CENTRAL BANK OF NIGERIA

CBN BRIEFS
2004 - 2005 EDITION

RESEARCH & STATISTICS DEPARTMENT
2004 - 2005

CBN BRIEFS

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PREFACE TO 2004 - 2005 EDITION

As in previous years, the 2004 2005 CBN BRIEFS are policy-oriented articles 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 their contents periodically, but also to include important developments in the financial system and the Nigerian economy in order to enhance their continued relevance.

In this respect, the 2004 2005 Series were developed against the background of recent developments in the economy, including banking sector consolidation as part of the financial sector reforms embarked upon by the CBN, the National Economic Empowerment and Development Strategy (NEEDS) as the new blueprint for Nigeria's economic development and the proposed Fiscal Responsibility law which is expected to enhance fiscal discipline at all levels of government and link their fiscal operations to realistic macroeconomic fundamentals.

EDITORIAL COMMITTEE,
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RESEARCH & STATISTICS DEPARTMENT

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 this and other 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 in1952 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 Central Bank of Nigeria Act (1958), and subsequent amendments (1991, 1998) include:

(a) Issuance of legal tender currency notes and coins in Nigeria;

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

(c) Promotion and maintenance of monetary stability and a sound and efficient financial system in Nigeria;

(d) Acting as banker and financial adviser to the Federal Government; and

(e) Acting as lender of last resort to banks.

Consistent with this mandate, the Bank is charged with the responsibility of administering the Banks and Other Financial Institutions (BOFI) Act (1991), as amended (1997 and 1998), with the sole aim of ensuring high standards of banking practice and financial stability through its surveillance activities as well as the promotion of an efficient payments and clearing system.

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) Issuance of Legal Tender Currency Notes and Coins

The Central Bank of Nigeria engages in currency issue and distribution within the economy. The Bank assumed these important functions since 1959 when it replaced the WACB pound then in circulation with the Nigerian pound. The decimal currency denominations, Naira and Kobo, were introduced in 1973 in order to move to the metric system, which simplifies transactions. In 1976, a higher denomination note N20 joined the currency profile. In 1984, a currency exchange was carried out whereby, the colors of existing currencies were swapped in order to discourage currency hoarding and forestall counterfeiting. In 1991, a currency reform was carried out which brought about the phasing out of 2kobo and 5kobo coins, while the 1k, 10k and 25k coins were redesigned. In addition, the 50k and N1 notes were coined, while the N50 note was put in circulation. In the quest to enhance the payments system and substantially reduce the volume and cost of production of "legal tender notes", the N100, N200 and N500 notes were issued in December 1999, November 2000, and 2001respectively.

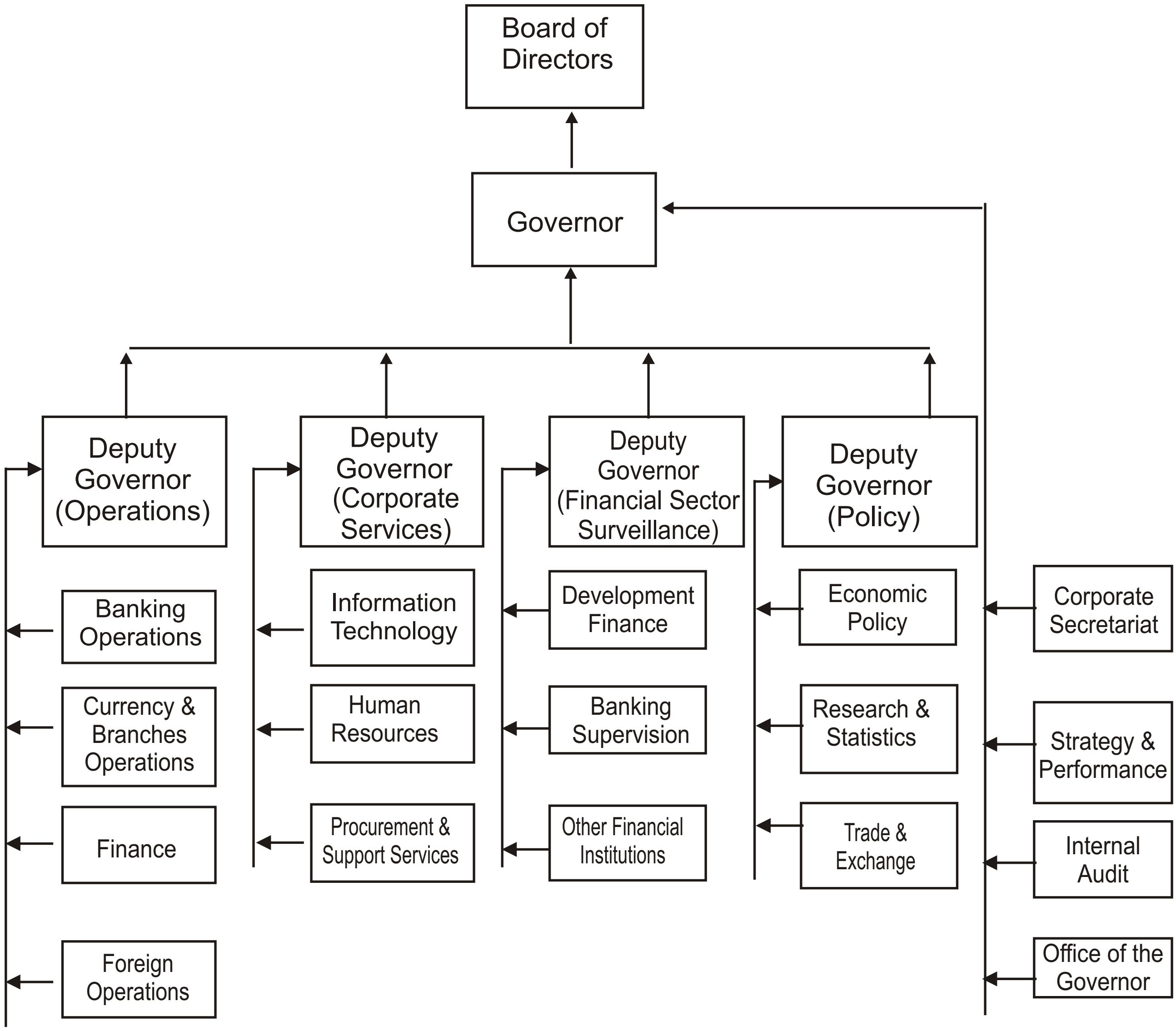
(b) Maintenance of Nigeria's External Reserves

In order to safeguard the international value of the legal tender currency, the CBN is actively involved in the management of the country's debt and foreign exchange.

(i) Debt Management:

In addition to its function of mobilizing funds for the Federal Government, the CBN 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 was formally transferred to the DMO in 2000.

Figure 1 : Organizational Structure of the CBN



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

(c) Promotion and Maintenance of Monetary Stability and a Sound and Efficient Financial System

The effectiveness of any central bank in executing its functions hinges crucially on its ability to promote monetary stability. Price stability is indispensable for money to perform its role of medium of exchange, store of value, standard of deferred payments and unit of account. Attainment of monetary stability rests on a central bank's ability to evolve effective monetary policy and to implement it effectively. Since June 30, 1993 when the CBN adopted the market-based mechanism for the conduct of monetary policy, Open Market Operations (OMO) has constituted the primary tool of monetary management, supported by reserve requirements and discount window operations for enhanced effectiveness in liquidity management. Specifically, liquidity management by the Central Bank of Nigeria involves the routine control of the level of liquidity in the system in order to maintain monetary stability. Periodically, the CBN determines target growth rates of money supply, which are compatible with overall policy goals. It also seeks to align deposit money banks' activities with the overall target. The CBN through its surveillance activities over banks and non-bank financial institutions seeks to promote a sound and efficient financial system in Nigeria.

(d) 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 the 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 instruments to be issued, while it acts as the issuing house on behalf of government for the short, medium and long-term debt instruments. The Bank coordinates the financial needs of government in collaboration with the Treasury to determine appropriately the term, timing of issue and volume of instruments to raise funds for government.

(e) Banker and Lender of Last Resort to Banks

The Bank maintains current accounts for deposit money banks. It also provides clearing house facilities through which instruments from the banks are processed and settled. Similarly, it undertakes trade finance functions on behalf of bank customers. Finally, it provides temporary accommodation to banks in the performance of its functions as lender of last resort.

4. 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 licences to five discount houses to participate in trading in government securities. In 200.., approval was given to some stockbrokers to also trade in TBs.

The CBN also fosters 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 the 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, 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.

Furthermore, 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), the Nigerian Deposit Insurance Corporation (NDIC), the Nigerian Export-Import Bank (NEXIM) and the Securities and Exchange Commission (SEC).

(b) Other Promotional Activities of the Bank

Through its regulatory activities, 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, introduction of the rural banking scheme and the promotion of agricultural and manufacturing activities nationwide through its monetary policy.

(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 agricultural finance, 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 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 increased effort to ensure the sustenance of the ACGSF and flow of credit to the agricultural sector, the authorised 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 ₦5000.00 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. In demonstration of CBN's commitment to its developmental function it remitted its share of the paid up capital to the Fund in full by 20th March, 2001.

(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 import raw materials and capital goods 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 facilities were, however, transferred to NEXIM in 1991. In its efforts to strengthen the operations 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$270million 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 this Scheme ceased in 1996.

(iv) Small and Medium Industries Equity Investment Scheme (SMIEIS):

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.

As at December 2004, a good number of banks had set aside 10 per cent of their profit before tax (PBT) for the scheme.

(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 will be set-up. Some of the enterprises covered by the scheme include cocoa, rubber, oil palm, coffee, gum Arabic, cashew, tea, fish capture, traveling etc. The modalities for the operations of the scheme were prepared with inputs from stakeholders through series of workshops held all over the country by the Bank in 2000. The main outstanding issue is the sourcing of the seed fund for the scheme. The refinancing scheme would be operated as a profit-making venture and as such there would be returns on investment, which will be shared as dividends to all stakeholders.

(d) 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 in which 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.

(e) Collaborative Research/Services 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 Report. 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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RESEARCH & STATISTICS DEPARTMENT

BANK CONSOLIDATION IN NIGERIA: RATIONALE PROCESSES AND PROSPECTS

The Nigerian banking sector has undergone remarkable changes over the years, in terms of the number of institutions, ownership structure as well as the depth and breadth of operations. These changes have been influenced largely by the challenges posed by the deregulation of the sector, globalization of operations, technological innovations and the adoption of supervisory and prudential requirements that conform to international standards. The deregulation of the sector which began during the period 1986 to 1990 was followed by a flood of new banks. The existence of so many banks coupled with the non-compliance with market regulations by majority of the players, poor management, poor credit policy insider dealings/abuses, economic recession etc led to high incidence of distress in the banking industry in the 1990s.

Furthermore, CBN's surveillance on banks recently revealed deterioration in banks' overall performance, based on CAMEL parameters. Banks' performance rating in 2004 showed that 10 banks were rated as sound, while 51, 16 and 10 banks were rated as satisfactory, marginal and unsound, respectively. Against this background, the CBN in July 2004 rolled out a 13-point reform agenda aimed at consolidating the banking sector and preventing the occurrence of systemic distress.

Two major elements in the reform package were the requirement that the minimum capitalization for banks should be N25 billion with effect from end-December 2005 and that the consolidation of banking institutions through mergers and acquisitions should be initiated.

Some of the goals the CBN intends to achieve by consolidating the Nigerian banking sector include:

- creating a sound and more secure banking system that depositors can trust;
- building domestic banks that investors can rely upon to finance investments in the Nigerian economy;
- encouraging industry consolidation and reducing systemic risks;
- fighting corruption and white-collar crimes through improved transparency and accountability, and insisting on sound corporate governance practices in the financial services sector;
- driving down cost structure of banks, improving banks' efficiency and encouraging competition with the goals of lowering interest rates and providing cheap credit to the economy; and
- meeting international benchmarks and minimum requirements for the integration of regional financial systems.

This BRIEF examines the rationale, options and processes of bank consolidation, as well as the challenges and prospects for Nigeria.

II. RATIONALE FOR BANK CONSOLIDATION

Business consolidation through mergers and acquisition has become a global phenomenon to achieve economies of scale and higher productivity. The need for financial institutions to merge becomes even more imperative in the face of the onslaught of greater competition arising from globalization and the pressure under World Trade Organization (WTO) for countries to open up their financial markets to further entry of foreign banks. For this reason, many countries are moving towards consolidating their banking system and Nigeria cannot be an exception.

A number of reasons have been advanced on why firms are consolidating or merging and some important factors driving consolidation have been identified. Our focus is on bank consolidation, but one should note that much of the same philosophy and rationale for bank mergers applies to other industries as well. Two primary factors affecting the need for banks to remain competitive are technology and deregulation. Whilst technology has blurred the lines of specialization among financial intermediaries, deregulation has significantly changed the way banks do business and where they do business. Technological improvement also means more change and the breakdown of traditional barriers, such as geography and product varieties. The two forces of technology and deregulation, working together, have resulted in what is referred to as the global economy. Also, the mixing together of technology and deregulation has produced rapid change that increasingly blurs accepted boundaries of time, geography, language, industries, enterprises, economies and regulations. As a result many merger partners today are creating financial supermarkets, where customers can have one-stop financial services.

In addition to market considerations, regulatory factors have accounted for some bank consolidation in different parts of the world. For example, the consolidation that took place in Lebanon, Malaysia, Kenya and South Africa were mainly policy-induced.

The justification for consolidation and enhanced capital requirement for Nigerian banks lies in the weakness and distressed condition of the banking sector. In addition, there were a large number of small players that could not operate profitably in a narrow margin market. Several of them were unable to support the real sector of the economy because of their small size, and hence the tendency to resort to sharp practices in order to make ends meet. Finally, several of the bank operated under a weak corporate governance structure, reflecting rudimentary, internal control system as many were family controlled banks. Thus, the banking sector reforms initiated by the CBN were designed to ensure a diversified, strong and reliable banking sector that will ensure the safety of depositors' money, as well as enable the banks play active developmental role in the Nigerian economy, and have the capability of emerging as competent and competitive players in the regional and global financial system. The reforms were aimed at creating a strong banking system, while consolidation was expected to address the problems of distress and technically insolvent institutions without resorting to the liquidation option.

III. COUNTRY EXPERIENCES

The financial services industry is restructuring and consolidating at an unprecedented pace around the globe. Particularly, in the United States and Western Europe transactions are numerous and breathtaking. Restructuring is also going on in Asia. Most striking is probably the ever-escalating scale of mergers in banking. In the US, there had been over 7,000 cases of bank mergers since 1980, while the same trend occurred in the UK and other European countries. Specifically, in the period 19971998, 203 bank mergers and acquisitions took place in the Euro area. In 1998 a merger in France resulted in a new bank with a capital base of US$688 billion, while the merger of two banks in Germany in the same year created the second largest bank in Germany with a capital base of US$541 billion. In many emerging markets, including Argentina, Brazil, and Korea, consolidation has also become prominent, as banks strive to become more competitive and resilient to shocks as well as reposition their operations to cope with the challenges of the increasingly globalized banking systems.

In Africa, where many banks are small in size in terms of their market capitalization, mergers in terms of volume and value have been relatively low. The five largest banks in Africa Standard Bank Group, ABSA Bank Ltd, Nedcor Ltd, First National Bank Ltd, Investec Group Ltd are based in South Africa and are all the result of mergers and consolidations. Standard Bank Group is the largest banking group in South Africa and Africa as a whole and was the result of the consolidation of several financial institutions over a period of ten years. As at end-December 2003, its shareholder funds totaled R28,667 million or $4,609 million. Similarly, the Amalgamated Banks of South Africa (ABSA) Limited is the second largest in the country and Africa as a whole with a shareholder fund base of R19, 350 million or $3,111 million. The bank was the result of the merger of over fifteen commercial banks, wholesale banks, finance houses, asset management companies, life assurance companies, insurance companies and advisory services across South Africa, Namibia, Tanzania, Mozambique and Zimbabwe. As a result of the merger, the bank has been able to create a powerful financial base that enables it to provide services to selected markets in the UK, USA, China, Hong Kong, Singapore and a substantial part of Africa.

In the case of Kenya, the initial consolidation of financial institutions was the liberalization of the financial sector in the early 1990s. This saw most banks consolidating their non-bank financial institutions subsidiaries. Besides, the government also addressed the capitalization issue of the banking industry through periodic amendments to the Banking Act. The Banking Act amendment in 1997 required banks to raise their paid-up capital from KShs.75 million to KShs.200 million over a two-year period. Further amendment to the Act in 1999 raised the capital gradually to reach KShs.500 million for banks and KShs.375 million for non-bank financial institutions by end of 2005.

The key learning points from the merger of banks in the two African countries are as follows:

i) In South Africa, bank mergers resulted in the emergence of the four largest conglomerates commanding perhaps 80% of the banking market plus a dominant share of the insurance and mutual fund sectors.

ii) Of the top 50 banks in sub-Saharan Africa, the first five positions are occupied by South African banks.

iii) In 2003, South African banks accounted for 70% of aggregate Tier 1 capital (i.e. ordinary shareholders' equity and retained earnings) of the sub-Saharan banking sector followed by Nigeria (8%) and Mauritius (3.8%).

iv) The higher capital resulting from the mergers has reduced the danger of bank collapse, enabled the banks to give more advances and make the necessary investments for better customer care.

v) The resulting economies of scale have rendered the banks more competitive and profitable. The merged banks, most of which were local, have been able to offer worthwhile competition to the foreign owned banks.

vi) Shareholders of the merged institutions have enjoyed better returns.

IV. OPTIONS AND PROCESSES OF BANK CONSOLIDATION IN NIGERIA

Merging institutions can be classified into two: mergers of unequals (the acquisition of one firm by another firm that is typically much larger and stronger) and mergers of equals (the so-called mega mergers, of which the large mega bank deals are typical).

In the case of mergers of unequals, it has been observed that bank acquisition tends to conform to a "survival of the fittest" syndrome, in which the less profitable and relatively slow-growing banks are more susceptible to being acquired. Also, banks with smaller market share, a lower capital ratio and those that devote a smaller fraction of their assets to lending tended to attract acquirers. Taken together, all these factors point toward relatively weaker banks attracting acquirers. When such banks are acquired, it creates the possibility of improved performance.

Experience has shown that most organizations that engage in mergers of equals perform better than the two firms standing alone. The combination of the two or more banks into one enhances the possibility of raising profits through either what is referred to as cost efficiencies (on the input side) or revenue efficiencies (on the output side). Consequently, combined banks often shift their product mix to more loans and higher valued products.

In order to streamline and set the pace for the consolidation of banks, the CBN approved the Guidelines and Incentives on Consolidation in the Nigerian Banking Industry. The guidelines stated that the only legal modes of consolidation allowed are mergers and outright acquisition/takeover. A mere group arrangement is not acceptable for the purpose of meeting the stipulated N25 billion capitalization requirement for banks. Therefore, all banks that have other banks as subsidiaries or have common ownership are encouraged to merge.

There are however, several options open to Nigerian banks to meet the stipulated minimum capital base requirement. These include:

- To approach the capital market for funds through an Initial Public Offer (IPO), Private placement or Rights Issue;
- To consolidate through a merger with like-minded and synergy-producing banks;

- To acquire another bank or be available for acquisition; and
- To close shop and surrender the banking license.

In line with the approved options, some banks have attempted to meet the required minimum shareholders' funds by accessing the capital market whilst others are pursuing private placement alternative. Some doubts have, however, been expressed whether the Nigerian capital market has the depth, breadth and resilience to absorb the many bank issues that have emerged from the market recently. The lack of adequate absorptive capacity of the capital market may be a constraint for banks wishing to raise capital from the market.

In anticipation of the likely problems that may be encountered in the consolidation process, the CBN provided some incentives for banks that consolidate and/or are able to achieve the set minimum capital base within the stipulated period, as follows:

- Authorization to deal in foreign exchange;
- Permission to take public sector deposits and recommendation to collect public sector revenue;
- Prospects of managing part of Nigeria's external reserves, subject to prevailing guidelines.

Other incentives that would be available in the process of meeting the guidelines include:

- Tax incentives in the areas of capital allowances, company income tax, stamp duties, etc;
- Reduction in transaction costs;
- Provision of technical assistance; and
- Provision of a help desk to fast-track approvals.

As at October 31 2005, twenty three (23) groupings involving 81 banks had submitted proposals for mergers to the CBN, while some banks have raised funds from the capital market and others are at various stages of the consolidation process. Also, 20 groups involving 57 banks have been granted pre-merger consent. Similarly, seven groups involving 22 banks had received approval in principle and four groups have been granted final approval. It is envisaged that about 25 banks would meet the consolidation requirement, which is about twice the number initially projected at the beginning of the programme.

V. CHALLENGES OF BANK CONSOLIDATION

Consolidation of banks is in fact a very difficult art. It requires extreme care, a clear methodology and a strong leadership from the highest levels of management. Successful mergers and acquisitions eventually depend very much on the ability of management to conceive well thought-through strategies, to develop synergies, combine cultures, and motivate teams.

When banks opt to achieve their objectives of meeting the minimum shareholders fund base requirement through consolidation, several challenges will have to be faced and handled with utmost care by both the consolidating entities and the regulatory bodies. Among the major challenges that may be faced by the banks include:

- Attitudinal change by bank owners and management, who may resist corporate consolidation for fear of losing control and erosion of their powers;
- Rigidities in bank ownership, which include a complicated web of cross-shareholding that bind banks to insurance companies, industrial groups and other banks;

- The corporate structure can pose problems especially in cases where the Memoranda and Articles of Association of a bank specifically prevent mergers and take-overs;
- Inherent natural resistance to cultural imposition which can create post-merger trauma, as some dominant banks may be tempted to force their smaller merger partners to assimilate/adopt their organizational culture; and
- Increased cost of maintaining several deposit accounts and higher cost and complexity of servicing a larger number of shareholders, as consolidation often results in larger size, larger shareholder base and larger number of depositors.
- Redundancy cost in the areas of Information Technology, Human Resources, and fixed assets such as branch offices.

