

CHAPTER SIX

CREDIT INSTRUMENTS AND FINANCIAL MARKETS

6.1.CREDIT AND CREDIT INSTRUMENTS

6.1.1. What is Credit?

Credit refers to the control over money, materials, goods or services in the present in exchange for a promise to repay at some future dates. This implies that, lenders forgo the use of money or its equivalent in the current time by making loans available or extending the credit to the borrower who promises to repay on terms specified in the loans Agreement or debt Instruments. Borrowers obtain resources to use for current production/consumption purposes before generating savings that could be used to repay the goods.

Credit is also defined as a device for facilitating the temporary transfer of purchasing power from those who have surpluses of it to those who are in need of it. Thus, credit involves a temporary transfer of wealth.

6.1.2. Features or Essentials of Credit

The following are the essential features of credit:

- A. **Trust and Confidence:** Trust is the fundamental element of credit. The lender will lend his money or goods on the trust and confidence that the borrower/lender will lend his money or goods on the trust and confidence that the borrower or buyer will pay back the money or price in time.
- B. **Time Element:** All credit transactions involve time element. Money is borrowed or goods are bought with a promise to repay the money or pay the price on some future date.
- C. **Transfer of Goods and Services:** Credit involves transfer of goods and services by the seller to the buyer on the pay-back promise of the buyer on some future date.
- D. **Willingness and Ability:** Credit depends in a person's willingness and ability to pay the borrowed money. In fact, credit of a person depends on his character, capacity and capital. It is these three C's on which a man's credit depends. A person who is honest and fair in his dealings possesses the capacity of making his business a success. Such a person can get credit easily.

- E. **Purpose of Credit:** Banks and financial institutions give large amounts of credit for productive purposes rather than for consumption purposes.
- F. **Security:** Security in the form of property, gold, silver, bonds or shares is an important element for raising credit.

6.1.3. Credit Instruments

Credit plays a significant role in modern business and that part is represented by credit instruments. These are written or printed or typed financial documents that serve either as promises to pay or as orders to pay. They provide the means by which funds are transferred from one party to another. Some of the important credit instruments are explained below:

- 1) **Promissory Note:** The promissory note is the earliest type of a credit instrument. It is an "I.O.U." (I owe you) –a written promise by a debtor to pay to another person a specified sum of money by an agreed given date, usually within a year with three days of grace. Such notes are issued by individuals, corporations and government agencies. A promissory note is drawn by the debtor and has to be accepted by the bank in which the debtor has his account for it to be valid. The creditor can get it discounted from his bank at a premium by paying interest till the date of recovery.
- 2) **Bill of exchange or Commercial Bill:** A bill of exchange is an order drawn by the creditor to the debtor instructing the latter to pay a specified sum of money to the former, or to the bearer, or to his nominee. The payment is to be made after some fixed date, usually 90 days with three days of grace. The following steps are involved in the bill of exchange. The bill is drawn by the drawer (creditor) and sent to the drawee (debtor) for acceptance. The bill is accepted when the drawee puts his signature on the bill. If it is a firm, then the stamp of the accepting firm is put on which an authorized person signs. Now the creditor can discount the bill either with a broker or a bank. The bill of exchange is a negotiable instrument which can be bought and sold by the holder of the bill till the time of its maturity at the prevailing rate of discount (interest). The discount rate is the market price of the bill. The higher the discount rate, the lower the price of the bill at the time of discounting, and vice versa. After the date of maturity, the holder of the bill presents it to the drawee that pays the amount written on the bill. The difference between a promissory note and bill of exchange should be noted.

A promissory note is drawn by a debtor and accepted by his bank, whereas a bill of exchange is drawn by a creditor and is accepted by the debtor.

