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Discount Houses and the Changing Financial Landscape in Nigeria

CENTRAL BANK OF NIGERIA

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CONTENTS

Pages

Text Tables

Text Figures

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ABSTRACT

This paper examines the role and activities of discount houses (DH) within the emerging financial market in Nigeria. The approach employed was an initial identification of the objectives of their establishment and to assess if these objectives have been met within the context of an evolving financial market. In particular, the operational and prudential guidelines for their operations were examined vis à vis compliance. In this regard, the paper adopts conventional statistics to evaluate the performance of the discount houses. Analysis of the statistics indicated that compliance with the provisions of some of the prudential guidelines has largely not been met. In particular, DHs have fallen short of the prescribed minimum liquidity target consecutively since 2006. Further analysis indicates that discount houses have consistently exceeded the prescribed maximum gearing target that is equal to or less than 0.5:1 between its aggregate borrowings and capital (plus reserves). This indicates a huge reliance on borrowings and term financing for sustained growth of its operations. The findings also revealed that the monopoly hitherto enjoyed by discount house operators has been diluted through the appointment of banks as money market dealers and introduction of non-discount house institutions into the Primary Dealer Market Maker (PDMM) system in the secondary market. This trend on the performance of discount houses reflects a combination of factors ranging from the changes in business orientation, financial landscape and macroeconomic environment, amongst others. The paper concludes on the need to make a definite pronouncement on the continued relevance of discount houses in the changing financial landscape and calls for a review of their operations. Recommendations include increase in capital base of DHs, transformation of DHs to specialised institutions such as investment companies or merchant banks subject to meeting the statutory and minimum capital requirements of specialised institutions.

JEL CODES: G2, G21, EO, E44, O16

KEY WORDS: Discount houses, non-bank financial institutions, treasury securities, financial intermediation, discount and rediscount facilities, monetary management

1.0 INTRODUCTION

Discount houses generally are non-bank financial institutions established to intermediate funds between a central bank and the rest of the banking institutions with the primary aim of assisting the monetary authorities in monetary management. Specifically, discount houses perform a liquidity management function in the money market, Ezeuduji, F.U et al (1996). To deepen and foster the growth of an active money market, there is a need to underwrite government short-term securities and promote active trading in private sector financial instruments. Revell (1973) had recognized that one of the important aspects of the functions of discount houses has always been the service provided to banks by enabling them to adjust their liquidity as conveniently as possible. Nevertheless, different countries use variant institutions to achieve the same purpose. For instance, in the United Kingdom, discount houses render a double service by first taking loans from the banks, which are repayable at call, and at the same time provide a ready market for short-term government securities, Wadworth(1971). In the United States of America, a consortium of financial institutions are used to undertake these functions being performed by the houses, while in Malaysia, and India, discount houses are used largely to perform the above-named money market functions Ezeuduji, F.U et al, (1998). Their participation in the open market operations of the central bank via the sale and purchase of short-term securities influence bank reserves in the desired direction. Also, by interacting with the monetary authorities on daily basis, the discount houses assist in creating optimal liquidity profile of the system. Overall, as institutions in the money market, discount houses assist in the promotion of orderly development of the market by smoothening out the surpluses and short falls in the supply of and demand for liquidity in the financial sector.

The major functions of the discount houses in the context of assisting the monetary authorities in liquidity management include:

- Promotion of growth and efficiency of the money market and orderliness in money market transactions;
- Intermediation of funds between the central bank and the deposit money banks;
- Facilitation of the issuance and sale of short-term government securities, including serving as underwriters;

- Provision of discount and rediscount facilities to banks thereby relieving the central bank of the burden of carrying out such tasks;
- Acceptance of short-term deposits, especially overnight deposits from banks;
- Provision of short-term accommodation to banks, which otherwise would have been provided by the central bank, among others.

In Nigeria, prior to the establishment of discount houses in 1993, the Central Bank of Nigeria (CBN) along with the banks performed some of the major money market functions. The shift from direct to market-based monetary policy and the commencement of the Open Market Operations (OMO) in 1993 expanded the scope of money market activities. Consequently, discount houses were licensed to serve as financial intermediaries between the CBN, deposit money banks and other financial institutions in the conduct of OMO. The houses are principal participants in both the primary and secondary segments of the money market and their operations enable the monetary authorities to gauge the liquidity position in the market. The participation of the discount houses enables the banks to manage their portfolios on daily basis as well as stimulate healthy growth, efficiency and professionalism in the money market. The establishment of the houses opened a conduit window for transmitting liquidity between the banks, the CBN and the investing public. As financial institutions, discount houses purchase money market instruments such as Bankers' Acceptances, Trade Acceptances, Bills of Exchange, Commercial Paper, among others. By purchasing these instruments in the secondary market, discount houses provide needed liquidity which enhances the cash flow of the holders, who choose to unwind their holdings before the maturity of their instruments. This would, to some extent improve the liquidity condition of the markets as well as help to restore confidence among banks. The houses not only play a crucial role in facilitating transactions in short-dated treasury instruments and private sector securities but provide liquidity for the economy. Although, they are not the only principal participants in the money market, they constitute a major vehicle for facilitating the implementation of monetary policy.

This paper is aimed at examining the performance of the discount houses visàvis their adherence to operational and prudential guidelines in Nigeria with a view to enhance their effectiveness, operational efficiency, contribution towards the attainment of monetary policy goals and the development of the money market in the country. The paper is organised in four sections. Following this introduction is section II which reviews the experiences of other jurisdictions in discount house operations. Section III appraises the performance of the discount houses in Nigeria, while section IV charts the way forward and offer some concluding remarks.

2.0 REVIEW OF EXPERIENCES OF OTHER JURISDICTIONS IN DISCOUNT HOUSE OPERATIONS AND LESSONS OF EXPERIENCE FOR NIGERIA

This section reviews the experiences and evolution of discount houses in some selected countries and their transformation into other institutions over the years. These experiences are based on the findings of a study visit in 2003 by staff of the CBN as part of activities towards the review of discount houses in Nigeria[1].

