, there is need for greater cooperation between the law enforcement agencies and the judiciary in order to engender some confidence in the new financial landscape.

With respect to loans recovery in the banking industry, the judiciary must be at the fore-front in ensuring that cases bordering on loan recovery are promptly dispensed with.

Overall, the government should focus on fine-tuning the legal framework, improving the judicial environment, economic and social infrastructure and providing an enabling environment for banking business.

ii. Expansion of Investment in Infrastructure

Nigeria's current dearth of infrastructure implies that additional investments are needed generally in the medium term. This will provide reduced cost of operations for the banks and translate to lower cost of funds for economic agents.

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INFLATION TARGETING FRAMEWORK OF MONETARY POLICY MANAGEMENT

Price stability has been identified by economists as a pre-requisite for economic growth. Thus, the overriding objective of monetary policy in many countries is to ensure the stability of the aggregate level of prices. It is generally believed that unstable prices cause uncertainty in expectations, thereby distorting the process of economic decision making. Inflation creates distortions by increasing the opportunity cost of holding (interest earning) money, and promotes inefficient use of real resources in transactions. High inflation also diminishes the net present value of current investments and makes returns on investment uncertain. It is therefore a major challenge for every central bank to adopt appropriate monetary policy framework to ensure price stability.

There are several frameworks available for the conduct of monetary policy. These include, among others, exchange rate targeting, monetary targeting, output (GDP) targeting, interest rate targeting and inflation targeting or a combination of these strategies. The choice of any framework depends, to a large extent, on the stage of development and the prevailing economic conditions at any given period of time. Monetary targeting regime had been practiced by many central banks (including the CBN), probably because of past strong links between monetary aggregates and policy targets. However, there has been a growing preference for inflation targeting in recent times due to changing relationships between different measures of monetary aggregates and policy targets, induced largely by financial sector liberalization and globalization. The attraction of inflation targeting stems from the perception that it can moderate inflationary expectations much better than the other monetary policy frameworks especially, when supported by transparent policy environment. Another unique feature of inflation targeting is that policy actions are directed at inflation itself rather than any intermediate measure.

Inflation targeting has a fairly recent history, with New Zealand and Chile being the first two countries to adopt it in 1990, followed by Canada in 1991 and the UK in 1992. By 2001, the number of countries that adopted the framework had increased tremendously, including Australia (1993); Sweden (1997); Czech Republic, Israel and Brazil (1997); Poland (1999); Colombia (2000); Korea, South Africa and Thailand (2000); Hungary, Iceland, Mexico and Norway (2001). Most recently, Ghana adopted the inflation targeting in 2004.

This Brief examines the meaning and elements of, and the rationale for inflation targeting. It also highlights the pre-conditions, critical success factors, as well as the challenges and prospects of adopting the framework in Nigeria.

Meaning and Elements of Inflation Targeting

Inflation targeting (IT) can be defined as a framework for policy decisions in which the central bank makes explicit commitment to conduct monetary policy to meet a publicly announced numerical inflation target within a particular time frame (Redebush & Walsh, 1998). It can also be described as a framework in which the primary goal of monetary policy is to achieve price stability in the form of an inflation target. By explicitly stating an inflation target, the central bank is able to mould well-anchored inflation expectations in the direction it deems appropriate, which in turn ensures more effective stabilization of output and employment. Consequently, a well-conceived and well-executed strategy of inflation targeting can achieve good results as regards output, employment as well as inflation.

Whichever way the definition is coined, inflation targeting involves four key elements: an institutional commitment to price stability as the primary goal of monetary policy; mechanisms rendering the central bank accountable for attaining monetary policy goals; the public announcement of targets for inflation; and a policy of communicating to the public and the markets the rationale for the decisions taken by the central bank. Therefore, inflation targeting relies on specific rules since the adoption of explicit targets calls for a commitment by the central bank to policy consistency.

A pre-requisite for setting the ex-ante inflation target is the setting up of a model or methodology for inflation forecasting that provides the monetary authorities with the right signals about the time-path of future inflation in order to successfully hit the chosen target. Specifying the inflation target requires making a number of choices with respect to: the price index to use in defining the target, setting the target in terms of either the price level or rate of inflation, the type of inflation to target (core or non-core), giving the target a numerical value, deciding whether to define the target as a point or a band, the target horizon and determining possible escape clauses or exemptions under specified circumstances. Usually, these decisions involve a trade off between flexibility and credibility.

In literature, three broad types of inflation targeting have been identified. These include Full Fledged Inflation Targeting (FFIT), Eclectic Inflation Targeting (EIT), and Inflation Targeting Lite (ITL). FFIT countries are clearly committed to their inflation target and are fully transparent in their pursuit of this goal. New Zealand is a good example of FFIT countries. Eclectic Inflation Targeting countries command sufficient credibility that can afford them the ability to maintain low and stable inflation without full transparency and accountability. Their record of low and stable inflation coupled with high degree of financial stability enable them to pursue other competing monetary policy objectives besides price stability. A common example of EIT country is the United States of America. Inflation Targeting Lite countries announce a broad inflation objective but, owing to low credibility, are not able to maintain inflation as the overriding policy objective.

Rationale for Inflation Targeting

As mentioned earlier, different central banks lay emphasis on a single or a combination of objectives in conducting monetary policy. Countries in the early stage of development generally pursue multiple objectives for monetary policy, namely, increasing economic development and growth, maintaining stable prices and defending the external value of the domestic currency. On the other hand, countries whose economies are developed tend to focus more on price stability as the main objective of monetary policy.

Generally, the circumstances that led different countries to adopt Inflation Targeting framework are the same. For a country like Australia, the objective of monetary policy is explicitly spelt out in the enabling Act of the central bank. Thus, IT becomes a natural consequence for the achievement of monetary policy objectives. In other countries, changes in the macroeconomic environment induced the cut over to IT. Some countries which adopted IT because of adverse economic environment include Chile, Brazil, Mexico, Thailand, etc. As noted earlier, the preference for IT in most cases, over monetary targeting regime is borne out of the fact that the hypothesized stable relationship between price levels and money supply no longer holds. This is because the financial system has so evolved that financial values are stored in a wide range of derivatives such that the theorized demand for money equations hardly capture the totality of the intricate relationships amongst economic variables.

Inflation targeting is distinct from monetary targeting, which most developing countries adopted in the mid-1970s. Under monetary targeting, the central bank applies its instruments (such as interest rates) to control monetary aggregates, which are considered the main determinants of inflation in the long run. Clearly, the ability of monetary aggregates to function effectively as intermediate targets is based both on the stability of their empirical relationship to the goal variable (i.e. inflation rate) and on their relationship to the instruments of monetary policy (Croce and Khan, 2000).

There are three distinct merits of inflation targeting over monetary targeting, as follows:

- It is easier for the general public to understand the explicit announcement of inflation targets than the growth of particular monetary aggregates.
- Given that the costs of inflation arise from both its level and its variability, the announcement of explicit inflation targets helps in reducing uncertainty about the future course of inflation and thus improves savings and investment decisions, as well as enhances the overall productivity of economic agents.
- Clarifying the central bank's intentions may help reduce volatility in the financial markets, with the attendant beneficial effects of lowering risk and exchange rate premium.

IT has been a successful strategy for the achievement and sustenance of price stability, especially for central banks in inflation prone environments. Proponents of inflation targeting have also argued that it is transparent, easily understood by the public and that it enhances the credibility of the central bank in the pursuit of monetary policy. Inflation targeting also enables monetary policy to focus on domestic considerations and to respond to shocks to the domestic economy.

Pre-conditions and Critical Success Factors

A number of lessons could be gleaned from the experiences of countries practicing IT, which are useful for marshaling out appropriate strategies for the successful implementation of the monetary policy framework in Nigeria:

i) Autonomy of the central bank to implement monetary policy without hindrance or interference.

ii) A high degree of coordination between the fiscal and monetary authorities in setting inflation targets and implementing policy objectives.

ii) Adequate sensitization of the populace on the IT framework which would, among other things, help to streamline expectations and assist in the achievement of set targets.

iii) Adequate technical know-how in inflation forecasting and model building.

iv) Availability of timely, reliable and high frequency data needed for effective implementation of IT.

vi) Serious consideration of economic fundamentals, particularly the short-run behaviour of inflation as a basis for setting inflation target.

Among the critical success factors are:

- Considerable degree of central bank independence;
- Absence of fiscal dominance with very limited financing of public sector debt by the banking system;
- Well-developed domestic financial and capital markets;
- Political support for price stability as a monetary policy objective.

Challenges and Prospects for Nigeria

Most of the IT nations have experienced low and stable inflation rates without sacrificing output growth. This was possible because the necessary pre-conditions existed. In Nigeria, given the existence of a vast informal sector with limited coverage, the implementation of some inflation-targeting fundamentals would pose enormous challenges. Like most developing countries, the pre-conditions for adopting IT are yet to be fully present in Nigeria, though there is reasonable advancement in that direction. However, the symptoms of "fiscal dominance" are still present.

In terms of communication requirement, inflation targeting poses some challenges. The major communication challenges faced in practice under IT framework are:

- How much to say about future policy, for example policy rate expectations; and
- The need to make people aware of limits of what monetary policy makers can achieve, particularly when the conditions become less favourable.

Recent developments in the Nigerian economy, engendered by improvements in the regulatory and operating environment, have enhanced the prospects of adopting IT in Nigeria. These include:

(i) A stable macroeconomic environment.

(ii) CBN's independence and policy actions in the conduct of monetary policy since the advent of democratic government.

(iii) The enactment of the CBN Act 2007, which clearly stipulates the maintenance of price stability as one of the core functions of the CBN.

(iv) Cooperation between the fiscal and monetary authorities which has engendered fiscal prudence and adherence to due process in fiscal operations.

In conclusion, the experiences of inflation targeting countries provide some useful lessons for effective implementation of IT in Nigeria. Adoption of IT would enable the central bank to be forward-looking and to gain public credibility.

THE FOREIGN EXCHANGE MARKET AND ITS MANAGEMENT IN NIGERIA

Foreign exchange is the means of effecting payment for international transactions. It is made up of convertible currencies that are generally accepted for the settlement of international trade and other external obligations. Such currencies include the United States Dollar, British Pound Sterling, European Euro, Japanese Yen, and the Canadian Dollar. A foreign exchange market is the medium of interaction between the sellers and buyers of foreign exchange in a bid to negotiate a mutually acceptable price for the settlement of international transactions. The objectives of such a market include the provision of an avenue for the exchange of national currencies and the creation of an effective mechanism for the allocation of foreign exchange.

The foreign exchange market consists of the sellers (supply) and buyers (demand) of foreign exchange. The major participants in the foreign exchange market are the monetary authority (Central Bank of Nigeria), authorized dealers (banks), agents of the public sector, and the private sector as well as correspondent banks abroad. The supply of foreign exchange is derived from oil and non-oil exports, capital receipts including draw-dawn on loans, expenditure of foreign tourists in Nigeria, repatriation of capital by Nigerians resident abroad as well as invisible receipts by the private sector. On the other hand, the demand for foreign exchange consists of payments for imports, external debt service obligations, personal home remittances (PHR) by foreign nationals resident in the country, financial commitments to international organizations and the country's embassies abroad, as well as other invisible out-payments by the private sector.

This BRIEF discusses the evolution of the foreign exchange market in Nigeria and the modalities for its operations and management.

EVOLUTION OF THE FOREIGN EXCHANGE MARKET

The evolution of the foreign exchange market in Nigeria up to its present state had

been influenced by a number of factors which include the changing pattern of international trade, institutional changes in the economy and structural shifts in production. Before the establishment of the Central Bank of Nigeria (CBN) in 1959 and the enactment of the Exchange Control Act of 1962, foreign exchange was earned by the private sector and held in balances abroad by commercial banks which acted as agents for local exporters. During this period, agricultural exports contributed the bulk of foreign exchange earnings. The fact that the Nigerian Pound was tied to the British Pound Sterling at par, with easy convertibility, delayed the development of an active foreign exchange market. However, with the establishment of the CBN and the subsequent centralization of foreign exchange authority in the Bank, the need to develop a local foreign exchange market became imperative.

The increased export of crude oil in the early 1970s, following the sharp rise in its prices, enhanced official foreign exchange receipts. Thus, most economic agents had to patronize the CBN for foreign exchange allocation to pay for international transactions. By 1982, owing to the foreign exchange crisis that set in, comprehensive exchange control measures were introduced to check the numerous activities of speculators and middlemen. The increasing demand for foreign exchange at a time when the supply was shrinking encouraged the development of a flourishing parallel market for foreign exchange premium that emerged over time as a result of the inadequate supply of official foreign exchange led to various abuses including under-invoicing of exports and over-invoicing of imports. These resulted in capital flight and the diversion of official foreign exchange to the parallel market, a practice known as round tripping.

The exchange control measures could not achieve the appropriate mechanism for foreign exchange allocation in consonance with the goal of internal balance. Consequently, this led to the introduction of the Second-tier Foreign Exchange Market (SFEM) in September 1986. Under the SFEM, the determination of the naira exchange rate and allocation of foreign exchange were based on market forces. To enlarge the scope of the foreign exchange market, bureaux de change was introduced in 1989 for dealing in privately sourced foreign exchange.