- 3) **Credit Cards:** An addition to credit instruments is the issue of credit cards by banks. Credit card holders are allowed credit facilities by the concerned bank for a specified period of time without any security from them. They can also purchase commodities from cloth and shoes to T.V.s and air conditioners and pay for such services as hotel bills, railways and airways tickets, etc. Without making cash payments. There are national and international credit cards.
- 4) **Cheque:** A cheque is an order on the bank, written by the drawer who has his deposit with that bank, to pay on demand the stated sum of money to the person named in the cheque. A cheque may be a “bearer cheque” or an “order cheque” or “crossed cheque”. The “bearer cheque” can be cashed by the payee (whose name appears on the cheque) or by any other person who holds it. The responsibility of making payment does not rest with the bank. If it is an “order cheque” the responsibility of payment to the payee is on the bank. In the case of a “crossed cheque”, the amount of the cheque must be credited to the account of the payee in his bank. The cheque is crossed on the left hand side upper corner and the words “Payee’s A/c only” are written there.
- 5) **Draft:** A draft, also called demand draft, is in the form of a cheque and is an order of a bank to its branch in some other city for making payment of the amount specified in it to the person or firm or organization. Besides receiving the amount of the draft, the bank charges a commission for preparing the draft. The draft is handed over to the debtor who sends it to the payee. The payee, in turn, presents it to his bank in that city to be deposited in his account. This is the procedure in the case of a “crossed draft”. If it is not crossed, the payee presents it to the bank on which it is drawn and receives the money after identification.

6.1.4. Significance of Credit

Modern economy is said to be a credit economy. Credit is of vital importance for the working of an economy. It is the oil of the wheel of trade and industry and helps in the economic prosperity of a country in the following ways:

1. *Economical:* Credit instruments economize the use of metallic currency. They are cheaper than coinage. The metal used in coins can be used for other productive purposes.
2. *Increases Productivity of Capital:* Credit increases the productivity of capital. People having idle money deposit it in banks and with non-bank financial institutions which is lent to trade and industry for productive uses.
3. *Convenient:* Credit instruments are a convenient mode of national and international payments. They help in transferring payments with little cost and without the use of actual money from one place to another quickly.
4. *Internal and External Trade:* As a corollary to the above by facilitating payments quickly, credit helps in the expansion of internal and external trade in a country.
5. *Encourages Investment:* According to Keynes, credit is the payment along which production travels and that bankers provide facilities to manufacturers to produce to full capacity. Credit encourages investments in the economy. Financial institutions help mobilizing savings of the people through deposits, bonds etc. These are, in turn, given as credit to trade, industry, agriculture, etc which leads to more production and employment.
6. *Increases Demand:* Availability of cheap and easy credit increases the demand for goods and services in the country. This leads to increase in the production of such durable consumer goods as motor vehicles, refrigerator, T.Vs. etc. These raise the standard of living of the people when they consume more goods and services. Consumption loans by banking and non-banking financial institutions coupled with the use of credit cards have made these possible.
7. *Utilizes Resources:* Credit helps in the proper utilization of a country's manpower and other resources. Cheap and easy credit encourages people to start their own businesses which provide them employment.
8. *Price Stability:* Credit helps in maintaining price stability in the country. The Central Bank controls price fluctuations through its credit control policy. This reduces the credit supply to control inflation and increases the supply of credit control deflation.
9. *Helpful to Government:* Credit helps the government in meeting exigencies or emergencies when the usual fiscal measures fail to fill the financial needs of the

government. Government resorts to deficit financing for economic development by creating excess credit.

6.1.5. Defects of Credit

Credit is a dangerous tool if it is not properly controlled and managed. The following are some of the defects of credit:

1. **Too much and Too Little Credit Harmful:** Too much and too little of credit are harmful for the economy. Too much of credit leads to inflation which causes direct and immediate damage to creditors and consumers. On the contrary, too little of credit leads to deflation which bring down the level of output, employment and income.
2. **Growth of Monopolies:** Too much of credit leads to the concentration of capital and wealth in the hands of a few capitalists. This leads to growth of monopolies which exploit both consumers and workers.
3. **Wastage of resources:** When banks create excessive credit, it may be used for productive and unproductive purposes. If too much of credit is used for production, it leads to over capitalization and over production, and consequently to wastage of resources. Similarly, if credit is given liberally for unproductive purposes, it also leads to wastage of resources.
4. **Cyclical Fluctuations:** When there is an excess supply of credit, it leads to a boom. When it contracts, there is a slump. In a boom, output, employment and income increase which lead to over production. On the contrary, they decline during a depression thereby leading to under consumption. Such cyclical fluctuations bring about untold miseries to the people.
5. **Extravagance.** Easy availability of credit leads to extravagance on the part of people. People indulge in conspicuous consumption. They buy those goods which they do not need even. With borrowed money, they spend recklessly on luxury articles. The same is the case with businessmen and even governments who invest in unproductive enterprises and schemes.
6. **Speculation and Uncertainty:** Over issue of credit encourages speculation which leads to abnormal rise in prices. The rise in prices, in turn, brings an element of uncertainty into trade and business. Uncertainty hinders economic progress.

