ELEMENTS OF BANKING

BY

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THE BUSINESS OF BANKING

- The term bank is derived from the Italian word bancho (Meaning bench) as the Jews in Italy kept benches in the market-place, where they exchanged money and bills.
- When a banker failed, his bench is broken by the populace; and we derive the term bankrupt from this circumstance.

The Concept of Banking

- Bank, means different things to different people in different economies. In order to reconcile the divergent views on the meaning and characteristics of banks, the banking laws in each economy provides operational definition and functional classification which governs banking practices in the economy.

- To many people, a bank refers to an institution which accepts deposits from the public and in turn advances loans by creating credit. It is different from other financial institutions in that they cannot create credit though they may be accepting deposits and making advances

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- However, a bank has been defined broadly as any financial institution that accepts, collects, transfers, pays, exchanges, lends, invests, or safe- guard money for its customers. This broader definition includes many other financial institutions that are not usually thought of as banks but which nevertheless provide one or more of these broadly defined banking services

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- Summarizing these definitions a bank is simply an institution which accepts deposits from the public and in turns advances loans by creating credit.

Bank and Banking Business

- Banking business is defined in Nigeria Banking Act 1969 as "the business of receiving money from outside sources as deposits irrespective of the payment of interest and the granting of money loans and acceptance of credits or the purchases of bills and cheques or the purchases and sales of securities for account of other or the incurring of obligations to acquire claims in respect of loans prior to their maturity or the assumption of guarantees and other warrantees for others or the effecting of transfer and bearing such other transaction as the minister may on the recommendation of the Central Bank by order published in the Federal Gazette designated as banking business".

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- However, in section 61 of Banks and other Financial Institutions Act (BOFIA) 1991, banking business means “the business of receiving deposits on current account, saving account or other similar account, paying or collecting cheque, drawn by or paid in by customer, provision of financial or such other business as the Governor may, by order published in the Gazette, designate as banking business”.

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- Under the Nigerian universal banking system, banking business was redefined as the ‘business of receiving deposits on current, savings and other accounts, paying or collecting cheque drawn or paid in by customers, provision of finance, consultancy and advisory services relating to corporate and investment matters, making or managing investment on behalf of any person and the provision of insurance marketing services and capital market business or such other services as the Governor of the Central Bank of Nigeria may be gazette, designate as banking business”.

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- Where there is a bank, there would be bankers. According to Heber, a banker “is a person or company carrying on the business of receiving monies and collection of drafts for customers subject to the obligation of honouring chequess drawn upon them by customers to the extent of the amount available on their account. A banker, therefore, can be summarized to mean a person or company carrying on banking business. The banking business includes Commercial banks, Merchant banks, Microfinance banks e.t.c.

HISTORICAL DEVELOPMENT OF BANK

- The historical development of Banking in Nigeria is linked with the increase in the intensity of international trade between Nigeria and Britain.
- This was because Nigeria had a major trade relationship with a country which as her colonial master.
- Banking in Nigeria started in 1892 with the establishment of a branch of African Banking Corporation in Lagos.

- The main function of the bank was that of importing and distributing silver coins from Royal Mint and implicitly regulating their circulation.

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- In 1893, barely a year from its establishment, the African Banking Corporation (ABC) was folded up and its interests therein transferred to Elder Demptster and Company.
- *The* vacuum in banking activities left by African Banking Corporation was filled in 1894 when an office of the British Bank for West Africa (now First Bank) was established in Lagos.

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- The functions of BBWA were the same as the defunct African Banking Corporation but it recorded greater successes than its predecessor.
- The bank helped a lot in providing the needed banking services to both the colonial government and the agricultural producers, who were the major exporters

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- The establishment of this bank also helped in sending to Nigeria the wealth of experience in banking operations which was already in an advanced stage in Britain and the same time improve the conditions then inherent in the economy for a take-off of a near complete monetary type of economy.
- Another commercial bank of British origin was established in 1925. The Barclays Bank D.C.O. (Dominic, Colonial and Overseas) as it was then called her helped in developing the banking base of the economy

CONT’

- The first indigenous bank to be established as an attempt to bring indigenous businessmen into the helm of economic activities in Nigeria was the Industrial and Continental Bank (ICB) established in 1929.
- The bank however failed in 1930 because of inadequate capital base, poor management and stiff competition with the well- established and experienced expatriate banks and trading corporations which diversified into financing business.