In 1995, the foreign exchange market was further liberalized following the introduction of an Autonomous Foreign Exchange Market (AFEM) for the sale of foreign exchange to end users by the CBN through selected authorized dealers at the market determined exchanged rate. In 1999, the Inter-Bank Foreign Exchange Market (IFEM) was introduced to deepen the foreign exchange market through the active participation of banks, oil companies, Parastatals, non-bank financial institutions, bureaux de change and private companies.The IFEM was abolished with the reintroduction of the Dutch Auction System (DAS) in July 2002.

STRUCTURE OF NIGERIA'S FOREIGN EXCHANGE MARKET

Nigeria's foreign exchange market is made up of three major segments, the official, autonomous (the inter-bank and bureaux de change) and the parallel markets. The various segments of the market evolved over time owing to developments in the economy. The official foreign exchange market, which is the largest and predominant segment of the market, has remained unchanged since the period of trade and exchange controls when the 1962 Exchange Control Act held sway. However, in terms of the operations of the official market, it has metamorphosed over the years, particularly, since the introduction of exchange and trade liberalization policy in 1986, the market has witnessed tremendous changes. From the second-tier Foreign Exchange Market (SFEM) in September 1986, the official market was unified in 1987 when the exchange rate for public sector transactions was aligned with the commercial exchange rate.

The inter-bank market for free funds or privately sourced foreign exchange was at the early stage dormant as foreign exchange was centralized in the CBN through the 1962 Exchange Control Act. However, the market came to life and became vibrant with the introduction of SFEM and the permission granted banks by the CBN to commence foreign exchange dealings among themselves. The sharp practices which emanated from the system, in the form of round tripping of funds, led to high volatility in the exchange rate. Consequently, this informed the merger of the official Foreign Exchange Market and the Inter-bank Market in 1989 into an enlarged Inter-bank Foreign Exchange Market (IFEM). In 1995, the Autonomous Foreign Exchange

Market (AFEM) for the direct allocation of foreign exchange to end-users by the CBN was established.

On October 25, 1999, the AFEM was, therefore, replaced with the Inter-bank Foreign Exchange Market (IFEM). The bureaux-de-change were established with the abolition of the inter-bank market in 1989 to accord access to small users of foreign exchange and enlarge the officially recognized foreign exchange market. Exchange rates in the bureaux-de- change are market determined.

The third segment of the foreign exchange market, parallel market has been in existence from the exchange control era. The disparity in exchange rate was even greater in some of the periods before Nigeria's major economic reforms. Since the market-based reforms, the widening disparity in exchange rates premium has further strengthened the existence of the parallel market, owing largely to the windfall gains arising from there. The parallel market is a residual market as it accommodates spill over demands from other sources. It has been established that scarcity in the official source and bureaucratic procedures necessitated the growth and development of the parallel market. Although transactions through it are limited and small, its speculative tendencies when well monitored and built into the general framework for foreign exchange and exchange rate management would result in a more effective and efficient system. In any foreign exchange management framework, whether in developed or developing economies, speculation, arbitrage, hedging, and portfolio switching are important elements in gauging the health and development of the foreign exchange market and, by extension the financial system.

Foreign Exchange Management Before 1986

Importers and exporters of non-oil commodities prior to 1986, were required to get appropriate licenses from the Federal Ministry of Commerce before they could participate in the foreign exchange market. The authorized dealers passed such applications for imports, backed by the licences and other relevant documents to the CBN for approval and foreign exchange cover, while they deposited the domestic currency equivalent with the CBN. Similarly, exporters' application was routed through the authorized dealers to the CBN and foreign exchange receipts were

expected to be surrendered to the Bank in exchange for domestic currency. Generally, import procedures followed the international standard of opening letters of credit (L/Cs) and subsequent confirmation by correspondent banks abroad. However, transactions on unconfirmed letters of credit and open accounts carried foreign exchange risks and the licensed banks and foreign exporters might lose in the process. The use of form "M" was introduced in 1979 when the Comprehensive Import Supervision Scheme (CISS) was put in place to guard against sharp practices such as over-invoicing and importation of undeclared items, which resulted in persistent drain on external reserves. The authorization of foreign exchange disbursement was a shared responsibility between the Federal Ministry of Finance and the CBN. The Federal Ministry of Finance had the responsibility for public sector applications, while the Bank allocated foreign exchange in respect of private sector applications. The CBN effected payments in all cases. In 1984, a major foreign exchange reform was carried out when the Federal Government through the CBN, decentralized foreign exchange allocation. Licensed banks were allowed to approve applications and allocate foreign exchange to their customers subject to a maximum allocated to them by the CBN. Allocations were made weekly by the Bank to the licensed banks. This practice was, however, discontinued in 1985 because of abuses by banks, and the CBN once more took over allocation of foreign exchange.

The principal instruments of foreign exchange management were trade and exchange controls and export promotion. During this period, the exchange rate was administratively determined with the objective of reducing external sector imbalances. Trade and exchange controls were, however, the most prominent as they exerted direct impact on various aggregates in the economy. The controls included quantitative restrictions in the form of import and export license requirements. Controls were tightened during the period of crisis but relaxed whenever the pressure lessened. Thus, from 1970 to 1980, controls were liberalized but tightened progressively from 1976 to 1979 and from 1981 to September 25, 1986 when the foreign exchange situation worsened and the pressure on the balance of payments persisted. Increased emphasis was placed on export promotion as a means of reducing

pressure on the external sector, The government introduced a number of incentives to boost non-oil exports. These included arrangements for setting up export free zones, concessions to exporters to retain 25 per cent of their export proceeds, the liberalization of export and import licensing procedures, and the provision for the establishment of an export credit guarantee and insurance scheme.

The major shortcoming of the exchange control system was its inability to achieve internal balance in the short-term and guarantee external equilibrium in the long run. Overvaluation of the currency under the system was a major obstacle that made the achievement of internal balance difficult. Specifically, the problems with the administration of the exchange control system can be summarized as increased dependence on imports, depletion of external reserves, encouragement of parallel market activities, reduction of competitiveness in export activities, reduced capital inflow, and the inability to pay on current basis. These led to the accumulation of payments arrears, which compounded the external debt problem. Exchange control was discarded on September 26, 1986 in order to evolve an exchange rate mechanism that would be more responsive to prevailing economic conditions.

IV FOREIGN EXCHANGE MANAGEMENT SINCE 1986

The Second-tier Foreign Exchange Market (SFEM) came into being on September 26, 1986 when the determination of the naira exchange rate was made to reflect market forces. Under the new system, the exchange rate became an active tool of economic management and the rate derived from the market served as the means for the allocation of foreign exchange.

The modalities for the management of foreign exchange market changed substantially since the introduction of the SFEM, in line with the principles of Structural Adjustment Programme (SAP), which emphasized a market-oriented approach to price determination. The supply of foreign exchange was mainly from oil receipts. The flow of non-oil foreign exchange receipts to the CBN in 1986 fell as a result of the provision that exporters could retain domiciliary accounts. The composition of demand for foreign exchange remained largely the same except that demand pressure increased.

The mechanism of exchange rate determination and allocation of foreign exchange under the deregulated system is based on forces of demand and supply. Within the basic framework of market determination of the naira exchange rate, various methods were applied and some adjustments carried out to fine-tune the System. A transitory dual exchange rate system (first and second tier) was adopted in September 1986. The first tier was managed, while the second-tier was subjected to market forces. The first-tier rate was applied to debt service payments, other public sector disbursements and pre-SFEM transactions, while all other transactions were undertaken at the second-tier rate, On July 2, 1987, the first and second-tier markets were merged into an enlarged Foreign Exchange Market (FEM). Various pricing methods such as marginal, weighted average, and Dutch system were adopted.

With the introduction of the SFEM, the Federal Ministry of Finance had its allocative powers transferred to the CBN, but it retained approving powers on public sector transactions. Its powers were enhanced in 1989 when it was assigned the responsibility for licensing bureaux de change. The bureaux de change were set up principally to enlarge the scope of the officially recognized foreign exchange market to accord access to small users of foreign exchange in a less formal manner and enhance macroeconomic management. They are required to deal only in privately sourced funds and were not allowed to finance imports. Reputable hotels were also accorded the status of authorized buyers of foreign exchange. Correspondent banks abroad continued with their intermediating role except that they stopped accepting responsibility for paying on behalf of Nigerian importers until reimbursements were made. This practice was a spill over from the latter years of exchange control when foreign exchange reserves were rather low.

The constant fine-tuning of the market culminated in the complete floating of the naira on March 1992 when the system of pre-determined quotas was discontinued. Under the new system, import procedures remained largely the same. Sales were suspended at the FEM by the CBN on December 15, 1992 while a pro-rata system of foreign exchange allocation was introduced early in 1993. The unabating pressure on the foreign exchange market resulted in a policy reversal in 1994 when the naira

exchange rate was formally pegged and the foreign exchange centralized in the CBN as the sole authority to allocate foreign exchange to end-users on pro-rata basis. Bureaux de change were authorized agents of the CBN in the purchase of foreign exchange while the parallel market was declared illegal. In addition, transactions on open accounts and bills for collection were discontinued.

Under the pro-rata system, the manufacturing sector got 50 per cent, finished goods 30 per cent, agriculture 10 per cent, and invisibles 10 per cent. The CBN allocated 90 per cent directly to the productive sectors, while the balance of 10 per cent for invisibles was allocated by the banks. The Banks that were then in the system were thus grouped into six categories for the purpose of invisibles allocation, made up of 3,6,9,19,32 and 52 banks with respective percentage shares of 20, 18, 15, 15, 15, and 17. For illustration, Category was made up of Union Bank, First Bank and United Bank for Africa with an allocation of 20 per cent.

The reversal of the policy in 1995 to that of a guided deregulation necessitated the institution of the Autonomous Foreign Exchange Market (AFEM) and the liberalization of foreign exchange dealings through the active participation of the bureaux de change in the AFEM. The bureaux de change would purchase and sell privately sourced foreign exchange at the autonomous exchange rate. The major goals of the new policy were to deliberately build-up external reserves to enhance confidence in the Nigerian economy, strengthen the naira and pave way for its sustained stability and ultimate convertibility. Under AFEM guidelines, private sector concerns would source their requirements from the AFEM at market determined rates. The banks were allowed to deal among themselves in autonomously sourced foreign exchange, while dealing in intervention funds from CBN in the autonomous market was prohibited. To ensure adherence to this rule, the CBN intervention funds were disbursed directly to end-users at current market rates. The mode of disbursement was maintained in 1996. Although the thrust of policy was retained in 1997, substantial liberalization of foreign exchange practices occurred. Such reforms included the lifting of the suspension of open accounts and bills for collection, removal of the limit on personal home remittances (PHR) by foreign

national as well as personal and business travel allowances.

In 1998, the bulk of policy measures in the preceding year was retained while some of the existing ones were either further liberalized or fine-tuned to align with developments in the economy. The new measures included the requirement that public sector parastatals and agencies should source their foreign exchange needs from the AFEM, the lifting of the ban on some categories of imports, including used vehicles, customs and port reforms to ensure clearance of goods within 48 hours through the computerization and installation of Automated System for Customs Data (ASYCUDA), and the phasing out of pre-shipment inspection of imports. The policy on pre-shipment of imports was later suspended owing to perceived abuses.

Apart from the institution of an appropriate mechanism for exchange rate determination, other measures increasingly applied in managing Nigeria's foreign exchange resources included demand management and supply side policies. Demand management policies were meant to curtail foreign exchange expenditure. This objective was pursued through external debt management policies as well as fiscal and monetary measures. New external borrowings were restricted to key projects and a Debt Conversion Programme was introduced in 1988 to further reduce the debt stock. The tariff structure was also re-aligned to reduce the importation of non-essential items.

Owing to the magnitude of the incidence of round tripping associated with the fixed official exchange rate which was highly subsidized and created distortions, the dual exchange system was merged in 1999. Thus, all public sector transactions were conducted at the AFEM rate which was market driven. Also, the Federal government reversed its decision by directing its agencies to transfer their deposits from the CBN to the banks. Despite these measures, the objectives of exchange rate stability remained elusive. Consequently, further reform measures were undertaken to ensure effective management of foreign exchange. On October 25, 1999, the Autonomous Foreign Exchange Market was reconstituted into the Inter-bank Foreign Exchange Market (IFEM) which was intended to promote inter-bank activities with a view to encouraging privately sourced foreign exchange for its funding. Participation in the

market was broadened in order to deepen the market, thus relieving the CBN as the major supplier of foreign exchange. Therefore, all banks, non-banks financial institutions, parastatals, oil companies, bureaux de change and other private companies become eligible to participate. The CBN would only intervene to influence the prevailing rate towards achieving the desired objectives.

Other complementary measures introduced included; the intensification of surveillance on banks and the imposition of sanctions on those apprehended for unethical practices, the management of excess liquidity through the issuance of additional instrument, the CBN certificate, the persuasion by the CBN for government to curtail fiscal expansion, government directive to its agencies and parastatals to move their capital accounts to the CBN and retain the recurrent accounts in banks and the retention of 100 per cent export proceeds and some export incentives to encourage exports to earn more foreign exchange and the introduction of 100 per cent destination inspection to ascertain the genuineness of imports and duties payable.

Nevertheless, the objectives of IFEM remained largely unattained as the Bank accounted for over 90 per cent of the funds traded during the period. The foreign exchange market was characterized by excess demand as well as significant depreciation of exchange rate as evidenced by the wide arbitrage premium between the official and parallel segments. There was also, the emergence of multiple exchange rates as well as an army of foreign exchange speculators and arbitrageurs. Consequently, there was a run on the external reserves, which fell from an end-December 2001 level of US$100.00 billion to US$8.00 billion as at July 2002.