7. **Black Money:** Excessive supply of credit encourages people to amass money and wealth. For this they tend to adopt underhand means and exploit others. To become rich, they evade taxes, conceal income and wealth and thus hoard black money.
8. **Political Instability:** Over issue of credit leading to hyper-inflation leads to political instability and even the downfall of government. This has happened in many Latin American countries.

6.2.FINANCIAL MARKETS

Financial market explains an arrangement that contract entities to trade financial claims under some established rules of conduct. Financial market could be defined as a forum for the exchange of financial products denoted in some cases by a physical location, but in others by a common electronic information system sharing data on prices and volumes transacted and where a number of professionals take an active part in the market processes. Financial markets in general deals in financial assets and liabilities of various maturities and consist of institutions, instruments, rules and regulations which guides the mobilization of funds from the surplus units of the economy to the deficit units. Conventionally, financial markets can be broadly divided into money and capital markets.

6.2.1. MONEY MARKET

The money market exists to provide funds for short term use of corporate entities and the government. It has developed over time because there are parties that had surplus funds to part with while there are others who needed such funds for operational use.

The money market consists of financial institutions and dealers in money or credit who wish to either borrow or lend. Participants borrow and lend for short periods of time, typically up to thirteen months. Money market trades in short-term financial instruments commonly called "paper."

6.2.1.1.Participants of Money Market

The core of the money market consists of the following financial institutions and corporate entities as well as government authorities.

1. Commercial banks : They engage in inter-bank borrowing and lending to each other using commercial paper, repurchase agreements, and similar instruments. These instruments are often benchmarked or priced by reference established rates, e.g., London Interbank Offered Rate (LIBOR) and Nigerian Interbank Offered Rate (NIBOR) for the appropriate term and currency.

2. Finance companies : Basically, they usually fund themselves by issuing large amounts of asset-based commercial paper which is secured by the pledge of eligible assets into a conduit. Examples of eligible assets include auto loans, credit card receivables, residential mortgage loans, commercial mortgage loans, mortgage-backed securities and similar financial assets.

3. Large corporations: These companies are known for strong credit ratings issue commercial papers on their own credit. Some other large corporations arrange for banks to issue commercial paper on their behalf by using commercial paper lines.

4. Government authorities: Federal, State and local governments issue paper to meet development funding needs. States and local governments issue municipal papers, while the federal government issues Treasury bills and Treasury certificates and other public debt instruments.

5. Trading companies: These companies often purchase bankers' acceptances to be tendered for payment to overseas suppliers.

6. Central banks: The apex banks of all countries do participate in the money markets to issue at one time and purchase at some other time, government papers on behalf of the government, and by extension to regulate demand for money and amount of money in circulation.

6.2.1.2. Functions of the money market

The money market performs certain functions which are identified as follows:

- i. The market helps to transfer large sums of money from savers to users for project undertakings;
- ii. It aids to transfer from parties with surplus funds, which will have remained idle, to parties with a deficit;
- iii. It facilitates the opportunity for governments to raise funds for developmental purpose;
- iv. The market facilitates the implementation of the monetary policy in the economy;
- v. It influences the determination of short-term interest rates in various economies around the world.

6.2.1.3. Money Market Instruments

Money market instruments are fixed income assets of high liquidity, very low risk, and short maturity. The maturity is mostly less than 12 months. There are several instruments available through which funds can be raised and traded in the money market. The proceeding subunits shall focus on these instruments.

1. **Certificated of Deposit (CDs)**– this refers to time deposit, which is commonly offered to consumers by banks, thrift institutions, and credit unions. A Certificate of Deposit is a receipt from a bank for deposit of funds with a stated maturity and specified interest rate. They are used to transfer surplus funds from one bank to another. There are two types of certificate of deposits Negotiable and Non-Negotiable Certificate of Deposits. CDs are short term debt instruments sold by banks and other depository institutions. It pays the depositor at maturity a specified amount of interest agreed upon during the term of the certificate plus the purchase price of the CD. For example, N2000, 10% CD will pay the depositor $N2000 + (10\% \text{ of } N2000)$ at maturity. The Non-Negotiable Certificate of Deposit (NNCD) has a feature of time deposit receipt, which cannot be negotiated before its maturity.