2.1. Review of Experiences of Other Jurisdictions

2.1.1. United Kingdom

The 1997 reforms implemented by the Bank of England (BOE) radically altered the procedure for the conduct of monetary policy in the United Kingdom. Prior to this time, discount houses were actively involved in the conduct of open market operations (OMO). However, since the reforms, the BOE now deals with any institution including bank, building society, or securities firm that wishes to become its counter-party in the conduct of OMO. The enlargement of the range of counter-parties and the widespread demand of treasury bills also encouraged the BOE to discontinue the requirement for discount houses (the only counter-party under the old arrangement) to underwrite the weekly treasury bills tender. As a consequence, the BOE, with effect from March 1997, expected the counter-parties to participate actively over time in the weekly tenders, not necessarily every week, but on most occasions and on sufficient scale to ensure that the tender was adequately covered. Currently, the Debt Management Office undertakes weekly treasury bill tender, while the BOE open market operations are conducted through a group of counter-parties. These are strong financial institutions, highly rated and capable of dealing in government debt instruments on the orders of the Bank of England. The criteria for their participation include:

- Technical ability to respond speedily to the BOE's operational demand;
- Active presence in the markets for at least one of the eligible instruments;

[1] Report by the official delegation of the Committee on the Review of Discount House Operations in Nigeria (2003).

- Active trading in the core sterling money market on a reasonably continuous basis with a host of unrelated counter-parties on a scale that would enable them distribute liquidity obtained from the BOE around the system;

- Regular participation in the daily rounds of operations. This does not mean taking part every day or in every round every day, but to participate on most occasions, on a reasonable scale;

- Provision of useful information on a regular basis on market conditions and developments in the sterling money market; and

- Compliance with the prudential and other requirements of the relevant supervisory body.

Any institution that meets the functional criterion is considered for enlistment as counter-party. However, the BOE can, at its discretion, cease dealing temporarily or for longer periods, with any counter-party. The following securities are eligible for use by the bank's counter parties in repo operations with the Bank: gifts (including gift strips), Sterling Treasury bills, Bank of England euro bills and euro notes, Eligible bank bills, and Eligible local authority bills, among others.

Prior to the inception of the arrangement adopted by the BOE in 1997, the discount houses had been subject to some special provisions. This was in view of the role they played in the BOE's money market operations and the associated obligations they had assumed. To enable discount houses transit smoothly into counterparty arrangement, the BOE made some special provisions for the discount houses as follows:

- The discount house must remain a specialist capitalized counterparty, subject to appropriate 'business rules' which place restrictions on the types of business it might undertake. The discount house continued to be supervised by the BOE under the special arrangement for discount house;

- Clearing bank secured deposits (overnight or call) with the discount house continued to count as primary liquidity for the banks; Banks secured deposits with the discount house attracted a risk weighting of 10.0 per cent;

- Deposits that the discount house took from UK banks (including those taken via repo) continued to be excluded from the calculation of its (the house's) eligible liabilities;
- The discount houses continued to have access to liquidity from BOE after the regular round of operations, by way of repo, up twice their capital.

However, a discount house that wished to participate in OMO as counterparty without availing itself of these provisions would, if accepted by the BOE as meeting the functional criteria, not be required to be separately capitalized and would also not be subject to the "appropriate business" rules. Currently, there is no discount house in operation in the United Kingdom.

2.1.2. South Africa

In the 1940s, the preponderance of excess liquidity in the South African financial system led to the establishment of the first discount house with the sole aim of facilitating liquidity management. Three privately owned discount houses were later licensed in 1984. The discount houses were licensed primarily to:

- Serve as intermediary between the Reserve Bank and the banks in Open Market Operations (OMO);
- Create core money facility for banks;
- Create market for securities; and
- Aid the implementation of monetary policy. Discount houses also enjoyed privileges such as exclusive right to the Reserve Bank's accommodations. The placements by banks with discount houses were regarded as liquid assets and they were permitted to maintain account with Reserve Bank and use Reserve Bank Cheque.

The discount houses were allowed to trade the following instruments: Treasury Bills, Government and Parastatal Bonds, Liquid Bankers Acceptance (BAs), Negotiable Certificates of Deposits (NCDs), Repurchase Transactions (Repo) with Reserve Bank and the banks on Treasury Bills and commercial notes. The sources of funds for the discount houses were wholesale deposits since they were not permitted to operate checking account. Consequently, about 95.0 per cent of discount houses' sources of funding were from banks, government and parastatals, particularly tax and loans accounts. In addition, there was an informal agreement with the banks that the discount houses will not market banks' retail clients.

In 1990, a new Banking Act was enacted. The features of the Act were as follows:

- No distinction between deposit-taking institutions, (commercial banks) and merchant banks, discount houses, building societies, mortgage institutions and finance houses.
- All deposit-taking institutions were issued a banking license.
- The new Act was silent on discount houses necessitated by: (i) technology developments in the financial system (ii) ability of the banks to manage liquidity. (iii) complexity in applying Basle Capital Accord 1, which only applied to banks. (iv) changes in the payments system, and (v) stability in the money market.
- The removal of privileges extended to discount houses and a level playing field for all deposit-taking institutions was established.
- Banks' placements with discount houses were no longer regarded as liquid assets.
- Banks were allowed to deal directly with the Reserve Bank in primary issues in government security.
- The competitive advantage of discount houses' exclusive participation in OMO was removed. All institutions were allowed to participate in OMO.
- Preferential rate for discount houses was removed in 1993.

By virtue of the new Act, the discount houses automatically became small banks. A company acquired three of the discount houses namely, National Discount House, Security Discount House and Interbank Discount House and converted them into small merchant banks. The merchant banks could not cope and subsequently surrendered its banking license in 2002. Presently, the conduct of Open Market Operations and Primary dealership in government bonds is undertaken through dealers who meet certain criteria. There are currently no traces of discount houses in South Africa. All the institutions that metamorphosed from discount houses have collapsed.

2.1.3. Malaysia

Discount houses began operations in Malaysia since 1963. In its early years, the discount houses played the conventional role as keepers of liquidity. It was the only group of institutions that was permitted to accept money call. Its functions were redefined with the financial reforms of 1980s when its role was expanded to become dealers and market makers in securities. The discount houses specialize in short-term money market operations and mobilize deposits from the financial institutions and corporations in the form of money at call, overnight money and short-term deposits. The funds mobilized are invested in Malaysian Treasury Bills (TB), Malaysian Government Securities (MGS), bankers acceptances (BAs), negotiable instruments of deposits (NID), and Cagamas bonds (these are mortgage-backed securities). The tenor of these securities ranged from overnight to over ten years in the case of MGS. The discount houses are also very active in the secondary market for these securities.