The regulatory authorities on their part would also face some daunting challenges, including:

- Ensuring that provision of adequate safety nets and compensation packages are made by the merging banks to ameliorate for potential job losses arising from mergers;
- Appropriate mechanisms for protecting possible disenfranchisement of small depositors who may not be welcomed by the emerging mega-banks;
- The regulatory authorities, especially SEC, would need to be empowered to be active in the market to prevent threat to competitive market and monopolistic tendencies of mega-banks from consolidation. Also, the NDIC and CBN would need to constantly monitor the activities and performance of the emerging mega-banks to prevent bank distress and failures.

Post-consolidation era would likely pose some challenges to all stakeholders in the banking system. On the part of banks, they will require strong management teams that are committed to bringing about overall performance improvements and capacity enhancements. The ensuing paradigm shift would require that new strategies would have to be conceptualized and articulated to address the increasingly complex issues that will arise during post consolidation era. At the industry level, it would not just be a question of mega banks emerging, rather the new financial landscape will compel bank management to re-examine their existing business models to see where their strengths lie and to what opportunities these strengths could be applied to enhance returns. There may be need to move toward strategic differentiation among banks in order to better serve the relevant market segments or niches. This may involve market specialization or functional specialization as banks decide which functional areas or combinations of risk management, customer services, product innovations, to exploit and maximize to their advantage.

At the individual banking institution level, the ability to make real improvement would also depend very much on the availability of competent human resource. The quality of manpower will be a defining element of performance and competition among banks. Attracting the best skills and talents in the industry must also be complemented with better management and communication so that there is an awareness and understanding of visions and shared values throughout the organization. Towards this end, training and development of employees must be seen as an important contributing factor towards value creation within the banks.

To ameliorate the effect of possible job losses or redundancies resulting from the consolidation of banks, the monetary authorities should ensure that the exiting staffs are compensated by the consolidated entity in line with industry standards.

VI. PROSPECTS AND BENEFITS OF CONSOLIDATING NIGERIA'S BANKING INDUSTRY

In spite of the constraints and challenges highlighted above, the prospects and benefits of banking system consolidation in Nigeria are numerous. The financing of huge projects will no longer present difficulties to the banks as the emerging banks would be able to undertake large transactions such as investments in technology, including oil and gas, telecommunications, power and construction industry. The achievement of an improved capital for a bank implies improved capacity to create loan assets. Thus, a stronger banking industry which the post-consolidation era entails would be able to proactively and adequately support the real sector of the economy. With better capital adequacy of the banks, the real sector would have easy access to long-term funds at reduced interest rates.

Other benefits derivable from consolidation of banks include:

- Greater efficiency and cost effectiveness;
- Enhanced ability to compete in the market place, both domestically and internationally;
- Leveraging on technology; and
- Diversification of operations, controlling risks and provision of broader array of products.

The thrust of bank consolidation, so far, has been on strengthening the banking system's resource and capital base and expanding operational networks. This is only the initial phase of the consolidation process. With the potential increase in competition, the banks would now be expected to go beyond the traditional, basic banking areas to engage themselves in complementary measures of efficiency. These include the shift of the payments and settlement system to real-time gross basis and the introduction of credit rating to allow for early identification of problems and improvement in credit risk management. In the medium term, as the banks gain the necessary expertise and resources to intermediate larger volumes of funds for customers whose needs have grown in size and complexity, we hope to see the emergence of Nigerian banks with a regional orientation. Beyond that, perhaps we can eventually be witnesses to the evolution of some Nigerian financial institutions with transnational reach.

Furthermore, consolidation of banks is a potent tool for realizing the expanding possibilities for new and better financial products and services. On the other hand, it connotes a corresponding increase in the responsibilities of the monetary authorities in ensuring the stability and robustness of the financial system. As the apex regulator of the Nigerian financial system, the CBN has gone some distance in achieving the right balance in the right direction. This is demonstrated by its commitment to see that the consolidation process is a success. So far, the bank has provided various incentives and created the enabling environment to encourage the banks. In response, the banks had switched from the initial posture of opposition to embrace the consolidation process wholeheartedly. Already, the consolidation efforts are yielding positive signs of success.

There is, however, the urgent need to overhaul the legal processes in order to complement the efforts of the regulatory authorities in realizing a sound and stable banking system. In the wake of the growth in the volume and complexity of financial transactions involving both local and foreign investors after the consolidation exercise, there is need for both the legislature and the judiciary to cooperate as well as work closely in the implementation of the existing banking laws in order to engender confidence in the new financial landscape. Also, the need for timely adjudication of cases pending in the courts cannot be over-emphasized.

It is also expected that consolidation of Nigerian banks will help the merged/acquired banks harness with greater efficiency their collective experience, expertise and technological know-how. Banks are therefore expected to imbibe best-practice corporate governance, improve on self-regulation, institute IT-driven culture, and seek to be competitive in today's globalized world. In the emerging landscape, banks would need to recognize the greater role of knowledge and information and communication technology (ICT). These will create increased convenience, increased access to information, speed of transactions, and enhanced control and management of resources. Also, in the transition towards a consolidated banking industry, strong corporate governance and risk management would become key elements of successful institutions. With the larger pool of resources after the merger process, banks are expected to further enhance these capabilities.

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RESEARCH & STATISTICS DEPARTMENT

RECENT DEVELOPMENTS IN THE CLEARING AND SETTLEMENT SYSTEM IN THE NIGERIAN BANKING INDUSTRY

The clearing and settlement activities are fundamental to the finality of business transactions and the efficient functioning of a country's payments system. This is essentially because whenever a payment instrument is issued or traded, there must exist an efficient means for transferring the instrument to the other party and also for effecting the final settlement. One of the major roles of a central bank and other institutions in the payments system is to ensure an unfettered execution of payments among the participants in the economy. Thus, the CBN is at the forefront of the process of clearing of payments and settlement of payment obligations because they are imperative to the stability of the financial system and indispensable in the effective transmission of monetary policy.

“Clearing” refers to processing a trade and establishing what the parties to the trade owe each other. Also, it is the method of exchanging instruments for transfer of value among banks. The clearing process comprises three main steps: issuing payment instruments, delivering them to paying banks and the obligation to pay. “Settlement”, on the other hand, refers to the transfer of value between parties, that is, discharging the payment obligations. Settlement is core in any payment transaction and except payment by cash which commands instant finality, other modes requires settlement for completion. Hence, settlement is the actual transfer of funds from payer's bank to payee's bank.

The key participants in the clearing and settlement system in Nigeria, are the Central Bank of Nigeria and the deposit money banks (dmbs), and until recently the 'clearing' banks. Over the years, the Nigerian clearing and settlement system has undergone remarkable changes from its rudimentary level of the early years of banking business to one with sophisticated features. This transformation reflected the improvements in financial services delivery, particularly, the increased use of cheques and order instruments, coupled with the introduction of modern information and communication technology (ICT) in the payments system. Therefore, the system evolved from the era when activities were concluded manually, through the period of semi-automation, to the present day automation of the 'clearing' processes and through settlement banks'.

The objective of this Brief is to highlight recent developments in the clearing and settlement system and outline the prospects for future improvements.

Evolution of the Nigerian Clearing and Settlement System

Until recently, the CBN was solely responsible for providing clearing and settlement services for commercial banks. The exclusion of the merchant banks in the past was due to the fact that they were not deposits taking institutions, however they appointed correspondent banks (commercial banks) through which their transactions were finalized. At the commencement of Universal Banking in 2001, the dichotomy between the commercial and merchant banks was removed and all the banks deposit money banks (DMBs) had equal access to CBN clearing services. The erstwhile CBN retail clearing process included the provision of premises for clearing houses in all its branches throughout the country, administering and sharing the costs of running the clearing houses with the bank. Thus, from a relatively lower volume and value of cheques at inception, activities in the clearing houses grew enormously to a situation where over 100 banks were members in 1992. Similarly, there have been a lot of improvements in the clearing and settlements cycle over time.

Basically, cheques deposited by customers with their banks are either sent for collection or paid. During the earlier period, cheques sent for collection especially up-country cheques, had virtually no determinable settlement period, while those for local payments had transit period of up to 28 days. This period of wholly manual clearing arrangement was fraught with many problems, including;

- Cumbersomeness of operations as all commercial banks were involved in clearing.
- High incidence of errors.
- Undue delay in the transfer of value.
- Low confidence in the use of cheques as a means of payment.

By 1990, a number of measures were introduced into the clearing and settlement arrangements, following a number of reforms which eliminated many of the problems of the earlier period. Prominent among the reforms, was the adoption of the Magnetic Ink Character Recognition (MICR) scheme which facilitated computer sorting analysis, and payment through banks. The advent of MICR accelerated processing of cheques and eliminated clearing errors, such that by 1991, the volume of cheques cleared nationwide increased above 7 million from less than 3 million in 1970. This development was made possible by the emergence of shorter clearing cycles than hitherto. The following clearing cycles subsisted during the period.

(i) Local Clearing 4 clearing sessions or 5 working days
(ii) Intra-State Clearing 11 clearing sessions or 12 working days
(iii) Inter State Clearing 20 clearing sessions or 21 working days

Furthermore, following the series of advancements in payments infrastructure, significant reduction in clearing cycles which conform to international standard was achieved.

Some of the factors responsible for this improvement included;

The introduction of the Nigerian Inter Bank Settlement System (NIBSS) in 1993, to provide same-day clearing and settlement of inter-bank transfers and payments.

The take-off of the Nigeria Automated Clearing System (NACS) in 2002, to enable banks to clear cheques and other financial instruments on-line from one another.

Advancements in the country's information communication technology (ICT).

The improvements in the CBN money transmission facilities.

Thus, by 2003, the volume of cheques cleared nationwide was 10,018,456, with clearing cycles reduced to;

(i) Local Clearing 2 clearing sessions or 3 working days
(ii) Intra-State Clearing Abolished and now 2 clearing sessions in Lagos area
(iii) Inter-State Clearing 5 clearing sessions or 6 working days.

Despite the improvement in the payments system under the NACS, the system's problem of allowing banks to overdraw their accounts with the CBN without any formal arrangement to redeem the position persisted. This situation created supervisory gap which necessitated proactive action by the CBN. Consequently, this led to the conceptualization of a new settlement arrangement which sought to eliminate existing shortcomings and facilitate the efficiency of the payments system.

Regarding the wholesale settlement, the Nigerian Inter-bank Settlement System (NIBSS) was established to facilitate the working of wholesale payments in the financial system. The institution came into being following the enormous growth in the volume of banking business, especially in inter-bank payments. Since the commencement of NIBSS operations, it has been providing the mechanism for same-day clearing and settlement of inter-bank transfers and payments on a deferred net settlement basis, and thus complementing the CBN retail clearing activities. NIBSS operations have grown over the years and has provided succor for the entire payments system as indicated in the volume and value of instruments handled in the system. Specifically, by the first full year of operation in June 1995, the volume of transactions was 13,511, valued at N458.0 billion, and by end-December 2003 the transactions handled had risen to 112,682 and valued N11,769.0 billion. In order to further enhance the operations of NIBSS and also improve the overall efficiency of the payments system, other complementing activities like the NIBSS Fastfunds and NIBSS Electronic Funds Transfer (NEFT) were introduced in 1999 and 2004, respectively. NIBSS Fastfunds is to cater for the funds movement needs of bank customers while NEFT is to offer a low volume high value transfer system that will embrace the settling of periodic direct debits or credits, such as standing order, government payments, utility bills etc. The NIBSS has since been maintaining a sameday float in inter-bank settlement transaction arrangements. However, the wholesale payments system is beset with some shortcomings which are receiving the attention of the monetary authority. The major challenge included the operation of multiple accounts at every CBN Branch and the problem of multiple collateralizations.

Settlement Banks and the Nigerian Payments System

The introduction of 'settlement bank' arrangement by the CBN on 1st April 2004 was to, among other things; improve the general procedures and infrastructure of retail payments in order to enhance the overall efficiency of the payments system.

Other objectives of the new settlement arrangement include;

- To foster a safe and smooth functioning banking system, devoid of collateral shocks and disruption,
- To subject all market players to market discipline, and eliminate incidences of overdrawn accounts through the cheque clearing system,
- To effectively monitor liquidity and credit problems of banks with a view to promptly addressing them, and reduce major pressure on interest and exchange rates usually triggered by systemic risk and crisis , and
- Strengthen the integrity of the payment system

Under the new arrangement, those banks that met the collaterzed and not set criteria by the CBN for direct participation were known as "Settlement Banks', while others, were the "Non-Settlement Banks".

The Settlement Banks were appointed based of the fulfillment of the following criteria;

Deposit of N15.0 billion as settlement collateral.

Branch network in the 22 CBN Clearing locations.

Volume of items cleared should not be less than 2.50 per cent of the total national volume for a period of six months.

Value of items cleared should not be less than 2.50 per cent of the total national volume for a period of six months.

The Non-Settlement banks, on the other hand, were required to satisfy the criterion below:

The 'non-settlement banks', subject to agency agreement, were required by its settlement bank, to deposit with it appropriate clearing collateral of not less that N250 million.

Therefore, seven banks that satisfied the requirements were appointed as settlement banks to clear instruments for themselves and for the non-settlement banks, on agency basis. The seven settlement banks are; First Bank of Nigeria Plc, United Bank for Africa Plc, Afribank Plc, Standard Trust Bank Plc, Guarantee Trust Bank Plc and Zenith International Bank Plc.

The Nigerian Settlement System: Challenges and Prospects for Future Improvement

Over the years, the Central Bank of Nigeria has taken remarkable strides at modernizing and enhancing the payments system. Nevertheless, the challenges facing the system remain enormous, prominent of which is the continuing use of large sums of cash in finality of transactions, despite all the efforts made to encourage the use of cheques. Since the commencement of the settlement bank arrangement in 2004, the payments system has, however, witnessed remarkable improvements. Not only has it encouraged the use of cheques among bank customers, it has also eliminated the overdrawn position of banks' accounts with the CBN. By so doing, the exposure of CBN and unsolicited injection of high powered money into the economy has been completely removed. With the continuing sophistication of the 'settlement bank' arrangement, it is hoped that the CBN would continue to be highly

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BANK'S COST OF FUNDS AND INTEREST RATE DEVELOPMENTS IN NIGERIA

The role of deposit money banks in an economy is very crucial in the process of financial intermediation. This is primarily because they are the institutions which hold money balances of, or which borrow from individuals and other institutions in order to make loans to the investing public and organizations. Thus, banks serve as the pivot for channeling funds from the surplus units to the deficit units in an economy. The deposit money banks are able to operate profitably because of the economies of scale in mobilizing funds from many sources and making them available for loans at a price. In the process of funds mobilization however banks incur some costs which generally influence the price or interest rate at which the funds are on-lent to their customers. Thus, cost being a major factor in the pricing of mobilized funds exerts a major influence on banks' conduct and performance, including their pricing behavior with regard to credits (loans) and deposits as well as their ability to serve as an effective channel for the transmission of monetary policy.

Over the years, Nigerian banks have been posting high cost of funds which has, in turn resulted in high lending rates. Given the fact that interest rate is a key element in resource allocation in a market economy, the incidence of charging high interest (lending) rate by banks continued to be a disincentive to investments as reflected in the low credit to the economy.

The objective of this Brief is to enlighten the reader on the issue of cost of funds and its role on interest rate determination in Nigeria.

CONCEPTUAL ISSUES IN INTEREST RATE AND COST OF FUNDS

Interest rates have been viewed from deferent perspectives depending on the economic situations and the influence they have on a broad range of economic decisions. As a charge made for the use of borrowed money, interest rate has significant influence on investment decisions. As a reward for choosing to abstain from consumption and accumulating financial assets, it rates influences the willingness to save. As a rate of return on capital, it has impacted on the demand for loanable funds by different types of borrowers, including private economic agents. On the other hand, the cost of funds is the entire outlay incurred in accumulating loanable funds by the owner of capital which may be individuals, firms or financial institutions. In the financial system therefore, banks cost of funds exert great influence through interest charges on loanable funds. Thus, because of the importance of the two notions of interest rate and cost of funds, it is imperative to examine those factors that affect their determination.

Firstly, the factors that affect interest rates include the level of savings (consumption), investment demand, inflation, price expectations, money supply, government deficit, monetary policy stance, and cost of funds. The price of any factor of production in a market environment is determined by the forces of supply and demand. Savings (consumption) constitute the avenue for the supply of credit, hence, increase in savings (invariably decrease in consumption), other things being equal, will lead to a fall in interest rate. On the other hand, investment represents the demand for credit. Thus increase in investment will lead to an increase in interest rate and vice-versa. Therefore, movements in these two variables are germane in determining the level of interest rate. A crucial feature of inflation is that of sustained increase prices, as such during inflation, the worth of money is devalued. Hence, lenders tend to increase the real rate of interest in order to compensate for the loss in real value of their money. The fiscal operations of government also influence the level of interest rates, especially when fiscal deficits are financed by the banking system. This method of financing tends to crowd-out other sector and thus exerts upward pressure on interest rate paid on the available funds by other market participants. The thrust of monetary policy also influences movements in interest rates. When the monetary authorities adopt an expansionary monetary policy stance, interest rate tends to fall, whereas a restrictive stance leads to a rise in interest rates. The level of banks cost of funds is another important determinant of interest rates. Where the cost of funds is low, interest rates may also be low, conversely interest rates are usually high when banks cost of funds is high. Other factors that affect interest rate include the exchange rate, structure of the banking system as well as the liquidity conditions of financial institutions.

Banks' cost of funds is driven by a number of factors, including the charges paid by banks on mobilized deposits, cost of banks overhead and operational costs that are attributable to the mobilized funds. The two concepts (cost of funds and interest rates) are closely interwoven such that the direction of causality, particularly, bank lending rate is always of interest to economists, bankers and financial analysts.

Banks' Cost of Funds and the Interest Rate Regimes in Nigeria

Over the years, the objectives of interest rates management in Nigeria, as enshrined in the monetary and credit policy of the CBN, centres largely on the moderation of inflation and inducement of increased financial savings, investment, employment and growth. Broadly speaking, developments in banks cost of funds and interest rates in Nigeria could be examined under two major regimes. These are the period prior to the introduction of the structural adjustment programme (SAP) in 1986, when rates were fixed by administrative fiat by the monetary authorities and the deregulation era when interest rates were freely determined by market conditions.

During the regulated era, the monetary authorities (CBN and the Government) relied on the exclusive use of direct control mechanism to fix interest rates and other banking charges. The major reasons for administering interest rates were the desire to obtain the social optimum in resource allocation, promote orderly growth of the financial market and combat inflation. Consequently, interest rates during this period were largely not responsive to bank cost of funds because the CBN fixed the rates in line with the desired macroeconomic economic objectives and a maximum limit was stipulated beyond which credit expansion was not allowed. Thus, resource allocation was based on the classification of preferred and less preferred sectors. The preferred sector which included agriculture, mining and manufacturing had concessionary interest rates while the less preferred sectors which included imports and commerce had higher rates. The practice of direct controls promoted stability of interest rates in the banking system because the rates were seldom changed by the monetary authorities. However, it led to the inefficient use of capital which resulted in inappropriate pricing of credits and deposits. Moreover, the prevailing rates were unable to keep pace with inflation, resulting in negative real interest rates. Thus, the problems of inefficient pricing and resource allocation, lack of competition and under-development of the financial markets, were among the factors that necessitated the deregulation of interest rates in the late 1980's.

The era of interest rate deregulation witnessed the abolition of all forms of controls and the determination of interest rates by market forces. This era could be divided into sub-periods. From August 1987 to 1993, the monetary authority introduced market based interest rate policy which allowed banks to determine their deposit and lending rates in line with the dictate of the market and direct negotiation with their customers. The period 1994-1995 saw the re-introduction of fixed interest rate to reverse the persistent increase in interest rates. For instance, the maximum lending rate reached an all time high level of 40.0 per cent in 1993, while the saving deposit rate was 13.6 per cent. The re-introduction was primarily due to a number of factors including; banking system's financing of huge fiscal deficit of the Federal Government which resulted in the “crowding-out” of credit to the private sector; high rate of domestic price inflation; technical insolvency of many banks resulting in distress borrowing and pervasive defaults in the money market; and the speculative attack on the foreign exchange arising from excessive borrowing from the banking system. With effect from October 1996, the earlier restriction on interest rates was removed, and the determination of interest rates became market driven by the forces of demand and supply of loanable funds. The monetary authorities only set the rules of engagement and allowed banks to participate according to market dictates within the rules. Thus, the period of deregulation afforded banks the opportunity to fix their respective interest rates depending essentially on their individual cost of funds and in accordance with the CBN's minimum rediscount rate (MRR). The MRR is a nominal anchor which is predicated on the need to affect the cost of funds to banks in order to vary the availability of reserves and to signal the direction of interest rate changes. As stated earlier, bank's cost of funds plays a significant role in influencing banks' lending rates in Nigeria, and thus its computation by deposit money banks has been a key concern to the monetary authorities. In this regard, the monetary authorities clearly defined what constitutes “banks cost of funds” in its monetary policy guidelines.

COMPONENTS OF COST OF FUNDS

Banks loanable funds are either mobilized from members of the public or borrowed. This sources can be further broken down into; non-bank, other banks and other funds.