2. **Commercial Paper (CP)**– this is a short term usually promissory notes issued by company at discount to face value and redeemed at face value. Commercial paper consists of short term unsecured promissory notes that are issued by large, well-known corporations and finance companies. It is a form of direct finance by large credit worthy corporations. The investors in the paper are normally high networth and credit worthy individuals and institutional investors. If a company, say Nestle or Cadbury or Total Oil need immediate funds, it can sell commercial paper to another corporation or financial institution. By definition, commercial paper is simply a promise to payback a higher specified amount at a designated time in the immediate future. CP is also issued at discount and has maturities ranging between 2 or 3 days to 270 days. The advantage of CP is that by issuing it, a company avoids/circumvents the process of applying for loan. The disadvantages include possibility of risk of default in repayment, illiquidity, and unsecured or non-collaterized nature of the instrument. The secondary market for commercial papers in Nigeria is yet to be recorded. Therefore, their marketability is weak and there is high tendency for default risk, although they attract higher return than TBs and TCs.

3. **Treasury Bills (TB)**- These are the most popular marketable government securities. They are issued at discount and have 91-day maturity. Once they are issued, Treasury Bills can be bought and sold in the secondary market through government securities dealer. The return of the bill is the difference between the face value and the purchase value of the instrument. The first issue of treasury bills was made in Nigeria in 1960. The advantages of treasury bills include short maturity, vertically default-free status, and ready marketability. Their primary disadvantages lie in the fact that yields are normally the lowest of any marketable security.

4. **Treasury Certificate (TC)**--The Federal Government Treasury certificates are public issues with short maturities ranging between 3 months and one year and consequently higher returns. They are also issued at discount once or twice every month with odd interest rates (such as 5.471% and 6.053%) and sold at par. The first TC in Nigeria was issued in 1968 to bridge the maturity gap between the short tenured bills (TB) and the long tenured Development Stocks (DS).

5. **Federal agency short-term securities** – these are peculiarly available in the U.S. They are short-term securities issued by government sponsored enterprises such as the Farm Credit System, the Federal Home Loan Banks and the Federal National Mortgage Association.

6. **Federal funds** – also peculiar to the U.S., they are interest-bearing deposits held by banks and other depository institutions at the Federal Reserve, which are immediately available funds that institutions borrow or lend, usually on an overnight basis. They are lent for the federal funds rate.

7. **Foreign Exchange Swaps** – this involves exchanging a set of currencies in spot date and the reversal of the exchange of currencies at a predetermined time in the future.

6.2.2. CAPITAL MARKET

Capital markets refer to financial markets that facilitate the buying and selling of long-term debt and equity-backed securities. The capital market facilitates the transfer of the wealth of savers to those who need funds for the purpose of long-term productive use, such as companies or

governments regarding long-term investments. The Securities and Exchange Commission regulates the operations of the capital markets, in their respective jurisdictions around the world, to protect investors against fraud, among other duties.

The capital market is concerned with long term finance. In another perspective, capital market consists of a series of channels through which some savings of the economy are made available for industrial and commercial enterprises and public authorities. The capital markets are used for the raising of long term finance, such as the purchase of shares, or for loans that are not expected to be fully paid back for at least a year.

Whenever a firm borrows from the primary capital markets, often the purpose is to invest in additional physical capital goods, which will be used to enhance generation of its income. It can take many months or years before the investment generates sufficient return to pay back its cost, and hence the finance is long term.

The loans in form of debt instruments like bonds from the capital markets are securitized, that is, they take the form of resalable securities that can be traded on the markets. Lending from the capital markets is not regulated unlike lending from banks and similar institutions. A third difference is that bank depositors and shareholders Capital market investors do not tend to be risk averse. Nevertheless, capital markets are not accessible to small and medium enterprises compared to banks.

6.2.2.1.Segments of Capital Market

Capital market operates in two segments such as the primary and secondary markets. Therefore, the two divisions within the capital market are the primary and secondary markets.

1. Primary Markets

In primary markets, new stock or bond issues are sold to investors, often through a underwriting mechanism. The main entities seeking to raise long-term funds on the primary capital markets are governments (which may be state, municipal, local or national) and business entities such as companies. Governments tend to issue only bonds and development loan stocks, whereas companies often issue either equity and debt instruments such as corporate bonds. The main entities purchasing the bonds or stock

include pension funds, hedge funds, sovereign wealth funds, and less commonly wealthy individuals and investment banks trading on their own behalf.