In a bid to address these adverse developments and enthrone sanity in the foreign exchange market, the CBN re-introduced the Dutch Auction System (DAS) in July 2002 with the objectives of realigning the exchange rate of the naira, conserving external resrves, enhancing market transparency and curbing capital flight from the country. Under this system, the Bank intervened twice weekly and end-users through authorized dealers bought foreign exchange at their bid rates. The rate that cleared the market (marginal rate) was adopted as the ruling exchange rate for the period, up to

the next auction. DAS brought a good measure of stability in exchange rate as well as a reduction in the arbitrage premium between the official and parallel market rates.

To further deregulate the foreign exchange market and also demystify access to travellers' cheques (TCs) by end-users, Travelex Global and Financial Services and American Express (AMEX) commenced the direct sale of TCs to end-users in February 2002. The initiative, among others, was aimed at addressing some travel-related problems associated with foreign exchange utilization. Specifically, the objectives were to; facilitate easy access to travellers' cheques by end-users; reduce the transaction cost to end-users of travellers' cheques; eliminate the use of spurious documents in obtaining TCs; reduce the gap between the official and parallel market exchange rate; and encourage the growth of bureaux de change operations.

Other measures adopted to enhance the operational efficiency of the foreign exchange market included; the unfettered access granted holders of ordinary domiciliary accounts to their funds, while utilization of funds in the non-oil export domiciliary accounts were permitted for eligible transactions. Furthermore, inward money transfers became payable in the currency of remittance. All oil and oil service companies were allowed to continue to sell their foreign exchange brought into the country to meet their local expenses to any bank of their choice, including the CBN. Procurement of foreign exchange for Business Travel Allowance (BTA) and Personal Travel Allowance (PTA) remained eligible in the foreign exchange market, subject to a maximum of US$2,500.00 per quarter for BTA and US$2,000.00 twice a year for PTA beneficiaries above 12 years old. For travels to countries in the ECOWAS Sub-region, both BTA and PTA are to be issued in ECOWAS travellers' cheques.

The foreign exchange market was further liberalized in February 2006, with the introduction of the Wholesale Dutch Auction System (WDAS) based on a two-way quote. With this System, the CBN remained an active market participant and could buy or sell foreign exchange depending on market conditions, while the authorized dealers which hitherto, only bought on behalf of their customers were now free to do so on their own account. In addition, they were allowed to trade with such funds in the inter-bank market. The adoption of WDAS was meant to consolidate the gains

recorded under the retail framework, enhance market depth as well as achieve convergence in rates between the official and other segments of the market. The operations of the foreign exchange Wholesale Dutch Auction System (WDAS) which was introduced in February, 2006 continued through the period, January to December, 2007. The collapse of the parallel market following the market reforms of 2006, gave impetus for the market to operate without the distortions associated with arbitraging, all through the period. Furthermore, there were substantial foreign exchange inflows from the oil companies and foreign investors subscribing to Federal Government bonds, initial public offers (IPO's) and the global depository receipts (GDR's) of some indigenous Nigerian banks. These factors, coupled with the robust external reserves guaranteed adequacy in supply of foreign exchange to banks and the end-users. Thereby engendering confidence in the market.

Foreign exchange swap transactions with the banks were also undertaken by the CBN to assist in liquidity management and achieve the reserve money target. Swap transactions involving the sum of US$1,035.00 million were undertaken with various banks at the cost of N376.05 million in 2007. This compared with forex Swap transactions of $940.00 million at a cost of N468.10 million in 2006.

There were support measures to strengthen the WDAS with a view to ensuring that its objectives were attained. These include; special foreign exchange auctions made to Deposit Money Banks (DMBS); direct sales of foreign exchange to licensed Bureaux De Change (BDC) operators, effective April 2006; increase in the Basic Travelling Allowance (BTA) from US$2,500.00 bi-annually to US$5,000.00 per quarter, and Personal Traveling Allowance (PTA) from US$2,000.00 bi-annually to US$4,000.00 per quarter; and the review of the Foreign Exchange Manual to accommodate all the transactions that were liberalized.

The Destination Inspection of goods that commenced in 2006 progressed in 2007. It would be recalled that the Federal Government appointed Messrs Cotecna, Societe Generale de Surveillance and GlobalScan to carry out Risk Management and Assessment on goods with scanning activities, while Messrs Web Fontainne was to provide the infrastructural backbone for the project.

The Roll out of the Automated System of Customs Data (ASYCUDA + +) System developed by the United Nations Committee on Trade and development (UNCTAD) had been completed in four major ports namely; Apapa, Tincan, Onne and Grilmadi.

Inspection under the scheme is risk based. Consequently, the companies carry out a Risk Assessment of imports based on information provided by the importers and their banks. The risk profiling is backed by Scanners located at various ports. The level of intervention required per consignment depends on the result of the risk assessment. The Nigeria Customs Service intervenes whenever they disagree with the advisory opinion expressed by the scanning companies in the Risk Assessment Reports (RARs).

GLOSSARY OF SELECTED TERMS

Comprehensive Import Supervision Scheme (CISS)

This scheme was set up to ensure that imports into Nigeria are of the right quality, value and quantity. To ensure this, pre-shipment inspection agents were appointed to confirm through a clean report of findings, that actual imports tally with the contents of approved Form "M". Destination inspection is also carried out in Nigeria to ascertain the correctness of clean report of findings from inspection agents.

Letters of Credit (L/Cs)

A letter of credit is an undertaking (credit pledge) by a bank accepting to redeem the liability of its customer on an import contract if the importer fails to make payment on maturity date and in accordance with all the terms of the credit purported in the L/C. They are opened for bank customers that have processed Forms "M" which serve as the intention to import. L/Cs guarantee that foreign exporters would get their money from the issuing bank through their correspondents abroad when such L/Cs are confirmed. The tenor or lifespan of an L/C is an initial 180 days but could be renewed for another period of 180 days. L/Cs could be revocable. Revocable L/Cs are not binding. It may be terminated at any time without recourse to all parties involved. Irrevocable L/Cs are binding and can only be determined at the maturity date. The terms of agreement must be met unless otherwise determined by all parties involved before maturity. When an L/C is confirmed and irrevocable, the credit risk borne by

the exporter is minimal. Confirmation of L/Cs reduces to the barest minimum, the problems associated with exchange and trade controls where they exist.

Open Account and Bills of Exchange

In an open account transaction, importers and exporters enter into a mutually acceptable contract involving the settlement of debt at future date. The exporter ships specified amount of goods based on trust and the assessment of the importer creditworthiness. On shipment, the exporter has no further recourse. He counts on the sincerity of the importer to effect payment. The exporter sends the documents in respect of the goods shipped directly to the importer. However, the interest of the exporter can only be safeguarded by the importer, as documentary claim of ownership cannot be easily proved without support from the importer. The burden of financing rests on the exporter, while the onus of settlement rests with the importer in an open account transaction. It is a very risky mode of financing international trade, but its unique features are in its simplicity and the fact that the parties would have been used to themselves since trust is the guiding principle in this case. Payment through the bills of exchange is an improvement over the open account mode of settlement. Bills for collection are negotiable instruments. They are drawn by the exporter on the importer who is required to pay a stated sum representing the value of goods shipped to the importer at a specified date. On shipment of goods to the importer, the exporter may send the accompanying documents direct to the importer or to his bank. In the event that the exporter requires his bank to collect proceeds of goods shipped on his behalf, he will draw a bill of exchange on the importer and this will be attached to the shipping documents. These will be deposited with the exporter's banker as bill of collection. A bill of exchange is either a clean or a documentary bill of exchange. A clean bill of exchange is not accompanied by documents. Only the bill of exchange is sent to the importer. It is based on trust like in open account transactions. However, the onus of payment here is on the exporter since he can send the accompanying documents in case of failure to honour or accept the clean bill of collection. A documentary bill of exchange is accompanied by relevant documents. Usually, when the bill of exchange is drawn on the importer by the exporter and sent to the importer's

bank by the exporter's bank, it is accepted as drawn by the importer's bank or some other financially reliable parties. Once accepted, it becomes legally binding. A bill of exchange could also be a sight or demand bill or issuance bill. A sight or demand bill requires that documents be released after payment would have been effected by the importer or the acceptor of the bill drawn by the exporter. However, if the exporter gave a credit period, the bill drawn by the exporter is an issuance bill and documents would be released to the importer once the drawn bill has been accepted by the importer (drawee) or some other party acting on his behalf. The security of payment is not as certain as in the case of payment through confirmed and irrevocable L/Cs. This is because importers may not be able to pay owing to various reasons, which may include changes in exchange and trade controls. This is without prejudice to the fact that the acceptance of documentary bills for collection makes the importer legally liable. Where exporter and importer are not well known to each other, and where exchange controls are dynamic, the best mode of payment is through documentary letters of credit.

Foreign Exchange Speculators and Arbitrageurs

Foreign exchange speculators are agents in the foreign exchange market who attempt to predict the future path of rate movement and influence the market accordingly. Their actions could be destabilizing if the mood of the market was not correctly predicted. On the other hand, foreign exchange arbitrageurs do not directly influence the course of exchange rate movement. They watch the market and move funds from the currencies that are declining in value to those that are rising in value. They earn the differential in exchange rate between different currency centres.

The Nominal, Real and Trade Weighted Exchange Rates

The nominal exchange rate is the price of one currency relative to another. The real exchange rate is the nominal exchange rate deflated by changes in relative prices. Trade weighted exchange rate is the value of a domestic currency against a weighted basket of currencies of the major trading partners. The weights assigned to each currency reflect the volume of trade with the country of domicile. The weights are reviewed regularly to take account of changing pattern of trade flows.

Foreign Exchange and Balance of Payment Position

Foreign exchange position is the difference between foreign exchange receipts and foreign exchange disbursements. If receipts are higher than disbursements, there is a net inflow or accretion to reserves. On the other hand, if receipts are lower, there is a net outflow and reserves would be depleted. Balance of payments position is the difference between the receipts by the residents of one economy and the payments to the rest of the world. An excess of receipts over payment shows a balance of payments surplus, while the reverse represents a deficit. When foreign exchange receipts and payments are adjusted for valuation changes in reserves, the net position would be identical to the balance of payments position.

External Balance

External balance is achieved when international payments of the residents of one country are equal to their receipts from the residents of other countries. It is synonymous with balance of payments equilibrium.

Internal Balance:

This refers to a state of convergence between domestic output and absorption or expenditure. When output is identical with expenditure, internal balance is considered achieved, and the rate of inflation is expected to be stable. The achievement of the savings investment identity is also viewed as internal balance. Monetary and fiscal policies, external debt management measures are usually applied to achieve internal balance.

CAPITAL ACCOUNT LIBERALIZATION: ISSUES, CHALLENGES AND PROSPECTS

The interdependence of the global economy and the increasing movement of factors of production across borders have resulted in financial integration and economic liberalization that facilitated the free flow of financial instruments and assets for investments and economic activities among countries. In addition, this dependency has been significantly strengthened by the dynamics of Information and Communication Technology (ICT) which had revolutionized financial services delivery across the globe. According to the IMF "…the explosive growth of international financial transactions and capital flows is one of the most far-reaching economic developments of the late twentieth century". The industrial countries embraced capital account liberalization in the 1970's to encourage resource flows in order to the address dearth of investments across international boarders following the collapse of the Breton Woods exchange system. This development has also trickled to the developing (LDCs) and emerging (EMEs) economies such that the World Bank noted the 8-fold increase in net inflows to those economies between 1985 and 2005.

The objective of this Brief is to elucidate on the imperatives and the desirability of the capital account liberalization with the purpose of highlighting the prospects and challenges for its adoption by Nigeria.

2.0 WHAT IS CAPITAL ACCOUNT LIBERALIZATION?

The concept of capital account is best understood within the broad context of a country's balance of payments. According to the IMF (2000), the capital account records capital transfers and acquisition/disposal of non-produced and non-financial assets. It also adduced that the flows which could be both long and short-term are often treated as the balancing item against current account deficit or surplus. Capital Account Liberalization (CAL) is therefore the systematic removal of administrative and legal restrictions on the capital account to permit the free flow of international capital in an economy. It refers to freedom from prohibitions on transactions on the

capital and financial accounts of the BOP and entails lifting of restrictions on foreign capital inflows and outflows. The two broad elements of capital transfers included Foreign Direct Investment (FDI) and Portfolio Investments. While the former involves direct injection of funds by way of real investment with long gestation in an economy as investors do not expect to repatriate funds immediately, the latter encompasses equity participations and bank lending which are largely "hot money" due to their short-term nature.

3.0 RATIONALE FOR CAPITAL ACCOUNT LIBERALIZATION

The rationale for CAL hinged on the postulate that liberalization ensure effective allocation of international capital to where returns are highest and provide opportunity for inter-temporal trade as well as engender inflows of FDI for growth. In this regard, it is desirable to move capital to economies where marginal productivity of capital is higher. In addition, embracing CAL by developing and emerging economies is rationalized on the need for foreign savings to bridge the savings gap to attain the desirable level of investment. These inflows would provide finances for economic activities as well as provide resources that can be efficiently channeled into poverty reduction strategies. Therefore, the liberalization of capital transactions improves country's balance of payments, bridge savings and foreign exchange gaps, smoothening temporary shocks on domestic income and consumptions, reduce costs of borrowing and ultimately spur economic growth. While capital inflows could provide important resources for economic development, its reversals may create systemic risks and precipitate the collapse of the economy. Therefore, there is need for caution as highly mobile capital could seriously undermine the economy and hence the need for some prerequisite to be met before the introduction and sequencing of CAL. The sequencing options in CAL include:

- Undertaking macroeconomic reforms, most especially ensuring sound financial system with good supervisory framework,
- Liberalization of trade (current account),
- Good database on capital inflows and maintain detail contingency plans for reversals, and;

Strong macroeconomic performance underpinned by fiscal discipline, among others.

