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## The Central Bank of Nigeria And The Payments System

by

Dr M. A. Uduebo, *nni*

### 1. Introduction

Let me begin by expressing my deep appreciation to the Director of Research of the Central Bank of Nigeria for the honour of inviting me to participate and present a paper to the Bank Executives at this seminar. It is my hope that the paper will make positive contributions to the attainment of the stated objective of the seminar.

I also wish to congratulate the Central Bank of Nigeria for the choice of the central theme of the seminar; namely, self-appraisal of the performance of the Bank against the background of the prevailing economic situation and the mounting public criticisms of the role of the Bank in the management of the Nigerian economy. I regard this as a bold and courageous initiative. Against this background of observed public criticisms and concern, the focus of the seminar could not have come at a better time. In this context, I consider the issue of the Bank and the payments system, the topic of this paper, as most appropriate and relevant.

As you all very well know, the payments system of any country is the mechanism for the settlement of business and personal transactions, thus providing a link between the real sector and the financial sector. The central bank and the commercial (clearing) banks are the main participants in the payments system.

In any modern economic society, the need for a functioning and efficient payments system is very obvious. Modern economies have developed or are developing multilateral payments systems in response to the sophistication in the development of economic activities, having developed beyond the stages of barter and bilateral systems of payments. This permits the settlement of financial obligations for economic operators no matter where such transactions are made. For the payments system to function efficiently, it is important that the financial system is properly developed and efficient, and other participants in the system support and promote its smooth and efficient functioning. In particular, the Central Bank must play a leading role by encouraging the introduction of appropriate payments instruments and formulating policies supportive of the efficient functioning of the payments system.

The rest of this paper, limited to the Nigerian payments system, is divided into four main parts. Part II outlines the payment instruments in Nigeria. Part III examines the role of the Central Bank of Nigeria in the payments system while an attempt is made in Part IV to proffer solution to the problems. Part V contains the summary and conclusions.

### 2. Instruments of the Payments System

The instruments of a payment system can be grouped into three broad categories: namely, currency or cash comprising bank notes and coins; paper-based (non-cash) instruments such as

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cheques, debit cards, credit cards and bank drafts; and paperless or electronic instruments such as automated teller machines. Other payments instruments are postal orders, money orders, vouchers and pre-paid cards.

### **Cash or Currency**

Cash or Currency is the legal tender bank notes and coins issued by a country - the Naira in Nigeria. In Nigeria, cash or currency is the most important acceptable payments instrument. Largely as a result of dwindling confidence in the financial system and payment by cheques, most people (except perhaps large-scale enterprises and the government) prefer payment in cash. The consequent high demand for cash has led to sharp increases in the volume of currency in circulation and currency outside banks. For example, the amount of currency in circulation increased nearly six-fold between 1990 and 1994, while in the same period currency outside banks increased by slightly more than six-fold. It is relevant to observe that in the same period, the expansion in national output was minimal, with the GDP annual growth rate of a mere 2.8 per cent from ₦90.4 billion in 1990 to 101.0 billion in 1994. Similarly, in the same period, the ratio of currency outside banks to total money supply (M1) was relatively high compared to what obtains in the developed and some other developing countries where, in contrast to the situation in Nigeria, the use of currency in making payments is inversely related to the stage of economic development in the country. The holding of large cash balances by most individuals and corporate bodies, has, however, proved beneficial to the economy by keeping economic activities going even during periods when banks close their doors to the public or are unable to meet customers' demand for cash.

Payment in cash has its own risks. These include the risks of being attacked by armed robbers resulting in loss of the money and/or life, and fear of accident; costs in terms of transportation and time if the payment has to be made in a distant place; and in respect of the beneficiary, the fear of being paid in counterfeited bank notes and coins. Similarly, the increasing demand for cash has additional cost implications for the currency issuing authority in terms of production, storage, handling, distribution, security and destruction. Besides, the large amount of currency outside banks, part of which could have been put in deposit accounts in the banks, implies reduction in the credit base of the banks.

### **Cheques and Paper-based Payment Instruments**

In Nigeria, the next most important instruments for payments, after cash, are cheques and paper-based instruments. They are not as dominant in the payments system as in the advanced countries. Of this category, cheques and drafts are most widely used for the settlement of contractual financial obligations mainly through bank clearing. Increased use of these instruments, hinges crucially on the growth and efficient functioning of the banking sector.