The non-bank sources are:

a. Demand Deposits
b. Savings Deposits
c. Time/term Deposits
d. Others

Other banks sources include;

a. Current Accounts
b. Call money
c. Time/term
d. Discount Houses
e. Others (Negotiable Certificate of Deposits & Bankers Acceptances)
f. Depository Certification Issued

A cursory look at banks average lending rates over the years revealed that the rate has been rising for most of the period. This upward trend serves as a disincentive to investment and impairs real growth of the economy. On the other hand, the deposits rates have remained relatively low. Thus, a persistent wide margin has remained between the lending and deposits rates with attendant distortions to the interest rate structure in the economy. This wide spread between deposit and lending rates is harmful to the economy, because low deposit rates cannot stimulate enough investible funds, while high lending rate discourages investment. This development has compelled the intervention of the CBN to ensure a proactive interest rate management, particularly, to enhance savings and investment within the economy.

The Central Bank of Nigeria (CBN) recognizing that funds employed by banks in the discharge of their financial intermediation role are sourced through borrowing or mobilized funds, allowed for the total recovery of the interest expended on the sourced funds. However, in order to keep banks' cost of funds at the optimum level, the CBN specified the items to be included in the computation of the 'cost of funds'. There are three (3) major components are allowed by the monetary authorities for the computation of banks cost of funds.

These are:

(i) Interest expense paid on deposits and borrowed funds,

(ii) Cash Reserve Adjustments which is the implicit cost of funds sterilized in CBN in compliance with the cash reserve requirement (CRR), and

(Iii) Deposit Insurance Premium being the implied premium cost of insuring the mobilized deposits.

These three components added together are recognized as being the Effective Cost of Funds (ECF) to the banks. Hitherto, banks' included overhead costs in the computation of cost of funds. The overhead costs were for the provision of private infrastructure such as power supply, water, IT facilities and other running costs. The inclusion of overhead costs as a cost item was disallowed by the CBN owing to the fact that banks tended to over-compensate for their overhead costs through high interest rates charges on loanable funds. There is no universally accepted standard for the computation of cost of funds, however, there are areas of commonality in other jurisdiction worldwide. A survey on United State showed that the computation of costs of funds indices was conducted by the Office of Thrift Supervision (OTS) in the US Treasury and the Federal Home Loan Bank (FHLB) of San Francisco through the published National Cost of Funds Indices (NCFI) and the 11th District Savings Institutions' Cost of Funds Indices (COFI). These indices are used by federally chartered institutions in charging rates on adjustable-rate mortgage loans made in accordance with OTS rules. Under the OTS regulation, interest costs comprise largely the interest expense paid on deposit and borrowed funds. This approach which may partly explain why interest rate is low in the US economy, excluded deposit insurance premium and the adjustments for the CRR unlike the Nigerian methodology.

PROSPECT AND CHALLENGES OF INTEREST RATE MANAGEMENT IN NIGERIA

The persistent high level of lending rates and low deposit rates, with the attendant wide margin between the two rates has been a major challenge to the monetary authorities in recent times. This is because it constitutes a threat to the achievement of domestic price stability, to promotion of savings culture and the desire to enhance availability of credit to the real sector of the economy. Thus, the CBN anchored its interest rate management on anticipating the financial market and developing appropriate policy measures using the available instruments. Specifically, the CBN has maintains a flexible interest rate policy stance, anchored on the proactive adjustments of the Minimum Rediscount Rate (MRR), complemented by occasional review of the Cash Reserve Requirement (CRR). For instance, in a bid to drive down interest rates in the banking system, the CBN progressively reduced its MRR by from 20.5 per cent in June 2002 to 18.5 percent in July and further to 16.5 percent in December. Following the continued desire to encourage general reduction in banks' lending rates, the MRR was further reduced by 150 basis points to 15.0 per cent in August 2003 to signal a downward direction of interest rate to banks. Furthermore, the monetary authority employed moral suasion, which led to a tripartite agreement between the CBN, Federal Government, and DMBs to influence the reduction in interest rate in order to encourage investments particularly, borrowing by investors in the real sector of the economy. This arrangement complemented an earlier initiative by the CBN, which allowed a concessionary CRR of 9.5 per cent for banks that lend 20.0 per cent and above of the loan portfolio to real sector while 12.5 per cent CRR was maintained for others. The dual CRR was, however, abolished in 2004, and a single rate of 9.5 per cent was maintained for all banks. Similarly, the MRR was further reduced by 200 basis points to 13.0 per cent in February 2005.

All these measures were adopted to influence the cost of funds as well as reduce the wide margin which has remained between lending and deposits rates. This would consequently reduce the high lending rates which have continued to constrain the demand for loanable funds by economic agents. It is expected that banks would support these initiatives in the interest of the economy. The recent re-capitalization and consolidation of banks holds bright prospects for the realization of the objectives of adequate investible funds at affordable cost to the real sector of the economy. It would also eliminate the existing oligopolistic structure in the banking system, promote effective competition and engender a low interest (lending) rate regime.

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LIQUIDITY MANAGEMENT IN NIGERIA

Liquidity management involves the routine control of the level of liquidity in the economy in order to maintain monetary stability. This is necessary because an excess supply of money will result in an excess demand for goods and services, which could lead to rising prices, exchange rate depreciation and/ or deterioration of the balance of payments position. The major problems confronting monetary policy management by central banks in developing countries are excess liquidity and dearth of appropriate intervention securities. To overcome these problems, central banks in some of these economies have introduced various intervention instruments side by side with existing government treasury securities. For several years, the problem of excess liquidity has persisted in the Nigerian economy, while the Central Bank of Nigeria (CBN) intervention securities for managing liquidity continued to be overburdened. Consequently, the CBN has introduced a number of other measures, including the issuance of its own intervention instrument (CBN Certificate) in 2001 to complement the traditional instruments, to help manage liquidity in a more effective manner.

As in other central banks, there are two main reasons why the CBN issued its intervention securities. First, partly due to cost considerations, the Federal Government since 1988 has consistently reduced the issuance of debt securities, thereby contributing to the scarcity of intervention securities. For instance, the issuance of development loan stocks was phased out in 1998, while treasury certificates were phased out in 1997. Since 1992, no new treasury bills have been issued except conversion of Ways and Means Advances to treasury bills as well as the conversion of treasury bonds to bills to increase OMO intervention securities.

The issuance of the National Savings Certificate (NSC), which is expected to take effect in 2005, would assist in managing excess liquidity on a more permanent basis. Secondly, the Federal Government enjoys significant inflow from oil exports to the extent that with prudent budgeting and implementation, government could maintain balanced budget, which would eliminate the need for debt financing. In addition, the Federal Government has recently curtailed borrowings from the CBN through the Ways and Means Advances to finance its budget deficits. This development is attributable largely to the Federal Government's resolve to operate a single consolidated account with the CBN whereby its borrowings are netted out from its deposits. Thus, the level of liquidity in the economy was significantly reduced in 2004.

This BRIEF is aimed at enlightening the reader on the framework that guides the design of an appropriate mix of instruments for liquidity management by the CBN as well as highlights the objectives, strategies and challenges of effective and efficient liquidity management in Nigeria.

II. SOURCES AND SIZE OF LIQUIDITY

The source and size of liquidity would suggest the type of securities the central bank would need to introduce. In Nigeria, the main sources of liquidity include, the federal government fiscal operations; earnings from oil, especially the monetization and sharing of the oil windfall; and the excess creation of credit by deposit money banks. Resulting from the expansionary fiscal operations of the three tiers of government in the last few years, which were financed mainly through the CBN Ways and Means Advances to the government, excess liquidity has persisted in the economy. For instance, the fiscal operations of the Federal Government resulted in deficits of ₦202.7 billion and ₦142.0 billion or 2.9 and 1.7 percent of GDP in 2003 and 2004, respectively. The deficit in 2003 was financed from domestic sources, mainly through the conversion of outstanding Ways and Means Advances to either treasury bills or treasury bonds. However, in 2004 it was financed from non-bank public and other funds, including Nigeria Liquefied Natural Gas (NLNG) dividend and loans from the 3.0 per cent Development of Natural Resources Fund. With these levels of deficits in the fiscal operations of the government, excess liquidity in the near future would remain. There is therefore the need for the CBN to design more durable instruments to manage the anticipated liquidity.

III. OBJECTIVES AND STRATEGIES OF INTERVENTION INSTRUMENTS

The goal of a central bank's intervention instruments is to facilitate efficient monetary operations as well as foster overall development of the money market. Given the size of the excess liquidity in the economy, a number of options as well as strategies would be required in designing the appropriate intervention instruments. The system of seeking to manage excess liquidity puts the CBN on the defensive, as the Bank is sometimes compelled to find ways and means to mop-up excess liquidity, for which there are no ready-made instruments. Central banks that have made relative success in the application of indirect monetary tools manage shortages and not excess liquidity. The main advantage of managing liquidity shortages is that banks in most cases begin each day with shortages, which compels them to seek for facilities from the central bank thereby affording the central bank opportunity to use the instruments of monetary policy effectively. On the contrary, these conditions do not exist in an environment of excess liquidity. A number of central banks manage liquidity shortages. To be able to do this, an enabling environment is consciously created over time by adopting appropriate policy actions. For instance, through an act of parliament, the German Government is precluded from borrowing from the Bundesbank. The government therefore, sources all borrowing requirement from the capital market. This has the effect of draining excess liquidity in the system on continuous basis thereby making credit institutions to begin each day with shortages. Also, when the Bank of England introduced indirect tools of monetary management in the early 1980s; it was faced with the problem of excess liquidity. To resolve the problem, the Bank adopted the policy of over-funding the borrowing requirement of government through treasury issues for a period of five years. The excess over government borrowing needs was sterilized, ostensibly to remove the liquidity overhang. Since then liquidity has remained at levels that facilitate effective monetary operations. Against this background, the introduction of medium to long term instruments by the CBN was designed to reduce excess liquidity in the economy to the level that would enable the bank to adopt the strategy of managing liquidity shortages and thereby ensure effective implementation of monetary and foreign exchange operations.

A central bank would consider introducing its own instruments when there are insufficient treasury securities. For example, government in Indonesia has been required to maintain a 'Balanced Budget' and also prohibited from issuing any domestic debt instruments. Consequently, Bank Indonesia was compelled to introduce two intervention instruments one each for absorbing and injecting liquidity since the country adopted OMO in 1983. In some other countries, government has become increasingly unwilling to continue their support for central bank's use of treasury securities for open market-type operations. In Mauritius for example, government discontinued the issuance of treasury bills for liquidity sterilization purposes because the cost was deemed too high. Thus, since July 1991, the Bank of Mauritius has issued its own intervention securities.

Also, at certain periods, government may not have need for issuing debt securities owing to favourable fiscal situation. This happened in Chile in the early 1980s and in Ghana during 1988-89. Central banks in these countries therefore had to issue their own intervention instruments for purposes of liquidity management. In other situations as in New Zealand for example, both the government and the central bank wanted a clear separation between monetary and debt management in order that the central bank might pursue its mandate effectively. The Reserve Bank of New Zealand therefore introduced its own bills in 1988 for controlling liquidity.

In theory, the origin of financial instrument for market development and policy intervention seems irrelevant. What matters are the characteristics of the instrument. It is expected that any set of instruments should foster the development of a free, well-functioning money market and market- based monetary policy operations. The literature identifies the following as desired characteristics of such instruments:

The use of new instrument should foster freely determined market interest rates;

The holders of instrument should be defined as broadly as possible to encourage competition thereby improving the process of interest rate setting and facilitating the transmission of monetary policy impulses;

The maturity of the instruments should be such that they encourage trading;

Transfer of ownership of the instrument should be easy;

Any tax on the instrument should be simple and transparent to facilitate trading and holding; and

Proper rules for rediscounting the financial instrument should be established.

Against this background and faced with the problem of persistent excessive liquidity in the Nigerian economy, the CBN has introduced other measures, including the introduction of its own

(CBN Certificate) in 2001 to complement its traditional instruments, to help manage liquidity more effectively in the country. The main advantage of the use of CBN certificate for monetary operations and development of the money market was that the Bank's monetary management was separated from debt management to some extent, thereby strengthening the Bank's operational independence. This, however, has the disadvantage of exposing the CBN to the risk of incurring large losses in its profit and loss account, especially if the size of excess liquidity is large and if it has to service the instruments alone. It also has negative effects on monetary policy as substantial payments made in respect of interest costs could be a source of liquidity injection.

IV. CBN'S STRATEGY AND INTRUMENTS OF LIQUIDITY MANAGEMENT

CBN's liquidity management strategy over the years is geared towards maintaining an optimum level of liquidity that is consistent with non-inflationary growth, through the use of market-based techniques. Since1993, Open Market Operation (OMO) conducted mainly in Nigerian Treasury Bills (NTBs) has remained the primary instrument of monetary management in Nigeria. However, the paucity of Nigerian Treasury Bills necessitated the use of the Nigerian Treasury Bonds in the secondary market for the conduct of Open Market Operations in 2004. These are complemented by Cash Reserve Requirement (CRR), discount window operations and the withdrawal of public sector funds from deposit money banks to the CBN. A specified uniform rate of 9.5 per cent CRR is currently fixed for all the banks based on each bank's total deposit liabilities (i.e. demand, saving and time deposits), certificates of deposit (CDs), and promissory notes held by the non-bank public and other deposit items. Interest is paid on CRR in excess of 8.0 per cent. The Minimum Liquidity Ratio was, however, maintained at 40.0 per cent, while discount window operations including repurchase agreements (repos) allowed banks and discount houses to access the CBN window for short-term financial accommodation. Also, the CBN certificate which was first issued in 2001 was expected to provide more flexibility in terms of competitive pricing and tenor as a complementary measure for liquidity management. The certificates were issued in two tranches of 180 and 360 days tenors. The yield on certificates of 180 day maturity was raised from 19.0 per cent in February to 19.5 per cent in August and 20.5 per cent in November that year, while that on the 360 day tenor was adjusted upward from 20.0 per cent in February to 21,5 per cent in April the same year, in line with the prevailing market conditions.

Furthermore, the withdrawal of public sector funds from deposit money banks to the CBN was initiated in 2004 to further address the problem of excess liquidity in the banking system, and to encourage the banks to mobilize savings from traditional sources other than the public sector. Its implementation in 2004 had proved very effective in liquidity management. Depending on the liquidity condition in the banking system, the CBN would resort to this instrument for liquidity management from time to time.

In addition, the Bank collaborated with the Federal Government towards the issuance of the national savings certificate (NSC), which is a medium to long-term security, designed to promote financial savings and to address the problem of excess liquidity in the banking system on a more permanent basis. Specifically, the introduction of the NSC is intended to broaden the financial market, and hence, establish the appropriate environment that will facilitate the effectiveness of the open market operations as a monetary and financial policy tool that will help stem the growth of excess liquidity in the banking system by trapping part of the liquidity to financial assets. As a direct obligation of the Federal Government of Nigeria, it is backed by the full faith and credit of the Federal Government. The coupon rate of the certificate is envisaged to be attractive and higher than the rates that banks pay on savings deposits. The NSC will be issued in 4 tranches of 3, 6, 9 and 12 years and in units of ₦1000.00 and multiple thereof, and thus, would encourage investment by low-income savers. The NSC shall be marketable and subsequent to original issuance, may be bought or sold in the secondary market at prevailing market prices. The certificate is expected to be launched in the fiscal year 2005.

v. CHALLENGES LIQUIDITY MANAGEMENT IN NIGERIA.

In spite of the significant efforts to address the problem of excess liquidity in the Nigerian economy, the CBN still faces a number of challenges in achieving effective and efficient mechanism of liquidity management.

First, fiscal expansion and the concomitant large fiscal deficits have militated against the efficiency of liquidity management Nigeria. In particular, the monetary financing of large fiscal deficits and the monetization of excess crude oil receipts have continued to pose serious challenges to liquidity management in the country. This has also remained a challenge towards promoting effective monetary policy implementation in the country. In this regard, it is will be necessary to ensure that the Fiscal Responsibility Bill is passed by the National Assembly and fully implemented. This would go a long way in ensuring fiscal prudence and adherence to budgeting provisions by the government.

Another challenge is the subsisting pockets of distress in the financial sector which erodes public confidence in the system and thus, leading people to withhold large cash outside the banking system. In 1998 for instance, 26 banks had their licenses revoked due to distress conditions. Most of the distressed banks had inadequate capital base. However, it is expected that the requirement of the new capital base of N25.0 billion for bankswould strengthen the banks and enhance their competitiveness. It is also expected to integrate the financial system to the global financial architecture as well as strengthen banks ability to use IT technologies including ATMs and other computer-based instruments that will enhance the effectiveness of the payments system and hence liquidity management in the economy.

Furthermore, there is the challenge of the country having a limited number of bank branches and the absence of banking facilities, especially, in the rural areas where access to banking services is practically impossible for a large section of the population. This has led to a great number of financial transactions still being carried outside the banking system. The recent reforms in the banking industry which is expected to engender competition in the industry and subsequent opening of new bank branches in the long- run would impact positively on liquidity management in the country. The reforms of the community banks could also provide the impetus for integrating rural financial market to the urban financial centres effectively channeling financial transactions through the payment system channels for efficient liquidity management.

Another major challenge is the problem of inefficient payments system in the country. Until recently, up-country cheques used to take about 21 working days to get cleared, while intra instruments take 12 days. It should be noted that an efficient payments system provides the basis for the Central Bank's liquidity forecasting and management process, the features of which affect the demand and supply of bank reserves, credit delivery and support for economic growth. It requires a clear and conscious strategy on the approach and the ability to measure and control excess liquidity. Specifically, an efficient payments system minimizes float, liquidity risks, as well as settlement, systemic, credit and operational risks which are inherent in financial transactions. If the payments system is underdeveloped and inefficient, the banking system will hold large amounts of excess reserves which often lends to highly volatile and unstable reserve floats. On the other hand, an efficient payments system promotes timely clearing and settlement, as well as payment finalities at least cost to customers. It is amenable to various types of inter and intra financial transactions and is available to all segments of the economy. The impact of such a system is to facilitate high inflow of liquidity into the banking system, enhance effective management of liquidity as well as improve the ability to implement monetary policy. In this regard, it will be necessary to ensure that the development of the Real Time Gross Settlement (RTGS) systems embarked upon by the CBN is fully implemented. This would facilitate individual payments across the settlement accounts of deposit money banks at the Central Bank as they progress from the sending bank to the receiving bank. The full implementation of RTGS for high-value, time-critical payments is an important element for establishing safe and effective settlement arrangements which will translate to efficient and effective liquidity management in the country.

Finally, the poor data quality from banks and other sources poses a great challenge for liquidity management in the country. The indirect approach which the CBN currently employs to manage liquidity in the banking system requires up-to-date information and monitoring. The lack of high frequency and reliable data renders economic analysis difficult. Thus, the unrealistic data returns by banks and other sources undermine the setting of accurate targets. In this regard, the urgent implementation of the wide area network (WAN) in the banking system by the Bank is highly recommended as the CBN will be in a position to access information on the financial sector on timely basis through the WAN.

GLOSSARY OF SELECTED TERMS

Excess liquidity: This is the level of liquidity that is over and above the optimum level of liquidity that is consistent with non-inflationary growth in an economy.

Open Market Operation (OMO): OMO is a market-based tool of monetary management. It involves the purchase and sale of government securities or approved bills by the CBN in open organized markets, with the intention of affecting directly the reserves of banks and thereby the flow of bank credit and money supply. A distinct characteristics of OMO is that the initiatives are taken solely by the CBN, while transactions are carried out in the secondary market at a discount.

Discount Window Operations: The discount window operations refer to the facility provided by the CBN that enables deposit money banks to borrow reserves against collaterals in the form of government or other acceptable securities. Currently, the CBN operates this facility in accordance with its role as a lender of last resort and to signal the direction of interest rate changes. Transactions are conducted in the form of short-term, largely, over-night loans, collateralized by the borrowing institution's holding of government debt instruments or securities approved by the CBN.

Reserve Requirements: Reserve requirements refer to the proportion of total liabilities which the deposit money banks are expected to keep as cash in vaults and deposits with the Central Bank. These are primarily to protect depositors against unforeseen developments in the operations of the banks. The CBN can control money supply by varying the requirements as desirable. Reserves requirements consist of the Cash Reserve Ratio (CRR) and **Liquidity Ratio (LR).** The CRR requires the deposit money banks to keep a certain proportion of their total deposit liabilities in cash balances with the CBN. Currently, the observance of CRR (9.5 per cent) applies to all banks in Nigeria. On the other hand, the LR stipulates the proportion of total deposits to be kept in specified liquid assets mainly to safeguard the ability of banks to meet depositors' cash withdrawals and ensure confidence in the banking system. Currently, the observance of LR (40.0 per cent) applies to all banks in Nigeria.

CBN BRIEFS

CBN BRIEFS

SERIES NO. 2004-5/06

RESEARCH & STATISTICS DEPARTMENT
THE NIGERIAN CAPITAL MARKET

The capital market is the long-term end of the financial market. It is made up of institutions, which facilitate the issuance and secondary trading of long-term financial instruments. Unlike the money market, which functions basically to provide short term funds, the capital market provides funds to industries and governments to meet their long-term capital requirements, such as financing of fixed investments-buildings, plants, bridges, etc.

In Nigeria, the capital market first came into existence with the establishment of the Lagos Stock Exchange in 1961. The Exchange was incorporated under the company's ordinance as an association limited by guarantee. The Lagos Stock Exchange was given initial financial backing by the Central Bank of Nigeria (CBN) in the form of annual subventions. Following the recommendations of the Government Financial System Review Committee of 1976, the Lagos Stock Exchange was re-named and reconstituted into the Nigerian Stock Exchange in 1977. Additional trading floors were also opened in the same year in Port Harcourt and Kaduna.

