MANAGEMENT OF MONEY MARKET INSTRUMENTS IN THE NIGERIAN FINANCIAL SYSTEM - AN APPRAISAL

P.O. Olarnewaju

Abstract

The proper management of money market instruments is one of the salient features of a viable financial and monetary system, which helps to facilitate smooth banking and financial transactions. In Nigeria, as in other developing countries, management of money market instruments is inefficient/unreliable and insecure. This paper is an attempt to analyse the Nigeria financial system and contemporary problems associated with the management of money market instruments. The paper concludes by suggesting the need for financial planning and the need to be more creative in product development on financial service delivery. By and large, making the money market more efficient to meet the challenges of the post consolidation era.

Introduction

Money market can be regarded as the various marketing arrangement, which involve the packaging issuance, trading and redemption of low-risk, short-term obligations which prices vary only marginally. In other words, it includes the buying of short-term obligations by deficit spending units and the selling of liquid assets by surplus spending units. The distinction is made essentially in order to include only those instruments that serve the secondary reserve requirement of financial institutions and other investor's instruments that posses a high degree of liquidity and at the same time provide moderate yield.

The Central Bank of Nigeria can trace the origin of the Nigerian money market to the issue of the first batch of treasury bills in April 1960. it was borne out of the desire by government to bridge its budgetary gap arising from seasonal variation in the normal flow of recurrent revenue and expenditures. Prior to this time, most of the money market activities in Nigeria were conducted in major financial center of Western Europe. This according to Nwankwo (1980 :20),.resulted in net outflow of business community funds to overseas countries. Besides the business organizations, government had no adequate machinery with which to meet its short -term financial requirements and carry out monetary policy and controls. Thus, in early part of nationhood, effective mobilization of short-term funds and investments outlets were limited and rudimentary.

It was this dearth of short-term funds outlets that gave rise to the establishment of indigenous money market where short-term funds could be mobilized and invested at all levels in the Nigerian financial market. This market the introduction of treasury bills as the premier money market instruments in the nation's financial system. Other money market instruments and scheme were also developed subsequently.

The reason for the establishment of the Nigerian money market have been summarized by Nwankwo (1980: 123- 124);

As the Nigerianisation of credit base, meeting of governments short-term financial needs, provision of good basis for operating and monetary policy and major step on the part of independent nationhood.

These roles are currently being played by the Nigerian money market via the employment of treasury instruments by the participants.

Money Market Participants

Universal, Commercial and Merchant Bank: By far, the most important buyers and sellers of money market instruments are universal, commercial and merchant banks. This is because according to Kidwell and Peterson (1980: 27);

Banks are continuously in the process of liquid reserves adjustment on account of the short-term nature of their liabilities, wide variation in loan demand and legal reserve requirement imposed upon them by regulations.

In the period of boom when banks have to contend with excess credit demand, secondary reserves/securities are sold to provide liquid cash to enable them meet their obligation to their client. Such secondary reserves or securities include Negotiable certificates of deposit, treasury bills, bankers bills, bankers acceptance etc.

The Central Bank of Nigeria (CBN): While the commercial and merchant banks constitute the largest class of participants in the money market, the central bank is ultimately the most significant on account of its position as the manager of the nation's money supply and the major buyer of treasury bills. The CBN liquidity management transcends the entire economy as it is it's responsibility • to ensure proper functioning of the financial system.

In Nigeria, the CBN is empowered to influence money market activities. This, it does not. only via its rediscount window but also direct intervention in the banking system be altering the . statutory reserve requirements of banks

Finance Companies: though small in number, they however, play important role in the smooth and orderly of the Nigerian, money market. The primary economic function of these units is to make market for money market instruments by maintaining active position in debt instruments issued. They ' generally are more active in commercial papers market in Nigeria.