It is generally believed that the growth in the use of cheques and other paper-based instruments in Nigeria has not been commensurate with the openness of the economy. In contrast to the six-fold increase in currency outside banks and currency in circulation during the period (1990 to 1994), the number of cheques cleared through the nation's clearing house system increased by less than two-fold (1.5-fold), although the value of the total cheques cleared increased more than six-fold, implying that although the increase in the number of cheques was modest, the value of the cheques issued was relatively large. The slow growth of the use of cheques for the

settlement of financial obligations is not a healthy development for the payments system despite the fact that its advantages over payment by cash (suitability for distant/large payments, safety and documentary evidence of payments) are widely acknowledged. From experience, it would appear that the use of cheques as at now is mostly prevalent among the big private sector enterprises and the public sector encompassing the federal, state and local governments; government departments and agencies as well as parastatals. Even then, some public sector operators are known to make large cash withdrawals particularly from the Central Bank for cash payments. Outside the big private sector enterprises and the government sector, the use of cheques is not popular. The small and medium scale enterprises and individuals often refuse to accept cheques for payment and prefer cash instead. It may also be mentioned at this juncture that many people now also refuse to accept bank certified cheques, as confidence in the instrument has greatly diminished. This is not a healthy phenomena for the development of a healthy and viable payment system in the country.

The reasons for the limited use and acceptance of cheques are many and varied. They include high incidence of bounced cheques issued by private sector enterprises, including drafts by banks, and individuals; forgeries of cheques; fraud through the use of cheques; and the long-waiting period for cheques to be cleared for payment which until January this year, was 5, 12 and 21 working days for local, intra-state and inter-state cheques, respectively.

Another payment instrument in this category is credit card. It is widely used in the advanced countries for virtually all payments almost as a substitute for cash and cheque. Its acceptance hinges crucially on its guarantee for payment. However, although it has been introduced in Nigeria since 1993 by three credit card companies, its impact on the payments system has been minimal, given the relatively small number of card holders and the amount of credit facility made available to them. There are indications that the use of credit cards will expand in future, provided that the business environment in Nigeria improves and the problems currently encountered by the companies (late payments by clients and inadequate infrastructural facilities) are resolved.

### **Electronic Payment Instruments**

These are non-paper computer-based technology payment instruments comprising mainly automated teller machines, automated clearing houses, and point-of-sale systems. Of these, only the automated teller machine has been introduced in Nigeria by one commercial bank with only six outlets in Lagos and a limited function of cash withdrawal. The automated teller machine, which offers 24-hour service, generally offers a wide range of service including cash withdrawal, balance enquiry, movement of funds among accounts, deposits of cash or cheque, and settlement of financial obligations. The automated teller machines and other related instruments are popularly used in the advanced countries where they are available. Their wider introduction and use in Nigeria could contribute significantly to improvement of the payments system.

### **Other Payments Instruments**

Other payments instruments that could be mentioned are postal and money orders, vouchers and pre-paid cards. These usually do not originate in the banking system. Many years ago, when there were only few banks and their branches operating in Nigeria, the post office facility of postal and money orders played a prominent role, among others, in the transfer of money from one city to another and payment of examination fees. Today, their role in the payments system is

small and diminishing. Similarly, various types of vouchers (petrol and luncheon), which used to be popularly used, have declined in their importance.

Lastly, the pre-paid phone cards recently introduced by NITEL is expected to facilitate patronage of telephone service but its impact on the payments system is not expected to be significant.

### 3. The Responsibilities of the Central Bank in the Payment System

The Central Bank of any country has a central role to play in the development of the payments system by planning and co-ordinating the desirable payments system, that will ensure public confidence in the system, facilitate the smooth and effective performance of the banking system and promote sustainable economic development in the country.

A major responsibility of the Central Bank of Nigeria relating to the payments system is that the Bank has the sole right of issuing notes and coins which constitute the legal tender in Nigeria. As stated in Section 18 of the Central Bank of Nigeria Act, 1958:

*The Bank shall have the sole right of issuing notes and coins throughout Nigeria and neither the Federal Government nor any State Government nor any other person shall issue currency notes, bank notes or coins or any documents or tokens payable to bearer on demand being documents or token which are likely to pass as legal tender.*

Furthermore, as provided in Section 19 of the Act, the Bank is required to make the necessary arrangements for the printing of notes and minting of coins as well as issuing the notes and coins. Thus, the Bank ensures adequacy of legal tender notes and coins for payments. This was the first legal function carried out by the Bank to sustain the payments system.