The Nigerian Stock Exchange (NSE) is the centre point of the Nigerian capital market, while the Security and Exchange Commission (SEC) serves as the apex regulatory body. The NSE provides a mechanism for mobilizing public and private savings, and makes such funds available for productive purposes. The Exchange also provides a means for trading in existing securities.

This BRIEF is aimed at enlightening the reader on the functions, structure, challenges and prospects of the Nigerian capital market.

I. THE FUNCTIONS OF THE NIGERIAN CAPITAL MARKET

The functions of the market include:

- Provision of an additional channel for engaging and mobilizing domestic savings for productive investment.
- Foster the growth of the domestic financial services sector and the various forms of institutional savings such as life insurance and pension funds.
- Improves the efficiency of capital.
- Facilitates the transfer of enterprises from the public sector to the private sector.
- Provides access to finance for small companies.

II. THE STRUCTURE OF THE NIGERIAN CAPITAL MARKET AND ITS INSTITUTIONS

The Nigerian capital market consists of the following institutions: Securities and Exchange Commission (SEC) - the apex regulator; the Nigerian Stock (NSE); the Abuja Commodity

Exchange (ACE); the Stock broking firms, the issuing houses as well as the registrars. There are two main segments of the market. These are primary and secondary markets. The major instruments used to raise fund at the Nigerian capital market include: equities (ordinary shares and preference shares); government bonds (Federal, states and local governments); and industrial loans/debenture stocks and bonds.

Some of the institutions in the Nigerian capital market are elaborated upon as follows:

(a) Securities and Exchange Commission

SEC is the apex regulatory institution of the Nigerian capital market. It is a federal government agency established by the Securities and Exchange Commission Act No.71 of 1979, which was re-enacted as Decree No.29 of 1988. The Commission also operates within the provisions of other statutory enactments that relate to securities business, corporate finance and investments in Nigeria. Significant among these are the Investment and Securities Act No. 45, 1999; Companies and Allied Matters Act, 1990, which vests the administration of unit trust schemes in SEC; the Trustees Investments Act of 1957 and 1962; and the Technical Committee and Privatization and Commercialization Act of 1988. Since inception, the SEC has been playing within the capital market, a similar role to that played by the Central Bank of Nigeria in the money market.

The main functions of the Commission are to regulate and develop the Nigerian capital market in order to achieve its wider objectives of investor protection and capital market development toward enhanced socio-economic development. Other major functions of the Commission include: regulation, registration, investigation, enforcement, mergers and acquisition, and developmental functions.

(b) The Nigerian Stock Exchange (NSE)

The NSE evolved from Lagos Stock Exchange. The functions of the Exchange include: providing facilities to the public for purchase and sale of stocks and shares of any kind; and controlling the granting of quotation on the Exchange in respect of shares and stocks. In the bid to reach out to the grassroots and bring the services of the stock exchange nearer to the investing public, the Nigerian Stock Exchange has since 1977 increased the number of its trading floors to nine , namely, Lagos, Abuja, Kaduna, Port-Harcourt, Kano, Onitsha, Ibadan, Yola and Benin. Also, in recognition of the crucial role of small and medium scale enterprises in the overall industrial development of the country, the NSE introduced the second-tier security market (SSM) for the listing of small and medium scale enterprises that were unable to meet the stringent requirements of the main market. In 1998, the Central Securities and Clearing System (CSCS) which is an on-line automated securities trading system was introduced by the Nigerian Stock Exchange to facilitate electronic settlement of deals between stockbrokers and customers through the in-house clearing system, and the Exchange central computer via a communication network. On March 1, 2000, the NSE also launched and commenced operation on its Trade Guarantee Fund (TGF) Scheme, aimed at arresting the risk of failed trade that may arise from the inability of a stockbroker to cover his/her purchase. In addition, the Exchange commenced T+3 settlement cycles in 2000 and, while its e-Business Platform/internet Portal was launched in July, 2002. These reforms, no doubt, were aimed at improving the efficiency of the Nigerian capital market and encouraging greater foreign capital inflows to the economy. The NSE made remarkable progress in the internationalisation of the market in 1999 with the cross-border listing of "M-net"/ Supersports" on the Exchange. The company was also concurrently listed on the Johannesburg Stock Exchange (JSE). In its further efforts at internationalization of the capital market, the Exchange has signed memoranda of understanding (MOU) with the Ghana Stock Exchange, and the Nairobi Stock Exchange to facilitate cross border listing of securities. All these, no doubt, were innovations that have placed the Nigeria Stock Exchange in a better position to attract foreign investors into the capital market.

© THE PRIMARY MARKET

This is the market for 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 placements. It is important to note that the fund raised through this primary segment of the capital market goes to companies as equity capitals. Following CBN's directive on banks' recapitalisation, the tempo of activities in the new issues market was very high in 2004, as many banks approached the stock market to raise additional funds. Consequently, the Exchange considered and approved 37 applications for new issues, valued at N235.5 billion in that year, compared with 26 applications valued at N185.0 billion in 2003. Analysis of the approvals in 2004 indicated that the sum of N25.7 billion was raised through Initial Public Offer (IPO); N62.0 billion through supplementary issue by already listed companies; N8.1 billion through rights issues; and N6.0 billion through bonds issue, while listing by introduction accounted for N86.1 billion, in addition to four (4) applications for supplementary listings valued at ₦37.7 billion. A total of 17 issues, involving 89.14 billion ordinary shares, amounting to ₦146.97 billion were floated in the first quarter of 2005. These included thirteen (13) offers for subscription, one (1) supplementary offer, two (2) rights issues and one (1) private placement.

In the first half of 2005, a total of thirty-two (32) new issues, involving 152.85 billion shares valued at ₦264.9 billion were recorded. These were made up of twenty (20) offers for subscription (₦208.9 billion) three (3) supplementary offers (11.3 billion), four (4) rights issues (₦19.3 billion) and five (5) private placements (₦25.4 billion).

(d) THE SECONDARY MARKET

This is the market for trading in existing securities. It consists of the stock exchange and over-the-counter markets. Money raised through this segment of the market goes to the investors. Activities in the secondary market have increased substantially over the years. This has been facilitated by the opening of trading floors in other the country by the NSE.

Transactions in equities dominated the market in 2004 with a total of 19.2 billion shares valued at ₦223.8 billion, which represents 99.9 and 99.1 per cent, respectively, of the total number and value of shares traded during the year. The market capitalization of the 276 securities listed on the Exchange appreciated by 55.5 per cent from ₦1.359 trillion in 2003 to close at ₦2.11 trillion in 2004. The growth reflected new listings and supplementary issues, particularly in the banking sub-sector, following the banking sector reforms. In the first half of 2005, however, the aggregate volume and value of traded securities fell by 5.2 and 15.4 per cent to 9.9 billion shares and ₦106.1 billion respectively, when compared with their corresponding period of 2004 levels. Similarly, market capitalisation & value index fell by 8.1 and 7.0 percent, respectively to close at ₦1.9 trillion and 26,877.92 (1984=100) in June 2005, compared with ₦2.1 trillion and 28,887.4 (1984=100) in June. The development during the review period was attributable to low activity in the secondary segment of the market owing to preference for new issues. Investors generally switched stocks and focused their portfolio choice on the flurry of initial public offers by banks in the primary market segment of the market.

(e) THE ABUJA SECURITIES AND COMMODITIES EXCHANGE (ASCE)

Following the report of the Odife Committee in 1997, reforms of the capital market were embarked upon, including further deregulation, which allowed for the establishment of the Abuja Stock Exchange to stimulate competition in the sub-sector. The exchange was incorporated in 1998, as Abuja Stock Exchange Plc (ASE) with authorized capital of N100,000 million and paid-up capital of N500 million subscribed to by the shareholders in the following order: CBN, 51 per cent, NICON, 30 per cent, NIDB, 9 per cent, Nigeria Re-Insurance Corporation, 8 per cent and NBCI, 2 per cent.

However, the Abuja Stock Exchange was short-lived as it was later converted to Securities and Commodities Exchange. The new Exchange is expected to assist the country in its drive to expand the horizon and contribution of Nigeria's non-oil exports to the gross domestic product (GDP). This, it will do through the internationalization and standardization of Nigeria's tradable commodities such as cocoa, sugar, cereals, cotton, rubber and even nonferrous metals. The direct implication of this is the further integration of Nigeria into the global commodities market.

(f) THE ISSUING HOUSES

This is one of the institutions in the capital market that is charged with the responsibility of preparing prospectuses, packaging, timing, pricing, underwriting and the sale of new securities offered to the public by companies and governments.

Packaging involves the determination of the selling point of the issue; the expected returns in comparison with alternative existing returns in the capital market; and the benefits beyond immediate returns that could accrue to investors. All these provide the marketing edge for the issue.

Timing must also be accurate, and should coincide as much as possible with a period when investors are likely to have ready cash to invest. It must also be timed not to coincide with a more attractive offer from an alternative instrument outlet.

In pricing, it is necessary to ensure that the issue is not over or under priced. Over price may mean that it will not be fully subscribed, thus increasing the underwriting liability of the issuing house, while if it is under priced either more stocks will have to be issued to raise the needed amount of money or the money will be short.

Another cutting edge function of an issuing house is to determine the best form of securities a company should bring to the market. It determines whether the company should issue ordinary shares, debentures or a hybrid.

(g) THE STOCK BROKING FIRMS

A stock brokering firm is the intermediary between the Nigerian Stock Exchange (NSE) and investors who may want to buy or sell securities. Put differently, it is a firm that buys and sells securities on behalf of investors for a commission called "brokerage". A Stock brokering analyst's role lies in educating the investor, generating data for accurate analysis and recommending stocks in an environment where stock prices hardly respond to the wider economic movements or changes. The activities of stock brokering firms, including their commission charges are regulated by the Nigerian Stock Exchange.

(h) THE REGISTRARS

A registrar is an institution in the capital market that keeps the records in respect of quoted stocks and shares in the market. At the event of one having problems with his/her share certificate or dividend, the registrar of the company in question should be contacted.

The duties of a company registrar include:

- ❖ Acting as agents to the companies who appoint them;
- ❖ Registration of the shares and the names of the owners in the shareholders' register;
- ❖ Preparation of share certificates as well as sending them to the shareholders; and
- ❖ Paying-out approved dividend to shareholders.

(I) THE INVESTMENTS AND SECURITIES TRIBUNAL (1ST)

In Nigeria, the investments and securities act No 45 of 1999 (ISA) was promulgated against the background of extensive reform of the Capital Market. The ISA gives Securities & Exchange Commission (SEC) wide powers to regulate and develop the Nigerian Capital Market. Among other things, it repealed the Lagos Stock Exchange Ac t and Section of other legislation of the Capital Market. Section 229 of the ISA established the investment body having the same status of a High Court of the Federal Republic of Nigeria. The 1st is empowered to adjudicate on matters relating to:

* Interpretation of any law, enactment or regulation to which the ISA applies
* Disputes between Capital Market Operators
* Disputes between quoted companies and the regulator or the Securities Exchange.

The 1st has since its inception in 2002 speedily resolved various Capital Market issues.

III. CHALLENGES AND PROSPECTS OF THE NIGERIAN CAPITAL MARKET

With the recent reforms in the economy, particularly in the banking sector, there is need for the capital market to develop the required resilience towards evolving a financial infrastructure that would engender and support economic growth and transformation in the economy.

In the first instance, it is expected that the shift in policy with regards to the banking sector would lead to an increase in the volume of papers issued by the private sector and a concomitant decline in government securities. The ensuing bank consolidation would provide further impetus to the growth in banking sector securities. The challenge for the capital market is to evolve comprehensive measures to strengthen, broaden and deepen the market to enhance its intermediary role in financing economic activities. The accelerated upgrade of systems need to be sustained, while the regulatory and prudential framework should continuously be reviewed to facilitate better disclosure standards and transparency of transactions. While this scenario poses a significant degree of dependence of the economy on the banking system for financing needs, and hence, exposed it to a greater degree of liquidity and systemic risk, the increased capital base of ₦25.0 billion, which is risk-focused would provide the desired investor protection.

Secondly, there is an obvious challenge to urgently develop a vibrant bonds market to allow the private sector access to a larger number of debt instruments in order to enhance the management of their liabilities. As government securities become active, the capital market would be in a position to play a crucial role in the pricing of credit risks, dosing off the heavy concentration of credit risks in the banking sector. The floatation of the Federal Government bonds and National Savings Certificate as well as the recent implementation of the Pensions Act 2004 would support the further deepening of the capital market. It is envisaged that when the pension funds fully come on board, funds managers would invest their excess funds with the capital market. In addition, efforts should be made to study the securitisation of other kinds of debt instruments with a view to further assisting the development of an active and vibrant private debt securities market to complement the market in equities and government securities.

The next challenge is for the capital market to be at the forefront of ensuring financial integrity in order to minimize the potential effects of the risk of contagion as well as reduce systemic risks. Thus, there is the compelling need to strengthen the regulatory framework and enhance corporate governance which are the cornerstones for promoting investor confidence as well as the promotion of sustained long-term growth of the capital market. In this regard, the proactive stance of the management of the Nigerian Stock Exchange and the Securities and Exchange Commission in their respective efforts at raising the standards of capital market should be sustained.

Furthermore, there is need to canvass for self-regulation in the institutions of the capital markets as well as the cooperation and full commitment by operators towards the challenge of employing professionalism and maintain high ethical standards of management. In this regard, the challenge to severely sanction errant market participants by the regulatory authorities of the capital market would be a welcome development. Perhaps, this would encourage the sustainable growth of the capital market to meet the globalising effects of emerging regional and international capital markets. The years ahead appear to be increasingly demanding and competitive, and only by imbibing good corporate governance by institutions, market participants and intermediaries can guarantee sustainability.

In addition, the challenges of consolidation of banks of which the operators in the capital market are the key market intermediaries would enhance the realisation of economies of scale and scope in the capital market. Consolidation would lead to increased competition and offering of products at the lowest possible costs in the bid to attract more investors. Through consolidation, banks would also be able to trade some of their balance sheet assets and risks through the capital markets. The capital market therefore needs to re-position itself to cope with the large volume of transactions that are likely to pass through it.

Another major challenge for development of the Nigerian capital market is the issue of investors' perception. The decision to invest in a financial instrument or indeed in a securities market or geographic region is usually influenced by perception. A good perception of a company, a country or region would attract investment into it, while a poor perception would undoubtedly impact negatively on the level of investment. International perception of a country's political and economic environments is often a strong influence on response of foreign investors to its security offering. With the return to democratic rule and the subsequent reforms in the economy, particularly in the banking sector coupled with the establishment of the Economic and Financial Crime Commission (EFCC) and the Independent Corrupt Practices Commission (ICPC), however, the confidence of both local and foreign investors in the economy is returning gradually. Consequently, the response of foreign investors to security offerings in the market is improving.

Besides, there is the challenge of low awareness about the operations and benefits of the capital market in the economy. The level of awareness of the populace about the capital market and the opportunities available in it would enhance the level of their participation in the market. The proposed inclusion of the capital market activities in the curriculum of secondary schools in the country would go a long way to create awareness about the market.

GLOSSARY OF SELECTED TERMS

REGULATION: This amounts to the protection of the investing public from deceit, and other unscrupulous practices in the sale of securities, which can destablise the market. This activity is carried out by the Securities and Exchange Commission (SEC).

REGISTRATION: Through this, the fitness or otherwise of an applicant to do business in the capital market is ascertained and the worthiness of the instrument for offer is assessed.

INVESTIGATION: This involves the investigation of all reports of violations and suspected violations of the securities law. As empowered by its enabling Act and Decree, SEC investigates all reports of violations and suspected violations of the securities law.

ENFORCEMENT: This is the process of ensuring that participants in the market comply with securities law. This responsibility is invested with the SEC and it has the power to institute penalties and remedial action if there has been any violation.

RULE MAKING: The Commission makes rules, creates and reviews operational procedures in the market as the occasion demands.

TIMING OF ISSUES: This involves the determination of the time and amount of issues by the SEC in order to avoid demand on the primary market beyond its capacity to absorb.

CAPITAL MARKET COMMITTEE: The capital market committee was inaugurated in 1990 as an advisory and consultative body to serve as forum to deliberate on matters affecting the capital market and also find ways and means of improving the system. The Committee is made up of representatives of the SEC, capital market operators and observers from other regulatory agencies such the Central Bank of Nigeria, Corporate Affairs Commission, among others.

NEW ISSUES: These are newly created securities of a corporate entity or government offered for subscription to the public. In other words, it is a means of raising funds for development financing.
d ordinary shares. They are ownership capital of a company held by individuals, corporate bodies and sometimes governments.

LISTED SECURITIES: These are corporate or government securities granted quotation by a stock exchange and subsequently traded on it.

MARKET CAPITALISATION: This is the market value of a company's paid-up capital, determined by multiplying the current quoted price by the total number of shares issued by the company and fully paid for by subscribers.

VALUE INDEX: The value index is a means of measuring stock market trends and performance over time. It is used as a barometer for monitoring upswings and downswings in the stock market.

CBN BRIEFS

CBN BRIEFS

SERIES NO. 2004-5/07

RESEARCH & STATISTICS DEPARTMENT

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, interest bearing bonds, gold, Special Drawing Rights (SDR) of the IMF, etc that are generally accepted for the settlement of international trade and other external obligations. Among the key currencies are 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 foreign exchange market consists of the sellers (supply) and buyers (demand) of foreign exchange. The major participants in the foreign exchange market in Nigeria are the monetary authority (Central Bank of Nigeria) authorised 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-down on loans, expenditure of foreign tourists in Nigeria, repatriation of capital by Nigerians resident abroad as well as invisible receipts by the private sector and foreign grants. 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 organisations and the country's embassies abroad, as well as other invisible out-payments by the public and private sectors.

This BRIEF discusses the evolution, structure and operational modalities of the foreign exchange market in Nigeria. It also examines the management and recent developments in the market.

I. 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 earned by the private sector was held in balances abroad by commercial banks which acted as agents for local exporters. During the 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 centralisation 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 patronise the CBN for foreign exchange allocation to pay for international transactions. However, as the oil market weakened and foreign reserves were depleted, comprehensive exchange control measures were introduced in 1982 to check the numerous activities of speculators and middlemen. The increasing demand for foreign exchange at the time supply was shrinking encouraged the development of a flourishing parallel market 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 turned out not to be an appropriate mechanism for foreign exchange allocation in consonance with the goal of internal balance. This led to introduction of the Second-tier Foreign Exchange Market (SFEM) in September 1986, whereby public sector transactions were carried out at official rate while all other transactions were conducted at market determined rates. To enlarge the scope of the foreign exchange market, bureaux de change was introduced in 1989 to provide access to small users of foreign exchange.

In 1995, the foreign exchange market was further liberalised following the introduction of an Autonomous Foreign Exchange Market (AFEM) for the sale of foreign exchange to end users by the CBN through authorised dealers at market determined exchange rates. 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-banks financial institutions, bureaux de change and private companies. The IFEM was abolished with the reintroduction of the subsisting Dutch Auction System (DAS) in July 2002.

II. STRUCTURE OF NIGERIA'S FOREIGN EXCHANGE MARKET

Nigeria's foreign exchange market is made up of three major segments, the official, autonomous (made up of 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 operations of the official foreign exchange market, have metamorphosed over the years, particularly, since the introduction of exchange and trade liberalisation policy in 1986. 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 centralised in the CBN under the 1962 Exchange Control Act. However, the market became vibrant with the introduction of SFEM and the permission granted banks by the CBN to effect foreign exchange dealings among themselves. The sharp practices which emanated from the system, in the form of round-tripping of funds, led to persistent instability in the exchange rate. Consequently, the official Foreign Exchange Market and the Inter-bank Market were merged in 1989 into an enlarged 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 recognised foreign exchange market. Exchange rates in the bureaux de change were market determined. In 1995, the official market evolved from a single to a dual exchange rate system in which a fixed exchange rate was applied for priority public sector transactions, while a market- based exchange rate was used for private sector transactions through the Autonomous Foreign Exchange Market segment.

With the introduction of the AFEM in 1995, the banks were once more allowed to engage in inter-bank dealings with only privately sourced foreign exchange. However, the operations of the AFEM failed to meet the objectives for which it was set up. For instance, the inter-bank market, which was supposed to source its funds privately, relied on the CBN. In effect, the CBN continued to fund the various foreign exchange markets. The continued demand pressure arising from this arrangement which led to the depreciation of the naira at the foreign exchange markets, necessitated the introduction of some reforms in the foreign exchange market. By January 1999, the fixed official rate for priority public sector transactions was abolished, and all public sector transactions were conducted at the AFEM market -based rate. Indeed, the fixed official rate encouraged the existence of a large premium, which deepened the practice of round tripping, thus funding the bureaux de change and parallel market. The elimination of the dual exchange rate system was followed by the introduction of another major reform, designed to check speculative tendencies that had been destabilising the naira exchange rate and the consequent depreciation of the naira. On October 25, 1999, the AFEM was therefore replaced with the Inter-bank Foreign Exchange market (IFEM). IFEM was conceived to deepen the foreign exchange market through the active participation of other players such as banks, oil companies, non-bank financial institutions, parastatals, bureaux de change and private companies. The CBN was, therefore, not expected to act as the major supplier of foreign exchange but as a participant who would only intervene in the buying and selling of foreign exchange as and when necessary.

The parallel market for foreign exchange has been in existence from the exchange control era. Since the market-based reforms, the widening disparity in exchange rates has further strengthened the existence of the parallel market, owing largely to the windfall gains arising therefrom. 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. 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.