Corporations: Corporations like financial institutions are also faced with the problem of liquidity management. Apart from standby cash arrangement with banks, large corporations of strong credit ratings are also involved in the issue or purchase of commercial papers. In time of excess liquidity, existing co-operations retire short term debt instruments and in their place purchase certificates of deposits or hold deposits in array of consumer type passbook and time deposit accounts.

Money Market Instruments - Characteristic; Packaging and Applications

We shall now proceed to discuss the features, packaging and application of some selected treasury instruments traded in Nigeria money market. This is to access the relative risks and return associated with these instruments either as a potential buyer or seller.

Treasury Bills: These are mere IOUS issued by the Federal Government through the Central Bank of Nigeria. They represent short-term debt instruments employ by government to borrow money in order to bridge temporary deficit gaps. They constitute the largest single segment of the Nigerian Money market and provide the government an important outlet for temporary idle funds and source of borrowing. Periodically, invitations are made in the newspaper to investing public to subscribe to treasury bills in multiples of N1000 at a discount. Treasury bills are issued with maturities ranging from three -twelve months. Purchases of treasury bills are affected via banks and non-banks authorized dealers. Subscribers are debited with discounted sales prices while on maturity; they are credited with the full face value. Treasury bills have very low default risk. Repayment of full value is certain as they represent state obligations. Thus, they are easily marketable thereby rendering the holders liquid. For example, holders of treasury bills can discount them for cash at the Central Bank discount window in case of need. Above attractions of treasury bills notwithstanding, it usually has low patronage from the investing purchase owing to the low yield viz-a-viz returns on similar treasury instruments.

Consequently, a considerable percentage of the issued treasury bills are bought by CBN and commercial Bank with very low weighted average cost of funds. In terms of applications, treasury bills are also issued as instruments of sourcing for short-term credit by government in order to tide them over period of temporary budget deficits. Apart from being a major source of short-term funds for government to cover temporary exercises of stale expenditure over income receipts, treasury bills are also used as instruments of monetary policy by the Central Bank of Nigeria, particularly in the execution of open market operation to mop-up excess liquidity in the economy.

Treasury Certificate: this is a medium-term government security, which matures after a period of one or two years. They are intending to bridge the gap between treasury bills and long-term government securities. This instrument therefore, differs principally from overnight call money and treasury bills only on terms to maturity. Its first batch was issued in Lagos in 1968. like treasury bills, treasury certificate are eligible for retliscounting at the CBN rediscount windows. It attract higher

coupon than treasury bills, in terms of volume, treasury certificates rants second in money market trading. The major attractions in treasury bills and the fact that its acquisition by financial institutions diversifies their liquid assets holding.

Negotiable Certificates of Deposit (NCD): They were introduced into the Nigerian money market 1975 as interbank debt instruments. However, the idea of NCD according to kid well and Peterson (1981) is not really new.

Certificate of deposit in one form or the other has been used by Banks as early as 1890s to attract consumer and business deposits.

The intensity of its use because noticeable during the last three decades. There are two types: Negotiable Certificate of Deposits (NCD) and Non-negotiable certificate of deposit (NNCD). If negotiable such instrument can be traded or discounted with any financial intermediary for cash prior to maturity. Whereas NNCD can neither be discounted nor traded with third parties before maturity. Nowadays, NCD and NNCD have denominations of N 100,000 to N500,000 each with coupon slightly higher than those of treasury bills and treasury certificates. NCDs and NNCDS are usually issued (sold) by merchant banks and bought by commercial banks and insurance Companies in Nigeria. The sole rate of growth of this debt instrument is due to the near absence of secondary market where they can be traded.

Banks by regulations are required to obtain Central Bank of Nigeria.

Approval to issue NCDS and NNCDS. They usually have maturities ranging from one to twelve months. The interest paid on NCD and NNCD is negotiated between the issuing bank and the buyer. The underling factors, which determine CDS rates are current market conditions, rates paid by competing banks on their CDS, yield on other similar short-term instruments, and issue characteristics such as default risk and marketability.