4.0 PROSPECT FOR CAL IN NIGERIA

Nigeria like most developing countries is characterized by low level of domestic savings and capital inflows are expected to provide the financial capital for economic activities. Nigeria has systematically liberalized its capital account, supported by fiscal consolidation which includes prudent fiscal management, transparency and accountability. Other measures facilitating CAL were the adoption of market based monetary and exchange rate policies, effective banking regulations and supervision, increased prudential regulations, enhanced central bank autonomy, inflation control and strengthening of macro-economic indicators.

Capital liberalization in Nigeria can be summed along the following lines:

The Nigerian Investment Promotion Commission Act of 1995 permits an alien and resident alike to invest in any enterprise specified under the Section 13 of the Act. A foreign investor who wishes to establish an enterprise in Nigeria shall first comply with the provision of the Companies and Allied Matters Act of 1990.

Foreign investors are permitted to invest in all sectors of the economy except in the production of arms, ammunitions, narcotic drugs and military apparels. They are also permitted to invest in government bonds, bankers' acceptances and securities that mature after a year subject to the issuance of a Certificate of Capital Importation (CCI) by the remitting bank or broker. A foreign investor however can divest the investment before maturity by the transfer of the underlying CCI.

The investors are guaranteed unrestricted repatriation of funds as dividends, loan servicing and repartition of capital and proceeds after tax. Nigerian as private entities can also secure foreign loans without restrictions in the form of capital or suppliers credit without government guarantee and must be documented through a CCI.

Other developments include the opportunity for Nigerian residents to invest in foreign currency dominated securities subject to the repatriation of proceeds of such investments that is credited to a domiciliary account. Operators of ordinary and

export proceeds domiciliary accounts are guaranteed unrestricted access to the use of such fund. Repatriation by private individuals into domiciliary accounts however remains a challenge.

5.0 CHALLENGES OF CAPITAL ACCOUNT LIBERALIZATION:

Sequencing of liberalization.

The premature liberalization of the capital account without a strong and stable macro economic environment would throw the economy of a country into chaos. To maximize the benefits of capital account liberalization while minimizing the risks, sequenced execution is critical. The conventional view of sequencing emphasizes the importance of achieving macroeconomic stability and developing domestic financial institutions, markets, and instruments before liberalizing the capital account. According to this view, capital account liberalization should occur late in a country's economic reform program. An alternative view stresses constraints on reforms and the limited capacity of countries to reform by themselves in the absence of external pressures. This view favours early capital account liberalization, which can serve as a catalyst for broader economic reforms and overcome vested interests' opposition to reforms. A middle view is that capital account liberalization should be part of a concurrent, integrated, and comprehensive approach to macroeconomic and structural reforms along with coordination of reforms in the domestic and external sectors. The benefits, costs, and risks of each of these three strategies will vary from country to country, depending on starting conditions and economic objectives. One approach would be to focus on the contribution each strategy would make to the broad objectives of improving efficiency in resource mobilization and allocation, as well as promoting financial and macroeconomic stability. This is to the extent that a specific reform improves resource allocation and helps to achieve or at least does not undermine financial and macroeconomic stability.

Although rules about sequencing capital account liberalization suggests that countries should liberalize long-term flows before short-term flows, and foreign direct investment before portfolio investment have the appeal of simplicity, but these are difficult to execute due the fungibility of capital. The maintenance of restrictions

on certain types of capital transactions may serve primarily to buy time for the more fundamental restructuring of financial markets, the adoption of appropriate prudential standards and supervisory arrangements, and the development of the necessary indirect monetary instruments

Economic Instability

Capital inflows thrive on international investor's confidence in an economy. An unstable economy resulting from consistent changes and incoherent policies, unfavourable macro economic indicators would result in unlimited capital movements out of an economy. This is due to short-term capital movement that may abruptly change direction for speculative reasons which may bring about changes in the size of official foreign exchange reserves. For this reason it is advisable to restrict volatile short-term capital movements in developing economies.

Inadequate Prudent Regulations

Prudent financial regulation and supervision are essential to maintain the financial sector's stability and growth. A weak and distorted banking system and capital market could lead to misallocation of resources and the creation of financial crisis. Prudential guidelines are aimed at promoting financial soundness of individual financial institutions, and protect investors against fraud. International transactions may involve certain types of risk that are not present in domestic transactions, including transfer, sovereign and country risk. In countries with weak or embryonic financial systems, both the pace of capital account liberalization and the design of prudential measures become more complex. Local financial institutions may have limited capacity to assess and manage risks associated with large capital inflows, and regulatory authorities may have limited supervisory capacity. For prudential reasons, such countries may need to develop financial institutions, markets, and instruments before they can liberalize their capital account. Countries may also need to adopt international standards of corporate accounting and the timely disclosure of information.

Ability to Tax Financial Transactions, Income and Wealth

A comprehensive liberalization of capital transactions and transfers does not signify

an abandonment of all rules and regulations applying to foreign exchange transactions, however, regulations may have to be strengthened in a number of areas. This includes prudential regulations related to nonresident and foreign exchange transactions and transfers. In the financial sector the type of capital transfers that may include capital and money market instruments, debt instruments, credit operations, direct investment, real estate transactions as well as investments by banks, individuals and corporate investors could be subjected to controls.

Reliance on Capital Inflows by Developing Countries

The reliance on international financing has to be curbed as most of these are denominated in foreign exchange. The domestic central bank not being able to print foreign currency has limited ability to undertake the lender-of the last resort operations necessary for those debtors to make good on their obligations.

Political Constraints

Government may be prevented from acting early to curb crisis despite warning signs of vulnerability. This may be as a result of lobbyists in and out of the economy with vested interest to protect. Hence the late intervention by the government could have led to a crisis situation that could be contagious on several other economies.

Prospects of Capital Account Liberalization.

Capital account liberalization can bring about large benefits when strategically managed. Effective use of capital inflows transforms the investment environment; generate multiplier effects as well as enhance the level of output and domestic savings. The pre-conditions that would facilitate these include:

A Stable and Liberalized Economy

Macroeconomic policies designed to avoid large external and internal imbalances are the first line of defense in the prevention of financial crises. These policies should aim to limit moral hazard, adverse selection, herding behavior and related problems, as well as contain their potentially damaging consequences. Polices often adopted include, fixed or quasi-fixed exchange rate to reduce uncertainty, curb appreciation, maintain external competitiveness and provide a nominal anchor to prevent domestic

instability. Monetary authorities sterilize through the purchase of foreign exchange, simultaneously sell domestic bonds or increase reserves requirements. However, this is costly in the long run due to the potential of leading to high domestic interest rates.

Buoyant Foreign Exchange Reserves

Reserve accumulation during the period of high capital inflow is also used to ensure the stability of the exchange rate and curb market uncertainty. This was practiced by Morocco in 1990, where 75 per cent of the capital inflows during the first three months were absorbed. However there is a social cost involved, measured by the cost of servicing capital inflow equivalent to the accumulated reserves and the income on these reserves.

Financial Sector Reforms

The liberalization of capital flows can be viewed as an aspect of financial sector liberalization. Capital inflows are channeled through financial intermediations that need to be strengthened, either to ensure the efficient use of the capital inflows or restructure due to competitive pressures. Moreover, capital account liberalization may induce banks and corporations to take on more foreign exchange risk. Capital account liberalization adds extra needs to the financial sector. An important condition is the maintenance of internationally competitive interest rates. This is required to minimize the risk of large balance of payments deficits and of unsustainable pressure on the exchange rate. Others include the availability and the nature of the deposit insurance schemes, the accounting standards for public disclosure of financial information, the presence of credit rating agency. These minimize risks that might bring about changes in the size and direction of the capital movements.

Flexibility of the Fiscal Policy

Fiscal policies are often procyclical because the fiscal process is inflexible relative to the volatility of capital flows and the need to provide public utilities. In the face of increasing capital inflows and ineffective fiscal and monetary policies, there is need for the improvement and tightening of the prudent regulatory framework.

A degree of elasticity should be built into a country's budget particularly on the

expenditure side to enable the budget adjust to the changing requirements of macroeconomic stability. It allows for certain brief tightening and relaxation to accommodate abrupt changes in the exchange or interest rate. This is particularly important under the conditions of a currency board where with limited instruments at its disposal, the central bank is deprived from the possibility of sterilize either capital inflows or capital outflows which is the most effective instrument for smoothing out fluctuations in short term capital flows.

Investors Confidence

The lack of confidence, because of frequent reversals of economic policies in the past may hinder the elimination of capital controls even if all prerequisites are in place. Such a country should seek to change capital market perceptions prior to the liberalization of the capital account by following a consistent policy and producing good economic results for a certain period of time. This would help to change expectations and would minimize the risk of speculative capital movements.

6.0 SUMMARY AND CONCLUSION

Foreign capital has long been cherished because of its potentials to increase the inflow of foreign exchange resources to the recipient economy and hence propel economic growth. What is important however, is the preparedness of a country to adopt CAL and the implication of various forms of inflows on its economy. Short-term capital is largely associated with economic and financial crises, hence the preference for long term capital that promotes stability and contributes positively to long term economic development. The lessons of experience from other countries show that liberalization should be implemented in a flexible and cautious manner. The logical sequence therefore, should be for countries to liberalize their current account, reform their economies, and develop virile institutions and a well developed domestic capital market before embarking on capital account liberalisation. There is the need to put in place appropriate and coherent economic policies as well as risk management instruments in order to manage capital account liberalization in a dynamic global economy.

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RESERVE ACCUMULATION AND MANAGEMENT IN NIGERIA

External reserves can be defined as those external assets that are readily available to and controlled by monetary authorities for direct financing of payments imbalances for indirectly regulating the magnitude of such imbalances through intervention in exchange markets to affect the currency exchange rate, and/or for other purposes (IMF 1999). Other uses of the external reserves also called international reserves include: to meet the transaction needs of countries, provide a cushion to absorb unexpected shocks, or a sharp deterioration in terms of trade as well as to meet unexpected capital outflows. It could also be used to improve a country's credit worthiness; and wealth accumulation through prudent management. Thus, the motives for holding adequate level of external reserves can be summarized into transaction, precautionary and speculative. It is held in gold, reserve position in the International Monetary Fund (IMF), Special Drawing Rights (SDR), foreign government securities and convertible currencies in bank balances abroad.

In Nigeria, over 85.0 per cent of external reserves is realized from the oil sector which are derived through the sale of Nigeria's crude oil equity by the Nigerian National Petroleum Corporation (NNPC), royalties paid by oil companies arising from the commercial exploitation of Nigeria's oil resources as demanded by the Petroleum Act of 1969, Petroleum Profits Tax (PPT), penalty for gas flaring, rentals, signature bonuses and receipt from gas sales. Other sources of accretion to the external reserves include withholding tax, Value Added Tax (VAT), company income tax, education tax, and rent/interests received from investments abroad, personal home remittances, export proceeds from non oil sources, grants, interest on WDAS accounts held by deposit money banks, WDAS purchases, and other miscellaneous receipts.

Effective management of external reserve is one of the major macroeconomic challenges currently facing many emerging economies, especially oil producing

countries like Nigeria against the backdrop of the favourable inflows caused by high commodity prices in recent times. The primary objective of the country's reserve management is to ensure that it is adequate to meet a range of defined national objectives, in particularly to defend the external value of the domestic currency. External reserves are also managed to control risks and thus ensure the security of reserves and guarantee reasonable earnings from its placement without jeopardizing the social responsibilities of the government. The management of the external reserves is, however, dependent on the general macro-economic and specific objectives of monetary policies.

This brief explains the importance of the external reserves, its composition, the need for its accumulation, management strategies as well as the challenges and prospects of reserve management by the Bank.

2.0 COMPOSITION AND ACCUMULATION OF EXTERNAL RESERVES

The composition of the external reserves varies in different economies and often reflects the investment choice of the monetary agent. Although individual items can be interchangeable, they individually represent the different implications for global liquidity and balance of payments adjustments. The composition of external reserves in Nigeria as dictated under the Banks and Other Financial Institutions Act (BOFIA) 1999 and the CBN ACT 2007 (Section 24) includes:

- Gold coin or bullion
- Securities of or guarantees by a government of any country outside Nigeria and the securities shall mature with 10years or less.
- Balance at any bank outside Nigeria where currency is freely convertible, and in such currency, notes, coins, money at call and any bill of exchange bearing at least two valid and authorized signatures and having a maturity not exceeding ninety days exclusive of the days of grace.
- Securities of or guarantees by a government of any country outside Nigeria, whose currency is freely convertible provided suh securities shall mature in a

period not exceeding ten years from the date of acquisition and are of such investment grade as may be determined by the Board from time to time.