III. FOREIGN EXCHANGE MANAGEMENT BEFORE 1986

Before 1986, importers and exporters of non-oil commodities were required to get appropriate licences from the Federal Ministry of Commerce before they could participate in the foreign exchange market. The authorised dealers passed such applications for imports, backed by the licences and other relevant document to the CBN for approval and foreign exchange cover, while they deposited the domestic currency equivalent with the CBN. Similarly, exporters' applications were routed through the authorised dealers to the CBN and foreign exchange receipts from such transactions were expected to be surrendered to the Bank in exchange for domestic currency. Generally, import procedures followed the international standard of opening of 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 import 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, decentralised foreign exchange allocation. Licensed banks were allowed to approve applications and allocate foreign exchange to customers subject to the maximum allocated to them by the CBN. Allocations were made weekly by the CBN 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. 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 licence requirements. Control were tightened during the period of crises but relaxed whenever the pressure lessened. Thus, from 1970 to 1975, controls were liberalised 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 exports proceeds, the liberalisation 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 summarised 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 payment 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 emphasised a market-oriented approach to price determination. The supply of foreign exchange has continued to be 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 recognised 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 are not allowed to finance imports. Reputable hotels were also accorded the status of authorised 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 later 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 5, 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 foreign exchange centralised in the CBN as the sole authority to allocate foreign exchange to end-users on pro-rata basis. 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 121 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, and 17. For illustration, Category 1 was made up of Union Bank, First Bank and United Bank for Africa (UBA), 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 liberalisation 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 the guidelines, private sector concerns sourced their requirements from the AFEM at the 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 the end-users at current market rates. The mode of disbursement was maintained in 1996. Although the thrust of policy was retained in 1997, substantial liberalisation 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 nationals as well as personal and business travel allowances.

In 1998, the bulk of the policy measures in the preceding year were retained while some of the existing ones were either further liberalised 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 installation of the 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. In the area of monetary policy, the Federal Government directed its agencies in 1989 to transfer their deposits from the banks to the CBN. The tariff structure was also re-aligned to reduce the importation of non-essential items. Excess liquidity was mopped up from the banking system through the issuance of stabilisation securities and the conduct of Open Market Operations (OMO).

Owing to the magnitude of the incidence of round tripping associated with the fixed official exchange rate which was highly subsided 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 banks. Despite these measures, the objective of exchange rate stability remained elusive.

Other complimentary measures introduced included, the intensification of surveillances on banks and the imposition of sanctions on those apprehended for unethical practices; the management of excess liquidity through the issuance of the CBN certificate; the appeal 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; the retention of 100 per cent export proceeds and some export incentives to encourage exporters 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 under IFEM was characterised by unbridled demand as well as misalignment of the exchange rate as evidenced by the wide arbitrage premium between 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$10.00 billion to US$8 billion as at July 2002.

V. RECENT DEVELOPMENTS IN THE FOREIGN EXCHANGE MARKET

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 reserves, enhancing market transparency and checking capital flight from the country. Under this system, the Bank intervened twice weekly and end-users through authorised dealers bought foreign exchange at their bid rates. The rate that cleared the market (marginal rate) was adopted as the ruling rate exchange rate for the period, up to the next auction. DAS brought a good measure of stability in exchange rate as well 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 utilisation. 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 rates; and encourage the growth of the 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 utilisation 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 the maximum of US$2,500.00 per quarter for BTA and US$2,000.00 twice a year for PTA for beneficiaries above 12 years old. For travels to countries in the ECOWAS sub-region, BTA and PTA were issued in ECOWAS Travellers' Cheques.

The pilot project of direct sale of TCs to end-users, which took off in February 2002, was sustained in 2003 with a total of 14 BDCs approved to commence the purchase and sale of TCs from Travelex Global Financial Services Limited.

Under the West African Monetary Zone Exchange Rate Mechanism (ERM) arrangement, member countries were required to maintain a band of plus/minus 10.0 per cent. However, given the appreciable level of external reserves (US$16.96 billion) and the relative stability of the naira exchange rate which was achieved in 2004, the CBN targeted to maintain a narrower band of plus/minus 3.0 per cent in 2005. The tight band was intended to anchor expectations and to enable investors and end-users of foreign exchange to plan and minimise transaction costs, based on realistic calculations of exchange risk exposures. The band would also discourage the destabilising practices of speculations, hoarding and carrying of large inventories by businessmen.

In order to deepen the foreign exchange market and ensure sustained exchange rate stability, the CBN would establish a framework and guidelines for the introduction of a Wholesale Dutch Auction System after the successful completion of the recapitalisation and consolidation of the banking industry by end-December, 2005. It is envisaged that the introduction of the Wholesale DAS will not only deepen the foreign exchange market, but will also assist in the convergence of the DAS and the inter-bank exchange rates and eliminate rent-seeking behaviour by authorised dealers.

GLOSSARY OF SELECTED TERMS

Foreign Exchange Speculators and Arbitrageurs: Foreign exchange speculators are agents in the foreign exchange market who attempt to predict the course of future exchange rate movement and influence the market accordingly. Their actions could be destabilising 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 into those that are rising in value. They earn the differential in exchange rates 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 weight assigned to each currency reflects 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 Payments 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 from the rest of the world and the payments by residents to the rest of the world. An excess of receipts over payments 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 equal 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 said to be 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 and external debt management measures are usually applied to achieve internal balance.

The Dutch Auction System: The Dutch Auction System (DAS) is a market-based system of allocating foreign exchange to end-users at their corresponding bid rates. Under the DAS, the CBN determines the amount of foreign exchange it will sell, at a price which consumers are willing to pay at the auction. The ruling market rate, however, is the **marginal rate** that clears the market, that is, the lowest successful rate at the bid. The marginal rate thereafter becomes the official rate for the period. The CBN, under the DAS, intervenes twice weekly in the market, leaving the other three trading days of the week for the inter-bank market to function. The modus operandi of the DAS contrasts sharply with the Inter-bank Foreign Exchange Market (IFEM), in which the Bank intervened daily and met virtually all demands from banks. The objective of the DAS is to enhance transparency in foreign exchange transactions, conserve Nigeria's foreign exchange resources through the achievement of a realistic naira exchange rate, which will minimise incidences of round tripping and capital flight as well as make goods produced in the domestic economy competitive with their imported counterparts. The DAS is also expected to eliminate subsidy in the pricing of foreign exchange, and thereby assist in eliminating multiple exchange rates in the system. More importantly, the CBN has firmer control over the amount of foreign exchange it offers to the market and is thereby placed in a stronger position to protect and manage the nation's external reserves. It would be recalled that DAS was first introduced in Nigeria in 1987, jettisoned, and reintroduced in 19901991 but could not be sustained because of the prevailing adverse macroeconomic conditions and the low level of external reserves during the period. However, the DAS was re-introduced on July 22, 2002 following the persistent fall in the level of external reserves since November 2001 and the high demand pressure for foreign exchange during the second half of 2002.

Comprehensive Import Supervision Scheme (CISS): This scheme was set up to ensure that imports into Nigeria are of the correct 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 Forms "M". Destination inspection is also carried out in Nigeria to ascertain the correctness of a clean report of findings from inspection agents.

Letter 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 tenure or lifespan of an L/C is initially 180 days but could be renewed for another period of 180 days. Letter of credit could be revocable. Revocable letters of credit are not binding. It may be terminated at any time without recourse to all the parties involved. Irrevocable letters of credit 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 at a minimum. 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, importer and exporter enter into a mutually acceptable contract involving the settlement of debt at future date. The exporter ships specified amounts of goods to the importer 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 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 easily be 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 is 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 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 for 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 for 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 affected 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 parties acting on his behalf. The security of payment is not as certain as in the case of payment through confirmed and irrevocable letters of credit. 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.

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RESEARCH & STATISTICS DEPARTMENT

THE NATIONAL ECONOMIC EMPOWERMENT AND DEVELOPMENT STRATEGY (NEEDS)

The National Economic Empowerment and Development Strategy (NEEDS) is Nigeria's home- grown poverty reduction strategy (PRSP). NEEDS is not just a plan on paper, it is a plan on the ground and founded on a clear vision, sound values, and enduring principles. It is a medium term strategy (2003- 07) but which derives from the country's long-term goals of poverty reduction, wealth creation, employment generation and value re-orientation. NEEDS is a nationally coordinated framework of action in close collaboration with the State and Local governments (with their State Economic Empowerment and Development Strategy, SEEDS) and other stakeholders to consolidate on the achievements recorded during the period 1999- 2003, and build a solid foundation for the attainment of Nigeria's long-term vision of becoming the largest and strongest African economy and a key player in the world economy.

Although NEEDS is essentially a federal government programme, it is fully owned by Nigerians. The President and the federal executive council fully endorse the programme; the National Assembly and the National Economic Council (NEC), which comprises all the 36 governors of the states, have also endorsed the programme. Various private sector stakeholders, NGOs, and Civil Society Organizations have also endorsed the NEEDS. The Drafting Committee of the NEEDS reflects the wide ownership and participatory nature of the exercise. The 35-member committee comprises Ministers, Representatives of Ministries and Agencies, President of the Manufacturers Association of Nigeria; President of the Nigerian Labour Congress; Chairman of the Coalition of Civil Society Organizations; the Nigerian Economic Summit Group; etc.

This BRIEF is aimed at enlightening the reader on the National Economic Empowerement and Development Strategy (NEEDS).

1. BACKGROUND TO THE NEEDS

Nigeria has lost decades of development due to negative-to-slow growth and has been one of the weakest growing economies in the world on a per capita basis especially for the period 1981-2000. This is despite the nations potential to become Africa's largest economy and a major player in the global economy by virtue of its rich human and material resource endowment. Much of these potentials have remained untapped, and if previous trends continue, Nigeria runs the risk of not meeting the internationally agreed Millenium Development Goals (MDGs) by 2015.Slow growth in the Nigerian economy has been attributed to various problems, some of which are institutional, while others are results of disharmony between goals and means. These include macroeconomic policy inconsistency, instability and policy reversals, conflicts of macroeconomic policy goals, public sector dominance in production and consumption, pervasive rent seeking and corruption occasioned by government being the hub of economic activities. Others are infrastructure inadequacy and decay,high volatility of major macroeconomic aggregates, weak institutional capacity for economic policy management and coordination among the tiers of government, and large debt overhang, among other. NEEDS aims to redress these imbalances by building on the progress made during the transitional phase of the new democratic dispensation (19992003). Evidently, there had been serious underestimation by policy makers and other stakeholders of the extent of social, political and economic decay of the Nigerian society prior to the democratic transition. However, despite the challenges, democracy has been consolidated with the first successful civilian-to-civilian democratic transition, and some improvements recorded in the economic terrain. For instance, electricity generation has more than doubled, the telecommunications sector expanded astronomically, as the number of telephone lines increased from about 400,000 in 1999 to about 3 million in 2003. The various initiatives in agriculture resulted in a boom with the return of groundnut pyramids in the North, while the Food and Agriculture Organisation (FAO) in 2003 declared that Nigerian agriculture grew by an unprecedented 7 percent. Industrial capacity utilization improved appreciably. Foreign direct investment in the non-oil sector grew from almost zero in 1999 to no less than US$ 2 billion in 2003. Consequently, the income level grew by an average of 3.6 per cent in the period 1999 - 2003 (as against the average of 2.8 per cent with zero per capita income growth in the 1990s). The size of the police force has also doubled since 1999. The rate of unemployment declined from 18 per cent in 1999 to 10.8 percent in 2003 (with estimated 3.5 million new jobs created during the period). Real wages have also risen significantly, thereby reversing the downward spiral in real income of workers that began since the 1980s.

Despite the progress, the challenges e remained daunting; Unemployment is still high (at 10.8% in 2003 meant that about 6.4 million people were actively looking for jobs without getting any). The GDP average growth rate of about 3.6 percent is still lower than the minimum of 5 percent required to prevent poverty from worsening and the 7 percent needed to meet the MDG target of halving the incidence of poverty by 2015. Anecdotal evidence suggests that the poverty incidence remains relatively high. The rate of urbanization (5.3%) is one of the highest in developing countries, the HIV/AIDS pandemic poses a great threat to the social fabric, and the other social and economic conditions are less than satisfactory. Reforming the public sector into an efficient and responsive instrument for delivering services to the people remain a challenge; corruption and fraud need to be fought ruthlessly; infrastructure decay need to be reversed and the private sector empowered to become competitive and lead the growth process; and the weak and vulnerable groups need to be lifted up. Indeed, the general value-orientation of the people need to be reshaped to de-emphasize rent-seeking, over-dependence on government for literally everything. There is need to promote hard work, entrepreneurship, discipline, honesty and respect for traditional values.

The NEEDS, in conjunction with the State SEEDS, constitutes the reasoned response to these challenges. A coordinated implementation of both programmes is expected to create at least seven million new jobs over the period, reduce poverty, and lay the foundation for sustained development.

2. AIMS AND OBJECTIVES OF NEEDS

NEEDS defines a process of development which is anchored on a clear vision, sound values, and enduring principles.

Statement of Vision and Mission:

The vision for Nigeria's development derives from her history, endowments, experience, and aspirations. The visioning process has drawn inspiration from the views of a cross section of stakeholders and the provisions of the constitution regarding the overall thrust of the aspirations of Nigerians. The vision underscores the necessity and urgency to build a modern Nigeria that maximizes the potentials of every citizen to become the largest and strongest African economy, and a force to be reckoned with in the world before the mid 21st century.

The most recent articulation of this vision is embodied in the 2001 Kuru Declaration as follows: ***To build a truly great African democratic country, politically united, integrated and stable, economically prosperous, socially organized, with equal opportunity for all, and responsibility from all, to become the catalyst of (African) Renaissance, and making adequate all-embracing contributions, sub-regionally, regionally and globally.***

The Mission is to use the instrumentality of the National Economic Empowerment and Development Strategy (NEEDS) as a nationally coordinated framework of action in close collaboration with the State governments and other stakeholders to consolidate the achievements of the last four years, 1999- 2003 and build a solid foundation for the attainment of Nigeria's long-term vision. Over the medium term, the NEEDS will lay the foundation and achieve significant progress in the areas of wealth creation, employment generation, and poverty reduction.

Core Values

NEEDS is anchored on the imperative to restore the fundamental values of Nigeria which have weakened over the years. According to the Vision 2010 Main Report, "Nigeria is a multi-ethnic society, with a value system that derives from the diversity of its people, religion and cultures. The elements of this value system include respect for elders, honesty and accountability, cooperation, industry, discipline, self-confidence and moral courage". The essence of the new value system is one that puts Nigeria, selfless service to the country and love of fellow citizen above all else. More specifically, the Strategy hopes to lay a solid foundation for a national self rediscovery and strong values based upon:

- Enterprise, competition and efficiency at all levels
- Equity and care for the weak and vulnerable
- Moral rectitude, respect for traditional values, and extolling of our culture
- A value system for public service that makes efficient and effective Service delivery to the citizens
- Discipline at all levels of leadership

The focus of NEEDS is wealth creation, employment generation, poverty reduction, corruption elimination and general value re-orientation. It is the strategy aimed at achieving the directive principles of state policy.

Three other principles that underpin the NEEDS are:

- An incentive structure that rewards and celebrates private enterprise, entrepreneurial spirit and excellence; and
- New forms of Partnership among all stakeholders in the economy to promote prosperity among all arms of government; Federal-state-and Local; public-private; civil society and the International Community; and indeed all stakeholders.
- A public service that delivers prompt and quality service to the people.

3. STRATEGIES OF NEEDS

NEEDS aims at putting the economy back on the path of consistent growth, and this requires systematic and consistent framework. Such a consistent macroeconomic framework would ensure predictability and sustainability of the macroeconomy, and high but broadly shared pro-poor growth.

In the real sector, the policy thrust is to sustain a high but broad based non-oil GDP growth rate of at least 5 % per annum consistent with poverty reduction and employment generation; diversification of the production structure away from oil/mineral resources; ensuring international competitiveness of the productive sector; drastic reduction of the role of government in direct production of goods and strengthening its facilitating and regulatory functions. The key instruments to be employed include: privatization, deregulation and liberalization; coordinated national sectoral strategies for agriculture, industry (especially SMEs) and services (especially tourism); infrastructural development especially electricity, transport and water; addressing problems of financing the real sector and investment; effective regulatory regimes; and targeted programmes to assist the private sector. In the fiscal sector, the policy thrust include: use of Medium Term Expenditure Framework to ensure predictable and sustainable public finance situation at all levels of government; pursuit of policies consistent with raising domestic savings and increasing private investments; and public debt sustainability. The key instruments include: reformed budget process with early involvement of stakeholders; tax reforms aimed at diversifying the revenue base; strengthening the Budget office; intergovernmental fiscal coordination based on a Fiscal Responsibility Act or any similar initiative; reformed and strengthened procurement process; oil-price-based fiscal rule and establishment of a stabilization fund for excess crude oil sales; and public expenditure rule with a deficit of no more than 3% of GDP. Policy direction and targets in the external sector include: export promotion and diversification of exports; gradual liberalization of imports; market-determined nominal exchange rate regime and avoidance of over valuation of the real exchange rate; and request for debt relief on most generous terms. In the monetary sector, the goal of policy remains price stability, and effective regulatory and supervisory mechanisms to ensure orderly development of the financial system. Inflation rate is expected to drop progressively over the programme period reaching single digit (9%) by 2007.The reform programme aims to reduce the spread between lending and deposit rates of interest. The instruments are those consistent with a deregulated financial system NEEDS rests on four key strategies: reforming the way government works and its institutions; growing the private sector; implementing a social charter for the people; and re-orientation of the people with an enduring African value system.

a. Reforming Government and Institutions:
The goal is to restructure, right size, re-professionalize and strengthen government and public institutions to deliver effective services to the people. It also aims to eliminate waste and inefficiency, and free up resources for investment in infrastructure and social services by Government. A key aspect of the institutional reforms is to fight corruption, ensure greater transparency, and promote rule of law and stricter enforcement of contracts. An explicit Service Delivery Programme to re-orientate government agencies towards effective delivery of services to the people is being introduced in government. In a summary, the goal is to make government and public institutions serve the people: to make government play a developmental role rather than a haven for corruption and rent-seeking. Part of the reforms at this level is to ensure a predictable and sustainable macroeconomic framework, especially through a sustainable fiscal policy framework.

b. Growing the private sector:
NEEDS is a development strategy anchored on the private sector as the engine of growth for wealth creation, employment generation and poverty reduction. The government is the enabler, the facilitator, and the regulator. The private sector is the executor, the direct investor and manager of businesses. The key elements of this strategy include the renewed privatization, de-regulation and liberalization programme, infrastructure development especially electricity and transport; explicit sectoral strategies for agriculture, industry/SMEs; services (especially tourism, art and culture, and information/communication technology), oil and gas, and solid minerals. Other elements of this agenda include the mobilization of long-term capital for investment; appropriate regulatory framework; a coherent and consistent trade policy and regional/global integration regime; and specific interventions to encourage the development of some sectors. For instance, in order to enhance rapid industrial growth and efficient exploitation of resources, Government shall encourage strong linkage between Science and Technology Parks (STPs), industry and R&D Institutions. In addition, there shall be deliberate efforts made to promote technology acquisition from within as well as across national boundaries.

In collaboration with the States, a key strategy is to promote the emergence and flourishing of industrial clusters. In a global economy characterized by increasing agglomeration of industries, promotion of clusters to ensure economies of scale is an important element of the strategy. The small and medium enterprises (SMEs) are critical for employment generation, and therefore receive special attention under NEEDS. In addition, NEEDS seeks to promote the emergence of medium and large commercial farms, plantations, and industrial conglomerates that would harness the economies of scale and effectively compete in today's global market.

c. Implementing a social charter:

NEEDS is about people: it is about their welfare, their health, education, employment, poverty-reduction, empowerment, security and participation. This is the overarching ultimate goal of NEEDS. With about 50 percent of the population being children, education under NEEDS is seen as the most important bridge to the future and a powerful instrument of empowerment. The HIV/AIDS epidemic is not just a social problem; it is a major threat to productivity and the economy. Effective health care delivery system, especially aspects directed at combating the scourge of HIV/AIDS and other preventable diseases (malaria and tuberculosis) is a key strategy for preserving a healthy workforce. Explicit programmes are directed at youth re-orientation and employment. The existing pension scheme which is in crisis is being replaced by a contributory pension scheme to give the senior citizens a better retirement life. Under NEEDS, reforms are ongoing to promote the emergence of a vibrant mortgage and housing development system that is led by the private sector. The priority given to agriculture (especially to improve the productivity of peasant farmers) is a key element of the poverty reduction strategy since over 50 percent of the poor are in agriculture. The continuing investment in water resources not only provides key social service to the people, it also provides irrigation for increased agricultural productivity. Industry, especially the SMEs, is expected to boost employment, particularly among the urban labour force. In collaboration with the States (under SEEDS) and local governments, an integrated rural development programme is a major strategy to stem the rural-urban migration. Another key strategy of the social charter is inclusiveness and empowerment. This is not just on the economic front, but deliberate programmes to give voice to the weak and the vulnerable groups through increased participation in decision-making and implementation, and laws and programmes to empower women, children, the handicapped, and the elderly. For example, NEEDS aims for a minimum of 30 percent representation for women in all aspects of national life wherever feasible.

d. Value Re-Orientation:

The key message of the NEEDS is that 'it is not business as usual'. The privatization programme is designed to shrink the domain of the state and hence the pie of distributable rents which have been the haven of public sector corruption and inefficiency. The act of privatization will release a few thousands of appointed Board members of parastatals to go into productive engagements. Public sector reforms also aim to emphasize professionalism, selfless service, and efficiency (value-for-money). The anti-corruption measures, fight against the advance fee fraudsters, and strive towards greater transparency in public and private sector financial transactions is to ensure accountability, and reduce to the minimum, illegal and illegitimate means of enrichment. Part of the reform agenda is to ensure that hard work is rewarded and that corruption and rent-seeking are punished. Public officials are to be accountable through some Bill of Rights (especially the Right to Information Act). The people will be mobilized to re-emphasize the virtues of honesty, hard work, selfless service, moral rectitude, and patriotism. The National Orientation Agency (NOA) and their state counterparts will be strengthened to actively lead the campaign. Government will also encourage the civil society organizations, Community-based organizations, NGOs, private sector organizations, religious and socio-cultural-traditional organizations, etc to provide leadership in the campaign for a new value system. Agencies and organizations will be encouraged to take specific steps to reward excellence as the demonstration effect could help to motivate imitation of exemplary behaviour by others.