Bankers Acceptance (BA's): This is time draft drawn on and accepted by a Merchant or Commercial Bank. When time drafts are 'accepted' a bank unconditionally promises to pay the holder the face amount of the draft at maturity, even if the bank encounters difficulty in collecting to Henning etal (1981: 114);

Is generally lower than interest rate on bank loans. As loan interest rise, acceptance proportionately for two reasons.

Finally, the fee charged on Bankers Acceptance are generally lower than that Associated with bank loans granted to companies of lower credit rating.

Commercial Paper: Bakare Remi (2000 :74), define commercial paper; as an unsecured, short term promissory note issued by blue chip companies mainly to finance receivables. It is usually issued at a discount reflecting prevailing market interest rates.

Commercial papers have become about the third most dominant money market instrument of trading in terms of volume in Nigeria. It generally has a profile of 90-365 days. The basic reason that firms issue commercial paper is to achieve interest rate savings as an alternatives to bank borrowing. Because commercial paper is an unsecured promissory note, the issue pledges no protect the investor on the event of default. Consequently, only large and well know firms of the highest credit rating can issue commercial papers.

The commercial paper market is almost entirely a wholesale one.

Usually, they are sold in the denominations of N250,000, N500,000 and Nl,000,000. The principal purchase of commercial papers are commercial and merchant banks. This is due to the relatively high yield of the instrument. Bank, stock broking firms and finance houses act as agents in the issue of commercial papers. They are also act as facilitators in the funds settlement of the transactions via the Central Bank clearing system on behalf of the issuers and purchases of commercial papers. There is no secondary market foe market for commercial papers, hence it is normally held by investors to maturity.

Interbank Deposit

(A) **Call Money:** This is a method of short term investment whereby participating institutions invest funds surplus to their immediate requirements on overnight basis with another bank. Call monies (strict-call) are withdrawable on demand. Call money scheme is among commercial and

merchant banks in Nigeria. The major reason for the establishment of call money (overnight money) scheme was to provide added opportunity to invest surplus funds on very short-term basis as opposed to a 91 - days treasury bills. Besides earning interest on overnight basis, call money is also withdrawable on demand. Hence, according to Nwankwo (1980: 124); call money provides first lines of defence against cash since it is withdrawable on demand.

The Central Bank of Nigeria clearing system facilities the operation of the interbank call money scheme. Accounts of buyers and suppliers of call monies are debted and credited respectively via, the Central Bank clearing system to give effect to call money transactions. Objectively considered, the money market instruments and the major participants in the investing short-term funds within the financial system. Parthemos (1977: 423 -45), provides a synopsis of the merits of money market as a subset of the financial system.

Firstly, money market provides important source of short-term finance on advantages loans. Also it is possible through successive rollovers for deficit units to raise funds on a continuous basis to finance their working capital requirements. Secondly, by bringing surplus and deficit spending units, the market provides more intensive use of cash balances held in the economy and in so doing facilitates real capital formation. Thirdly, conditions in the money provide an important guide for monetary policy since yield on money market instruments easily react to changes on supply and demand conditions. The behaviour of the market provides one of the most immediately available indications of the current relationship between demand and supply of credit,

Challenges and Problems Associated with Management of Money Market Instruments

Management of short-term funds by financial institutions entails the purchase and sale of money market instruments. Financial intermediaries being profit-oriented organizations seek to obtain low cost funds and invest same in high yielding assets. Robinson and Wringhsman (1991:29), identify two sets of interest rates, which financial intermediaries must focus upon in order to make profit;

These interest rates are those they receive as leaders of credit (interest revenue) and those they pay on debt instruments issued by them. The significance of these two sets of rates is underscored by the dominant role the play in cost and revenue sources of financial institutions. To ensure maximization via short-term funds management assets they buy must be higher than the interest costs from the financial claims they issue. This yield on short-term funds (money market instruments) depends on several factors. One of such factors is default risk. According to Yeager and Seitz (1982 :514). The higher the risk the greater the interest charge on the financial assets bought and therefore, the higher the return to the financial intermediary.