- Treasury bills having maturity not exceeding one year issued by the government of any country outside Nigeria whose currency is freely convertible
- Nigeria's gold tranche at the International Monetary Fund.
- Allocation of Special Drawing Right (SDR) made to Nigeria by the International Monetary Fund.
- Investments by way of loans or debenture in an investment bank or development financial institutions within or outside Nigeria for a maximum period of five years in so far as:
    - the amount is not more than 5 per cent of the total foreign reserves
    - the reserve level at the time of investment is more than such amount as will sustain twenty-four months of import, and
    - the loan or debenture is denominated in foreign currency:

provided the investment bank or development financial institution referred to in this section carries such a rating by rating agencies as may be prescribed from time to time by the Bank; and
Such other securities and investments as may be approved from time to time by the Board:

provided they are liquid foreign currency assets that are of investment grade and in the form of freely convertible currencies.

In Nigeria, over 90.0 per cent of external transactions are denominated in the US Dollar even though there are reserves holdings in euro and the pound sterling. Most of Nigeria's international repayments and receipts are denominated in the US dollar. The holdings in US dollar accounted for 87.6 per cent of the total in 2006, while it increased marginally to 87.8 per cent in 2007.

Ownership Structure of the External reserves

The external reserves consist of three components: the Federation, Federal government and the CBN. The Federation component consists of sterilized funds (unmonetized) held in the excess crude and PPT/Royalty accounts at the CBN, belonging to the three tiers of government. This portion is that which has not yet been monetized for sharing by the federating units. It is sometimes ignorantly referred to as the reserves of the country. The federation component of the reserves consists of unmonetized but sterilized funds held in the form of excess crude at the PPT/Royalty account. The federal government account comprise of funds belonging to some government agencies used for financing Joint Venture Cash call payments, infrastructural developments and government's letter of credit. The CBN portion is that which is monetized and shared by the three tiers of government monthly by the Federation Accounts Allocation Committee (FAAC) as stipulated by the constitution and the revenue sharing formula. The monetized reserves at end December 2006 was 70.3 per cent and 71.0 per cent of the total in 2007. It is used by the Bank to conduct its monetary policy and defend the value of the domestic currency. Total external reserves of the Federation, Federal Government, and the CBN in 2007 was US$12.4 billion, US$2.7 billion and US$36.3 billion representing of 24.2, 5.2 and 70.6 per cent of the total, respectively. When compared with the figures in 2006, the Federation reserves and the CBN reserves rose by 26.8 and 22.0 per cent respectively, while the Federal government reserves fell marginally by 4.3 per cent. The reserves adequacy can be measured by the total months of imports that the level of external reserves at a certain period. The external reserves can cover at end period 2006 and 2007 were US$42.3billion and US$51.3 billion equivalent to 16.7 and 16.1months of import cover, respectively.

Accumulation or Spending

Global reserves increased from USD 2.0 trillion at end December 2002 to over USD 4.0 trillion end-January 2006 with emerging markets and developing countries accounting for the bulk of the increase. Accumulation of reserves is a strategy adopted by central banks at one time or the other for various policy objectives. A country with

high inflows of short term capital may adopt reserve accumulation to sterilize the inflows and curb inflation. Other countries taking a cue from the Asian crises to beef up their reserves to hedge against financial crises, finance fiscal expenditures on imports, supports confidence in their domestic economy and currency, and fund intervention in the foreign exchange market. Reserves accumulation is mostly driven by capital account surplus as in China, India, Korea and Taiwan, while in Nigeria and Russia, it resulted into current account surplus. Nigeria's reserves have risen significantly in recent times.

3.0 EXTERNAL RESERVES MANAGEMENT IN NIGERIA

3.1 Major Considerations in External Reserves Management

The main objective of the management of external reserves by the Central Bank of Nigeria as stipulated in the CBN Act 2007 is to maintain external reserves at levels considered by the Bank to be appropriate for the economy and the monetary system in Nigeria. The management of Nigeria's external reserves has three main objectives namely; safety, liquidity and return. The safety of the reserves is the most important objective of CBN's reserves management. To achieve this, the CBN invests the reserves mainly in government securities such as treasury bills and bonds, and in foreign banks with highest credit quality. The Bank ensures that adequate liquidity ratio is sustained to promote timely intervention, finance daily transactions and other financing that may be required. The CBN ensures it earns returns that can sustain its operating cost.

3.2 The Role of the Monetary Authority Authorities

The management of external reserves is critical to a central bank since the movement in the quantum of reserves, the deployment of the reserves as well as the allocation of the net accretion to reserves between sterilization and monetization impact on monetary aggregates and the ability of a central bank to efficiently conduct monetary policy. Central banks are therefore interested in the management of external reserves, not only to ensure that monetary policy is not compromised, but also to ensure that the external value of the domestic currency is protected through intervention in the foreign exchange market.

The Central Bank of Nigeria's premier mandate on external reserves management was to maintain external foreign exchange reserves at levels considered to be appropriate for the monetary system in Nigeria (CBN Act 1958). The CBN assumed responsibility of the management the external reserves with the acquisition of the sterling assets backing of the West African currency Board's notes and coins in 1959. The management of the external reserves was however, diffused as federal institutions, regional governments, the marketing boards, various statutory agencies, provident funds, the commercial banks as well as some selected institutions held external reserves. Consequently, the CBN controlled only 27.5 of the total in 1957. The Federal Ministry of Finance initiated the move for the centralization of the reserves with the CBN in 1961. By end 1978, the Bank had over 91.2 per cent of the nation's reserves. Early management strategy for the management of the external reserves in Nigeria was on the preservation of the purchasing power following the drop in foreign exchange earnings due to the fall in the price of primary commodities, along with high import bills and fall in external reserves.

A review of external reserves management in Nigeria showed that most of the nation's reserves are in liquid assets, foreign currencies and foreign government securities. A small proportion representing gold and SDR, have been managed over the years by correspondent banks abroad as well as reputable international investment companies with instructions from the CBN. This is expected to diversify the investment portfolio and ultimately enhance returns, which are crucial to increase income. The reserve management strategy of the Bank was reformed during the Bank's reengineering programme termed "Project EAGLES" to reflect best practices. These included the inauguration of a new Investment Committee to oversee reserve management the adoption of a Strategic Asset Allocation (SAA) to optimize returns in the long terms. Consequently, the SAA tranched the reserves into liquidity and investment. The liquidity tranche is to meet the day to day liquidity needs of the Bank; the investment tranche as a buffer to the latter, and is to achieve maximum return on investments.
The Bank in 2003 joined the World Bank's Reserves Advisory and Management Program (RAMP) to build capacity in reserve management. In addition to the apportioning a part of the reserves to the World Bank to manage at a fee, the Bank also

benefited under this arrangement in building capacity for internal funds managers.

The banking sector reforms of 2006, that witnessed the emergence of 25 banks with a huge capital base, created the opportunity for local banks to partner with foreign banks and assets managers to mange a portion of the country's external reserves, and to develop internal capacity in asset management. Fourteen domestic banks partnered with overseas banks in this regards. The foreign partners were required to have a Standard and Poor or Fitch and Moody's long and short term ratings of AA- and AA+ as a custodian or A and A+ in the case of an asset manager. They must also have a five year track record, maintain at least a subsidiary in any of the OECD countries and the approval of the relevant off-shore regulatory authority.

Prior to the introduction of the new Nigerian Pounds, the CBN was mandated to hold 80 per cent of its reserves to back the new currency. Emphasis continued to be focused on safety and liquidity during periods of declining level of reserves with reserves maintained in call accounts and time deposits with maximum tenor of 90 days. The import cover of fourteen months in 1959 deteriorated to less than seven months in 1962. This development led to the introduction of the Exchange Control Act as a direct instrument to adjust the demand for foreign exchange to supply, conserve the foreign reserves and encourage essential impost. The administration of the Exchange Control Act was vested in the Federal Ministry of Finance, while the CBN was appointed as the principal administrative agent of exchange control in Nigeria. With the civil war further depleting the reserves, such that it could barely finance two months imports, there was a clamp down of foreign exchange on invisibles and export proceeds other than oil exports. The strategies did not achieve its set goals hence foreign exchange budgeting was introduced in 1971. The increase in crude oil prices under OPEC in 1974 saw the reserve rising from four months of import cover in 1973 to twenty-four months in 1974. In December 1974, the CBN diversified from holding high proportion of its reserves in pound sterling into seven currencies (US Dollars, Pound Sterling, Deutshe Mark, Canadian Dollars, Swiss Franc, French Franc and Japanese Yen). The government on the advice of the Central Bank, directed that proceeds of export to countries of convertible currencies should be paid in the new

scheduled currencies. To increase the earnings from investments, an Investment Management Committee was constituted to oversee the management of the reserves from 1974 -1976. Reserves were further diversified into fifteen different currencies in addition to investments into bonds and treasury bills. The Currency composition was not reflective of the trading partner, but to preserve the purchasing power of the reserves. The Trade and Exchange Control applied with varying degree of intensity until 1986 and was aimed at curtailing outflow of foreign exchange in order to allow for build up of reserves. The second tier foreign exchange market was introduced in 1986 as a component of the SAP to achieve a unified market determined rate for the Naira and ensure optimal foreign exchange utilization. The dramatic increases in commodity prices including crude oil prices as from 1999, led to the surge in reserves accretion. Consequently, the reserves rose from USD5.4billion in 1999 to USD 43 billion at end November 2006, despite the outright settlement of the Paris club debt.

3.3 Current Reserves Management Practices

Central Bank of Nigeria (CBN) in 2006 appointed external fund managers for the professional management of our external reserves to diversify investment and leverage on the expertise of the foreign banks in the quest to transform Nigerian banks into global financial institutions. The CBN had traditionally kept the external reserves as deposits with foreign banks. This was the first time that it was appointing foreign assets managers to manage part of its reserves, in line with global best practice. All the foreign institutions that partnered with domestic banks are reputable international asset managers with excellent track records each with a minimum credit rating of 'AA' rating by international rating companies. Except for Crown Agents, each of the selected Asset Managers had over US $50 billion-US$1.6 trillion as asset under management.

The asset managers in partnership included: Black Rock, J.P. Morgan Chase, H.S.B.C, BNP Paribas, UBS, Credit Suisse and Fortis Investec. Others are Morgan Stanley, ABN Amro, Cominvest, ING, Bank of New York and Crown Agents.

4.0 CHALLENGES AND PROSPECTS

Issues characterising the reserves of a country are predicated on the sustainability of the level of reserves to meet the country's requirements. The conventional standard is that external reserves should be able to finance three to four months of imports at the current rate of average monthly disbursement. The reserves/total demand liabilities criterion is predicated on the competitiveness of the external sector.

Challenges

The following presents challenges to reserves management in Nigeria:

Reserve Adequacy

The traditional indicator of the measurement of the adequacy of reserves is the months of imports in which three months of import cover is deemed adequate. The Asian crisis have proofed this insufficient hence other inflows and outflows are now taken into consideration. These include debt servicing, contingency in the form of capital reversal and capital flight, the vulnerability of balance of payment items and reserve drawdown. In Nigeria, the major sources of capital outflows are import bills and external debt payments, while commodity exports mainly account for the inflows. This infers that the adequacy of external reserves is dynamic as the level of inflows and outflows varies.

Volatility of foreign exchange inflow arising from Nigeria's over dependence on oil for over 90 per cent of its foreign exchange earnings makes it vulnerable to the fluctuations in crude oil prices. In addition, high import bills contributed to the fluctuations in the level of reserves over the years and the way the reserves were being managed.

The Legal and Institutional Environment

Sections 162(1) and 162 (3) of the Constitution stipulates the revenue allocation formula for each tier of government and their right to spend. This create liquidity surfeit that impacts on ability of the CBN to efficiently mop up excess liquidity (CBN ACT 2007)

Social Discontent at the Niger-Delta

Currently, The activities of the militants in the oil producing Niger Delta have been disrupting the exports of crude oil, thereby cutting revenue, despite the favorable international prices. This development also directly impact on international oil prices.

National Disasters and Emergences

The incidence of national disaster and emergencies are never preplanned, hence a country must be well prepared for circumstances that could dip into its reserves. It should be noted that the world climatic situation is changing and natural emergencies are showing up in places hitherto adjudged stable.

Training and Retention of Staff

Reserve Management task is becoming more complex as central banks are moving into new asset classes with higher risk/return profile in search of higher risk adjusted returns.

The CBN is moving from the hitherto investment in money market instruments such as time-deposits; treasury bills, etc into longer dated instruments like treasury and agency bonds (having explicit guarantee of a sovereign government). These are default-free instruments, they however have market risk. The Bank is making efforts to develop capacity in reserves management. The challenge is therefore, how to retain these staff.

Prospects

The sustainability of the success achieved in reserve management and the ability of the country to continuously respond to the dynamic global environment hinges on the following prospects:

High Crude Oil Prices

The increasing energy need all over the world and the instability in region with high oil reserves continue to drive the phenomenal increase in the oil price, a trend expected to remain unchanged in the short run. This will invariably translate to more accretion to the reserves.

Expected Higher Returns on Investments

The use of external managers in partnership with local banks in higher returns assets would promote higher income.

Increase Demand of Liquefied Natural Gas

The massive volume of the natural gas reserves of the country which is a growing source of energy worldwide would contribute significantly to foreign exchange earnings of the country.

Increase in Non-Oil Exports

There is a gradual drive by the country to increase non-oil exports such as mining of solid mineral, and agricultural exports in the economy. These would earn foreign exchange for the country and increase the external reserves.

Improved Capacity Building

The policy on partnership agreement between local and foreign banks in the management of external reserves would increase the ability of Nigerian technocrats to develop reserve management skills.