4. IMPLEMENTATION OF NEEDS

Over the years, ineffective implementation of plans has been a major issue. NEEDS is poised to be different: it is a plan on the ground. Already, a number of the programmes of the current administration are consistent with the major policy thrusts of NEEDS. The coordination of the implementation is headed by the President and there is a systematic process of monitoring and evaluation. At the federal level, commitment to the implementation of NEEDS appears total. There will be periodic (quarterly) review of performance assessment of achievements, constraints and prospects. In addition, there is an Independent Monitoring Committee made up of men and women of sterling qualities most of whom are directly involved in the reform process and will report directly to the President based on targets and objectives set for the various reforms. The National Assembly will also play their constructive and complementary oversight roles.

A key element of the implementation relates to a system of collaboration and coordination between the Federal and State Governments, donor agencies (through more effective donor coordination), the private sector, civil society, NGOs and other stakeholders. Given the federal structure of Nigeria and the fact that the states and local governments will increasingly control more resources than the federal government, only a coordinated approach can produce the intended results. All the statutory institutions for inter-governmental coordination of development programmes such as the National Council of State; National Economic Council; National Council on Development Planning; and the Joint Planning Board will be actively deployed for the coordination function. All the sectoral councils such as the National Council on Education, Health, Agriculture, etc will be more proactive than before in coordinating sectoral strategies.

5. FINANCING THE NEEDS

The investment target of NEEDS is ambitious, and is put at about US$4.5billion per annum. The programme is to be self-financing, and would be from various sources including;

a. Savings through elimination of waste

- Expenditure Reduction Imperatives: The FGN will withdraw from programmes and projects best left to states and local governments to implement, not only in order to avoid duplication of efforts but to enhance efficiency in programme/projects execution and monitoring.

- Fiscal Regime: The reform seeks to drastically reduce the payroll and overhead expenditures as well as prescription of extra budgetary expenditures. The capital budget will also be rationalized to eliminate projects that cannot be funded to completion.
- Civil Service Reforms: This will release/conserve/generate resources.
- Monetization Policy: This will lead to reduction in cost in the long run.
- Management of Treasury Accounts: Asingle account will be maintained with the CBN to avoid cash management problems that lead to unecessary borrowing from the CBN.
- Setting up of the Due Process /Procurement Mechanism: This will result in savings.
- University autonomy: The universities will be free to charge fees and generate income from research and semi-commercial ventures.

b. Institutional Reforms

This will be through the following:

- Fiscal Responsibility Act: This will lead to increased level of transparency and accountability and better management and efficiency in the use of public resources.
- Banking and Financial Sector Reforms: This will engender better supervision of the activities of banks/financial institutions that currently abuse the system for revenue collection and remittance.
- Solid Minerals:Increased revenue from rents and royalties derivable from this sector is expected.
- Long Term Funds: The capital market will be deepened by encouraging investment in insurance and pension schemes. The National Saving Certificate scheme will also provide an attractive alternative to small savers.

c. Sale of Assets: This will be from Privatization proceeds and sale of government assets.

d. Tax Reforms: This will come through strengthening the tax collection mechanism, increased revenue from oil and gas operations, and increase in taxes

e. External Financing: This will come from debt relief, foreign direct investment and official development assistance (ODA)

f. Others: This includes payment of interest on delayed payments due to the government, recovery of looted/misappropriated funds, partnership with the private sector, private sector investment in infrastructure, small and medium industries equity investment scheme (SMIEIS) and workers home remittances by Nigerians abroad.

6. PROSPECTS AND CHALLENGES

Prospects

There are prospects for the NEEDS. These are anchored on various programmes which have already been put into place by the government in line with the NEEDS strategy anmd which have received tremendous support from the people. Such programmes include the Anti-corruption Crusade of the government manifested in the establishment of the Independent Corrupt Practices Commission (ICPC) and the Economic and Financial Crimes Commission (EFCC). Corruption has been fingered as a major problem in the achievement of economic development in Nigeria. The activities of the agencies especially, the EFCC which recorded some successes have rekindled hope on the reduction of this monstrous economic malaise. The prospects of the NEEDS has been further brightened by the commitment of the various tiers of government to adhere to issues such as budget discipline and excess crude account where extra income accruing from increased oil prices are kept for the rainy day. Moreover, some states have launched the SEEDS. The prospects of generous debt relief for the country consequent upon the successful execution of NEEDS, provides strong stimulus and offers a bright prospect for the programme.

Challenges

The major challenge faced by NEEDS include sustained political will. This is very important because of the tendency to relax wherever there are indications of noticeable improvement. There is also the challenge of sustaining the tempo of public awareness and consciousness about the programme. This is very necessary in order to ensure and retain the commitment of the people. In this regard, publicity at the grass root should be continued.

Figure 1: The NEEDS at a Glance

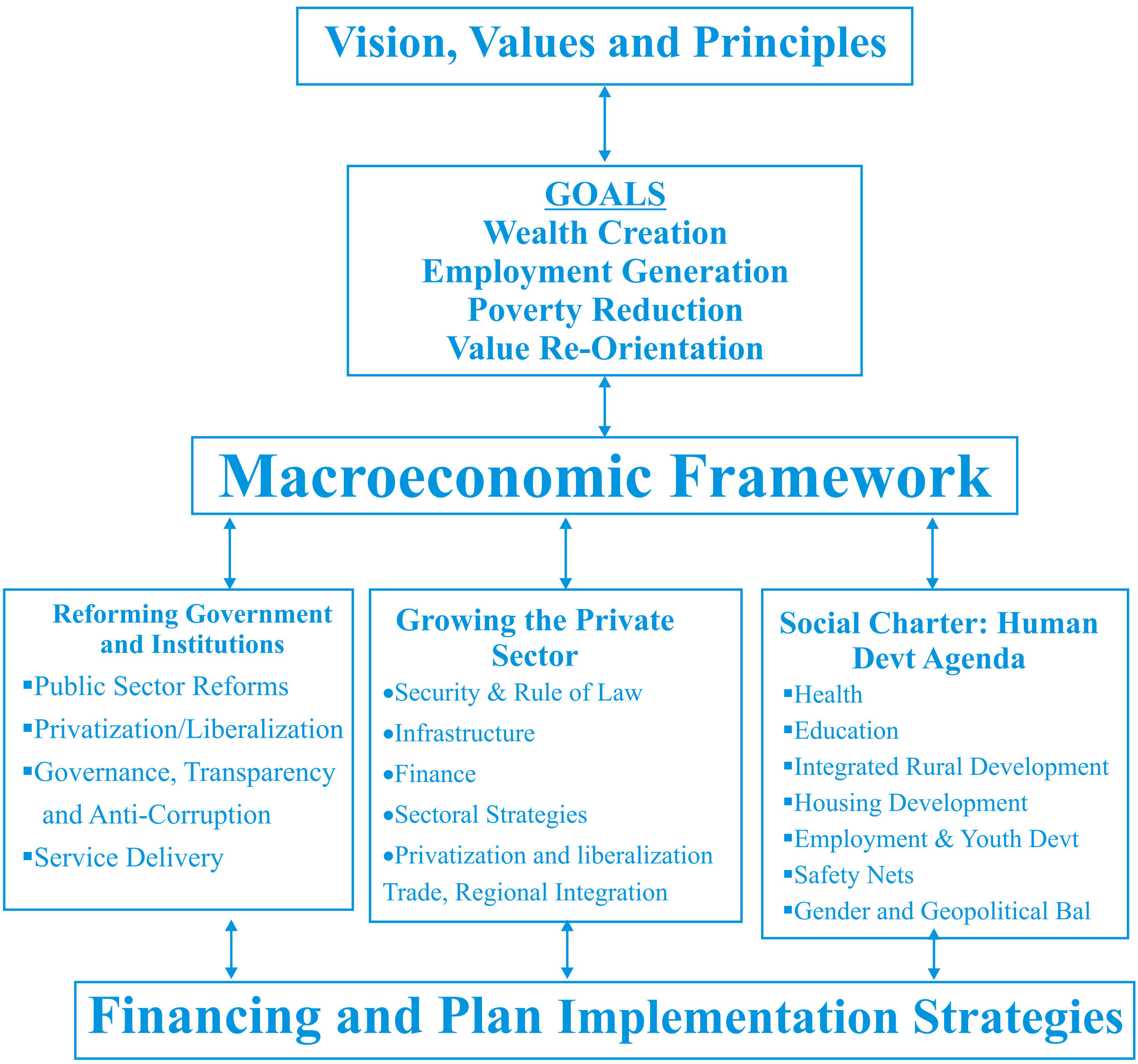
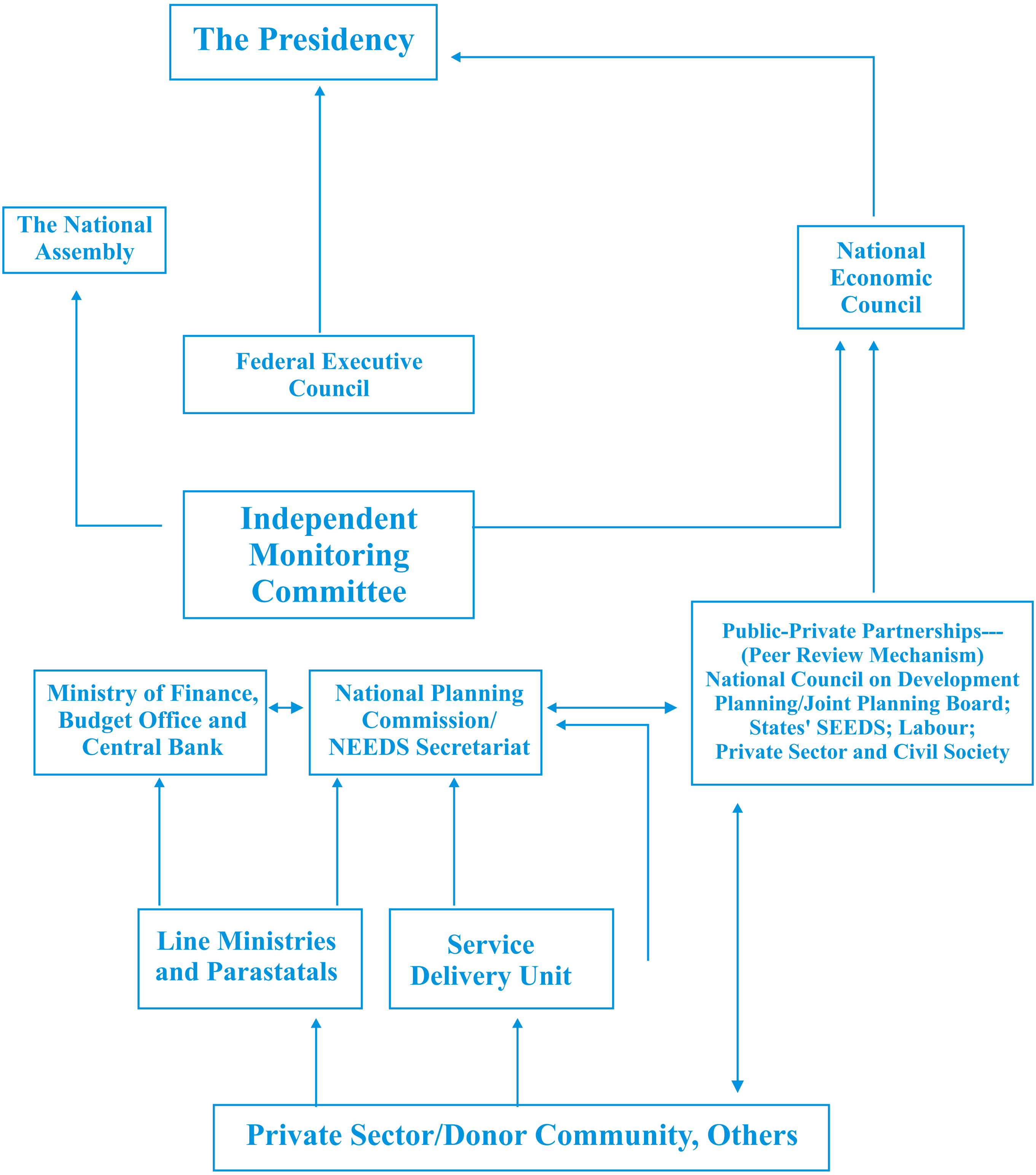


Figure 2: Institutional Framework for the Implementation of Needs



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ENHANCING MICROFINANCE IN NIGERIA: PROBLEMS AND PROSPECTS

INTRODUCTION

Microfinance has been defined as a development tool used to create access for the economically active poor to financial services at a sustainably affordable price. The economically active poor are either micro entrepreneurs who operate in the informal sector (trading, farming, hiring of tools, machinery and equipment, food catering) or people earning wages. Such poor people earn their living in either rural or urban areas. The financial services for which access is sought are mainly savings and loans. It is estimated that in the developing countries financial services are not available to about 90% of the population and these are the people that microfinance tries to reach.

The objective of this brief is to provide an overview of microfinance in Nigeria and highlight its problems and prospects. It also reviews some country experiences and suggests strategies for enhancing microfinance in Nigeria.

MICROFINANCE INSTITUTIONS AND THEIR GOALS

The providers of Microfinance can be categorized into; formal, informal and semi-formal. Moneylenders, traders, pre-financers, producers or suppliers of goods and services on credit, friends and family members are informal microfinance providers. The semi-formal providers are credit unions and Non-Governmental Organizations (NGOs). Banks constitute the formal providers of microfinance. The semiformal and the formal are institutional providers. They are referred to as Microfinance Institutions (MFIs).

One of the goals of MFI is social development of the poor. To achieve this, MFIs try to reach as many poor people as possible, going further below the poverty line. Thus, outreach has been the missionary goal of microfinance. This social development goal creates improvement in access to schooling, health facilities and better nutrition. It also empowers the otherwise voiceless. The other goal, which is economic, is to provide a sustainable service. The critical role of sustainability is the ability of the MFI to provide the financial services to the poor continuously over time. Otherwise any welfare gain may roll back making the poor even poorer. Sustainability implies that the MFI is able to cover its costs with revenue earned from its operations. To be sustainable therefore MFIs must apply commercial principles to their activities. This means that microfinance is a commercial business rather than a welfare operation. If microfinance is a commercial business, then it must show profit or surplus income at the bottom of the income statement. The surplus income would enable the MFIs expand their business.

A REVIEW OF MICROFINANCE EXPERIENCE IN NIGERIA

The inability of the formal financial institutions to provide financial services to both the urban and rural poor, coupled with the non-sustainability of government sponsored development financial schemes, induced the growth of private sector-led microfinance in Nigeria. Microfinance institutions in Nigeria provide services to both the urban and rural poor and finance micro enterprises. A Central Bank of Nigeria survey (2001) indicated that the operations of private sector led formal microfinance institutions are relatively new, as most of them were registered after 1981. They operate in both urban and rural areas. The bulk of MFIs clients in Nigeria are women. Many private sector led MFIs began as NGOs established for the promotion of women's rights. Apart from the general belief that women are marginalized in terms of economic opportunities and should have separate promotional agenda, the MFIs are of the view that women perform better than men in managing meager resources and promoting micro enterprises.

Unlike in the banks, asset based collateral is de-emphasized. MFIs also concentrate on short term financing, owing perhaps to the short term nature of their funding sources. The bulk of their financing is on trading activities and 14.1 percent of the total funding are for farming activities while only 3.5 per cent was put into manufacturing (Anyanwu 2004). Credit to the service sector was very minimal, while there was no consumption loan at all. It must be noted that lending is done on group basis where the collateral is the collective pledge of the group to repay, based on community recognition.

Above all, the beneficiaries were all low income individuals, operating micro enterprises, indicating that the poor are really at the heart of micro finance in Nigeria. The seemingly disproportionate coverage of commerce in MFI activities is attributed to the quick and high returns that come from investments in the sector, compared with the long gestation periods and lower returns that are associated with the agricultural and manufacturing sectors.

Private sector led MFIs in Nigeria depend substantially on aids and grants, which come mainly from abroad. On the average, about 51.0 per cent of their operations are funded from this source, while 20.9, 0.9 and 1.9 per cents were sourced from mobilized savings, owners' capital and bank loans respectively. The balance was made up from unidentified sources.

Prior to the emergence of formal microfinance institutions, informal microfinance activities flourished all over the country. This microfinance arrangement operated and still operates under different names: “esusu” among the Yorubas of Western Nigeria, 'itutu' for the Igbos in the East and 'adashi' in the North for the Hausas. Modern formalized microfinance now operates side by side with the informal services.

A REVIEW OF THE ACTIVITIES OF FORMAL MICROFINANCE INSTITUTIONS IN NIGERIA

The past approach to economic development in Nigeria relied heavily on government intervention in virtually all sectors of the economy, including the financial sectors. Thus, in the bid to provide access to investible funds to induce output growth for improvement in living standards in the country, specialised financial institutions were established by government since 1960. A brief appraisal of the institutions created and policy measures evolved by government to provide financial services to the poor in the past are outlined below:

DEVELOPMENT FINANCE INSTITUTIONS AND MICROFINANCE IN NIGERIA

Development finance institutions (DFI) were established to contribute to the growth of specific sectors of the economy and could provide an additional source of funding to the MFIs. This could be done on on-lending basis, instead of the current practice of dealing directly with micro enterprise owners, using the latter as an intermediary would be more efficient because MFIs have greater expertise in financing smaller intermediaries. Each DFI was designed with the function of promoting the development of a specific sector or sub-sector (CBN, 2000). They include;

a) **The Nigerian Industrial Development Bank (NIDB):** was established in 1964 and charged with the function of harnessing both local and foreign skills & private capital in the development of new industries and expansion of existing ones.

b) **The Nigerian Bank for Commerce and Industry (NBCI):** established in 1973 in order to provide equity capital and funds to small and medium scale enterprises.

c) **The Nigerian Agricultural and Cooperative Bank:** this institution was also established in 1973 and was of more relevance to micro enterprises. It was designed to assist financing of agricultural projects thereby enhancing the level and quality of agricultural production.

d) **The Federal Mortgage Bank of Nigeria:** established in 1977 with the mandate to provide funding for residential and other housing needs of individuals and corporate organizations.

OTHER FINANCIAL INSTITUTIONS

a) Peoples Bank of Nigeria (PBN)

Established by the Federal Government in 1988 with an initial take-off grant of N30 million to meet the credit needs of small borrowers who were unable to satisfy the stringent collateral requirements demanded by conventional banks. The bank was designed to cater for the credit needs of informal sector operators such as artisans and petty traders in both the urban and rural areas, and was expected to facilitate access to credit for economic operators at the grassroots and thereby increase their self-reliance. The PBN continued to depend on government subventions for its operations. Since this was not sustainable, it was subsequently merged with the NACB in

2000 for better performance.

b) Community Banks

These are self-sustaining financial institutions owned and managed by local communities such as community development associations, town unions, co-operative societies, farmers' groups, social clubs, etc. to provide financial services to the respective communities. They are to promote rural development and enhance economic growth and development at the grassroots' level. Their activities complement those of rural bank branches and branches of the PBN. They accept deposits, provide ancillary banking services, invest their funds in various money market instruments and provide credit facilities to their customers. The deposit and lending rates of the CBs are often lower than those of commercial banks.

The distress in the financial sector in the mid-1990s led to the entrapment of N500 million in the bank. Other problems that the community banks face include incompetent board and management, poor record keeping, insufficient assets to meet obligations and inadequate earnings. In order to address the developments in the economy which called for sufficiently higher capital to absorb and cushion risks associated with doing business in the sub-sectors, community banks were directed to raise their capital base from ₦3 million to ₦5 million on or before August, 31, 2001.

SPECIAL SCHEMES AND FUNDS

Special schemes and funds were also created to facilitate access to credit for microfinance activities nationwide. Among these were the Family Economic Advancement Programme (FEAP), National Directorate of Employment (NDE) program and the Small and Medium Scale Enterprises (SMEES)

(a) Family Economic Advancement Programme:

This was a micro credit scheme program aimed at stimulating appropriate economic activities at the grass roots level through establishment of cottage industries and creating avenues for the people to earn higher incomes. It was established by the government in 1988 in reaction to the increasing levels of poverty occasioned by the implementation of the structural adjustment policies. The main objectives of this program included:

- Provision of loans directly to people at the ward level in order to enable them establish small-scale industries;
- Provision of employment opportunities at the lowest levels
- Improved standards of living;
- Encouragement of producers at the lower levels to form cooperative societies through which to promote development consciousness;
- Involvement of the private sector, state and local governments in the funding of the production process; and
- Reducing the rural to urban migration

that leads to the congestion of the cities and impoverishment of the rural areas.

In 1997, FEAP disbursed a total of N1.72 billion to 11,767 cooperative societies nationwide. Between 1997 and 1999, the cottage industries under FEAP had a budgetary allocation of N8.7 billion as micro-credit to reduce poverty (Okunmadewa 1999 & CBN 1999). It must however be recognized that most of this was allocated and true beneficiaries were sidelined in favour of shadow personalities.

