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The need for discount houses in Nigeria.

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THE NEED FOR DISCOUNT HOUSES IN NIGERIA

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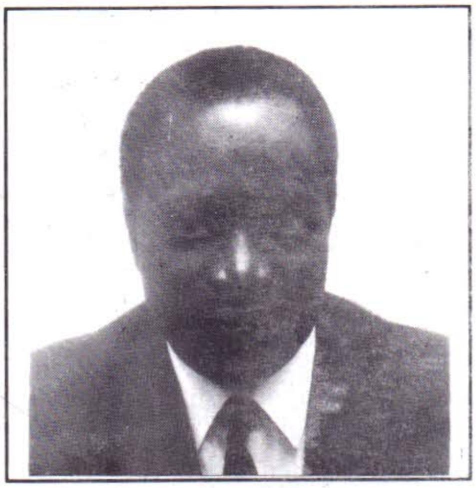
I feel delighted and highly honoured to be invited by the Money Market Association of Nigeria to present a paper at this workshop. Although I was scheduled to speak on :The Theoretical Basis and Antecedents for the Establishment of Discount Houses" I have decided to talk on "The Rationale for, and the antecedents to, the proposed establishment of discount houses in Nigeria". This is because I think that the latter topic would address the issues on the establishment of discount houses more poignantly than the former. As economic agents in the financial market, you would recognize that the establishment of discount houses is one of the most potent means of strengthening the Nigerian financial system. Consequently, the organizers of this technical workshop have struck the right note in their decision to provide this forum.

The efforts to deregulate all sectors of the Nigerian economy through the Structural Adjustment Programme (SAP) introduced in 1986 have considerably influenced developments in the financial sector. In the sector, reforms have taken the forms of simplification of the format for sectoral credit allocation, deregulation of bank deposit and lending rates, introduction of an auction system for dealings in treasury instruments and liberalization of procedures for establishing new banks. The next logical step in the process of financial deregulation is one under which the cost and availability of credit are determined through the financial markets. This step is often referred to as the indirect approach to monetary control as against the direct approach which involves the imposition of credit ceilings on banks by the monetary authorities.



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In its 1991 and 1992 Budget, the Federal Government indicated that the strategy of monetary management would shift to the use of indirect monetary policy instruments. However, government did recognize the existence of many problems which should be tackled before the introduction of the new approach. While attempts have been made to solve many of the problems, some of them such as inadequate institutional structure of the financial sector, are still outstanding.

The objective of this paper is to discuss the antecedents for the establishment of discount houses in Nigeria as well as their functions. In order to facilitate the presentation, the paper is divided into three parts. Part I highlights the role of discount houses and their functions. Part II discusses the rationale for establishing discount houses in Nigeria. The paper ends in Part III which contains a discussion on prospects of discount houses in Nigeria as well as a concluding remark.

PART I
THE ROLE OF DISCOUNT HOUSES

Discount houses are financial institutions which intermediate funds among banks. They invest in short-term securities especially treasury securities and other short-term financial instruments. Discount houses are expected to assist financial institutions to effectively manage their idle cash balances by bringing together surplus and deficit units in the money market.

In general, discount houses stand in between the Central bank and the licensed banks. This implies that banks in need of short term funds shall first exhaust the available facilities at the discount houses before having recourse to the central bank. It is needless to emphasize that discount houses do not accept deposit from non-bank institutions.

In countries where they exist, discount houses have played the role of primary dealers in treasury securities, and the provision of discount facilities to banks in need of funds. This implies that discount houses, with their large cash balances, perform the role of underwriting of issues of treasury securities. The conspicuous absence of institutions that could discharge this function in the Nigerian financial system represents a tremendous gap in our institutional arrangement.