Fiscal Support

In line with its reform agenda under the National Economic Empowerment and Development Strategy (NEEDS), the Federal Government continues to pursue prudent fiscal operations that support the reserves management initiatives of the Bank. The Fiscal Responsibility Act of the government along with prudent management of the nation's resources would ensure long-term macroeconomic stability of the economy, and secure greater accountability and transparency in fiscal operations.

THE MILLENNIUM DEVELOPMENT GOALS (MDGs): IMPLEMENTATION STRATEGIES AND CHALLENGES FOR NIGERIA

At the UN Millennium Summit held in New York in September 2000, world leaders adopted the Millennium Declaration, committing their nations to a new global partnership to reduce extreme poverty and setting out a series of time-bound targets, all with a deadline of 2015, which have become known as the Millennium Development Goals (MDGs). Under the Declaration, leaders from every country agreed on a vision for the future a world with less poverty, hunger and disease, greater survival prospects for mothers and their infants, better educated children, equal opportunities for women, and healthier environment; a world in which developed and developing countries worked in partnership for the betterment of all. This vision comprised of 8 development goals, which provide countries with a framework for development and time-bound targets by which progress can be measured.

The MDGs represent a global partnership that has grown from the commitments and targets established at the world summits of the 1990s. Responding to the world's main development challenges and to the calls of civil society, the MDGs promote poverty reduction, education, maternal health, gender equality, and aim at combating child mortality, AIDS and other diseases.

This Brief outlines the major goals, targets and indicators as well as the journey so far in the attainment of the MDGs in Nigeria. It also examines the challenges of this global developmental initiative for Nigeria.

Goals, Targets and Indicators

The MDGs consist of eight goals to be achieved by 2015 in response to the world's main development challenges. They were drawn from the actions and targets contained in the Millennium Declaration that was adopted by 189 nations and signed by 147 Heads of State and Governments during the UN Millennium Summit in September 2000.

Set for the year 2015, the MDGs are an agreed set of goals that can be achieved if all actors work together and do their part. Poor countries have pledged to govern better, and invest in their people through health care and education. Rich countries have pledged to support them, through aid, debt relief, and fairer terms of trade.

There are basically **8 Goals, 18 quantifiable targets that are measured by 48 indicators.**

GOAL 1: ERADICATE EXTREME POVERTY AND HUNGER

Target 1: Reduce by half the proportion of people living on less than a dollar a day

1. Proportion of population below $1 per day (PPP) (World Bank)
2. Poverty gap ratio, $1 per day (World Bank)
3. Share of poorest quintile in national income or consumption (World Bank)

Target 2: Reduce by half the proportion of people who suffer from hunger

4. Prevalence of underweight children under five years of age (UNICEF)
5. Proportion of the population below minimum level of dietary energy consumption (FAO)

GOAL 2: ACHIEVE UNIVERSAL PRIMARY EDUCATION

Target 3: Ensure that all boys and girls complete a full course of primary schooling

6. Net enrolment ratio in primary education (UNESCO)
7. Proportion of Pupils Starting Grade 1 who Reach Grade 5 (UNESCO)
8. Literacy rate of 15-24 year-olds (UNESCO)

GOAL 3: PROMOTE GENDER EQUALITY AND EMPOWER WOMEN

Target 4: Eliminate gender disparity in primary and secondary education preferably by 2005, and at all levels by 2015

9. Ratio of girls to boys in primary, secondary, and tertiary education (UNESCO)

10. Ratio of literate women to men 15-24 years old (UNESCO)

11. Share of women in wage employment in the non-agricultural sector (ILO)

12. Proportion of seats held by women in National Parliaments (IPU)

GOAL 4: REDUCE CHILD MORTALITY

Target 5: Reduce by two thirds the mortality rate among children under five years

13. Under-five mortality rate (UNICEF)

14. Infant mortality rate (UNICEF)

15. Proportion of 1 year-old children immunized against measles (UNICEF)

GOAL 5: IMPROVE MATERNAL HEALTH

Target 6: Reduce by three quarters the maternal mortality ratio

16. Maternal mortality ratio (WHO)

17. Proportion of births attended by skilled health personnel (UNICEF)

GOAL 6: COMBAT HIV/AIDS, MALARIA AND OTHER DISEASES

Target 7: Halt and begin to reverse the spread of HIV/AIDS

18. HIV prevalence among 15-24 year-old pregnant women (UNAIDS)

19. Condom use rate of the contraceptive prevalence rate and

population aged 15-24 years with comprehensive correct knowledge of HIV/AIDS(UNAIDS, UNICEF, UN Population Division, WHO)

20. Ratio of school attendance of orphans to school attendance of non-orphans aged 10-14 years

Target 8: Halt and begin to reverse the incidence of malaria and other major diseases

21. Prevalence and death rates associated with malaria (WHO):

22. Proportion of population in malaria risk areas using effective malaria prevention and treatment measures (UNICEF):

23. Prevalence and death rates associated with tuberculosis (WHO):

24. Proportion of tuberculosis cases detected and cured under directly-observed treatment short courses (WHO)

GOAL 7: ENSURE ENVIRONMENTAL SUSTAINABILITY

Target 9: Integrate the principles of sustainable development into country policies and programmes; reverse loss of environmental resources

25. Forested land as percentage of land area (FAO)

26. Ratio of area protected to maintain biological diversity to surface area (UNEP)

27. Energy supply (apparent consumption; kg oil equivalent) per $1,000 (PPP) GDP (World Bank)

28. Carbon dioxide emissions (per capita) and consumption of ozone-depleting CFCs (ODP tons):

Target 10: Reduce by half the proportion of people without sustainable access to safe drinking water

29. Proportion of the population with sustainable access to and improved water source (WHO/UNICEF)

30. Proportion of the population with access to improved sanitation (WHO/UNICEF)

Target 11: Achieve significant improvement in lives of at least 100 million slum dwellers, by 2020

31. Slum population as percentage of urban population (secure tenure index) (UN-Habitat)

GOAL 8: DEVELOP A GLOBAL PARTNERSHIP FOR DEVELOPMENT

Target 12: Develop further an open, rule-based, predictable, non-discriminatory trading and financial system, including a commitment to good governance, development, and poverty reduction both nationally and internationally

Target 13: Address the special needs of the least developed countries, including: tariff and quota free access for least developed countries' exports; enhanced programme of debt relief for HIPCs and cancellation of official bilateral debt; and more generous ODA for countries committed to poverty reduction

Target 14: Address the special needs of landlocked countries and small island developing States

Target 15: Deal comprehensively with the debt problems of developing countries through national and international measures in order to make debt sustainable in the long term.

Target 16: In cooperation with developing countries, develop and implement strategies for decent and productive work for youths

Target 17: In cooperation with pharmaceutical companies, provide access to affordable essential drugs in developing countries

Target 18: In cooperation with the private sector, make available the benefits of new technologies, especially information and communications.

This target is measured under the following indicators:

i) Official development assistance

32. Net ODA as percentage of OECD/DAC donors' gross national product (targets of 0.7% in total and 0.15% for LDCs)

33. Proportion of ODA to basic social services (basic education, primary health care, nutrition, safe water and sanitation)

34. Proportion of ODA that is untied

35. Proportion of ODA for environment in small island developing States

36. Proportion of ODA for transport sector in landlocked countries

ii) Market access

37. Proportion of exports (by value and excluding arms) admitted free of duties and quotas

38. Average tariffs and quotas on agricultural products and textiles and clothing

39. Domestic and export agricultural subsidies in OECD countries
40. Proportion of ODA provided to help build trade capacity

iii) Debt sustainability

41. Proportion of official bilateral HIPC debt cancelled

42. Total number of countries that have reached their HIPC decision points and number that have reached their completion points (cumulative) (HIPC) (World Bank-IMF)

43. Debt service as a percentage of exports of goods and services (World Bank)

44. Debt relief committed under HIPC initiative (HIPC) (World Bank-IMF)

45. Unemployment of 15-24 year-olds, each sex and total (ILO)

46. Proportion of population with access to affordable, essential drugs on a sustainable basis (WHO)

47. Telephone lines and cellular subscribers per 100 population (ITU)

48. Personal computers in use and internet users per 100 population (ITU)

Attainment of the MDGs: The Journey So Far

In response to world leaders' request, the United Nations Secretariat in 2001 presented a roadmap for the implementation of the MDGs. It served as an integrated and comprehensive overview of the current situation, as well as outlining the potential strategies for action designed to meet the goals and commitments of the Millennium Declaration.

Available data indicated that the world has made significant progress so far in achieving many of the Goals. Between 1990 and 2002 average overall incomes increased by approximately 21 per cent; the number of people in extreme poverty declined by an estimated 130 million; child mortality rates fell from 103 deaths per 1,000 live births a year to 88; life expectancy rose from 63 years to nearly 65 years. An additional 8 per cent of the developing world's people received access to water and an additional 15 per cent acquired access to improved sanitation services. But progress has been far from uniform across the world - or across the Goals. There are huge disparities across and within countries. Within countries, poverty is greatest for rural areas, though urban poverty is also extensive, growing, and under-reported by traditional indicators.

Sub-Saharan Africa is the epicenter of crisis, with continuing food insecurity, a rise of extreme poverty, stunningly high child and maternal mortality, and large numbers of people living in slums, and a widespread shortfall for most of the MDGs. Asia stands out as the region with the fastest progress, but even there, hundreds of millions of people remain in extreme poverty, and even fast-growing countries fail to achieve some of the non-income Goals. Other regions have mixed records, notably Latin America, the transition economies, and the Middle East and North Africa, often with slow or no progress on some of the Goals and persistent inequalities undermining the progress of others.

In Nigeria, the National Economic Empowerment and Development Strategy

(NEEDS) recognizes the challenge of achieving the MDGs. It therefore devoted considerable attention to poverty reduction strategy under its social charter. NEEDS identifies the causes and sources of poverty and identifies what role different stakeholders in the economy will have to play to deal with them. In this regard, NEEDS' goals are supported by macroeconomic framework that rest on empowering people, promoting private enterprise and reforming the way government does it work. This architecture has to be financed and the costing of the MDGs should form an important aspect of the NEEDS financing agenda. Unfortunately, NEEDS failed to quantify the costing for the implementation of the MDGs. According to the NEEDS document, MDGs costing cannot be done without data gathering. However, the National Planning Commission (NPC) annually produces a report on Nigeria's MDGs status, having taken account of the intervention undertaken in terms of goods, services and infrastructure and the outcome.

Challenges for Nigeria

The achievement of the Millennium Development Goals by the stipulated 2015 has far reaching implications for Nigeria. The implementation strategies also pose serious challenges for the country. Some of these challenges, which are classified as generic and specific, are highlighted below:

The most important factor for the achievement of the MDGs in Nigeria is the commitment of the government to provide adequate budgetary allocations to the core human development sectors. Currently, all social indicators show that the human development index in Nigeria do not meet acceptable standard, and therefore requires urgent attention. The challenges of financing the MDGs are enormous but the data problem is even more precarious. Without solving the data problem, it will be impossible to cost the MDGs intervention programmes which would precede financing.

Eradication of Poverty and Extreme Hunger

Studies show that economic growth normally translates to increase in per capita income, thereby impacting positively on poverty reduction. Recent economic reforms in Nigeria have engendered economic growth, and available data indicate

that the incidence of poverty in Nigeria has declined significantly to about 54 percent in 2006. However, there is need to increase public investment in areas of health, nutrition, education and public infrastructure.

Eradication of extreme hunger and achieving food security poses a challenge for the country. Although agriculture recorded substantial growth in recent years, production of grains, particularly rice, has remained low, resulting in massive importation of the commodity. Another area of concern is the lack of sufficient focus on animals and fisheries production. Attention should be focused on how to raise food production to match the growing population and ensure adequate food security.

Maternal Mortality Ratio

The possibility of reducing the maternal mortality ratio by three-quarters by 2015 is a challenge, given the health conditions in the country. This is because of the following emerging issues:

- Teenage pregnancy - who are usually prone to serious pregnancy complications.
- Cultural and attitudinal practices which have affected the belief of most mothers against Ante-Natal Care (ANC).
- Delay in seeking ante-natal care due to cost, distance to health centre and other difficulties.
- Use of Traditional Birth Attendants (TBAs) who adopt harmful health practices.

The country is, however, poised to halt and begin to reverse the scourge of HIV/AIDS, malaria and tuberculosis. The current intervention efforts of the government and other non-governmental agencies need to be sustained.

Literacy Level

Notwithstanding the impressive achievements recorded so far in the education sub-sector, there are a number of challenges to the improvement of the literacy level in the country. These include:

- Limited resources, relative to rich nations, to cope with the expected expansion in the education sector.
- Inefficiency associated with high level of recurrent spending vis-à-vis capital expenditure, as well as the low quality of teaching.
- Inequity in the distribution of educational opportunities between the rich and poor, as well as between urban and rural areas.

Water supply and Sanitation

A greater proportion of city dwellers still rely on unhygienic sources of water supply (wells and rivers) and are further exposed to poor sanitation. Similarly, the rural poor are faced with lack of potable water. A major challenge therefore is to ensure that majority of Nigerian have access to safe water and good sanitation.

Environmental Sustainability

The current rate of environmental degradation resulting from the production and consumption of natural resources calls for efforts towards reversing the increasing rate of deforestation, desertification, flood erosion and gas emissions (i.e. the pollution of the atmosphere and water). The government is faced with the challenge of financing the elimination of the devastation caused by economic exploitation on our environment, especially in the Niger Delta region.