From its inception also, the Central Bank of Nigeria was charged with the responsibility of ensuring a viable payments system. Section 29(s)(1) of the Bank Act provides as follows:

*The Bank may: promote the establishment of bank clearing systems and give facilities for the conduct of clearing business in premises belonging to the Bank.*

Also in Section 42 of the Act, it is provided that:

*It shall be the duty of the Bank to facilitate the clearing of cheques and other credit instruments for banks carrying on business in Nigeria. For this purpose the bank shall, at any appropriate time and in conjunction with the other banks, organize a clearing house in Lagos and in such other place or places as may be desirable in premises provided by the Bank.*

Consequently, after commencing operation in July 1959, the Central Bank of Nigeria in May 1961, established the first clearing house in Nigeria – the Lagos Clearing House. Thereafter, as

Central Bank branches were opened in the state capitals, clearing houses were opened in such branches. Today, there are twenty-one clearing houses in operation in State Capitals and the Federal Capital Territory, Abuja. Also, plans are on the way to establish more clearing houses in the newly created states in the Federation.

Over the years, the Bank monitored the developments in the economy generally and, in collaboration with the Bankers' Committee, made proposals and/or introduced measures to improve the payments system. In reaction to the high incidence of bounced cheques and in an effort to encourage the wider use and acceptability of cheques, the Federal Government, on the recommendations of the Bank, promulgated the Dishonoured Cheques (Offences) Decree No. 44 of 1977 and the Bankruptcy Act of 1979. Also related to the payments system because of its systemic ramifications, is the promulgation of the Failed Banks (Recovery of Debts) and Financial Malpractices in Banks Decree No. 18 of 1994. All these were aimed at sanitizing the banking system and restoring public confidence in the system.

Other notable improvements introduced or encouraged by the Bank are implementation of the Magnetic Ink Character Recognition (MICR) programme, computerization and automation of the banking system, and establishment of the Nigeria Interbank Settlement System.

The MICR programme introduced in January 1991 is expected to modernize the processing of cheques and other instruments. The programme is, however, running behind schedule. While the first and second phases have been completed (installation of MICR equipment by the CBN and commencement of MICR cheque processing; and adoption of similar MICR technology by the three big banks), implementation of the third phase (adoption of the MICR system by all other banks in the Lagos area) has been stalled due to shortage of MICR cheques. Phase four would extend the programme to all the states and Abuja while the final phase envisages the automation of the Lagos Clearing House. Considering the important contribution the MICR programme can make to improve the clearing system, greater efforts should be made to remove the bottle-necks in the programme implementation, especially supply of adequate MICR cheques and procurement of high-standard equipment.

The banks have also been encouraged to modernize their operations in other ways. In response, most banks have commenced automation and computerization of their services.

In further efforts to improve the functioning of the payments system, the Bankers' Committee established the Nigeria Inter-bank Settlement System Plc. in 1993. The company, which commenced operations in June 1994, is expected to complement the Central Bank's clearing and settlement procedures. Over time, it is expected to minimise bottlenecks and settlement delays as well as provide same day clearing and settlement of high value inter-bank transfers and payments.

In fairness to the Central Bank, it has put in great efforts to ensure an efficient payments system; but the efforts have not yielded commensurate results. Today, the payments system is less efficient than it was a decade ago.

#### **4. Proposals for Improving the Payments System**

It has been aptly indicated in the paper that the Nigerian payments system is inefficient, slow, unreliable and insecure. Although relatively adequate legal provisions, rules and regulations, and programmes have been put in place to improve the functioning of the payments system, there has not been appreciable improvements commensurate with such efforts or to match the stage of

development of the economy. It is considered that if the problems inherent in the two major payments instruments (currency and cheque, particularly the latter) are removed and the existing legal provisions, programmes, and rules and regulations are comprehensively reviewed and implemented, the payments system would improve appreciably. It is also important to lay a strong payments base before introducing new and sophisticated payments instruments into the system. Accordingly, the following proposals are proffered for improving the functioning of the payments system.