This is to compensate the financial intermediary for the high probability of temporary or permanent loss of principal funds and interest. There is also the risk associated with the volatility of interest rate otherwise known as interest rate risk. The term structure of interest posits that, the longer the term of investments, the higher the interest rate risk and therefore, the higher the return expected on the investment.

Furthermore, the credit worthiness of the deficit spending unit can influence the rate of return on investment funds. Van Home (1971:53), says that, the lower (higher) the credit worthiness of a deficit spending unit, the higher (lower) the interest rate charged on funds lent to it by financial intermediaries.

For example, blue chips with very high credit rating issue commercial papers at which lower rates at interest than companies with lower credit standing. Also important in the determination of rate of return on investment funds is the marketability of the short-term debt instruments. In general, the more marketable and instruments is, the lower the rate of interest. In other words, money market instruments with secondary market tend to attract lower coupon than those instruments (e.g Commercial papers) without secondary markets for the holders. To enable financial instruments lend financial intermediaries minimize the cost of gathered funds and maximize the return on its investments. The opportunity open for investigable funds will, to a large extent determine how much financial intermediaries are willing and able to pay for money procured from surplus spending units. In practice, specific rates attached to varying profile and sizes of short-term funds. Often times, however, interest cost is negotiable. In all, it depends on the skill, knowledge and financial strategies of the financial intermediaries concerned in negotiating funds with surplus spending units. Effective short-term funds management entails proper matching of costs of funds with return expected on investments. Profit expectations are dependent on the efficiency of liabilities management of financial institution in relations to returns on the intended investment. Where the spread between costs of funds

obtained from surplus spending units and return on money market financial intermediaries, profits margin expectations will be high. This ideal should be the hallmark of most financial institutions.

The major problems associated with the management of money market instruments or short-term funds are the volatile nature of money market interest rates. That is, the problem of interest rate risk as opposed to credit risk. Added to this interest rate risk is the problem of funds availability. For example, short-term funds availability is dependent on the ever-charging business conditions and unpredictable government monetary policies in most developing countries.

In addition to risk associated with the volatile interest rates on money market instrument, there also exists thought to a lesser, credit risk. Duesenbury (1964 : 267), asserts that;

Every investment that financial intermediaries undertake involves some risk. Consequently, the loss of both interest and principal is quite high especially where high returns are expected. For example, commercial paper tends to have higher credit risk than treasury bills. This confirms the fact that higher yields on investment elicit higher probability of principal and interest default. In consideration of this therefore, if financial intermediaries are to remain in business, they must reconcile the desire to net higher yields on investment and the riskiness of such investments.

Hand in hand with the above, is the problem of keen competition? The problem arises as a result of multiplicity of financial institutions in the Nigerian financial system, all competing public. Investor will not want to patronize the financial institution that charges the least rate of interest. Hence, financial institutions may, in the face of competition, have to offer competitive rates of interest lo surplus spending units in order to secure their funds. This subsequently leads to reduction in profit margin.

The marching of receipts of funds surplus spending units with sale of financial assets to other problems in money market instrument management in Nigeria. Improper timing often results in shortage of funds for profitable investment or idle funds on which substantial interest charges must be borne.

.

Recommendations

Efficiency in money market operation or short-term funds management therefore, required among other things, proper resolution of the problem discussed above.

1. The management of short-term funds by banks and indeed any financial intermediary requires marketing skills and swiftness in product/service delivery to clients. This is to ensure that financial intermediaries money market operations are carried out at a profit.
2. The major macro-economic factor that influences the volume and turnover of funds in the Nigerian money market is the level of aggregate savings. The level of savings swing with the cyclical business movements in the economy. The differential levels of efficiency of funds management in banks are affected by the quality of management, its attitude to risk, its marketing strategies and industry competition. The factors also affect the banks selection of money market instrument for trading.
3. In this regard, it is my considered opinion that management must bring its skill to bear on securing for optimum mix deposit funds and the same time identify profitable investment opportunities. Moreover, financial intermediaries should as a matter of policy emphasize free or cheap deposit on its short-term operations. This helps in minimizing the overall average costs of funds to the organization.