(b) The Small and Medium-Scale Enterprises (SMEES)
Apex Unit Loan Scheme

In order to increase access to credit by SMEs, the CBN and the Federal Ministry of Finance, on behalf of the Federal Government, obtained a World Bank Loan for the SMEs. The total project cost was US$415.8 million of which the World Bank provided US$273 million or 64 per cent. Entrepreneurs were expected to provide US$79.7 million or 19.2 per cent of the project cost, while participating banks (PBs) were expected to provide the balance of US$66.1 million. 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. Disbursements under the SMEII Loan Scheme closed on 31st March, 1996, in line with the World Banks policy that disbursements should end two years after the closure of approval which was March, 1994.

c) National Directorate of Employment

The National Directorate for Employment (NDE) was established in 1987 to promote self-employment through training and loans to unemployed youth, however the main orientation of the program was to reverse rural-urban migration by encouraging investment in rural agriculture. The National Open Apprenticeship Scheme (part of the NDE) was also initiated to support the placement of apprentices in informal sector workshops, and to supplement their practical training with other forms of formal training for skills they would need in the future for their enterprises. Again, only a small percentage of unemployed youth and apprentices benefitted from this initiative, which was constrained by under funding and various forms of corruption and abuse. Other programs created by the NDE included;

(a) Vocational Skills Acquisition Programmes;
(b) Entrepreneurial Training;
(c) Training for Rural Development;
(d) Training for Labour-based Work Programmes.

d) Rural Banking

To encourage banking habit nationwide and channel funds to rural development, the CBN introduced the Rural Banking Scheme in June, 1977 in three phases, viz; 1977 1980, 1980 1985 and from 1st August, 1985 to 31st July, 1989. As at end-June, 1992, 765 of the 766 branches stipulated by the CBN had been opened. Also, until September, 1996 the CBN stipulated that not less than 50 per cent of the deposits mobilised from the rural areas was to be advanced as credit to rural borrowers.

A number of policy measures aimed at increasing credit access to the real sector of the economy by the Central Bank of Nigeria include:

The decision by the Bankers Committee that 10.0 per cent of profit before tax of every bank be set aside and channelled to equity investment in Small and Medium Industries Equity Investment Scheme (SMIEIS) in August 2001. To ensure the effectiveness of the programme, banks are expected to identify, guide and nurture enterprises to be financed under the scheme. Under this reintroduction of SMIEIS, targeted activities include agro-allied, information technology, telecommunications, manufacturing, educational establishments, services, tourism and leisure, solid minerals and construction. Banks are expected to render to the CBN, on quarterly basis, their investment report under the scheme.

The second recent policy measure is the CBN Rediscounting and Refinancing Facility (RRF) for medium to long-term credit. The need to encourage medium to long-term lending to the productive sectors of the economy so as to expand and diversify the production base of the Nigerian economy led to the institution of this policy measure in January, 2002. Under the facility, deposit money banks can issue Promissory Notes, based on their loans and advances with maturities of not less than 5 years, for agricultural production, semi-manufacturing and manufacturing, solid minerals and information technology. The RRF is designed to provide temporary relief to banks which face liquidity problems as a result of having committed their resources to long-term financing of the specified productive sectors.

In furtherance of CBN's commitment to its developmental functions, and in collaboration with the World Bank, an inter-departmental committee, designated as the ***Micro Finance Policy and Programme Development Committee (MPPDC)***, was created by the Apex bank. Membership is drawn from the Bank's Development Finance Department (DFD), Other Financial Institutions Department (OFID), and the Research and Statistics Department (R&SD). The mandate of the MPPDC includes the following:

- To identify the rural and microfinance institutions in Nigeria affected directly or indirectly by government policies;
- Work out the legal, self-regulatory, and supervisory framework under which rural and micro finance institutions will operate in Nigeria;
- Advise the Management of the Bank on the method of integrating the informal micro finance institutions (MFIs) in the country with the formal financial sector, and;
- Recommend appropriate strategies for mobilizing funds from rural areas and MFIs.

Significant progress has been made and a Microfinance Policy is being put in place to set up Microfinance Banks (MFBs). Plans are also underway to have the MFBs established at local, state and national levels, with N20 million, N50 million and N100 million capital bases as stated in a recent public address by the Director, Development Finance Department, CBN . Foreign partnership with local banks is also not ruled out. Some banks consequent to the policy, had plans to set up subsidiaries that would focus on microfinance with United Bank for Africa (UBA) leading this category. Under these new settings, micro credit would be given as outright loans rather than equity.

INFORMAL MICROFINANCE PROVIDERS IN NIGERIA

There are principally three forms of informal credit markets in Nigeria;

a) Those who operate in cash - giving out cash credits;

b) Those whose credits are in kind i.e. in form of stock replenishment, goods procurement, facility procurement like motorcycles, motor vehicles, etc to beneficiaries to either expand their trade or start a new line of business;

c) A hybrid of the two where goods procurement is augmented with working capital to enable the beneficiary begin immediate operations.

The literature of informal finance appears to have focused greater attention on the "in-cash" type. A common characteristic of this form of informal financial markets is that they make available to individuals use of credit and savings in the form of pooled resources. The "in-kind" type of informal finance also involves pooling of labour. It is used in agricultural projects like land clearing, planting, and harvesting or for building a new village house. This type of labour-pooling informal finance approach varies among different ethnic groups. Among the Yoruba it is known as aaro. The aaro pools together the labour of two or more people, to work on a farm for a given period. This has to be 'repaid' to other members of the pool on rotational basis and for the same number of periods. There is another type called the 'owe' which has more people on the pool than the aaro.

In the northern part of the country, the same type of "in-kind" informal finance is known as 'gayya'. The gayya groups for work on the farms using simple farming implements. However there is another type that uses animal power credit where ox-drawn carts are used. Participation here has remained low due to the lack of financial capability of many farmers to acquire the animals or to hire them for use on farms.

The most common form of informal credit markets involving the transfer of cash in Nigeria is the Esusu (common amongst a broad spectrum of south- western Nigerians). In the southern part of the country, the many heterogeneous communities have different variants of the phenomenon, often reflecting the peculiarities of their communities. For instance, amongst the Igbo of the southeast, it is commonly known as Itutu, while amongst the Yoruba, it is called Ajo. The Ibibio call it Efe, while the Ijaws call it Oku. In the north central zone, the phenomenon is severally known as Adashi, Adashe, Dashe, Bam, while its non-cash form is commonly called Ihyumbe amongst the Tiv.

Kinds of Informal Credit Arrangements

Esusu/Itutu/Adashi

Esusu or Itutu or Adashi is a contribution-based-savings-scheme that is principally interest-free and operates on the principle of 'ROSCAS' - rotating savings and loans associations. They are all very common especially amongst the rural communities of Nigeria. The main factors for the arrangement or membership are shared/common interest and the meetings as well as contributions are periodic in nature i.e. may be weekly, fortnightly, or monthly depending on what members agreed upon. The binding principle is that once the contribution has commenced and other beneficiaries have taken their turn, members cannot voluntarily withdraw their membership without disrupting the schedule. Thus, group pressure makes continuity possible.

Bam

Bam is a periodic savings scheme mostly in the north central part of the country. Essentially, it involves the meeting of like minds with the intention to provide a pool of savings to be withdrawn and terminated at the end of the year, mostly towards November/December of every year. Members register with a stipulated fee, including as many members of their families as possible.

These loans normally carry a predetermined interest element, which are paid upfront on receipt of the loan and have an exceptionally high repayment rate with no default, as group pressure compels a high repayment rate. The loans are also highly collaterised and fully repayable before the close of the bam season and the personal property of the loan beneficiary is at risk upon default. The collateral is often the savings of the beneficiary and those of his guarantor.

Daily/Periodic Contribution

This is like a savings scheme amongst traders in which an agreed amount of money is paid daily to a convener, agreed upon by the traders. Members are free to pay on a daily basis, any amount so desired, which must be recorded promptly in the register and the membership card. The savings are paid back to the contributors at the end of an agreed period usually a month. The major difference between this scheme and esusu is that members need not know themselves apart from the collector and also there is no loan facility to contributors (members).

SEMI-FORMAL MICROFINANCE INSTITUTIONS

Savings and Credit Associations

This type of association operates in a more formalized way than the esusu kind of association, and is therefore much closer to variants of the formal financial system. Savings and credit associations may or may not be registered under legislation but they are always registered under the Co-operative Association Act. This type of semi-formal financial institution has a significant showing in rural Nigeria.

Cooperatives

Cooperative Thrift and Credit Societies provide a veritable source for funds mobilisation and participatory credit administration in Nigeria. Mainly, these societies and unions have played a significant role in the development of Nigeria's rural economy. Cooperative societies are business associations of persons, usually of limited means, who voluntarily come together on the basis of equality and equity for the enhancement of members' corporate and individual welfare. They are organised to achieve the economic goals and aspirations of members largely to eliminate the exploitative tendencies of middlemen and money-lenders. Cooperatives are especially very popular in Nigeria, particularly in south-western Nigeria where they have existed for over a century, and have achieved remarkable results.

Rotating Savings and Credit Association (ROSCA)

ROSCAS have a long history in developing countries and they continue to be a major source of credit in African countries. Usually, a small group is formed from a village or family group where enforcement costs are low because of powerful social sanctions. Each member agrees to pay periodically into a common pool, a small sum so that each, in rotation, can receive one large sum. Where individuals need to purchase a high priced item ROSCA provide funds with small spreads between return to savings and the cost of borrowing. It is built on trust, made up of homogenous groups of people from the same ethnic background, same work place or same neighbourhood. If a member defaults in making payment he is banned by the community and if a member is banned from one group he is rejected by the community.

CHALLENGES OF MICROFINANCE IN NIGERIA

Over the years, the various specialised financial institutions established by the government have been faced with one problem or the other and as such could not meet the objectives for which they were set up. The reasons for their failure include the following:

1) First, because the programmes offered very low interest loans, the volume of funds supplied was limited, and it was impossible for the lending institutions to achieve self-sustainability.

2) Second, lending volume and sustainability were further eroded because these institutions lacked incentive to undertake careful underwriting and enforce timely repayment.

3) Third, State - owned programme, particularly those that lack profit incentives, were very vulnerable to political influence. Borrowers were frequently selected for political reasons rather than because they fit the profile of the ostensibly targeted beneficiaries or were sound credit risks.

4) Finally, wealthy households appropriated the benefits of many of these programmes because they preferred to borrow from them rather than from the unsubsidized informal sector. Consequently, the development finance institutions suffered serious erosion of their capital bases and had to be recapitalized for survival.

To commercialize Microfinance, the MFIs should aim at up scaling their operations and transforming into regulated financial institutions. On the other hand, the commercial banks also should be downscaling their operation to provide micro-financial services.

What then are the issues underpinning MFIs up scaling to commercialize their operations? They are; Product development, Product pricing, Profitability, Competition and Professionalism. In Africa entry of commercial banks into Microfinance is rare. Where they have been, it has been due to state ownership and mandate. The private commercial banks' lack of motivation is due to a number of factors such as lack of knowledge, transaction and monitoring costs, low interest rate and profitability.

The challenges of the informal microfinance institutions are tied to the peculiar nature of their operations. Their deposits are largely small in size, the velocity of funds mobilization and financial intermediation is high, interest rates are not market-based and often of shorter duration and higher than those in the formal markets. In addition, interest on loans is collected upfront and finally, the size of deposit has a high seasonality element. Because of seasonal variations, mobilisation of deposits is especially affected in periods of poor harvest. At such times, there is little to be lent by the operators to promote financial intermediation hence, the volatile nature of deposits.

LESSONS OF EXPERIENCE FROM INDONESIA, GHANA AND THE PHILIPPINES

Nigeria like Indonesia, Ghana and the Philippines, is a developing country and they all share similar characteristics hence the basis for attempting to draw lessons of experience from these three countries which have made significant progress in the area of MFIs development. Nigeria like Indonesia has a very large population and with the exception of the Philippines, the other three countries have a gross national income per capita of less than one thousand dollars, while that of Nigeria is the least. Population below the poverty line is high for all these countries ranging from 27.1 per cent for Indonesia in1999 to 36.8 per cent for the Philippines in 1997. For Nigeria, it was 34.1 per cent in 1992 - 93 and the situation deteriorated further in the late 1990s. Domestic credit provided by the banking sector as a per cent of GDP was estimated by the World Bank to be only 12.4 per cent for Nigeria in 2000 and as high as 66.2 per cent for Indonesia. This is a clear indication of the need to develop microfinance institutions in Nigeria so as to improve the per capita GDP growth rate estimated at 0.4 per cent in 1999 - 2000 for Nigeria compared with 3.1 per cent for Indonesia.

a) <u>The Indonesian Case Study</u>

The report by Marisol Raviez examined five Indonesian micro-finance programmes owned by the central or a local government that currently serves low-income clients in lowdensity areas. The highlights of their findings are presented below.

i) Structure of Microfinance Sector in Indonesia

Under the **Badan Kredit Kecamatan (BKK)**, financial institutions owned by the South Kalimantan provincial government, there are 110 units for its 109 sub-districts and field staff are required to travel to surrounding villages to transact business. The 34 BKK units created before 1992 make loans and accept deposits while the 76 units created after 1992 only make loans but charge higher interest rates for sustainability. The **Lumbung Kredit Pedesaan (LKP)** is a system of semi-formal financial institutions owned by the provincial government of Nuga Tenggara Barat (NTB). LKP is very similar in structure and function to BKK.

The **Program Hubungan Bank dan KSM (PHBK),** on the other hand is a micro-finance program sponsored by the Central Bank of Indonesia (BI) and the German Government's Agency for Technical Cooperation (GTZ). The program operates in 10 provinces and had expanded to 3 more, by March 1996, 323 banks or bank branches were participating in this program. The program provides technical assistance to private and state-owned banks, non-governmental organisations (NGOs), and borrower groups to help them develop group lending skills. Client groups can obtain loans and open savings accounts. The **Pembinaan Peningkatan Pendapatan Petani nelayan Kecil (P4K)** also is a group-based micro-enterprise lending and promotion program targeting the rural poor. P4K operates in 6 provinces and expanded on a pilot basis to an additional 12. Ministry of Agriculture extension workers act as agents for the government-owned Bank Rakyat Indonesia (BRI) to extend lending and savings services to the rural poor. The program also provides training in micro-enterprise skills, and attempts to link borrower groups with community activities and social service agencies.

Finally, the **Badan Credit Desa (BKD)**, is a system of village based financial institutions where units are owned by individual villages and operated by village governments. BKD units are located in the rural areas of Java. There are 5,345 units, of which 4,806 were active in 1996. All units make loans and accept deposits.

ii) Loan Characteristics

Loan products vary by institutions but generally carry high interest rates and have short repayment periods. While PHBK and P4K make group loans, LKP and BKD make individual loans. BKK primarily makes individual loans, although some of its units have begun to make group loans. Nominal effective annualized interest rates ranged from about 24 per cent for P4K, to over 400 per cent for those PHBK loans that pass through several intermediaries. Most of the programs' loans have effective annual real (inflation adjusted) interest rates of 50 per cent or more. This is much higher than the BRI Unit Desa real interest rate of about 21 per cent for prompt payers. The programs' maximum loan terms vary from 3 to 18 months and loans are paid in weekly/monthly installments. None of the programs requires collateral for small loans.

iii) Outreach and Sustainability

On the average loan sizes range from 7 to 13 per cent of Indonesia's GDP per capita (US$67 to US$130). The ratio for 9 of the world's most respected micro-credit programs is 16 to 136 per cent. Women account for 40 to 62 per cent of the programs' borrowers, versus 20 to 90 per cent for the internationally respected programs. The programs accept voluntary savings deposits, and have a savings requirement to obtain at least some loans. Savings accounts generally earn interest at a rate approximately equal to the inflation rate. Four of the five programs have experienced rapid growth in the number of loans they have issued in recent years.

Four of the programs had annual default rates of 3 per cent or less in 1994 and 1995. This level of default is satisfactory by international micro credit standards. BKK can now operate on a sustainable basis without subsidies. LKP and PHBK have experienced rapidly declining subsidies in recent years. P4K's subsidies increased from 1993 to 1995, but even in 1995 its subsidy was significantly lower than in the early 1990s.

b) The Experience of Ghana and the Philippines

Responding to the rapid growth of various types micro-finance institutions (MFIs) around the world and the gap in knowledge on whether and how these institutions should be regulated, a team from the World Bank comprising Hennie Van Greuning, Joselito Gallardo and Bikki Randhawa produced a Policy Research Working Paper No. 2061 (February 1999) entitled, *"A Framework for Regulating Micro-finance Institutions.* The paper sought to provide a framework for addressing regulatory issues which impact the operations and the institutional development of MFIs.

The two countries selected for this field testing and assessment were Ghana and the Philippines, which have a wide range of informal, semi formal and formal MFIs providing financial services to the poor, but have legal systems and regulatory frameworks which differ in how financial intermediation activities by MFIs are regulated and/or supervised. Subsequent in-depth work on issues in developing sustainable rural/micro-finance in Indonesia reviewed earlier presented an opportunity to deepen the assessment of how the legal and regulatory environment is important to sustainable micro-finance.

The assessment and comparative analysis carried out focused on the key issues in the legal system and judicial processes, as well as on the regulatory and supervisory environment for microfinance which are being addressed by the governments and microfinance stakeholders in the countries.

Structure of Microfinance Sector in Ghana

Ghana has a tiered range of formal, semi-formal and informal institutions, providing microfinance services to the urban and rural poor and underserved sectors of the economy. Financial intermediation and credit activities are under the regulatory jurisdiction of the Bank of Ghana (BOG). The regulatory framework under the Banking Law (1989) and the Non-Bank Financial Institutions (NBFI) Law (1993) accommodate a tiered structure of licensed financial intermediaries and of financial regulation. The risk management criteria considered by BOG as important for MFIs include: capital adequacy; mandatory liquidity reserves; security for loans; recognition and classification of delinquent loans; provisioning for portfolio at risk; as well as guidelines and standards for writing-of of non-performing loans.

Structure of Microfinance Sector in the Philippines

Compared to Ghana, the Philippines has a comparatively wider range of formal, semi-formal and informal institutions providing microfinance services to the urban and rural poor and underserved sectors of the economy. Financial intermediation and credit activities are under the regulatory jurisdiction of the Bangko Sentral ng Pilipinas (BSP). The regulatory framework under the General Banking Law of 2000 (which repealed the General Banking Act of 1949) and a number of parallel Laws governing specialized banks and NBFI have made room for a tiered structure of licensed financial intermediaries and of financial regulation. The General Banking Law of 2000 provides adequate room for banks and quasi-banks to have foreign equity content: foreign individual and non-bank corporations are permitted to own or control up to 40 per cent of the voting stock of a licenced bank or quasi-bank. The percentage of foreign-owned voting stock is determined by the citizenship or individual shareholders, regardless of its place of incorporation. The risk management criteria considered by BSP as important for MFIs include: capital adequacy; solvency standards; mandatory liquidity reserves; security for loans; recognition and classification of delinquent loans; provisioning for portfolio at risk, as well as guidelines and standards for writing-off of non-performing loans.

Lessons for Nigerian Microfinance

From Indonesia, we learn that provision of credit to low-income people with a valuable service at an initial, affordable cost to governments or donors is a necessity as well as the reduction or even elimination of high real interest rates. There is also the need for subsidies, aggressive pursuing of repayments, and achieving a significant volume of business. MFIs would also be able to obtain strong financial performance through the use of incentives for staff and clients; and clients in remote areas can be reached through sub-district based units and field staff. It is pertinent to note that poorly designed supervision systems, will weaken the system as well as inability to face political pressures that undermine their commitment to sound banking practices.

The Indonesian experience also revealed that the long-term health of MFIs can be promoted by limiting microfinance subsidies. This is achieved by ensuring that microfinance initiatives follow market-based principles which include: (i) instituting accounting and report formats that accurately tract all (including in-kind) subsidies and (ii) appropriately provision for bad-debt and depreciate fixed assets. In addition, annual subsidy reduction goals should be set to promote MFIs self-sustenance, particularly for private providers that would subsequently have to generate profits to remain in the market.

Use the tiered regulatory approach to promote development of sustainable microfinance as done in the Philippines and Ghana, by clearly identifying pathways for NGOs and Semi-formal MFIs to become legitimate institutions under the regulatory framework with greater ability to access finance resources from commercial markets. e.g. CARD Rural Bank in the Philippines, Sinapi Aba Trust in Ghana. Though all three countries have licensed rural banks, their relative financial performance and sustainability profiles have differed significantly largely because of differences in effective governance by owners/stakeholders and the base of unimpaired capital and ability of owners to step forward with additional capital. This identifies the effectiveness of corporate ownership.

Finally, the adjustments to risk management criteria made by BOG and BSP recognize the special characteristics of microfinance operations and provide useful lessons for regulatory authorities in other countries like Nigeria. For instance, with respect to capital adequacy standards, the prudential levels set for licensed MFIs by the banking authorities in the Philippines, Indonesia and Ghana do not differ much from the levels set for the larger commercial and thrift banking institutions in those countries. Global best practice experience of MFIs reporting their operating and financial performance data to the Micro Banking Bulletin provide clear empirical evidence to support more prudential capital adequacy standards for MFIs.

STRATEGIES FOR ENHANCING MICROFINANCE IN NIGERIA

Micro credit has been changing the lives of people and revitalizing communities in countries where it has been successful particularly in Asia; that microfinance can be profitable is incontrovertible. BancoSol of Bolivia, an internationally famous Microfinance bank due to its success was formed by the transformation of PRODEM, an NGO.

Commercialization of microfinace is the process that will achieve exponential growth of outreach sustainably. ***Outreach*** is defined as the ability of an MFI to provide high quality financial services to a large number of clients. The indicators of performance include changes in number of clients, percentage of female clients, total value of assets, amount of savings deposit, value of outstanding loan portfolio; average savings deposit size, average size, number of branches, and so on.