Gender Equality

Female enrollment at all levels of education and their involvement in the political scene are still low, compared with their male counterpart. The challenge for the government is to work out an acceptable formula that would guarantee that women participation in governance is raised to at least 30 percent by 2015.

Provision of Shelter

Poor housing finance mechanism remains a major handicap to the provision of shelter for the citizenry. The current high cost of housing construction is certainly out of the reach of the common man. The government is faced with the challenge of developing effective and efficient housing finance scheme, as well as improving on the slum settlements and providing them with basic social amenities.

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RESEARCH AND STATISTICS DEPARTMENT

REFORMS IN NIGERIA'S PENSION SYSTEM

Pension is regular income paid by the state to people who have meritoriously left the state service after attaining the retirement age, or by former employers to people who have retired from work.

The primary objectives of any pension scheme include the following:

- provide benefits to retirees during retirement
- provide benefits on disablement of an employee
- provide benefits to the employees' dependants after death
- give peace of mind to employee while in service
- encourage savings
- foster a cordial relationship between the employers and the employees
- encourage the exit of old employees, thereby giving younger ones promotion prospect.

There are universally two broad categories of pension systems namely:

(i) Non-contributory, defined benefits Pay-As-You-Go (PAYG) System, where the employer is responsible for the payments of gratuities and pension to the employees usually by creating a fund into which regular payments are made for the benefit of the employees and;

(ii) Defined contributory, pre-funded system scheme by both employers and employees on a periodic basis throughout the work life of the employees. Such contributions are pooled into an account and administered for the purpose of the payments of retirement benefits to the employees as and when due.

In practical terms, however, the implementation of pension schemes worldwide involves some sort of hybrid of the two broad classifications.

This Brief highlights the major policy and institutional reform in the Nigeria's pension system.

BACKGROUND TO NIGERIA'S PENSION REFORM

Prior to the enactment of the Pension Reform Act of 2004, Nigeria pension scheme was plagued with problems that defied solutions for years. Before this period, Nigeria's public and private sectors operated different pension schemes. The several attempts made at unifying the schemes for the benefit of all the parties were largely unsuccessful. Generally, the following pension schemes were operational under the Pension Act 102 of 1979 (as amended):

- Public sector PAYG pension scheme
- Private sector occupational pension scheme
- Nigeria Social Insurance Trust Funds (NSITF) scheme
- Individual or Personal Pension Scheme

The public sector in Nigeria operated the PAYG scheme whereby retirement benefits were paid from current revenue through budget allocations. Under the PAYG system, the benefits were defined; an employee could determine his entitlements. The system was largely non-contributory as employees were not contributing to the pension funds.

In the private sector, employers and employees were not under any obligations as there was no legal provision to that effect. However, many employers operated pension schemes of one sort or the other for their employees. Three types of schemes were operated by private sector employers in Nigeria. These included:

- the pure premium where benefits were in the form of annuity paid at regular interval and pensioners could take up to 25.0 per cent of the total annuity in cash on retirement.
- Provident funds where retirement benefits were taken in lump sum only immediately after disengagement from service and was usually tax-free.

- Death-in-service-benefits, were cash payments in multiples of the deceased employee's final emolument to his next-of-kin.
- The NSITF established by the NSITF Act of 1993 as a social insurance scheme for private sector employees who must register to be part of the scheme. It was funded from contributions from both employers and employees on monthly basis with fund deductible at source. The benefits payable under the scheme included retirement pension and grant, invalidity pension and grant, survivor's pension and funeral grant.
- Individual/Personal Pension Plans which were pension contracts purchased from life assurance companies by individuals to provide for old age and are usually available for self employed, employees without pension coverage and those that require supplementary coverage in addition to an existing one. The terms of funding and benefits payable were mutually negotiated with the company offering such services.

Many problems bedeviled both the private and public sectors pension schemes operated in the country. Consequently, the scheme failed to achieve the primary objective of providing succor to employees at old age. These problems made most retirees suffer untold hardships. As a matter of fact, the problems became so precarious that most of the schemes were no longer sustainable. In particular, the public sector scheme was hampered by inadequate budgetary provision and untimely release of funds which resulted in delays in payments and accumulation of pension arrears. Prior to the enactment of the 2004 Pension Act the outstanding pension liabilities nationwide, were estimated at over N2.5 trillion.

Under the private sector scheme, many of the employees were not covered by the pension scheme put in place by their employers and many of such schemes were largely not funded. Besides, where the schemes were funded, they were mostly grossly inadequate and characterized by malpractices usually involving the fund managers and trustee to the funds.

Generally, the problems that characterized the old pension schemes included:

i. Inadequate budget provisioning for the pension system.

ii. Outright fraud and malpractices occasioned by the collusion of the pension funds managers and Funds Board of Trustees.

iii. Poor corporate governance by pension assurance company service providers resulting in closures or insolvency and subsequent default of pension contract.

iv. Different benefits formulae among occupational groups

v. Increasing number of pensioners and the difficulties in monitoring existing numbers due to inadequate database which culminated into incidence of ghost pensioners particularly in the public service.

vi. Poor pension administration and inadequate delivery structure of payments.

THE 2004 PENSION REFORM

In order to address the problems associated with the pension scheme in the country, the Pension Reform Act of 2004 was enacted. The main objectives of the Pension Act included:

a. To ensure that every person who worked in either the public service of the Federation, or the private sector receives retirement benefits as and when due.

b. To assist individuals save for their livelihood during old age and thereby reducing old age poverty.

c. To ensure that pensioners were not subjected to hardship due to inefficient and cumbersome process of pension payments

d. To establish a uniform set of rules, regulations and standards for the administration and payments of retirement benefits for public and private sectors.

e. To curtail the growth and accumulation of pension liabilities.

As a marked departure from the erstwhile pension scheme, the Pension Act 2004 expressly provided that the scheme be governed by the cannons of safety and security

of benefits, transparency, accountability, equity, flexibility, inclusivity, uniformity and practicability. The adoption and subsequent implementation of these principles have engendered confidence and sustainability of the new pension scheme.

The Pension Reform Act 2004 established the National Pension Commission (PenCom) as the body to formulate the overall pension policy, regulate, supervise and ensure the effective administration of pension matters in Nigeria. In addition, PenCom would be responsible for issuance of guidelines for the investment of pension funds and establish standards, rules and guidelines for the management of pension funds as well as approving and licensing pension fund administrators, custodians and other institutions relating to pension matters.

Features of the 2004 Pension Scheme

The provisions of the Pension Act 2004 spelt out the features of the new scheme in order to achieve its stated objective. According to the Act, the new scheme is contributory, fully funded, and privately managed. It also provide for third party custody of funds and is based on individual account.

At the take-off of the new scheme, employees with 3 years or less to retirement were allowed to continue under the old arrangement, while the persons listed under section 291 of the Federal Republic of Nigeria's constitution were exempted. The new pension scheme is mandatory for organizations that have 5 or more employees.

Under the new pension scheme, both employers and the employees contribute a minimum of 7.5 per cent of the employee's emoluments into the employees' Retirement Savings Accounts (RSA). While the new Pension Act superseded and repudiated all existing legislations in the public sector. Some of the existing private sector pension scheme would continue provided that there is evidence to show that (a) the retirement Fund was fully funded at all times, and any shortfall was made up within 90 days; (b) the pension funds assets were separated from the assets of the employer; (c) the pension funds assets are held by a licensed custodian.

The Act also made provision for any employer managing its existing pension scheme prior to the new enactment to apply to the PenCom as a Closed Pension Fund

Administrator (CPFA) to continue to manage such pension scheme. A CPFA cannot open or manage RSAs for employees other than its own or employees of its parent company if it is a subsidiary.

Under the new scheme, pension funds were to be privately managed by Pension Funds Administrators (PFAs). PFAs should be limited liability companies, who have been licensed to open RSA for employees, invest and manage pension funds in a manner prescribed from time to time by PenCom. Other obligations of the PFAs are to provide regular information to the employees and pay retirement benefits as prescribed under the Act as and when due.

The scheme also provided for the establishment of the Pension Fund Custodian (PFCs) whose function is to warehouse pension fund assets, including contributions sent directly by the employers. The PFCs upon receipts of the contributions shall notify the PFAs, who shall subsequently credit the RSAs of the employees. The PFCs shall be responsible for executing transactions and undertake activities relating to the administration of pension fund investments upon instruction by the PFA. Essentially, the PFCs are responsible for keeping pension fund assets in trust for the PFAs.

MICROFINANCE POLICY: IMPLEMENTATION STRATEGIES AND SUPERVISORY FRAMEWORK FOR NIGERIA

It is generally accepted that long-term sustainable microfinance programmes hold enormous potential for national economic growth and development. To date, provision of microfinance services has had some positive impacts on the individual households' budget and changed the quality of life of millions of people in developing countries, especially in South East Asia, the Pacific and Latin America regions. Yet, the majority of economically active poor, in many countries, still lack access to basic financial services i.e. credit, savings opportunities, insurance and money transfers, availability of which could significantly raise their standard of living and better equip them to manage their lives with dignity and to influence their destiny. The latent capacity of the poor for entrepreneurship would be significantly enhanced through the provision of microfinance services to enable them engage in economic activities and be more self-reliant; increase employment opportunities, enhance household income, and create wealth.

In Nigeria, the formal financial system provides services to about 35 per cent of the economically active population, while the remaining 65 per cent are excluded from access to the financial services. This 65 per cent are often served by the informal financial sector, through Non-Governmental Organization (NGO) microfinance institutions, moneylenders, friends, relatives, and credit unions. The non-regulation of the activities of some of these institutions has serious implications for the Central Bank of Nigeria's ability to exercise one aspect of its mandate of promoting monetary stability and a sound financial system.

A microfinance policy which recognizes the existing informal institutions and brings them within the supervisory purview of the CBN would not only enhance monetary stability, but also expand the financial infrastructure of the country to meet the financial requirements of the Micro, Small and Medium Enterprises (MSMEs). Such

a policy would create a vibrant microfinance sub-sector that would be adequately integrated into the mainstream of the national financial system and provide a strategic platform for the evolution of microfinance institutions, promote appropriate regulation, supervision and adoption of best practices. The policy would create a platform for the establishment of microfinance banks; improve the CBN's regulatory/supervisory performance in ensuring monetary stability and liquidity management; and provide appropriate machinery for tracking the activities of development partners in the microfinance sub-sector in Nigeria.

This Brief highlights the Microfinance Policy Framework of the CBN and also examines the implementation strategies and supervisory framework for its effective delivery to the target groups.

WHAT IS MICROFINANCE?

Over two decades ago, microfinance simply meant the provision of very small loans (micro-credit) to the poor, to help them engage in new productive business activities and/or to grow/expand existing ones. However, microfinance has come to include a broader range of services. These include mainly credit, savings opportunities, insurance and money transfers, as practitioners came to realize that the poor, who lacked access to traditional formal financial institutions, needed and required a variety of financial products to achieve meaningful improvement in their business activities. Microfinance refers to loans, savings opportunities, insurance, money transfers and other financial products targeted to the poor. The average loan size varies from country to country, but in most cases, the average loan is equivalent to $120.0-150.0 in the respective currency. For example, in Philippines, the average loan size is $124.0

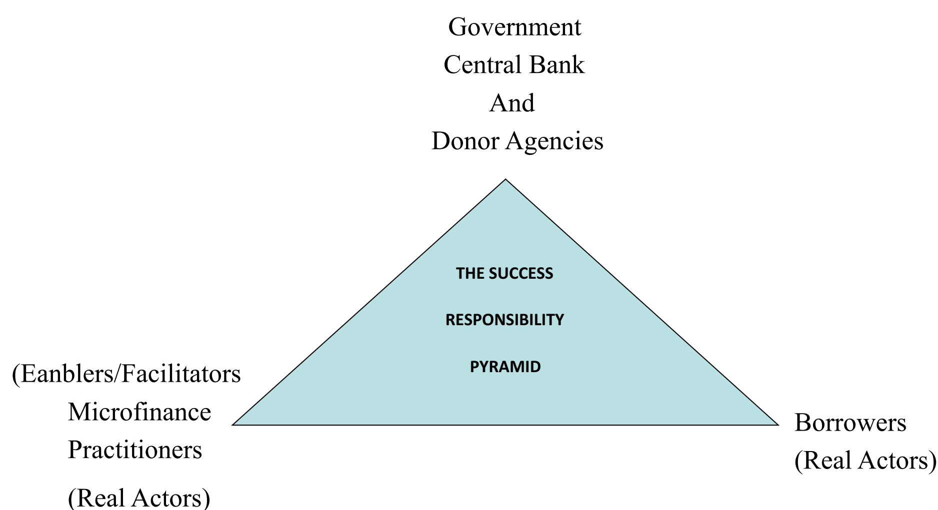
Three features distinguish microfinance from other formal financial products. These are (i) the smallness of the loans advanced or savings collected, (ii) the absence of asset based collateral and (iii) simplicity of operation. Consequently, a microfinance institution (MFI) has come to be defined as any institution that provides credit and other financial services to the low income entrepreneurs who are traditionally not served by the conventional/formal financial institutions. A microfinance institution

can be non-profit organization (NGO), a regulated financial institution, a commercial bank or a combination of these, that devotes all or part of its resources to provide microfinance products to the low income clients, mainly credit.