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- In 1930, a group of other enterprising Nigerians founded the Mercantile Bank which went into liquidation in 1936 barely five years front its establishment because of the same factors that caused the failure of the first indigenous bank.
- In 1933, a third indigenous bank was established by name the National Bank of Nigeria.

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- In 1945 and 1947, the Agbonmagbe (now Wema Bank) and the African Continental Bank were established, respectively.

CENTRAL BANK OF NIGERIA

- A Central Bank is a state (national) bank established to keep a country's financial system under control and close supervision.
- It is the apex institution of all financial institutions in the country.
- It is normally a government bank but not managed by government

GENESIS OF THE CENTRAL BANK OF NIGERIA

- The establishment of the West African Currency Board (WACB) provided the base for a monetary type of economy in Nigeria. Its powers were however limited, it was completely devoid of powers to control the quantity of money within its area of control. The inability of the Board to control the supply of money created the need for establishing a Central Bank in Nigeria

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- In spite of the clear need for a Central, Bank, propositions and reports for the establishment of such a bank in Nigeria met with a not so straight forward by the opposition by the colonial authorities and half-hearted study reports by the Initial persons or persons (independent or appointed), that studied the possibilities and advantages of establishing such an institution in Nigeria

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- The Form of such reports in favour of the establishment of a Central Bank in Nigeria came from Dr. Mar during the Second World War. Dr. Mar however, concluded that establishing a Central Bank in Nigeria presupposed the presence of a stock exchange market which was not in existence. The motion moved by Chief (Dr.) Mbadiwe K.O. on April 9, 1952 at the House of Representatives gave a kick-start effect signifying the actual need for Nigerian owned Central Bank. From 1951 to 1955, there were three other reports namely:
- Newlyn and Rowan report;
- Fisher report and
- IBRD report;

CONT'

- All these reports covered the possibility of establishing a Central Bank in Nigeria.

FUNCTIONS OF THE CENTRAL BANK OF NIGERIA (CBN).

CBN Ordinance of 1958 subsequent amendments based the functions of the CBN as follows:

- Issuance of legal tender currency notes and coins in Nigeria.
- Maintenance of Nigeria's external reserves to safeguard the international value of the nation's currency.

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- Promotion and maintenance of monetary stability and a sound and efficient financial system in Nigeria.
- It acts as banker and financial adviser to the Federal Government of Nigeria.
- Acting as a banker and lender of last resort to banks .
- Acting as the apex regulator and supervisor of all financial activities in Nigeria.

CBN REGULATORY, SUPERVISORY AND MONETARY FUNCTIONS

- The BOFI Act of 1991 grants extensive powers to CBN for supervising, examining and controlling the activities of banks, ensuring their adequate liquidity as well as offsetting their debts for firmness or safety of the banks.
- These powers are additional to those granted to it in the Central Bank of Nigeria Act No. 24 of 1991, and the latest review in 2007.

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- The supervision and control of banks are achieved through the examination (periodic and special) of bank books and the annual release of credit policy guidelines to the banks.
- The instruments of autonomy to enable the CBN conduct monetary policy to ensure macroeconomic stability, which is a sine-qua-non for sustainable growth

CONT’

- Monetary policy is an economic policy used in the adjustment, control, stabilization and management of money supply in an economy.
- In the process of influencing the money supply by the monetary authority, inflation is also controlled.

OBJECTIVES OF MONETARY POLICY

- Stability of exchange rate.
- Ensure minimal rate of inflation
- Promotion of economic growth
- Maintenance of balance of payment equilibrium
- Full employment.
- Redistribution of income from the rich to the poor

INSTRUMENTS OF MONETARY POLICY

- Open market operation
- Cash ratio or reserve requirement
- Bank rate or discount rate.
- Special deposit.
- Moral suasion
- Liquidity ratio.

PROHIBITED ACTIVITIES OF CBN

- Granting loans upon the security of any shares.
- Granting of unsecured advances, except to the Federal Government in respect of temporary deficiency arising from budget revenue
- Engaging in trade or having a direct interest in any commercial, industrial, agricultural or any other undertaking except the interest is acquired to satisfy the debts due to it, and it should be disposed of at the earliest opportunity
- Purchasing share of any bank, corporation or company.