Following the financial reforms of 1989 – 1990, the principal dealers (PD) system was introduced in 1989 where 11 other financial institutions were officially appointed along with the seven discount houses as primary dealers to underwrite the primary issue of MGS, which was then the domain of the discount house. In 1990, the Malaysian Central Bank (BNM) removed the requirement for commercial banks to observe primary liquid asset ratio, thereby making it possible for them to acquire MGS of any maturity to meet liquidity requirement instead of placing call money with discount houses.

The operations of the discount houses came under the purview of BAFIA 1989, and discount houses were required to comply with the requirements of 75:25 ratio of investment in Government Paper to Commercial Paper. The removal of the monopolistic market revealed the fragility of the discount houses when their business was adversely affected. The removal of the primary liquid assets requirement which relegated the role of discount houses as keepers of liquidity to simply a market player for short-term securities meant that in an environment, where BNM had maintained tight monetary policy stance which saw rates soaring, discount houses were caught holding a large portfolio of low yield fixed assets, resulting in some cases in capital losses. As a compensatory measure, the discount houses were subsequently appointed sole principal dealers in Treasury Bills. The discount houses were also permitted to invest and deal in longer-term securities of up to five years. These palliative measures did not bring any relief when interest rate was on an upward trend. The BNM subsequently allowed discount houses to invest on papers with maturities of up to ten years and the 75; 25 investment ratio was removed. In addition, discount houses were allowed to lend to other banking institutions in the interbank market of up to twice their shareholder's funds. These provided discount houses with greater flexibility in their portfolio management, and effectively transformed the discount houses from playing the role of keepers of liquidity to bona fide securities dealers, Discount houses were expected to observe at all times a minimum risk weighted capital ratio of 8.0 per cent.

In 1991 – 1995, as part of the measures to liberalize the financial system and provide level playing field among the various institutions, including the discount houses, the following reform measures were implemented:

- The interbank limit imposed on discount houses was removed;
- Discount houses were allowed to invest in, underwrite and manage issues of Private Debt Securities (PDS). However, discount houses were not allowed to invest in PDS which are convertible into ordinary shares, have attached warrants or transferable subscription rights;
- Non-interbank repos of less than one month maturity with corporates was restricted to discount houses and principal dealers only; and
- Discount houses with the necessary expertise were allowed to carry out funds management operations.

Between 1996 and 1998, the principal dealership (PD) system was reviewed and the number dropped from 23 to 16, of which three were discount houses. There had been a revision in the capital requirement for PDs resulting in a drop in their number from 16 to 11. Following the rationalisation of the operations of non-bank financial institutions, all discount houses in Malaysia ceased operations at end- December 2006. Some were absorbed under banking groups, obtained licenses to operate as merchant or investment banks or simply folded up (Bank Negara Malaysia and Securities Commission 2006).

2.1.4. Zimbabwe

The activities of discount houses in Zimbabwe started in the 1950s with two discount houses operating as extension of the Reserve Bank. The two discount houses traded mainly in Treasury Bills and all discounting activities in respect of government securities were done through these two outfits. They also served as intermediary between the Reserve bank and other financial institutions. The Reserve Bank, however, realized that the execution of monetary policy through the two discount houses only was not adequate. In addition, the two discount houses could not cope with the volume of transactions. Thereafter, privately owned discount houses were licensed in the 1960s and their activities were fashioned from the British financial system. The discount houses were supervised from London and settlement was conducted daily in London. The discount houses were licensed primarily to:

- Serve as vehicle through which monetary policies were executed;
- Discount and re-discount Treasury Bills;
- Act as market makers in the money market;
- Serve as intermediary between the Reserve Bank and the banks in OMO;
- Source funds for productive sector and also for the government and parastatals;
- Create opportunities for pension funds and asset managers;
- Act as intermediaries for Reserve Bank's support funds to the banks.

The discount houses dealt largely with the corporate market and their clients were mainly financial institutions registered under the Banking Act. The source of funding for discount houses were the banks, finance houses, mortgage institutions, building societies, pension funds, unit trusts, and asset managers, etc. The assets traded by the discount houses were Treasury Bills, Government Bonds, NCDs, Bankers Acceptances (BAs), Grain Bills, Petroleum Bills, and Municipal Stock.

The Zimbabwe discount houses modelled the British way enjoyed the following privileges:

- Maintained checking account with the Reserve Bank. Only discount houses and commercial banks maintained such accounts with the Reserve Bank;
- Issued the Reserve Bank's cheque for their trading transactions;
- Placements by financial institutions with the discount houses were regarded as liquid assets for the purpose of liquidity ratio computation;
- Sole underwriters of primary issues of government securities;
- Exclusive right to Reserve Bank's accommodations; and
- Open Market Operations conducted through the discount houses.

Supervision and regulation of discount houses were by way of moral suasion. However, discount houses were required to:

- Maintain 90.0 per cent of their deposit liabilities in specified liquid assets;
- Hold assets of up to six years "maturity"; and
- Not to transact in foreign exchange (FX).

Other financial institutions became conscious of the privileges enjoyed by the discount houses and agitated that they should be allowed to deal directly with the Reserve Bank and not through the discount houses. Thus, in 1966, Zimbabwe embarked on economic reforms and by 2000; a new Banking Act was enacted. The essential features of the Act are as follows:

- Only commercial banks maintained accounts with the Reserve Bank;
- All deposit taking institutions are considered as banks;
- All the privileges extended to discount houses were removed;
- Banks were allowed to be primary dealers in government securities; and
- The functions performed by the discount houses as enumerated above are being performed by banks and other financial institutions.

There is no dedicated market making institution in the money market. Despite the removal of the undue advantage enjoyed by discount houses, new discount houses were licensed. The capital requirement for establishing discount houses after the amendment to the Banking Act in 2000 includes:

- Taking/placing funds from\with banks and other deposit taking institutions;
- Dealing in Treasury Bills, Government Bonds, NCDs, Bankers Acceptances (BAs) Grain Bills, Petroleum Bills, Municipal Stock; and
- Placements with discount houses are no longer regarded as liquid assets for the purpose of the computation of liquidity ratio for financial institutions.

Also, discount houses engaged in other financial activities such as asset management, pension funds, commercial and merchant banking, unit trust, stock broking, etc. through subsidiaries. For example, Inter market Discount Houses (A financial supermarket), has a pension fund, assets management company, unit trust, commercial bank, and a stock broking outfit. In fact, it owned the largest assets management and pension fund outfit in Zimbabwe.