- (a) The Central Bank should take a greater responsibility in improving the functioning of the payments system through adequate supervision of banks, planning and co-ordination of all activities relating to the payments system. The seeming shift of its responsibilities in this regard to the Bankers' Committee is not advisable. This must not be construed to mean irrelevance of the Committee in the process. The Bank should be able to take decision on critical issues in the interest of the payments system, not minding which bank is affected. In this connection, it might be advisable for the Bank to establish within the Bank a permanent unit to plan and co-ordinate the development of the payments system.
- (b) Efforts must be made to minimise or eliminate counterfeiting of payments instruments particularly currency and cheques. The law relating to counterfeiting of payments instruments should be reviewed to stiffen the penalties and vigorously enforced to discourage the practice.
- (c) There is the urgent need to improve the wider use and acceptability of cheques by reducing or eliminating the high incidence of bounced cheques and other abuses associated with the use of cheques such as forgeries, theft, etc.
  - (i) First, all legal provisions aimed at encouraging and protecting the use of cheques must be enforced, stiffer penalties could be introduced where existing ones are considered inadequate, and persons who issue bounced cheques as a practice, in addition to other punishments such as fine and imprisonment, should be prevented from further use of cheques by having all their accounts in whatever bank closed.
  - (ii) Second, it should be made mandatory for all banks to compile a comprehensive list of such offenders and submit to the Central Bank for appropriate action.
  - (iii) Third, the recent reduction in the duration of cheque clearing from 5, 12, and 21 days for the clearing of local, intra-state and inter-state cheques, respectively, to 3, 5 and 15 days, respectively, is a step in the right direction. However, it is suggested that this is still too long and could be reduced further to 2, 4 and 10 days, respectively. But the most important thing is to ensure that the reduced clearing period is effectively implemented; at the moment, the *status quo* has been maintained in some clearing banks.
  - (iv) Fourth, certain organizations and institutions in the country should be encouraged to use cheques for payments, like the Federal, State and Local Governments, private sector enterprises, and individuals. At such a time it is determined that adequate trust and confidence has been restored in the use of cheques, a limit could be placed on the amount

of money withdrawable by cash.

- (d) It is important that the high dominance of currency in the payments system be gradually reduced. It is expected that this will be made possible if cheques become more widely used and payments through other instruments expand.
- (e) The clearing system needs to be further improved in several ways:
- (i) The physical environment of the Lagos Clearing House needs some attention to make it conducive for increased productivity. More importantly, it should be automated as quickly as possible.
  - (ii) As a matter of urgency, the Central Bank should institute a mechanism for the prompt settlement of clearing positions. At the moment, banks are allowed to accumulate huge sums in clearing positions, a practice that has helped to conceal the true state of financial stress in some of the banks. It is suggested that graduated minimum balances in relation to deposits or observed clearings be maintained by the clearing banks in the Central Bank.
- (f) The implementation of the MICR programme which is expected when fully completed to enhance the speed, scale and efficiency of the cheque processing system should be speeded up. The uncompleted phases of the programme should be properly rescheduled and completed; all bottle-necks in the implementation of the programme, such as inadequate supply of MICR cheques to the banks and inadequate MICR installed equipment should be removed. Given that the equipment have started to breakdown even before the programme has fully taken off, it is suggested that the issue of equipment be critically examined and a firm decision taken. As it does not appear that the equipment can stand the test of time, it is suggested that the equipment be discarded and replaced with a different and new type of equipment. It is also recommended that encoding of all MICR cheques be done by the NSPMC, as against the current practise of each bank encoding for itself.
- (g) Although the electronic funds transfer system of payment can make positive contribution to the Nigerian payments system, its introduction to the Nigerian banking system is not recommended at this point in time. To introduce it now would amount to overloading the payments system with payments instruments when most of the basics are not working efficiently. It is preferable to see the instruments so far introduced functioning efficiently before introducing new ones.

## 5. Summary and Conclusions

The paper examined the current state of the payments system and the role of the Central Bank in the process. It examined the various payments instruments particularly those used in Nigeria, including currency or cash, cheques and paper-based instruments, electronic payments instruments, as well as other payments instruments such as postal and money orders, vouchers and pre-paid cards. It noted that currency is the most acceptable payment instrument and the demand for it continues to grow as lack of trust and confidence continues to grow in



payment by cheque. It also pointed out that although currency ensures certainty for the value contracted, it entails risks of counterfeiting and loss to armed robbers as well as the disadvantage of bulkiness in making large payments. It also noted that payment by cheque is the next most important payment instrument. Unlike other countries, cheques are not readily accepted in Nigeria because of lack of trust and confidence in the instrument, long clearing period and other problems such as forgeries, theft and fraud. Other payments instruments have not made significant impact on the payments system.

The paper also examined the role of the Central Bank in the payment system and concluded that the Central Bank has a crucial role to play in planning and co-ordinating measures to promote the smooth and efficient functioning of the payments system. It also highlighted the major problems in the payments system, particularly those relating to the use of currency and cheques and made appropriate proposals for improving the system. The paper is of the view that if the problems surrounding the use of currency and cheques, particularly the latter, are removed, the payments system could function efficiently.

In conclusion, efforts to improve the smooth and efficient functioning of the payments system should be given urgent attention. In particular, the Central Bank should assume greater responsibility than hitherto in this direction as well as in another complementary area (bank supervision) that has important relevance for the functioning of the payments system. An efficient payments system coupled with effective bank supervision will, in turn, facilitate implementation of economic policies.

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