   The need for financial planning and forecasting in short-term funds management cannot be over-emphasized. This enables financial intermediaries to predict changes in demand for supply of funds in the money market together with movements in interest rates. This will ensure that maximum advantage is taken of future money market opportunities. In practical terms, this entails the setting of long-range targets like desired on money market investment. To ensure timely correction of any deviations from plan, it is necessary for financial intermediaries to evolve a system of continuous appraisal of the performance of the different instruments in relation to the expected result.
5. There is also the need for the financial intermediaries to be more innovative in the
   management of their short-term funds. Specifically, they need to develop new products in addition to the existing ones. This will enable them to enjoy the benefits of business diversification. Product innovation widens the money market operations and hence larger

clients base.

6. More importantly, the management of instruments of financial intermediation in the Nigeria money market requires the need to explore secondary market for other short-term funds instruments. In order to expend the market and encourage more investors to participate in it, there is therefore the need for banks to explore, organize, and develop a viable secondary market, similar to what obtain in the capital market.

Conclusion

In conclusion, the Nigerian economic environment has in recent times becomes very dynamic. Financial intermediaries operate within this environment. Government policies have made significant changes in the system of intermediation in the nation's financial system. Financial intermediaries, in order to continue to operate efficiently and profitably within the financial system, must be able to predict and adapt to the changes in the environment. More importantly, the financial intermediaries-should be in a position to turn these changes in the financial environment to business opportunities that can be tapped.

References

Adekanye, F. (1983). *The elements of banking in Nigeria.* Lagos: F.A. publishers limited

Agundu, P.U. et a! (2005). Strategic promotion and bank service delivery, *Journal of research in national development,* 3(1): pp 54-62

Bakare, Remi (2000). *The financial market glossary* Lagos: prince prints ltd. P.74

Falegan, S.B. (1987). Nigerian exchange rate system, *Nigeria journal of financial management:* June, pp 118-123

Deusenbury, J.S. (1961). *Money and credit impact and control foundation of modern economic series.* Prentice Hall Inc. Eaglewood Cliff: New Jersey

Henning, C.N. Piggot, W & Scott, R.M.(1981). *Financial markets and the economy.* Prentice Hall Inc. Eaglewood Cliff: New Jersey

Kidwell, D.S. & Person R.L. (1981). *Financial institutions market and money.* The Dryden press, Hindsal: Illinois.

Nwankwo, G.O. (1980). *The Nigerian financial system.* London: Macmillan publishers limited

Ojo, A.T. and Asewunmi (1982). *Banking and financial in Nigeria,* Graham burn: Berdford shire.

Okigbo, P.N.C. (1981). *Banking and financial system, structure and growth.* London: Longman group.

Oyeide, T.A. (1994). The financial system and economic growth in the context of political transaction CBN's economic and financial review: 32 (3) September, pp 200-267

Oyetan, J.A (1997). Packaging banks for successful recapitalization. The Nigerian Bank: Jan-June, pp 21-24

Parthemos J.A. (1977). *Instruments for the money market.* Wdited by Thomas cook, Federal Reserve Bank: Richmond.

Robinson R,I. & Wrightsman, D (1971). *Financial markers. The accumulation and allocation of wealth.* NcGraw Hill book co. New York

Van Home, J (1971). *Financial markets and policy I"' edition.* Prenlice Hall Inc. Eaglewood Cliffs: New Jersey

Weston, J.F. & Seitz, N (1982). *Financial institutions management tests and cases.* Reston publishing company Inc: Virginia.