When a firm decides to raise money for long term investment, one of its first steps is to consider whether to issue bonds or shares. The process is more likely to involve face-to-face meetings than other capital market transactions and companies will have to enlist the services of an investment bank to mediate between themselves and the market. On the primary market, each security can be sold only once, and the process to create batches of new shares or bonds is often lengthy due to regulatory requirements.

The investment bank then acts as an underwriter, and will arrange for a network of brokers to sell the bonds or shares to investors. This second stage is usually done mostly through computerized systems, and more often than not, brokers will contact their favoured clients to advise them of the opportunity. Firms raising the funds from the capital market can avoid paying fees to investment banks by using a direct public offering, even though it involves incurring other legal costs and can take up considerable management time.

2. Secondary Markets

These are the markets for old securities. Therefore, in the secondary markets, existing securities are sold and bought among investors or traders over the counter, usually on an exchange or the stock exchange, which serves as the nerve centre for the market operations. Such transactions in existing securities can also be traded with means of electronic arrangements. The existence of secondary markets enhances the willingness of investors to deal in the primary markets, as they know they are likely to be able to swiftly cash out their investments whenever the need arises.

Trading on the secondary markets involve the use of an electronic trading platform. Most transactions in capital market are executed electronically. Nevertheless, sometimes a human operator is involved, and sometimes unattended computer systems execute the transactions such as the algorithmic trading. Most transactions in capital market take place on the secondary market.

On the secondary markets, there is no limit on the number of times a security can be traded, and the process is usually very swift, and with the rise of strategies such as high

frequency trading, a single security could in theory be traded thousands of times around the world within a single hour. The transactions on the secondary market don't directly help raise funds, but they do boost the chances for firms and governments to raise funds on the primary market, since prospective investors have assurance that if they want to get their money back, they will easily be able to re-sell their securities.

However, at times secondary capital market transactions can pose negative effect on the primary borrowers, as in the case when a large proportion of investors try to sell their bonds, this can push up the yields for future issues from the same entity. In modern times, several governments have tried to lock in as much as possible of their borrowing into long dated bonds, so as to obliterate the vulnerability to pressure from the capital markets.

6.2.2.2. Capital Market Instruments

In contrast to money market instruments, which have maturities of one year or less, capital market instruments have maturities of more than one year. Besides, they are those with perpetuity and those that confer ownership on holders.

There are four major instruments used in the capital market. They include: debt instruments, preferred stock, common stock and risk asset instruments. Details about these instruments would be discussed later in the subsequent section. The most common nature of the capital market is that it is the market for long term securities and provides services that are essential to a modern economy. It provides access to a variety of financial instruments that enable economic agents to pool price and exchange rate risks. The principal capital market instruments will be discussed in the proceeding subunits.

1. Debt Instruments

Debt instruments in the capital market are those for securing long-term loans or borrowing. That is, they are bought and sold on the market for funding huge and long term investment. Debt instruments may be classified into two: those secured by specific assets e.g. mortgage bonds; and those not secured by specific physical assets e.g. debentures.

Debt instruments are long-term issues raised by organization or government parastatals. They attract fixed rate of interest, which are paid at a start coupon rate on their nominal value. Suppose

the nominal value of bond is N200, 000 and the coupon rate is 10% the bond will receive #20,000 interest. One peculiarity of Debt instruments is that their obligations are met before payment, due to long term capital market instruments. In Nigeria, the federal government debt stock (bond) remains the most popular marketable government security in its capital market.

2. Preferred Stock

The preferred stock occupies an intermediate position between long-term debts, e.g. bonds. Preferred stock is considered a fixed income security, like common stock, it is part of the stockholder equity. The preferred stock holders receive dividend while the debt holders receive fixed interest payment. On the part of investors, debt securities attract low risk than the preferred stocks and common stock. Although the expected returns from preferred stock has a nominal value and dividend is paid at a fixed percentage of the nominal amount.

3. Common Stock

Company stock holders (Ordinary Shareholders) are its true owners. The common stock holder of a company have residual claim in the company. Their claims are paid after the debt holder and preferred stock holder have been paid in full. Common stock is considered a permanent form of long term financing, since, unlike the debt and preferred stock, common security. The expected return on the common stock investment is high as well as its risk.