MICROFINANCE POLICY FRAMEWORK FOR NIGERIA

Creating a microfinance sector that would achieve the desired and essential poverty alleviation goals requires a well articulated policy, to act as a road map/catalyst to achieve the desired objectives. The policy needs to be effectively and efficiently implemented. However, successful implementation calls for all the stakeholders to play their individual respective roles and to take their individual responsibilities seriously and with focused commitment, if a vibrant and all inclusive microfinance sub-sector that is deliberately and adequately mainstreamed into the national financial system to provide the needed stimulus for growth and long-term development are to be created. The policy should be able to harmonize the operating standards and provide strategic platform for evolution of professionally managed microfinance institutions, promote appropriate regulatory and supervisory guidelines and adoption of best practices, thus achieving long-term sustainability.

The triangle below suggests the respective roles and responsibilities:



It was with the deep appreciation and full commitment to the above, that on 15th December 2005, the Central Bank of Nigeria (CBN) in collaboration with the Federal Government and other stakeholders launched the Microfinance Policy, Regulatory and Supervisory Framework for Nigeria. The launching was performed by the President of the Federal Republic of Nigeria and Commander-In-Chief of the Armed Forces, Chief Olusegun Obasanjo (GCFR). A policy that would meet the above needs, through the provision of diversified financial services at competitive pricing in dependable, timely and long-term sustainable manner to the active poor of this nation was critical. Further, this policy would result in donors; coordination, with deliberate, systematic and predictable mobilization and maximization of allocation of scarce resources for capacity building. The policy would also facilitate the participation of private sector in microfinance for a wider, more effective and efficient way of delivering services and financial advice.

The policy and regulatory framework document is comprehensive and articulates the creation of a vibrant and all inclusive microfinance sector that would reach millions of the active poor in all areas of Nigeria. It is directed towards giving direction, harmonizing standards, professionalizing and coordinating the operations of the NGO-MFIs, and Microfinance Banks in the country. Furthermore, the policy is the "starting point in creating a plan for prosperity", as detailed in the country's National Economic Empowerment and Development Strategy (NEEDS). The new Microfinance Policy fully supports and complements the NEEDS" vision, values, principles and goals, especially with regards to poverty reduction, employment generation, wealth creation and reducing inequality, in full collaboration with the private sector, all aimed at empowering the Nigerian people.

Similar to the NEEDS document, the Microfinance Policy places special emphasis in partnership between people and government in mobilizing resources to achieve greater prosperity. Together, the two documents seek to create an integrated, well streamlined and holistic financial system and will be the country's plan/a road map for future prosperity of all Nigerians. The two documents call for disciplined culture in doing business and in financial activities, with appropriate honesty, transparency and

accountability. Further, they appreciate that, the role of the government is that of an enabler and facilitator and not a participant in market driven business activities directed towards achieving economic growth. They also, call for co-operation, self-confidence and self-reliance among all Nigerians. In addition, the Microfinance Policy also has the provision for wholesale funding to assist in building and integrating MFIs and MF Banks into the broader financial sector, to offer technical and regulatory policy guidelines and disseminate field-based knowledge on sound microfinance principles and best practices.

Furthermore, the policy recognizes and calls for professional management of MFIs and MF Banks, accreditation of the Chief Executives of MF Banks, professional and diversified board to ensure good governance, achievement of wider outreach, extensive capacity building, regular and effective regulatory and supervisory practices, all directed towards ensuring continued high standard of performance and hence, long-term sustainability.

POLICY OBJECTIVES

The specific objectives of the microfinance policy are to: make financial services accessible to a large segment of the potentially productive Nigerian population which otherwise would have little or no access to financial services; promote synergy and mainstreaming of the informal sub-sector into the national financial system; enhance services delivery by microfinance institutions to micro, small and medium entrepreneurs; contribute to rural transformation; and promote linkage programmes between universal/development banks, specialized institutions and microfinance banks.

i) The Goals of Microfinance Banks

In order to achieve the objectives of serving the financial thirsts of the active poor, it became imperative to establish microfinance banks which would serve the purposes of providing diversified, affordable and dependable financial services to the active poor, in a timely and competitive manner, that would enable them to undertake and develop long-term, sustainable entrepreneurial activities; mobilizing saving for intermediation; creating employment opportunities and increasing the productivity of

the active poor in the country, thereby increasing their individual household income and uplifting their standard of living; enhancing organized, systematic and focused participation of the poor in the socio-economic development and resource process; providing veritable avenue for the administration of the micro credit programmes of government and high net worth individuals on a non-recourse case basis. In particular, this policy ensures that state governments shall dedicate an amount of not less than 1 per cent of their annual budgets for the on-lending activities of microfinance banks in favour of their residents; and rendering payment services, such as salaries, gratuities, and pensions for various tiers of government.

In line with the new policy, community banks in Nigeria were to convert to microfinance banks. The policy stipulates that the minimum paid up capital for MFBs licensed to operate in a Local Government Area shall be N20 million, while those licensed to operate state-wide would be N1.0 billion. Hitherto, community banks operate as single unit banks with a capital base of N5.0 million but with the conversion to MFBs they can now operate branches and cash centers. While currency centers do not require any stipulated provision of minimum shareholders free funds, opening of full-fledged branches are subject to the availability of N20 million free funds of the banks for each new branch. In the same vein, MFBs seeking to cover an entire state from the onset must have N1 billion capital base before starting operation.

ii) Policy Targets

Based on the goals highlighted above, the targets of the policy are to: cover the majority of the poor but economically active population by 2020 thereby creating millions of jobs and reducing poverty; 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 per cent in 2020; and the share of micro credit as percentage of GDP from 0.2 per cent in 2005 to at least 5.0 per cent in 2020; promote the participation of at least two-thirds of state and local governments in micro credit financing by 2015; eliminate gender disparity by improving women's access to financial services by 5.0 per cent annually; and increase the number of linkages among universal banks, development banks, specialized finance institutions and microfinance banks by 10.0 per cent annually.

iii) Policy Strategies

A number of strategies have been derived from the objectives and targets as follows: license and regulate the establishment of microfinance Banks (MFBs); promote the establishment of NGO-based microfinance institutions; promote the participation of Government in the microfinance industry by encouraging States and Local Governments to devote at least on per cent of their annual budgets to micro credit initiatives administered through MFBs; promote the establishment of institutions that support the development and growth of microfinance service providers and clients; strengthen the regulatory and supervisory framework for MFBs; promote sound microfinance practice by advocating professionalism, transparency and good governance in microfinance institutions; mobilize domestic savings and promote the banking culture among low-income groups; strengthen the capital base of the existing microfinance institutions; broaden the scope of activities of microfinance institution; strengthen the skills of regulators, operators and beneficiaries of microfinance initiatives; clearly define stakeholders' roles in the development of the microfinance sub-sector; and collaborate with donors, coordinate and monitor donor assistance in microfinance in line with the provisions of this policy.

STRATEGY FOR IMPLEMENTATION

The first step towards the successful implementation of the microfinance policy is the immediate assessment of the skill gaps in the CBN, the practitioners and borrowers. Once the gaps have been identified and agreed upon, a deliberate, systematic and intensive capacity building to enhance and improve the existing skills, must begin without delay. Other steps would be to identify and invite available donor sources to fund these capacity building activities; strengthen the Microfinance Unit staffing in the Development Finance Department (DFD) and the regulatory and supervisory staffing in Other Financial Institutions Department (OFID); the Microfinance Management Team Certification process must be agreed upon and put in place without delay after specifying clearly which exams one is required to pass before he/she is considered certified , which institutions are authorized to offer trainings in the preparations for these examinations and who are the recognized and approved examiners of those examinations?

An independent organization, like the Institute of Chartered Accountants of Nigeria (ICAN) or Chartered Institute of Bankers of Nigeria could be mandated to conduct these examinations and be given whatever support it needs to do so.

Other strategies are to create and strengthen national institutions within Nigeria and support and develop them to become centers of excellence for training in micro finance to leverage information on lessons learnt, dissemination of knowledge on best practices within the sector and to undertake any required certification locally, instead of trainees going overseas; identify and remove the bottlenecks that could hinder continuous and systematic progress in the microfinance industry in the country i.e. make the process of licensing MF banks impartial and timely; avoid the "inordinate days" in decision making, said to be noted in the development and finalization of the National Microfinance Policy; provide appropriate enabling environment and incentives to encourage and attract private sector and universal banks to invest in the micro finance industry; in support of the policy, government to stay out of the microfinance industry and reduce its social programmes, that would undermine the implementation of market/private sector driven microfinance programmes, give the active poor a hand, not a hand-out charity! Charity does not create discipline! Instead it creates and encourages continuous dependency; encourage and offer more support to MF banks that contribute most in employment and wealth creation; make commercial funding available, through independently managed wholesale funders and MF Banks; encourage new MFB and/or MFIs to become self-accounting and to achieve financial self-sufficiency within five years after inception, if they have to make a meaningful contribution to the market; and create awareness of the millennium development goals for microfinance institutions.

REGULATORY FRAMEWORK

The regulatory framework would help this new window of opportunity for the emerging microfinance banks to bring financial services to people who never had access to such services before. It would require the support of government and those of regulatory authorities. The framework would require the CBN to collaborate with the appropriate fiscal authorities in providing a favourable tax treatment of MFB's

financial transactions, such as exemption from value added tax (VAT) on lending, or tax on interest income or revenue. Similarly, the principle of exemption from profit tax shall be applied to any MFB that does not distribute its net surplus but ploughs it back and reinvests the surplus to finance more economically beneficial micro, small and medium entrepreneurships. Furthermore, a Rediscounting and Refinancing Facility (RRF) shall be made available to MFBs for purpose of providing liquidity assistance to support and promote microfinance programmes. This would enable MFBs that have met the CBN prudential requirements to, on a sustainable basis, provide and render micro credits and other services to their clients.

SUPERVISORY FRAMEWORK FOR MICROFINANCE BANKS

i) Licensing and Supervision of Microfinance Banks

The licensing of microfinance banks shall be the responsibility of the Central Bank of Nigeria. A licensed institution shall be required to add “microfinance bank”; after its name. All such names shall be registered with the Corporate Affairs Commission (CAC), in compliance with the Companies and Allied Matters Act (CAMA) 1990.

ii) Establishment of a National Microfinance Consultative Committee

A National Microfinance Consultative Committee (NMFCC) shall be constituted by the Central Bank of Nigeria (CBN) to give direction for the implementation and monitoring of this policy. Membership of the Committee shall be determined from time to time by the CBN. The Microfinance Support Unit of the CBN shall serve as the Secretariat to the Committee.

iii) Credit Reference Bureau

Due to the peculiar characteristics of microfinance practice, a credit reference bureau, which shall provide information on microfinance clients and aid decision making, is desirable. In this regard, the present Credit Risk Management System in the CBN shall be expanded to serve the needs of the microfinance sector.

iv) Rating Agency

The CBN shall encourage the establishment of private rating agencies for the sub-sector to rate microfinance institutions, especially those NGO-MFIs which intend transform to microfinance banks.

v) Deposit Insurance Scheme

Since MFBs are depositing-taking institution and in order to reinforce public confidence in them, MFBs shall qualify for the deposit insurance scheme of the Nigeria Deposit Insurance Corporation (NDIC).

vi) Management Certification Process

In order to bridge the technical skill gap, especially among operators of microfinance banks, the policy recognizes the need to set up an appropriate capacity building programme for MFBs. To this end, the CBN shall put in place a microfinance bank management certification process to enhance the acquisition of appropriate microfinance operational skills of the management team of MFBs. A transition period of twenty four (24) months shall be allowed for the take-off of the programme, with effect from the date of launching the policy.

vii) Apex Association of Microfinance Institutions

The establishment of an apex association of microfinance institutions to promote uniform standards, transparency, good corporate practices and full disclosures in the conduct of MFI business shall be encouraged.

viii) Linkage Programme

The policy recognizes the importance of the provision of wholesale funds for microfinance banks to expand their outreach. Pursuant to this, the CBN shall work out the modalities for fostering linkages between universal/development banks, specialized finance institutions and the microfinance banks to enable the latter source for wholesale funds and refinancing facilities for on-lending to their clients.

ix) Establishment of a Microfinance Development Fund

In order to promote the development of the sub-sector and provide for the wholesale funding requirement of microfinance banks, a Micro Finance Sector Development Fund shall be set up. The Fund shall provide necessary support for the development of the sub-sector in terms of refinancing facility, capacity building, and other promotional activities. The Fund would be sourced from government and through soft facilities from the international development financing institutions, as well as multilateral and bilateral development Institutions.

x) Prudential Requirements

The CBN recognizes the peculiarities of microfinance practice and shall accordingly put in place appropriate regulatory and prudential requirements to guide the operations and activities of the microfinance banks. Licensed MFBs shall be required to disclose their sources of funds, in compliance with the Money Laundering Prohibition Act 2004.

xi) Corporate Governance for Microfinance Banks

The board of directors of MFBs shall primarily be responsible for the corporate governance of the microfinance banks. To ensure good governance of the banks, the board of directors shall be responsible for establishing strategic objectives, policies and procedures that would guide and direct the activities of the banks and the means to attain same, as well as the mechanism for monitoring management of the day-to-day affairs of the banks shall be the responsibility of the Management team; the board of directors shall however, be responsible for monitoring and overseeing Management actions. Consequently, the licensed microfinance banks shall be expected to operate under a diversified and professional board of directors.

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