In February 1997, a primary dealership was introduced and discount houses were no longer required to operate accounts with the Reserve Bank. In 2002, the exclusive privileges which discount houses enjoyed in the primary take-up of securities was withdrawn as any licensed financial institution with an RTGS account could directly access instruments issued by the Reserve Bank. The largest and oldest operating discount house in Zimbabwe; Discount House of Zimbabwe (DCZ) a subsidiary of Kingdom Financial Holdings (KFHL) wound down in October 2009 citing viability issues after 50 years in operation. As at July 2012, there were no discount houses operating in the Zimbabwean economy, even though the capital requirements for discount houses were increased from $7.5million to $60million Zimbabwean dollars, (Reserve Bank of Zimbabwe (2012))

2.2. Lessons of Experience for Nigeria

In most of the countries reviewed, reforms of their financial system had reduced, if not eliminated, the need for discount houses. In the UK, Singapore and South Africa, discount houses had been replaced by other institutions in the conduct of open market operations. Specifically, the use of counterparties and principal dealers in liquidity management and trading of government debt instruments had rendered discount houses unnecessary in both the UK and South Africa. The reforms of the payments system in these countries had also resulted in few, highly rated and well capitalized banking institutions, which have direct access to the discount window of the monetary authorities, thus enhancing the role of their central banks as the lender of last resort. The reforms of the payments system and the use of few banks as counterparties to the monetary authorities have also changed significantly the focus of the existing discount houses. Overall, the experiences in these countries indicated that United Kingdom, South-Africa, Malaysia and Zimbabwe initially attempted to change the operational focus of discount houses, but later had to dispense with the use of the houses in the conduct of open market operations. In particular, the discount house system has been replaced in the United Kingdom and South Africa with the primary dealership/counter party system whereby the monetary authorities deal with only institutions that meet some specified requirement. United Kingdom had transitional arrangements which allowed discount houses to meet up with the requirements set for the new counter parties which took over their functions over a period of time. Unfortunately, no discount house was successful in this bid. In most of these countries, the general experience was the transformation of the houses into investment banks or other forms of financial institutions as the financial system deepened.

3.0. APPRAISAL OF DISCOUNT HOUSES IN NIGERIA

This section provides an insight into the state of the discount houses in Nigeria. It reviews the operations of the discount houses in Nigeria to determine the extent to which the objectives for which they were established have been met. The adopted approach examines the performance of DHs vis-a vis the relevant operational/prudential guidelines. This appraisal becomes more important, especially in the context of operational performance to determine their continued relevance in the growth and development of the domestic money market.

Prior to the establishment of discount houses in Nigeria, the Nigerian money market was characterised by a period of excess liquidity but low patronage of treasury bills even with fairly attractive yield for the 91-day tenor bills. The inter-bank market was endangered due to loss of confidence amongst participants in the market. The conduct of monetary policy was through the use of direct controls such as stabilisation securities, credit limit and reserve requirements. However, the authorities considered the aforementioned approach out of tune with modern day monetary policy management. Hence, when the Central Bank of Nigeria (CBN) finally opted for indirect monetary control (following deregulation of the financial system) using discount houses as principal dealers, the following were considered to be the rationale for the establishment of discount houses:-

- Assist in the creation of a market driven liquidity management framework;
- Deepen the money market by developing an active secondary market;
- Act as intermediaries between CBN and banks;
- Serve as underwriters of government securities; and
- Promote active trading in private sector financial instruments

Discount Houses were set up by the provisions of Section 28, of the Central Bank of Nigeria (CBN) Decree No.24 of 1991 and sections 61 of Banks and Other Financial Institutions (BOFID) Decree No. 25 of 1991 as amended. The founding objectives and principal duties of discount houses were:

- Promote rapid growth and efficiency of the money market in Nigeria;
- Act as intermediaries between the Central Bank and the licenced banks in OMO transactions and other eligible securities of not more than three years maturity as defined under the CBN's expanded discount window guidelines;
- Facilitate the issuance and sale of short-term government securities and other eligible short-term commercial bills;
- Provide discount/re-discount facilities for treasury securities and other eligible financial instruments;
- Provide fund/portfolio management and financial advisory services; and
- Accept short-term investments on an intermediary basis; and
- Other functions which may be prescribed by the CBN from time to time.

Given the prevailing environment when discount houses were established, it was only natural that any product offering must deal with the challenge of low confidence in the money market. Consequently, the introduction of secured transactions using treasury bills was one key factor that renewed interest in this instrument. Discount houses in their market-making role embarked on effective maturity transformation by buying the 91-day treasury bills with shorter tenor borrowings from banks and the investing public, whilst securing such borrowings with the treasury bills purchased and by so doing, they took on the rediscounting liquidity and interest rate responsibilities.

With the success in this initial offering, other derivatives of treasury bills and commercial bills which enabled them to provide short-term accommodation to banks emerged, and were facilitated by the window at the CBN where the discount houses could square their positions at the end of the day either through Repurchases or Reverse Repurchase Transactions. It is instructive to state that the situation in the past which was characterised by fiscal indiscipline through incessant resort to "Ways and Means" advances which were later securitised as treasury bills, and issued beyond the absorptive capacity of the market at below market rates made underwriting impossible. Other limiting factors are the uneven (until recently) and unplanned nature of the primary market issuance, and the dearth of accurate data on major macroeconomic indices and liquidity projections. As pointed out above, the reporting format which excluded the quantum of treasury securities that discount houses buy on their own rights tended to underscore the extent of their holding and investment in treasury bills for which they bear the discounting risk.

3.1 State of Discount Houses in Nigeria

3.1.1 Growth of Discount Houses (DHs)

In September 1992, three Discount houses obtained approvals-in-principle to commence operations in Nigeria and by 1993, they were operational. In 1996, the number increased from three (3) to five (5) and has remained unchanged till date. In comparison with other similar institutions within the financial sector, it can be safely asserted that the growth in the number of discount houses has been stagnant compared to other financial institutions. For instance, the number of microfinance institutions increased from 611 in 1993, to 821 at the end of 2011, while the number of primary mortgage banks actually declined by a whopping 60.0 per cent between 1993 and 2011 (Table 1). Without doubt, some of these mixed developments can be attributed to regulations which may have facilitated a restructuring in operations.