In many countries, the provision

of primary finance for treasury securities i undertaken by a consortium of banks which may be formally established or simply arranged as occasion demands. For example, in Singapore a standing consortium of 7 licensed banks finance the primary issues of treasury securities following the winding up of the discount houses in the country in 1987. In Malaysia, government securities are underwritten by 23 principal dealers, comprising 9 commercial banks, 7 merchant banks and 7 discount houses. The United States of America has no discount houses and yet adequate finance for government securities is provided through the money market. The United Kingdom, however, has a number of discount and finance houses licensed to handle the financing of the issues of government securities. It should, however, be stressed that in these countries, unlike in Nigeria, there is a well developed secondary market in treasury securities so that the primary dealers themselves are always relieved of the financial burden of temporary inappropriate portfolio holdings of the securities.

PART II
THE RATIONALE FOR ESTABLISHING DISCOUNT HOUSES IN NIGERIA

Currently, as provided in the Central Bank of Nigeria (CBN) Decree, the function of underwriting of issues of treasury securities is under-taken by the CBN[1]. The performance of this function has always increased the difficulty inherent in monetary management as the amount of treasury securities usually taken up by the Bank is very large, producing an unduly large amount of Bank's credit to government. This has made the control of the net domestic assets of the Bank problematic. The full impact of the excessive CBN credit to government on money supply is realized when government draws on the proceeds of the issues of treasury securities to finance its operations. The private economic agents which are being paid for the services rendered will deposit their earnings in their accounts in their respective banks, thereby providing additional sources of credit creation to the banks. The larger the CBN's financial accommodation of government the greater the amount of high powered money available to government to inject into the economy and also, the more volatile is money supply.

Fortunately, as a safeguard, the Central Bank of Nigeria Decree provides that the CBN could delegate the function of underwriting the issues of treasury securities to an agent.[2]

Consequently, the CBN has issued guidelines to enable banks and other financial institutions to establish discount houses which could act as private agents for underwriting government securities. Thus, apart from the intermediatory role to be provided to banks as already highlighted, the establishment of discount houses in Nigeria will not only facilitate the solution of the debt management problem of the Federal Government, it will also assist in minimizing the incidence of monetary instability in the economy.

The need to establish discount houses in Nigeria is further buttressed by the behaviour of banks with respect to their holdings of government securities. Available data on holdings of treasury bills and certificates indicate that Nigerian banks do not respond adequately to the issues of treasury instruments inspite of the safety of the securities. The proportion of new issues of treasury bills taken up by banks has been so low that they cannot be counted upon to provide the primary finance for underwriting treasury securities. Also, trading in the securities on the secondary market is so limited that one could regard the secondary market in the securities as non-existent. The aversion of banks to the holding of treasury securities has resulted in a disproportionately large holding of the securities by the CBN. It is therefore hoped that the establishment of discount houses in Nigeria will not only relieve the CBN of the debt management problem but will also lead to the development of an active secondary market in the securities. Another major reason for the establishment of discount houses in Nigeria is the need to provide adequate institutional environment for the shift in strategy of monetary control from the imposition of credit ceiling to the use of market based instruments. The monetary authorities have recognized the need to change the strategy of monetary policy from the direct imposition of credit ceilings on banks to the market based indirect approach to monetary control. Steps have been taken by the CBN to ensure a successful and

1. *Federal Government of Nigeria. Central Bank of Nigeria Decree 1991 section 34(1). Supplement to Official Gazette Extraordinary No. 26 Vol. 78, 12th June, 1992.*
2. *See Central Bank of Nigeria Decree Section 34(2).*