With the small sizes of MFIs in Nigeria and very conservative commercial bank systems, expanding the access of the MFIs, especially the financial NGOs which are not allowed to hold saving deposits, to wholesale funds through linkages to financial market will greatly improve the liquidity required by the NGOs. This of course, may need a review of the regulatory provisions such as that of limit of unsecured loans. Such linkages will enable MFIs to achieve profitability, its dual objectives of social and economic development of the poor and the marginalized.

It is apparent that a framework for the effective and efficient provision of microfinance services in Nigeria must include a firm legal and regulatory environment. To this end, Nigeria needs to draw from the lessons of experience of Ghana, the Philippines and other countries where the financial system approach has been adopted. This is the only way to expand outreach and guarantee sustainability.

Microfinance is not limited to borrowing, but also includes other financial services such as savings, insurance, transfer facilities, etc. Savings facilities are a particularly important component that assures the successful performance of MFIs hence the situation whereby development finance institutions in Nigeria were not allowed to mobilise savings should be done away with. However, stringent prudential guidelines must be stipulated for compliance by MFIs to protect depositor's funds. Mobilisation of savings from the general public must be contingent on MFIs complying with existing banking laws. The framework for banking laws in Nigeria should be structured to provide MFIs a clear view of the thresholds to attain on the path to institutional development and transformation. The future for sustainable microfinance in Nigeria lies in a regulated, licensed environment because there is no other environment that will permit massive, sustainable delivery of an increasing variety of financial services to the poor to effectively link them to the more developed sectors of the economy.

Another area that require attention for sustainable microfinance provision in Nigeria is incentives for customers and staff. Carefully designed incentives for customers and staff are key features of successful and sustainable microfinance programs. The lessons of experience from Indonesia are a good reference point in this regard. Most of the programs reviewed under the Indonesian case study encouraged staff to maintain high collection rates and maximize profits by linking staff compensation to the volume of repayments collected and for profitability. Adopting this system will certainly eliminate the problem of poor repayment which does not allow the credit facility to go round. Most also, promote demand, by making it relatively easy for customers to obtain loans. They facilitate physical access to services through the use of conveniently located facilities and/or field staff and credit agents. Most of the programs have relatively simple application procedures, and provide customers with loans within a few days or weeks of initial inquiry. This will eliminate one of the major problems of rural borrowers in Nigeria, particularly farmers whose activities are time bound. None of the program requires physical collateral for small loans. They promote prompt repayment by linking borrowers' access to future loans and their future loan sizes to punctual repayment of current commitments.

Government-owned financial institutions can be vulnerable to political considerations and public perceptions that depress system productivity. Thus, if the Nigerian government chooses to operate a microfinance program, it should ensure that political considerations do not undermine the programs commitment to sound banking practices. To this end, granting a government-owned microfinance institution autonomous status can help reduce the political pressure it faces. Government can force institutions to operate with hard budget constraints and declining subventions. When the institutions are commercially viable, governments can privatize them. This is particularly instructive as regards the moribund DFIs in Nigeria namely, NACB, NBCI and NIDB, which have now been merged as stated earlier as one of the restructuring strategies.

In order to service clients in remote areas, the Indonesian experience of the BKK/LKP system of a network of small, sub-district based units with field staff is worth emulating to be able to cover the vast Nigerian rural landscape. The system functions well in Indonesia because (i) customers have relatively easy access to banking services, (ii) lenders control their agents thereby ensuring that they work in the bank's best interests, and (iii) services can be delivered in a relatively cost-effective way. However, using agricultural extension workers as credit agents was found to be cumbersome and inflexible. The Indonesian case study experience revealed that reliance on agricultural extension workers as credit agents reduced the lender's ability to enforce loan repayment and pursue repeat business because it does not directly control this staff. Furthermore, borrowers had difficulty accessing the lender directly, and extension workers were distracted from their core jobs. This further confirms the need to use the appropriate manpower for credit delivery programs.

Finally, for microfinance programs, to effectively service farmers in Nigeria, loans should be tailored to smallholder needs, as they form the bulk of the producers in the rural sector. To this end, seasonal loans that do not require frequent repayments should be offered. To reduce the risk of entering this market, these loans could be introduced initially on a pilot basis. They could then evaluate demand and repayment performance to determine the loan products and staff approaches that obtain the best results.

PROSPECTS

The demand for microfinance in Nigeria is high and increasing. Continuous lay-off of labour from both public and private sectors, and the growing number of graduates form schools and colleges are pushing a large proportion of the population into the informal sector. Many micro enterprises are springing up and without bank financial support, microfinance arrangements have become the saving grace. Also the domestic market is large, with over 120 million people, in need of various goods and services. Large volumes of financial transactions are carried out by microfinance institutions, with little or no publicity around them. Their operations are not explicitly captured in official statistics and their activities are hardly reported on by the mass media. Yet their transactions impact directly on a large section of the population, especially the poor.

The activities of the MFIs have expanded phenomenally in the last ten years, in terms of size, branch expansion, staffing, volume and value of both credit and savings. The driving force is the desire to extend financial services and improve the living conditions of the poor.
Savings were not seen as an integral part of micro finance in the earlier years, as the main sources of funding were personal savings, and grants from international organizations. However, the problems of financial sustainability, given the waning interest of donors, have induced the operators to encourage savings with them; thus, the value of savings increased twenty fold (CBN 2001).
In all therefore, microfinance institutions' activities were said to have expanded significantly in terms of their asset base, branches and employees, number of borrowers and outstanding loans; and number of savers and the value of savings. The rising volumes of financial transactions indicate that the low income group and indeed the poor are bankable. All they need is access and convenience which the banks denied them, but have been provided by the MFIs. Also the rising volume of transactions done by the MFIs can no longer be ignored by the monetary authorities. There is need to regulate their activities and capture them directly in the official financial statistics.

The willingness of the low income group to borrow and repay at seemingly high interest rates confirm the view that the financial problem of the poor has to do more with access to capital and not high interest rates. Interest rates in the microfinance institutions are much higher than the prevailing rates in the banks, reflecting perhaps the greater risk and higher operations cost which MFIs have to bear. Yet the poor, the low income group readily patronize them.

The savings rates in the MFI are therefore more attractive, hence their ability to mobilize lots of savings. However, reflecting the low income level of the clients, the average savings deposit size was small. Although bank lending rates are lower, the low income group does not have access to it as they cannot provide the required collaterals.
The available data indicate that the poor are bankable. Like interest rates the repayment rates were high, averaging over 80 per cent. The repayment is lower in the banking sector. It averaged 79 per cent in 2002 and much lower at 58.6 per cent during the distress period of 1990-95. The higher repayment rates in the microfinance sector were traceable to the collective responsibility of clients who are required to be in groups. Grouping of clients enhances the security of credits as they jointly assume responsibility for repayment. A defaulting member jeopardizes the chances of members of the group getting new loans, thus they put pressure on one another to ensure repayment for the collective good.

The MFIs are funded through a number of sources. Donations and grants from international organizations accounted for about 46.6 per cent of total funding sources in 2003. This was followed by mobilized savings 20.9 per cent and owners' capital 13.6 per cent. Unidentified sources and bank loans were at the rear with 7.0 and 1.9 per cent, respectively. The need for financial sustainability makes it necessary that funding from equity and savings sources as well as other sustainable avenues should increase substantially to reduce the high dependence on aids and grants which come mainly from abroad.

CBN BRIEFS

CBN BRIEFS

SERIES NO. 2004-5/10

RESEARCH & STATISTICS DEPARTMENT

THE PROPOSED FISCAL RESPONSIBILITY LAW

Introduction

The Nigerian government is undertaking several reforms to ensure improvement in the lives of the Nigerian people. One of such key areas that was well articulated in the NEEDS document is reforming Government. Although a lot of revenue accrued to government in the last three decades, fiscal priorities seemed to have been misplaced. In other words, fiscal resources were not channeled to the areas where they would have been of the most benefit to the Nigerian people.

The proposed Fiscal Responsibility law is expected to lead to increased level of transparency, accountability, better management and efficiency in the use of public resources.

The objective of this BRIEF is to enlighten the reader on the importance of the law and highlight the major issues covered in the proposed law.

Objectives of the Proposed Law

The major objectives of the proposed law are: improving inter-governmental fiscal coordination, promoting macroeconomic stability, ensuring transparency and strengthening accountability as well as providing an enabling environment for generating growth and reducing poverty.

Nigeria operates a federal system of government with federal, state and local governments having their various functions. Consequently each adopts fiscal policies without proper coordination and without properly weighing the effects on the overall economy. When the various tiers of government stop working at cross purposes, and resources are deployed efficiently then macroeconomic stability can be attained. One way of achieving this laudable goal is to adopt fiscal policy rules which have a way of exerting a useful restraining influence on those entrusted with the nation's economic management.

It should be noted that several countries have adopted similar legislation with beneficial effects on their economies. Some of the countries are Brazil, South Africa, India, New Zealand, and Canada. The United Kingdom has adopted a code for fiscal stability. The result has been an overall improvement in economic management.

MAJOR FEATURES OF THE BILL

Some of the key features of the bill are discussed below.

MEDIUM TERM STRATEGIC PLAN

The law stipulates that Budget must be conducted within a Medium Term Fiscal Framework (MTFF) that is, with more than one year in mind. This process is expected to efficiently reconcile needs with available resources and to give agencies a more consistent source of funding. In addition, it ensures allocation of money to priority projects. The law ensures that annual revenue and expenditure estimates are consistent with the Medium term strategic plan. It does this by specifying monetary, fiscal and real sector targets and by ensuring consistency of annual revenues and expenditures. It is intended to guide the FGN and the states in budget preparation.

MANAGEMENT OF REVENUE

The law provides for the effective collection and prompt remittance of all statutorily levied taxes as well as creation of new revenue bases

BORROWING

One of the major difficulties facing governments in Nigeria has been excessive and indiscriminate borrowing. The proposed fiscal responsibility law stipulates that new debts will be based on cost/ benefit analysis and proceeds directed to growth and development of the economy. It requires accountability in the utilization of borrowed monies and provides for the access of the public to information on public debt. Similar to the British code for fiscal stability, the money borrowed can be used only for capital expenditure and human capital development.

SAVING AND ASSET MANAGEMENT

The law stipulates that accounts be opened at the Central Bank of Nigeria for federal and state governments to cushion commodity price volatility. It states that excess revenue above a predetermined reference price will be saved in a separate account by each government. Drawing could only be accommodated when there is a fall in commodity price below the predetermined level for three consecutive months. It further provides that resources saved in the above stated accounts are to be prudently invested and managed by the CBN.

DUE PROCESS MECHANISM

In line with the principle of good governance, accountability and transparency in government business particularly in project implementation, the Government established procedures and criteria that must be fulfilled before public funds could be released to Ministries, Departments and Agencies for payment to contractors. These set of criteria, steps or conditions are generally referred to as "Due Process". Such criteria include: priority rating of the project, the potential benefits of the project and whether they can be quantified, technical feasibility, selection of contractors through open tendering, adequate costing of the project, cash flow forecast consistent with procurement plan, and confirmation of physical verification where large assets are to be acquired. This procedure has been instituted at the federal level and several states have adopted it.

COMPLIANCE AND ENFORCEMENT

A fiscal management council comprising representatives of the federal government, the six geo-political zones as well as the civil society and the private sector will oversee the monitoring, implementation and enforcement of the law. The Bill provides that any violations of the law will be investigated and forwarded to the Attorney-General for prosecution. The law also created offences and prescribed sentences.

Use a loose fiscal rule to stabilize expenditures and the budget position. Rely on a relatively tight fiscal policy stance supported by appropriate monetary policy to maintain macroeconomic stability.

A consistent implementation of the fiscal responsibility law when passed will bring harmony between fiscal and monetary policy.

It will minimize risk and fluctuations in government fiscal operations.

Use fiscal policy to support growth in agricultural and non-oil exports

Issues

- Need to implement a medium term fiscal framework and a fiscal policy rule which allow Nigeria to save for the future as well as insulate the budget from the volatility in oil prices in the near to medium term.
- Build a national consensus around a results-oriented allocation of fiscal resources centered on rapid economic growth
- Corruption has to be rooted out of the government at all levels and transparency should be the guiding principles for all fiscal operations.

CHALLENGES

There are a number of challenges facing the passage of the bill. These shall be briefly highlighted here. The first is that some states express the fear that the bill is an attempt by the Federal Government to create a unitary system of appropriation, expenditure, disbursement and control of public funds throughout the federation to be monitored by Federal agencies and officers. It is also stated that the bill limits the powers of the state houses of assembly to make laws for their respective states. It is contended that the provisions of the bill taken together have the overall effect of merging and centralizing governance.

A lot of efforts have been made to disabuse the minds of those who labour such fears. First, the safety of funds seved from excess revenue from oil or other minerals assured; especially when such funds are in separate accounts in the name of the various governments. Secondly, all the geopolitical zone will be represented on the fiscal management council. Finally, the stakeholders will continue to enjoy the protection of the worts.

PROSPECTUS

With the growing realization of the need for sustainable macro economic stability, and the important role which the proposed law will play in its attainment, there is hope that the bill will be enacted into law without undue delay. Indeed, with the passage of the bill the country will experience a break from the fiscal policy in the past that has been very procyclical which was neither good for macro-economic stability nor engendered confidence by the private sector in public sector management. The law will build a national consensus around a result oriented allocation of fiscal resources centred on rapid economic growth.

CBN BRIEFS
SERIES NO. 2004-5/11

RESEARCH & STATISTICS DEPARTMENT

MONETARY INTEGRATION IN WEST AFRICA

Economic integration has been of major interest to African leaders since the 1970s. This is because it was considered that it would accelerate Africa's long term development. Monetary integration is a sub-set of economic integration and it refers to monetary cooperation arrangements that may involve the establishment of a central monetary authority, a unified monetary policy and a single currency or an exchange rate mechanism by which all the national currencies of a group are made convertible into one another.

Monetary integration confers a number of advantages on the

cooperating countries. The standard function of money as a medium of exchange is more efficiently performed as the costs of conversion and forward cover under a flexible exchange rate system are eliminated, leading to a boost in trade, investment and growth. Secondly, monetary integration enhances allocative efficiency; it helps to conserve the foreign exchange reserves of the group. On the other hand, there are costs associated with monetary integration. These include loss of sovereignty in the pursuit of independent stabilization policies. The opportunity to apply monetary and exchange rate policies are severally constrained. The ability to use fiscal policy to influence domestic economic activity is also limited.

The main objective of this BRIEF is to shed some light on the topical issues of monetary integration. In addition, it will help to sensitize the public on the costs of and benefits of Nigeria's decision to join the West African Monetary Zone.

MONETARY INTEGRATION IN WEST AFRICA: A SHORT HISTORICAL PERSPECTIVE

The idea of monetary integration in West Africa started in 1975 with the establishment of the Economic Community of West African States (ECOWAS). An integral part of the effort was the introduction of a single currency in the sub-region for which the ECOWAS Monetary Cooperation Programme was adopted in 1987. Progress in this direction has been slow in spite of the introduction of ECOWAS Travellers Cheques. It has nevertheless neither succeeded in adopting an exchange rate mechanism for the national currencies nor introduced a single currency in the sub-region. It is important to recognise the existence of CFA, which was introduced during the colonial period in French speaking West African countries, which has greatly facilitated macroeconomic stability and growth in the francophone countries. The CFA was linked to the French Franc and was freely convertible into

French Franc. In that way the arrangement guaranteed the international convertibility of the currency. Of the 16 countries that signed the protocol to establish an economic and monetary union, eight (8) of them had established a monetary union, the Union Economique et Monetaire Quest Africaine (UEMOA). To resolve the subsisting problems, ECOWAS Heads of State during its 22nd Summit held in Lome in 1999, adopted a two-track approach to its monetary integration process. Following that decision, the Anglophone countries held a meeting in Bamako and agreed to establish the second West African Monetary Zone (WAMZ).

BENEFITS OF INTEGRATION

Several benefits accrue to countries that participate in monetary integration. The key benefits are discussed below: -

- The single currency will eliminate currency trafficking along border towns in the sub-region
- It will allow comparison of prices among countries, since all prices will be denominated in common units, thereby improving the efficiency of markets and boosting trade among participating countries
- The operation of a common central bank will enhance the credibility of financial policy as there will be greater discipline in the execution of monetary and fiscal policy.
- It will lower transaction costs of informal sector trades and the losses associated with currency fluctuations.

COSTS OF INTEGRATION

There are also some costs associated with monetary integration. The most prominent of the costs are the following: -

- Countries have to undertake tough policy adjustments to meet the convergence criteria:- Trends in inflation, foreign reserves/months of import cover, central bank financing of budget deficits and government budget/gdp ratio.
- Participants' loss of national sovereignty in the use of monetary instruments such as the exchange rate and interest rate.
- Susceptibility to different external shocks.

LINGERING PROBLEMS

There are a number of lingering problems that hamper successful monetary integration in the West African sub-region. Some of the most prominent are: the delay in signing protocols and amending the relevant laws as well as lack of awareness on the part of leaders and citizens about the potential benefits of integration. There is also the issue of the absence of genuine commitment on the part of the leaders.

It has been observed over the years that Presidents and Heads of Government of West African countries are usually quick in adopting regional initiatives but rather slow in ensuring that the necessary protocols are signed and that the relevant laws are amended to reflect the changes. In countries where democracy is in vogue, it shows the inability of the executive to carry along the law makers who have the responsibility of ratifying the protocols. This has often led to unnecessary delays. For example, Article 15 of the WACB statutes states that the member states shall ensure that the statutes of their national central banks and other relevant national legislations are compatible with the WAMZ Agreement. Thus, it is clear that in order to overcome delays in signing protocols of agreement and amending old laws and regulations there is a need for the executive to hold regular sessions with the legislature about the initiatives it is taking and decisions reached at regional bodies. Undoubtedly, that will hasten the process of implementation.

Another problem identified is the need to sensitize the people of the sub-region to the benefits derivable from monetary integration in order to drum up support for the exercise. This is important because in the final analysis it is the people who will carry on the trade, exchange payments and move from one place to another in actualizing the protocols of agreement. Therefore, sensitization of the people cannot be over-emphasized. Yet another problem has been the inability of the member countries to meet the agreed macroeconomic targets. These macroeconomic indicators described as the convergence criteria are divided into the primary and the secondary criteria. The former refers to the major indicators that all member states are expected to achieve within a given time framework. These are: the achievement of a single digit inflation by 2000 and the 5.0 per cent or les by 2003; reduction of the budget deficit/GDP ratio excluding grants on commitment basis to 5 per cent or less by end 2000 4.0 per cent by end-2003; curtailing central bank financing of government deficit to 10 per cent or less of the previous year's tax revenues; and gross official reserves should cover at least 3 months imports by end 2000 and 6 months import by end 2003. The reserve adequacy for the latter period as reduced to 3 months. The secondary criteria are as follows:

- Prohibition of new domestic arrears and liquidation of all existing arrears;
- Tax revenue to be more than 20 per cent of GDP;
- Wage bill to be less than 35 per cent of total tax revenue;
- Public investment to be more than 20 per cent of tax revenue;
- Maintenance of real exchange rate stability in the context of an exchange rate mechanism; and
- Maintenance of positive real interest rate.

Member countries are expected to meet these criteria in order to ensure stable macroeconomic conditions necessary for economic and monetary integration. However, the performance of the countries in relation to these expectations have been less than satisfactory as several of them have fallen short of the compliance levels by wide margins. Indeed none has met the criteria on a consistent basis.

Finally, there is need for the leaders to demonstrate genuine commitment to the course of monetary integration by setting up the required institutions, by funding them through prompt payment of their contributions and regular monitoring of the activities of the various institutions set up to actualize the dream of monetary integration. The extent to which these countries work to meet the convergence criteria will show the extent of their commitment to common economic objectives and the monetary union.

THE PROSPECTS

The prospects of realizing the objectives of monetary integration are bright. This hope derives from the efforts made so far by the leading countries. Several of them have set up in their home countries facilitating institutions and procedures such as the Ministry of Integration and the elimination of the necessity to ratify decisions and protocols agreed to at their summits. In Nigeria, the Government has set up a Ministry of Integration and Cooperation. In addition, regional institutions that will foster the integration process have also been set up. For instance, the West African Monetary Institute, which is the forerunner of the West African Central Bank, has been discharging its mandate in four critical areas:

- Monitoring the macroeconomic performance and movement towards macroeconomic convergence of member countries.
- Fostering the harmonization of laws of financial institutions in various member countries with those of the statutes and agreement of the West African Monetary Zone.
- Sensitizing of the stakeholders of the common currency
- Addressing technical issues that will pave the way for an effective currency union, including the design of: a common monetary policy, an exchange rate mechanism, a foreign exchange management system and the structure of the West African Central Bank.

Undoubtedly, integration offers many opportunities for prosperity. The challenges are also daunting. The key challenges are in the areas of fiscal sustainability, external sector viability, especially ability to withstand external shocks given that most of the countries depend on primary products and minerals. The degree of financial sector integration and payments system, the conduct of banking supervision and regulation, deposit insurance schemes, harmonization of mercantile and labour laws as well as the harmonization of statistical procedures. It will be recalled that the inability of most of the \countries to satisfy the convergence criteria and the inadequate sensitization of the major stakeholders led to the postponement of the take off of the adoption of a common currency, the ECO. WAMZ was not able to take off effectively on July 1 2005 as earlier envisaged.

The failure of the countries to meet the convergence criteria and other pre-condition for a sustainable monetary union led to the decision to commission a comprehensive evaluation of the process with a view to recommending a more realistic and credible time-table for the commencement of the second currency (ECO).

All things considered monetary integration is desirable and with deep commitment, the objectives of integration will be realised, especially as several of the countries are working assiduously to meet the convergence criteria.