Table 1: Assets and Liabilities of Other Financial Institutions

	Number of Institutions				Assets and Libilities (N Billion)			
	Discount Houses	Microfinance Banks	Primary Mortgage Banks	Finance Houses	Discount Houses	Microfinance Banks	Primary Mortgage Banks	Finance Houses
1993	5	611	252	N/A	4.5	3.1	3.6	13.4
1999	5	550	115	N/A	15.1	8.9	7.6	8.9
2005	5	725	90	112	99.3	82.8	99.9	37.4
2011	5	821	101	114	320.8	11.97	357.1	117.6
Growth over period (%)	0	34.37	-59.92		7028.89	286.13	9819.44	777.61

Source: CBN Statistical Bulletin and Annual Reports

3.1.2 Assets Structure and quality

Total assets and liabilities of the three (3) DHs operating from inception stood at ₦4.4 billion by end-December 1993. However, with the licensing of two additional discount houses, the total assets and liabilities of the five (5) DHs increased by 56.4 per cent (from ₦4.4 billion to ₦6.9 billion at end-December 1998) within the first five years of operation with almost half of the increase accounted for by the 2,000 per cent rise in claims on banks (₦0.1billion to N3.1 billion). In subsequent years, the assets of the DHs increased astronomically, averaging 548.0 per cent between 1998 and 2007 with the growth attributable largely to increase in claims on Federal Government and banks. However, the period between 2008 and 2011 witnessed a decline of 23.1 per cent in aggregate assets, reflecting an increasing strain on the liquidity of the discount houses.

The short-term nature of the liabilities of discount houses and the need to properly position the houses to effectively drive the activities of the money market necessitated the provision of prudential guidelines to ensure not only the proper mix, but also the appropriate maturity profile of assets and liabilities. The 2008 revised guidelines for discount houses in Nigeria states that the objectives and principal duties of a discount house shall be to:

- Promote rapid growth and efficiency of the financial markets in Nigeria;

- Act as primary dealers in treasury bills, Federal Government Bonds and other eligible securities.

- Facilitate the issuance and sale of financial securities;

- Provide discount/re-discount facilities for treasury securities and other eligible financial instruments;

- Provide fund/portfolio management and financial advisory services;

- Accept investments on an intermediary basis;

- Engage in securities trading, including equities, corporate bonds and government securities;

- Trade in foreign exchange;

- Engage in capital market activities as issuing houses, underwriters, and brokers;

- Undertake other financial services subject to meeting the risk-based supervisory requirements and the statutory capital as may be specified by the relevant regulatory bodies; and other functions which may be prescribed by the CBN from time to time.

It further states as part of the prudential requirements that DHs are required to:

- Transfer to the statutory reserve a minimum of 15.0 per cent of profit after tax if the reserve fund is less than the paid-up capital and a minimum of 10.0 per cent if the reserve fund is equal to or more than the paid-up capital

- Maintain capital funds to risk assets ratio of 1:13 and capital adequacy ratio of 10% or as may be prescribed by the CBN.

- Not to exceed a maximum ratio of 50:1 between its total borrowing and capital plus reserves without prior approval from the CBN.

- Not to grant to any bank, facility of more than 50% of its shareholders' funds unimpaired by losses without the prior approval of the CBN

- At all times maintain not less than 60 per cent of total borrowing in government securities.

At inception, discount houses' investment in Federal Government securities of less than 91-day maturity was ₦4.03 billion and accounted for 120.0 per cent of their total deposit liabilities. This was the highest peak ever achieved since inception. Between 1997 and 2002, this ratio had declined to 39.0 and 75.0 per cent, respectively. Analysis of the data indicated that in its first ten (10) years of operation between 1992 and 2002, it was only in 1997 that discount houses' investment in FG securities was below the prescribed minimum level of 70.0 per cent as stipulated in the prudential requirements at the time (Table 2).

Table 2: Asset Structure of Discount Houses

	Target	1993	1997	2002	Target	2007	2011	2012 September
Assets Structure								
Assets		4,029,614.0	1,498,180.0	32,771.0		115,365.9	60,768.4	29,118.40
Treasury Bills of Less Than 91 Days Maturity		4,029,614.0	1,498,180.0	32,771.0		115,365.9	60,768.4	29,118.40
Treasury Bonds		0.0	0.0	0.0		0.0	0.0	0.0
Liabilities		3,352,974.0	3,841,902.0	43,693.0		258,869.0	210,170.2	221,214.10
Structure of Assets Ratio[1] (%)	**70**	120.2	39.0	75.0	**60**	44.6	28.9	13.2
Total Borrowings & Amount Owing		2,924.0	2,222,591.0	18,465.0		161,819.2	57,242.5	69,806.90
Borrowings		2,924.0	2,219,959.0	11.0		3,239.6	3,000.0	0.0
Amount Owing		0.0	2,632.0	18,453.0		158,579.5	54,242.5	69,806.90
Capital & Reserves		436,003.0	1,430,542.0	6,511.0		22,849.1	49,612.1	34,568.70
Capital		385,000.0	950,355.0	3,327.0		11,086.5	15,645.2	15,645.20
Reserves		51,003.0	480,187.0	3,184.0		11,762.5	33,966.9	18,923.40
Gearing Ratio: x:1	**x=50**	0.0	0.1	2.8	**x=50**	7.1	1.2	2.0

Source: Central Bank of Nigeria

Note: 1/Target for Structure of Assets Ratio was set and retained at 70% between 1993 and 2002. It was changed to 60% in 2003.

In 2003, the target was reviewed downwards and DHs were required to invest not less than 60.0 per cent in treasury securities. For three (3) consecutive years (from 2003 to 2005), DHs surpassed the 60.0 per cent benchmark. However, since 2006, DHs have not met the prescribed minimum target. Investments in FG securities declined steadily from a peak of 80.1 per cent in 2005 to 12.8 per cent in 2008. The situation was reversed with an actual level of 28.0, 22.0 and 28.9 per cent recorded in 2009, 2010 and 2011, respectively. Overall, available data show that though DHs investment in FG securities have accounted for the larger proportion of DHs aggregate assets since inception, it has fallen short of the prescribed minimum target for seven (7) years since 2006. This deteriorating trend on the performance of discount houses which became quite visible since 2006 reflects a combination of factors ranging from the changes in business orientation, market and macroeconomic environment, amongst others. It further indicates the burgeoning risk carried by DHs on their books. A persistent under-achievement of the stipulated minimum target with regards to investment in FG securities has liquidity risk implications for DHs holdings as it undermines their capabilities to meet immediate divestment needs of its clients.