smooth shift to the new techniques. The Bank has conducted studies with a view to enhancing its implementation capacity for the indirect monetary and credit control. As a result of the insight gained, monetary policy has been structured to facilitate the shift in policy. Other changes include the introduction of the prudential guidelines for banking operation, the establishment of the Nigerian Deposit Insurance Corporation, the requirement of higher capital base for banks, the promulgation of CBN Decree (No. 24) and the Banks and Other Financial Institution Decree (No. 25) of 1991. The CBN has also issued guidelines for the operation of finance companies in Nigeria. Further steps taken to ensure a favourable environment for the introduction of the new technique include, the efforts made by the CBN to mop-up excess liquidity from the banking system through the issuance of stabilization securities since August 1990 and the identification of insolvent banks. Some insolvent banks have been identified through rigorous bank examinations. One of the banks has been recommended for restructuring, while remaining are for self-restructuring under the close supervision of the CBN. Under the indirect approach to monetary control the CBN, in a bid to achieve optimal level of money supply in the economy, will control the monetary base using money market instruments, reserve requirements and the discount rate alongside with liquidity management measures. The effectiveness of these instruments demands that any avenue that could lead to excessive creation of money should be avoided. The establishment of discount houses in Nigeria is therefore one of the steps proposed by the monetary authorities to strengthen the financial sector with a view to increasing efficiency in the use of the resources available to banks as well as equipping the sector for improved performance in the financing of treasury securities.

PART III
PROSPECTS OF DISCOUNT HOUSES IN NIGERIA AND CONCLUDING REMARKS

The prospects of growth of discount houses depends, inter alia, on growth of the economy, the structure of the assets in which they could invest as well as the ability of the operators to be innovative in the development of the secondary market in securities. An examination of the structure of assets approved in the guidelines for discount houses in Nigeria reveals that the discount houses when established have bright prospects.[3] According to the guidelines, discount houses can invest in short-term accommodation to banks, treasury bills, treasury certificates, and negotiable certificates of deposits. Other instruments in which they could invest include banker's acceptances, eligible commercial papers, eligible development stocks, eligible state bonds, promissory notes issued by State Governments and any other securities that may from time to time be approved by the CBN. Given the rapid expansion of the Nigerian economy and the growth in government activities it is clear that discount houses in Nigeria will not only have busy schedules but will also be lucrative. The current abundance of treasury securities in the Nigerian money market, the high prospects of new issues either to replace maturing ones or increase the amount already existing as well as the bulging needs to finance banks and state governments provide sufficiently guaranteed market for discount houses in Nigeria.

The above observation implies that the discount houses when established face bright prospects as the buoyant money market works in their favour. However, discount houses have to be cautious to ensure that they achieve the objectives for establishing them. One of these objectives is the promotion of secondary markets in government securities. They have to be highly innovative to ensure that the market in these securities is developed to the level that is comparable to that existing anywhere in the world. If they are cold and dormant, as it was in Singapore, only expecting the guaranteed income to flow in, other financial institutions may snatch their enviable privilege and force them out of business.

However, in the final analysis, how much success to expect from the activities of the Discount Houses would depend on the response of the larger financial system to the changed matrix of institutions in the system. Being the principal counterparties with which the Discount Houses would transact business, banks would need to so adjust their Treasury operations as to grasp fully the opportunity presented by the existence of the Discount Houses. There is perhaps no better forum to press home this message

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3 *See Guidelines to Discount Houses in Nigeria page 8*

tiveness, especially with regard to their activities in the securities market. Their functions were then assigned to appointed dealers willing to play the expected role of market makers in government securities. For the same reason, the discount houses in Malaysia have played less than satisfactory role as market makers. This has arisen principally because they have neither been able to raise adequate capital nor were they sufficiently competitive in the market for liquid funds. Consequently, their share of the market has been constrained largely to the restricted funds they could raise from the Central Bank. It need hardly be emphasised therefore, that growth prospects of discount houses in Nigeria hinge principally on the dynamism and innovativeness of the operators.

Thank you for your attention.

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than this gathering of bank Treasurers, who by their schedules would be the first point of contact between the Discount Houses and their banks.

By convening this workshop, your umbrella organization, the Money Market Association of Nigeria, has indicated that it is conscious of this prime responsibility now thrust on its members and is willing to brace up fully for it.

I wish to commend you for this worthy initiative and hope that this Workshop would succeed in securing for the new arrangement, the needed support and co-operation of all.

Thank you for your attention.