THE NIGERIA BANKING STRUCTURE

- **Commercial banks**

The duties performed by commercial banks include among others:

- Maintenance of current account.
- Acting as agent for collection
- Honouring cheques drawn on the banks
- Safe keeping
- Periodic payment through customer’s standing order
- Financing of import and export trade (Opening of letter of credit)
- Acceptance of deposit
- Discount of bill of exchange.
- Granting of loans and advances
- Responding to status enquiries

Merchant banking

- According to BOFIA (1991), a merchant bank means “a bank whose business includes receiving deposits on deposit account, provision of finance, consultancy and advisory services relating to corporate and investment matter; making or managing investment on behalf of any person”.
- Merchant banks are wholesale banks that engage in the provision of specialized banking services that are tailored to the needs of each client

FUNCTIONS OF MERCHANT BANK

- **ACCEPTANCE OF DEPOSIT**
- Like the commercial banks, merchant banks also accept deposit from the public. However, the minimum deposit is larger than that of commercial banks.
- **GRANTING OF LOANS AND ADVANCES**
- Merchant banks provide loans to their customers in different forms including bridging loans and syndicated loans. The loans granted are either for short term, medium term or long term depending on the needs of the customer.

CONT’

- **EQUIMENT LEASING.**
- Section 61 of BOFIA (1991) define leasing to mean “the business of letting or sub-letting movable property on hire for the purpose of the use of such property by the hirer or any other person in any business whatsoever and where the lessor is the owner of the property regardless “

CONT’

- **UNDER WRITING AND BROKERAGE SERVICES**.
- Merchant banks act as issuing house for the issue of shares, bonds and debenture on the stock market and for private placement. In the course of issuing shares, etc., they at times underwrite some of the issues to a particular level. To underwrite means that they buy the shares of the company and re-sell the shares to interested members of the public at a later date.

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- **FACTORING**
- Factoring is a way of raising fund by selling a company’s accounts receivables (debtors) to a third party which may be a financial intermediary.
- **INVESTMENT AND FINANCIAL ADVISORY SERVICES**
- They provide advice to their customers on investment and financial issues like mergers, acquisitions, project financing, capital reconstruction, debt financing, privatization of government enterprises, issues of shares and stocks.

THE NIGERIAN MONEY MARKET

- **INTRODUCTION**
- The money market is one of the two markets in the financial market. This compliments the capital market in providing the needed channel through which the corporate entities and the government can raise funds to finance their operations.

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- While the capital market provides funds for long-term use by the government and corporate entities, the money market provides the government and corporate entities funds for short-term use in their operations.
- Therefore, the money market plays vital role in the economy in relation to its operations which channel funds from the savers to the users of such funds on short-term basis.

DEFINITION OF MONEY MARKET

- The money market is a component of the financial market for assets being used for short-term borrowing of funds by corporate entities and government.
- This implies that the money market is used for buying and selling of financial instruments with original maturities within a period of one year.

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- Money market provides liquidity funding for both corporate entities and government.
- Such financial instruments being used in the money market include Treasury bills, Treasury certificates, Commercial papers, and Bankers’ acceptances, Certificates of deposits, Bills of exchange, Repurchase agreements, Federal funds, Short-lived mortgages, and Asset-backed securities.

OPERATIONS OF MONEY MARKET

- In terms of its operations, the money market consists of financial institutions and dealers in money or credit facilities who wish to either borrow or lend.
- The operations in money market generally involve trades in short-term financial instruments which are commonly called "paper."

CONT’

- The core of the operations of the money market is in the area of interbank lending.
- The commercial banks normally borrow and lend to each other using commercial papers, repurchase agreements and similar financial instruments.
- In countries like the United States, federal, state and local governments do all issue paper to meet their funding needs

CONT’

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

PARTICIPANTS IN MONEY MARKET

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

MONEY MARKET INSTRUMENTS

- In general terms, the various financial instruments being used for transactions in the money market are identified and discussed below:
- **Certificate of deposit**
- This is for time deposit, commonly offered to consumers by banks, thrift institutions, and credit unions.
- **Repurchase agreements**
- These are short-term loans, normally for less than two weeks and frequently for one day, arranged by selling securities to an investor with an agreement to repurchase them at a fixed price on a fixed date.
- **Commercial papers**
- These are short-term issues such as promissory notes issued by company at discount to face value and redeemed at face value.