In contrast to the traditional approach of measuring asset quality in broad classifications of substandard, doubtful and loss, this study uses the ratio of loans to shareholders' fund as a proxy for asset quality. The industry-wide loan to shareholders fund[2] of discount houses was above the required threshold level for most of the sample period. Though the guideline stipulated that not more than 75% and 50% of each DH shareholder's funds unimpaired by losses should be disbursed to a single obligor under the 2004 and 2008 guidelines, this study assumes the 50% as an industry threshold for the entire sample period. An analysis of the industry-wide loan portfolio indicated that loan facilities to banks and other debtors constituted more than half of the industry-wide shareholders' fund. With the exception of 1996 when industry-wide loan to shareholders' fund was 19.61 per cent, this ratio for all the other years was in most cases above the maximum threshold. The marked increase in loan to shareholders' fund above prescribed threshold levels is indicative of declining performance in portfolio management.

3.1.3 Market Share: Assets

In terms of market share, the largest portion of DHs assets was domiciled with the Federal Government, accounting for 94.4 per cent of aggregate assets at inception in 1993. At end-2011, discount houses' claims on Federal Government had declined and stood at 69.6 per cent, other assets (13.2 per cent), and claims on others (10.9 per cent) which comprised commercial bills, CBN certificates, loans and advances. The evolution of the market share reflects the underlying change in structure of asset holdings of discount houses. For instance, there have been increased activities by state governments in the money market as evidenced by 1.6 per cent share of DHs claims on state governments, compared with 0.0 per cent at inception. Claims on banks have declined significantly accounting for only 3.4 per cent of DHs aggregate assets (Table 3).

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[2] Out of the five (5) discount houses, four (4) reported on loan portfolio of which one (1) reported not granting loans to banks or debtors during the sample period; The five (5) discount houses reported on their shareholders' fund unimpaired by losses. Estimates may have been underestimated as a result of differences in years of commencement of operations, differences in accounting years and non-rendition of the relevant data.

Table 2: Composition of aggregate assets (%)

Composition of aggregate asset (%)	1993	1997	2002	2007	2011	2012*
Cash and Balances with Banks	0.14	1.43	1.29	0.21	0.75	1.08
Claims on Federal Government	94.43	21.59	57.21	59.87	69.61	57.60
Claims on State Governments	-	0.00	0.00	0.00	1.62	2.03
Claims on Banks	3.11	44.18	22.99	29.02	3.37	3.78
Claims on Other Financial Institutions	-	0.00	-	0.60	0.00	6.87
Claims on Others	0.00	25.48	8.79	7.08	10.93	18.17
Other Assets	2.32	4.81	8.94	3.03	13.23	9.91
Fixed Assets	-	0.25	0.77	0.19	0.49	0.56

*As at September, 2012
Source: CBN Annual Reports and Statistical Bulletin

3.1.4 Statutory Reserves

The establishment of discount houses coincided with the period when the use of open market operations was introduced as one of the monetary policy tools to replace the direct controls for managing liquidity in the economy. Discount houses were established mainly to facilitate the issuance and sale of short-term government debt instruments and also to accommodate short term financial needs of commercial banks. Consequently, through their operations, the houses were expected to facilitate the growth and efficiency of the money market and enhance the implementation of open market operations by the Central Bank of Nigeria.

The initial law establishing discount houses and guiding their operations granted the houses the exclusivity of operations in the open market operations and made them the only player in the open market for government securities, thereby allowing them to take full advantage of the arbitrage opportunities arising from a partial monopoly of the market. Consequently, the first few years of operations by the houses was characterised by significant progress in line with the take-off of the open market operations as a monetary policy tool. The trend in the quantum and growth of the transfer to statutory reserves (arising out of increasing operating surpluses) as well as the need to comply with Section G (i) of the revised prudential guidelines is an indication of the lucrativeness of the sub-sector during this period (Table 4 and Figure 1).

Table 3: Discount Houses Transfer to Statutory Reserve

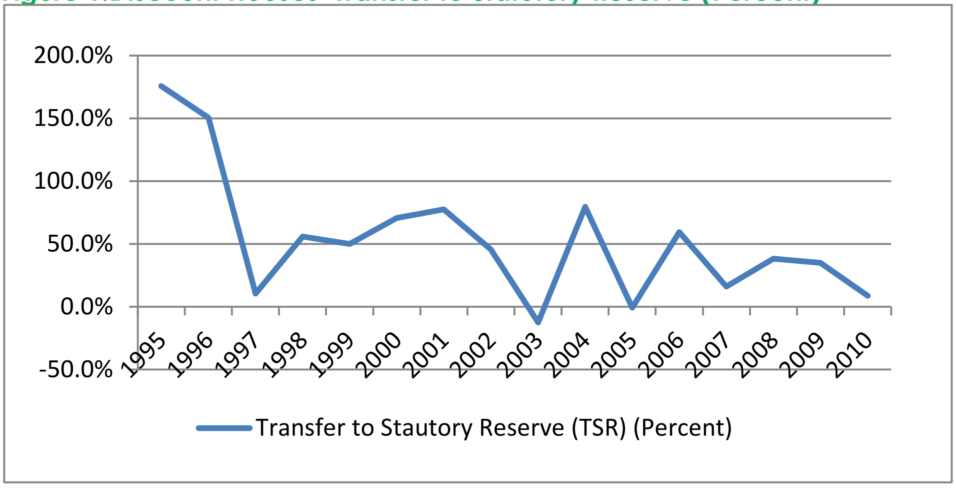
Discount Houses Transfer to Statutory Reserve																		
Year	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Transfer to Stautory Reserve (TSR) (₦ Million)	0.5	18.5	51.0	127.8	141.2	220.0	329.9	563.0	1,000.0	1,457.2	1,274.1	2,289.7	2,275.8	3,631.3	4,217.4	5,828.8	7,873.9	8,553.2

Source: CBN Statistical Bulletin and Annual Reports

With the introduction of the autonomous foreign exchange market in 1995/1996, there was an observed reduction in the magnitude of growth in surplus. Though the momentum for continuous growth was maintained, it was at minimal rates partly as a result of the increasing activities of the commercial banks in the money market which partially weakened the regime of monopoly by the houses in money market operations (Figure 1). The negative impact of the introduction of the autonomous foreign exchange market which provided an alternative and more attractive option and the overall effect of increased activities of the deposit money banks (DMBs) influenced the clamour for the review of the operating guidelines of the houses.

