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## THE NEED FOR DISCOUNT HOUSES IN NIGERIA

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*The paper deals with the desirability of establishing discount houses in Nigeria and their potential to assist financial institutions manage their idle cash balances by bringing together surplus and deficit units in the market. It argues that the need arises not only because of the necessity to reduce the dominant role played by the Central Bank of Nigeria (CBN) in underwriting the issues of treasury securities, but also the attendant large credit usually made available to government by the CBN as a result. In addition, the paper stresses that the existence of discount houses will also induce banks to take up a larger proportion of treasury securities than they have done hitherto. Another major reason emphasized by the paper is the need to provide conducive financial environment as well as appropriate institutional structures for the shift from direct to indirect monetary control that has recently been tentatively put into operation. The paper concludes with the observation that discount houses face bright prospect in Nigeria especially with the array of instruments available to them in a rapidly expanding economy, provided that they ensure the existence of secondary market and generally be innovative towards the attainment of rapid growth and competitiveness.*

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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 could address the issues on the establishment of discount houses more poignantly than the former. Indeed, the establishment of discount houses might be 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 effort to deregulate all sectors of the Nigerian economy through the Structural Adjustment Programme (SAP) introduced in 1986 has considerably facilitated reforms in the financial sector. Such reforms include the 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

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the monetary authorities.

In its 1991 and 1992 Budgets, 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, while Part III contains a discussion on prospects of discount houses in Nigeria as well as 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, and 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 between the central bank and the licensed banks. This implies that banks in need of short term funds should 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 means 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 is 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 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 undertaken by the CBN.<sup>1</sup> The performance of this function has always tended to compound the difficulty inherent in monetary management, due to the large amount of treasury securities usually taken up by the CBN resulting in undue large 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 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 the more volatile the 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.<sup>2</sup> 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 intermediary 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 problems 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 in spite 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. Steps have been taken by the CBN to ensure a successful and 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 the others are to undertake self-restructuring under the close supervision of the CBN.

Under the indirect approach to monetary control the CBN, in order 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 liquidity management measures. The effectiveness of these instruments demands that any avenue that leads 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.<sup>3</sup> 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 also invest include banker's acceptance, 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 need 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, the discount houses will have to be cautious to ensure that they achieve the objectives for which they were established. One of these objectives is the promotion of secondary market in government securities. They have to be highly innovative to ensure that the market in these securities is developed to a level comparable to anywhere else 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 counter-parties 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 than a gathering of bank treasurers, who by their schedules might be expected to 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.

#### REFERENCES

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, 1991.
2. See Central Bank of Nigeria Decree Section 34(2).
3. See "Guidelines to Discount Houses in Nigeria," p. 8.