CONT’

- **Treasury bills**
- They are short-term debt obligations of a national government that are issued to mature in three months.
- **Treasury certificates**
- They are short-term debt obligations of a national government that are issued to mature in three to twelve months.
- **Money funds**
- These are the pooled short maturity, high quality investments which buy money market securities on behalf of retail or institutional investors.

FUNCTIONS OF MONEY MARKET

- There are pertinent functions that the money market performs in any economy, among which are the following:
- Transfer of funds within the economy for short-term use.
- The market facilitates operations of the financial system.
- Facilitates transactions between parties with surplus funds and parties with a deficit.

CONT

- Helps the corporate entities to raise funds with which to enhance their working capital.
- Provides facilities for discounting of financial instruments.
- Allows corporate entities to hedge against failure in meeting requirements of their operational activities.
- Allow governments to raise funds to meet current expenditure in their operations.

CONT’

- Allow governments to raise funds to meet current expenditure in their operations.
- Helps the government in implementing monetary policy through the open market operations.
- Operations in the money market help determine short-term interest rates in the economy.
- Enhances the growth and development of the economy.

SAVINGS- INVESTMENT PROCESS

- The savings-investment process involves the direct or indirect transfer of individual savings to business firms in exchange for their securities. ,
- A broader view of the savings-investment process would include the exchange of pooled individual savings for financial claims in the form of mortgage and other loans to individuals wanting to buy houses or make other purchase and hold debt securities issued by governmental units.

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- **Savings** is the part of personal income that is neither consumed nor paid out in taxes.
- The income saved is channeled to business firms in two different ways:
- Households buy bonds and securities issued by business firms, and the firms then use the money to buy investment goods
- Households deposit savings into banks. The banks then lend the money to the firms, which use it to buy investment goods.

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- **Investment** is the portion of final products that adds to the nation’s stock of income yielding physical assets or that replaces old, worn-out physical assets.
- The Final goods that business firm keep for themselves are called private investment or private capital formation

CONT'

- Private investment consists of inventory investment and fixed investments.
- **Inventory investment** means goods purchased by the business firms but not resold to consumers in the current period, but stays in the stock, to raise the level of inventories. **Fixed investment** includes all final goods purchased by business firms other than addition to inventory

CONT’

- It includes all final goods purchased by business firms that are not intended for resale.
- The main types of fixed investment (investment on capital goods) are structures (factories, office building, plants and machinery).
- When income increases, savings increase, when savings increase investment also increases. Savings and investment although do not increase proportionately.

CONT'

- Therefore, more savings means more investment, which implies increase in production, which leads to more demand for factor inputs, which results in more income, which implies more demand; that leads to more investment, leading to rapid economic growth, this again leads to increased savings, and the whole process is cyclical.
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CONT’

- **Capital formation** means increasing the stock of real capital in a country.
- In other words, capital formation involves making of more capital goods such as machines, tools, factories, transport equipment, materials, electricity, etc., which are all used for future production of goods.
- For making additions to the stock of Capital, saving and investment are essential.

Process of Capital Formation:

- In order to accumulate capital goods some current consumption has to be sacrificed.
- The greater the extent to which the people are willing to abstain from present consumption, the greater the extent that society will devote resources to new capital formation.

CONT'

- If society consumes all that it produces and saves nothing, future productive capacity of the economy will fall as the present capital equipment wears out.
- In other words, if whole of the current productive activity is used to produce consumer goods and no new capital goods are made, production of consumer goods in the future will greatly decline

Three Stages in Capital Formation:

- **Creation of Savings**:
- An increase in the volume of real savings so that resources, that would have been devoted to the production of consumption goods, should be released for purposes of capital formation. **Mobilization of Savings**:
- A finance and credit mechanism, so that the available resources are obtained by private investors or government for capital formation.
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CONT’

- **Investment of Savings:**
- The act of investment itself so that resources are actually used for the production of capital goods

The Role of Financial Institutions in the Savings-Investment Process

- Banking and Finance systems constitute the most effective means in the industrialization process.
- The volume of financial resources available and the conditions under which domestic savings might be most readily drawn into productive use are important in determining priorities in industrial development

CONT'

- Financial Intermediaries might have to play some additional non-orthodox role in developing role in developing countries by way of contributing to these countries' economic development.
- In many countries, financial institutions are increasingly utilized to mobilize and channel available domestic resources to economic sectors considered essential for growth.