The introduction of Universal Banking in 1999 marked an important turning point in the history of discount houses in Nigeria as the policy allowed commercial banks to provide other services such as merchant banking, insurance, factoring, housing finance, stockbroking, custodian services and trusteeship among others. The commercial banks were able to extend their primary financial functions into other allied services. However, this policy, while creating a number of financial supermarket, had negative effects on the discount houses in Nigeria as their primary functions became incorporated under the commercial banks services. Specifically, the usurp of the functions of the discount houses by banks could be viewed as one which hampered the operation of the discount houses. Prior to the introduction of Universal banking programme, discount houses existed as the sole dealer in government securities, while the CBN acted as the underwriter. However, since the commercial banks were bigger in size and possessed the competitive strength arising from mergers, acquisitions and recapitalisation, they more or less took over the traditional functions of the discount houses.

Figure 1:Discount Houses' Transfer to Statutory Reserve (Percent)



Source: Adapted from CBN Statistical Bulletin

3.1.5 Gearing

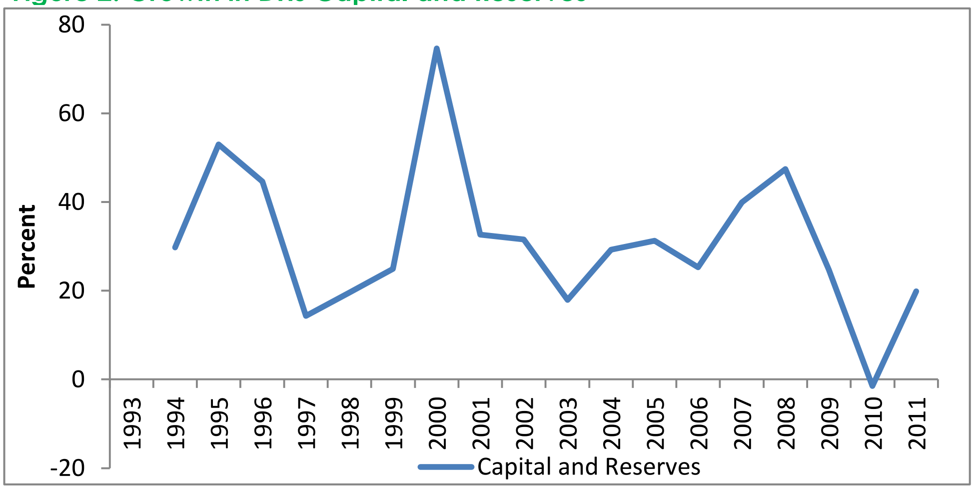
Discount houses' are required to maintain a gearing ratio that is equal to or less than 0.5:1 between its aggregate borrowings and capital (plus reserves). With the exception of fiscal 1993 and 1999, DHs have consistently exceeded this prescribed maximum target, thereby relying heavily on borrowings and term financing and less equity financing for sustained growth of its operations. The observed growth in DHs leverage position has not necessarily transformed to increase in shareholders wealth, but rather the interest expense and credit risk default elements that come with high leverage has impacted negatively on shareholders wealth. It is long recognised that though equity financing may not be sufficient to expand a business venture, there should be a balance between equity and debt financing, hence, the globally accepted gearing ratio of 0.5:1. The over-dependence on debt finance by DHs can probably be attributed partly to the operational guidelines which hitherto (prior to October 2008) restricted the ownership base of DHs to banks and other financial institutions such as insurance companies. However, in recognition of the increased level of financial and associated risks as well as the need to reform the operations of DHs in Nigeria, the CBN expanded the ownership base of DHs to include individuals and other corporate bodies in late 2008. Though still above the maximum target, there has been a visible impact of this revision in the ownership structure of DHs as it has resulted into a gradual reduction in gearing from a peak of 7.1: 1 observed in 2007 to 1.2:1 in 2011, (Table 2)

3.1.6 Capital Base

The aggregate capital base of the DHs increased from ₦436 million at end-1993 to ₦34.6 billion as at September 2012. In nominal terms, the DHs appear to have a strong capital base. However, a growth analysis indicates that the DHs have not been well capitalised thus implying that the core capital ratio may not have been sustained. There was a decline in the volume of capital and reserves in the period 1995 to 1997 before it peaked in 1999. This peak has not been attained since then and in particular, the periods under the recent global financial crisis indicated that capital growth has been on a consistent decline (Figure 2).

Analysis of the capital adequacy ratio indicated that for the reporting institutions with available data, the ratios were above the minimum regulatory requirement of 10 per cent suggesting a strong capitalization of those institutions which could be attributed to the profit levels reported by most of the discount houses.

Figure 2: Growth in DHs Capital and Reserves



Source: CBN Statistical Bulletin, Growth analysis: authors computation

As part of their key objectives, DHs are required to act as primary dealers in treasury securities and other eligible securities. However, an analysis of available data indicates that in spite of its laudable performance of this role, the aggregate value of DHs holding of money market assets has relatively been constant over a range of 1.7 to 11.4 per cent, leaving the balance to other money market participants. The holding structure of money market assets shows that the value of DHs holdings averaged 5.1 per cent between 1993 and 2005. The apriori expectations are that the volume and value of their holdings would be high since they maintained monopoly of a significant portion of the securities market at least prior to the inclusion of commercial banks in the securities market. DHs holding of money market assets peaked in 2007 at 11.4 per cent. Relative to their performance prior to 2006, DHs holding of money market assets increased marginally between 2007 and 2009 perhaps due to competition from other participants in the market as the relaxation of market restrictions encouraged the entry of other money market participants. However, it was observed that since 2008, DHs holdings of money market assets recorded a steady decline to 1.7 per cent as at end 2011, below the 1995 level of 2.02 per cent (Table 5).

Table 5: Value of Money Market Assets (N'Million)

Instrument	1995*	2000	2004	2005	2006	2007	2008	2009*	2010	2011
Treasury Bills	103,326.5	465,535.80	871,577.00	854,828.00	701,399.80	574,929.43	471,929.43	753,580.00	1,277,100.00	1,277,100.00
Treasury Certificates	23,596.3	-	-	-	-	-	-	-	-	-
Development Stocks	0.0	2,406.30	1,250.00	980.00	720.00	620.00	520.00	520.00	220.00	220.00
Certificates of Deposits	48.0	-	-	-	-	-	-	-	-	-
Commercial Papers	10,034.9	19,002.50	88,830.00	194,591.20	204,613.70	363,369.50	822,700.90	509,079.10	189,216.40	189,216.40
Bankers' Acceptances	8,102.4	31,774.90	41,620.00	41,123.50	78,497.60	81,834.00	66,398.70	62,243.60	79,172.30	79,172.30
FGN Bonds			725,600.00	250,830.00	643,940.00	1,186,150.50	1,445,999.58	1,946,400.00	2,901,600.00	2,901,600.00
Total	**145,108.1**	**518,719.50**	**1,003,277.00**	**1,342,352.70**	**1,629,171.10**	**2,206,903.43**	**2,807,548.61**	**3,271,822.70**	**4,447,308.70**	**4,447,308.70**
Value of Money Market Assets Held By Discount Houses	**2,928.6**	**25,672.60**	**47,082.10**	**72,805.80**	**107,302.70**	**252,169.31**	**240,623.06**	**222,355.88**	**158,079.90**	**73,321.60**
Value Held by Discount Houses as a Proprtion of Total Money Marlet Assets (%)	**2.02**	**4.95**	**4.69**	**5.42**	**6.59**	**11.43**	**8.57**	**6.80**	**3.55**	**1.65**

Source: Adapted from CBN Annual Reports; Author's computation. *A new reporting format was adopted in 1995.

Overall, the discount houses continued to show strong performance with positive trends in key financial ratios, albeit for certain period of time. The main highlights of the performance of the discount houses during this period was a comparable achievement of assets structure ratio above the stipulated minimum requirement. However, compliance with the prudential requirements has been largely underachieved. In addition, discount houses are highly geared, thereby, overshooting the maximum requirements.

4.0. WAY FORWARD AND CONCLUSION

4.1. Way Forward

The history of discount houses is traced back to 1992 when they were established mainly to mobilise surplus short-term funds in the market for investment in Nigerian Treasury Bills (NTBs), thereby facilitating the monetary and liquidity management effort of the CBN. Since then, their role and function have evolved to such an extent as new debt instruments and functions have been added to their portfolio. Over the years, they have featured prominently in assisting the authorities to promote and develop the secondary market in treasury bills. The fate and well-being of the houses are closely tied to the performance of the Nigerian Treasury Bill (NTB) market, as they have become an integral part of that market and synonymous with the debt market over the years. Their focus and expertise, built over a decade, have been and continue to be centred principally on the debt market unlike other financial institutions, whose stakes in the market are much lower because of their involvement in other areas of finance and financial services. Discount houses have contributed in no small way to the rapid growth and efficiency of the money market in Nigeria. Their involvement in Treasury Bills and Commercial Bills through outright sales, purchases and repurchase transactions has helped in stimulating demand for these instruments by providing secondary market liquidity.

Currently, the discount houses have found themselves at a cross road amid efforts by the authorities to rationalise, reform and consolidate the financial sector. The financial sector reform efforts by the Central Bank of Nigeria have always had the strategic and underlying objective of evolving an optimal financial structure that is relevant to Nigeria and strong enough to absorb the impact of market liberalization and globalisation. Consequently, the Nigerian financial landscape has witnessed financial institutions coming together to take advantage of economies of scales in order to be more competitive both at national and international levels. In this new arrangement, players in the financial sector are expected to face mounting pressure to become more competitive, innovative, strategically focused and technologically-driven. In addition, they are expected to be guided by global practices to meet the increasingly sophisticated demand of consumers and businesses alike. Most of the strategic functions of the houses have been taken up by the banks and other emerging money market operators such as money market dealers.

Therefore, discount houses could be encouraged to transform themselves into significant and meaningful players in an increasingly open and competitive business environment through mergers or business combinations. The on-going financial sector reforms provide an opportunity to fine-tune the founding principles of discount houses industry, as it was done in UK, South Africa and a host of other countries, more so as the Nigerian financial sector has evolved. Discount houses have shown their capabilities to respond to market demands which made it possible for them to retain their roles as active players (underwriters, investors and traders in the debt market). However, the financial environment is different now from when they were first established. There is a need to make a definite policy pronouncement on the continued existence of discount houses. It is recommended that a rationalization of their operations be embarked upon and possible transformation into merchant banks or specialised institutions depending on their capabilities. In such new form, they will continue to operate as major player in the money market supported along with the primary dealers, while also playing their specialised/wholesale roles as required by their new form.

4.2. Conclusion

This paper highlighted the key contributions of discount houses to the development of the securities markets and how they, discount houses, have over the years, developed competencies in trading in money market and fixed income securities, developed market initiatives and new product offerings in the market. However, this role has been threatened due to a changing financial sector landscape, payment system reforms, introduction of money market dealers and primary dealer market maker system. Overall, the Discount houses showed strong performance with positive trends in key financial ratios, albeit for certain period of time.

However, compliance with the prudential requirements has been largely underachieved with industry loan to shareholders' fund far above the maximum threshold levels and gearing ratios overshooting the maximum requirements which are critical warning signals that cannot be ignored or left to market forces to adjust. The regulatory authorities as part of its reform measures for the industry had broadened the product lines (basket and tenors of debt instruments) of discount houses to include bonds (government and corporate) thus providing a platform for DHs to play a developmental role in the Nigerian debt market. The emerging financial markets would require effective risk management and one key product used in risk management are derivatives, which are basically instruments created on an underlying asset in order to manage risk, promote financial engineering and increase market participation. There are requisite skills in the discount houses and this expertise could be expanded and developed into this area of need as the market advances and deepens. In other words, while the establishment of discount houses impacted significantly on the strengthening the growth of the money market, the changing financial landscape has necessitated that they build more capacity to operate beyond just the money market and play more elaborate role of driving general real economic expansion. Discount houses could be encouraged to specialise in proven areas of expertise. Such may be a more efficient mechanism for bringing borrowers and investors together beyond the traditional method of intermediation. The knowledge base of DHs in portfolio, funds management and financial advisory services could be leveraged upon to deal with challenges in the emerging financial landscape.

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