CONT’

- Depending on the success of their intermediation function, financial institutions could promote increased “realized” and “financial” savings and aggregate savings in general.

CONT'

The major reasons why the development of appropriate financial institutions would bring about an increase in the volume of realized savings as follows:

- Greater opportunity to save via the introduction of new assets that are more attractive than those previously available.
- Enhanced yield of the available variety of financial assets

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- The direct institutional effect, whereby the existence of financial institutions promote higher marginal propensities to save.

BANK’S BALANCE SHEET ANALYSIS

- **ASSET: USE OF FUNDS**
- Nigerian banks attempt to place emphasis on liquidity by listing the more liquids assets first so that customers can see that they hold sufficient cash and other assets to meet depositors’ demands.

Cash and Short –term funds

- **Cash**
- This is the amount of notes and coins held in the strong room of all branches of the bank and in the Head Office to meet customers' demand for cash withdrawals.
- Banks know from their experience what amount to keep in their strong rooms as cash.

CONT'

- **Short term Funds**
- This refers to items in course of collection within Nigeria as well as balances with banks abroad.
- These assets represent the claim that the bank has on other banks for items in course of collection.

CONT'

- **Government Securities**
- These include Treasury bills, Treasury Certificates and Development Stocks and Bonds. Treasury Bills and Treasury Certificates provide a safe short term investment avenue for the surplus funds of banks
- They are issued by the CBN weekly for 90-91 days but they are very liquid as they can be rediscounted with the CBN before their maturity date.

CONT’

- **Statutory and other Deposits**
- These include balances on current account with Central Bank which do not attract interest, Cash Reserve Deposits, Special Deposits and Letter of Credit Deposits e.t.c.

CONT’

- **Investment with other banks**
- These include investment in Call Money, Fixed Deposits and Negotiable Certificates of Deposit with other Banks.
- **Loans and Advances**

This is by far the largest asset on the balance Sheet of many banks. All loans and advances are technically repayable on demand except for term loans. In practice is not the case.

CONT’

- **Other Assets**
- Items under other assets include Prepayments, Accrued Interest Receivable, Suspense Resources and Uncapitalised Expenditure

CONT

- **Fixed Assets**
- This represents the bank investment in buildings (premises), equipment and furniture e.t.c. The amount is usually the depreciated value of bank buildings, furniture fixtures and all equipment and machinery acquired for the bank’s operations.

LIABILITIES: SOURCES OF FUNDS

- **Share Capital**
- The issued and paid-up capital is represented by the shares held by individuals, institutional investors and governments
- **Statutory Reserves**
- Every bank in Nigeria is required by law to

Maintain a reserve fund, and shall out of its profits each year and before any dividend is declared

CONT'

- **Profit, Share Premium Account and General Reserve**
- These are the profits earned over the year which have not been distributed. Part of the balance on these accounts may eventually be capitalized or used for the purpose it was set aside for. It can also be called Revenue Reserve.

CONT’

- A bank may have Capital Reserve on its Balance Sheet as a result of revaluation of fixed assets, especially branch premises purchased and revalued at higher than purchase price at future date.
- The excess is placed on a Share Premium Account. The important difference between Capital Reserve and Revenue Reserve is that the latter can be distributed to the shareholders as dividend while the later cannot be distributed.

CONT'

- **Debenture Stock and Loan Capital**
- These are medium term loans to a bank at a fixed rate of interest and repayable over a fixed period of time to finance certain capital projects of a bank.
- **Customers' Deposits**
- As loans form the largest asset of a bank, customer' deposits are the largest liability on a bank's balance sheet. The depositors are creditors of the bank whose money, or part of it, must be repaid on demand or notice in accordance with the agreement.

CONT’

- **Other liabilities**
- These include provision for taxation due to the Board of Inland Revenue and provision for dividend. They also include cash security for Letters of Credit, collection deposits and remittance deposits