Journal of Sustainable Development in Africa (Volume 9, No.2, 2007)

ISSN: 1520-5509

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Should the Investment Banking and Corporate Finance Spirit Of Merchant Banks Be Exorcised From the Nigerian Banking System?

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Abstract

A very critical question which this paper addresses relates to whether or not the investment banking and corporate finance spirit of merchant banks be exorcised from the Nigerian Banking System. It attempted by x-raying the rich professional heritage left by merchant banks in their corporate finance and investment banking services. The revelation is today's Nigerian would of necessity invoke and imbibe the essence and spirit behind these functions carried out effectively by merchant banks during their years of spectacular existence. By so doing, both the consolidated and the stand-alone banks would be in a position to further their pursuit of strategic competitiveness and globalize relevance. The obvious implication of this paper, thus, is that the banking system in particular and the economy in general stand to benefit tremendously if the spirit of merchant banking is allowed to live on in the country.

Introduction

The introduction of universal banking in the Nigerian financial system in 2001 coupled with the banking consolidation reforms of 2005 is said to have cast a thick shadow on the spirit and essence of merchant banking in the country. For one thing, the advent of the universal banking removed the line of separation between commercial and merchant banks. All banks in the system were meant to operate on an even slate, with no advantages enjoyed by one category over another. They all were branded deposit money banks. Further accentuating the matter is the 2005 requirement by the Central Bank of Nigeria to raise the minimum capital of all banks to an all time high of ₦25 billion. This precipitated unparalleled banking consolidations that had never been witnessed in the history of Nigeria and even the entire African sub-region. The effect of these and other developments in the industry appear to be the near-total loss of independence, self-existence, and identity of the erstwhile institutions known as merchant banks.

But, can we say that merchant banks have lost their relevance or that the banking industry can do without the earlier cherished tonic which these institutions brought into the Nigerian Banking system? That they positively affected the system is true when we particularly consider their special features discussed in Ezirim (1996a) as including scale of operations, nature of services, gap thesis argument, branch networking, and flexibility and dynamism. The importance of merchant banks in transmitting flexibility and dynamism in the banking system especially in the area of professionalism, flexibility and dynamism was further expressed in Collins (1977:59) when he simply saw Merchant banking as “a business based primarily on skills, where a successful merchant bank is an association of men and women of above average ability who make available to a variety of clients a wide range of fee-rewarded financial services”. Adewunmi (1985:2) corroborated this when he affirmed that “the hallmark of merchant banking would include, among others, high level, specialized expertise, imagination, adaptability, integrity, innovativeness, maneuverability, flexibility and individuality”. Can we say that all these have gone into oblivion since the exit of merchant banks from the Nigerian banking scheme? Ezirim (2005) believes that the spirit of merchant banking still leaves on in Nigeria despite all the developments earlier posited.

How then can we know for sure that the above position is correct? We must take a cursors inquiry into the peculiar operations of this banks and see how relevant they are in the present dispensation. In Ezirim (1996), a list was made of these important services to include: acceptances and discounting; deposit mobilization and treasury operations; credit operations; equipment leasing; money market operations and investments; corporate finance services and/or capital market operations, investment management and financial advisory services; and international operations. In this paper we discuss the nature, taxonomy, and relevance of corporate finance services including project financing, loan syndication, and issuing house operations. Others are investment management, financial advisory services. We shall also consider their international banking operations. Among other revelations we see what makes merchant banks, investment bankers as they operate in the capital market. Also merchant banks are not spectators in the international banking arena but key operators.

Some Historical Issues and Background

Merchant banking in Nigeria came into existence in 1960 by the pioneering effort of Philip Hill (Nigeria) Limited on September 14th, 1960. The Nigerian Acceptances Limited followed suit on

25th November 1960 to become the second merchant bank to be registered in the country. The progenitors of these institutions were British both in essence and in spirit. The two institutions operated identically both in the types of services and in the way and manner they functioned. It was not surprising that they merged in 1969 and continued to exist as one institution in the name of Nigeria Acceptances Limited (NAL) up till 1973 (Adewunmi, 1985; Ezirim, 1996).

The monopoly was broken in 1973 with the entrance of Union Dominion Trust (UDT) Bank Nigeria Limited, which was renamed Nigerian Merchant Bank Limited in 1977. Ever since, many merchant banks entered the scene such that as at 1996 there were a total of 51 merchant banks with 143 branches. Distress and insolvency situations that plagued the Nigerian banking system saw to the demise of many of these institutions such that as at 2001, the number of merchant banks depleted to 23. A major explanation to the demise of these banks related to the disadvantageous capital sourcing position in the face of commercial banks – their prime competitors. Further, commercial banks using their advantageous capital position eroded the merchant banks of their most cherished assets – their professional, well-trained staff. The centre could no longer hold ever since (Ezirim 1996, 2006). By the year 2001, the universal banking scheme had come into effect as a deliberate policy of the Central Bank. Thus, the system was sanitized of any sectional leanings. Merchant banks were free to become commercial while commercial banks were equally free to become merchant or both. Thus, the age-long capital sourcing and utilization advantages/disadvantages and every wall of partition were removed. The total number of banks in the system (now known as deposit money banks) depleted from 115 in 1996 to 88 in 2004 (Central Bank of Nigeria, 2004). The distress condition witnessed in the banking system was accused of this institutional numerical depletion.

With the policy of the CBN requiring deposit money banks to recapitalize to the tune of ₦25 billion or lose their license, the 88 remaining banks sought to find ways to comply with the directive. This brought about a situation of scramble for capital among banks from all sources. Some went to the capital market and raised funds. Some merged with other banks; others were acquired; while some used a combination of two or more of the above strategies. The result was the emergence of 25 consolidated banks as at December 31st 2005. In all these, it seemed that the nomenclature, merchant banks simply became a historical matter. Where went all the 51 merchant banks of 1996 and the 23 of 2004? As it were, they seem to have been consumed by the universal banking experiment of fused into the more globalized banks that arose out of the consolidation quagmire.

Notwithstanding, it is thought that the spirit of merchant banking lives on even when their physical identity is suspect. We take a glimpse of this spirit in the specialized services they undertook and left as legacy for the Nigerian banking system. Two of such services are the corporate finance and investment banking services with both local and international dimension. These would form the mainstay of our subsequent discussion.

Corporate Finance Services

In its most rudimentary form, corporate finance services of merchant banks was defined for all the activities of these banks in assisting corporate customers to receive due financial assistance and advice. Since most of the customers of merchant banks are business organizations, every service provided to meet their financial requirement would qualify as a corporate finance service. From this broad perspective, such services aforementioned in Ezirim (1996a) as term lending, leasing, and trade finance ought to be included. Osayemeh (1986:172) viewed it more broadly to mean "the provision of financial assistance as well as advisory services to the public, mainly corporate customers, corporations and governments. However, for the purpose of this paper we limit the corporate finance activities to unique operations of merchant banks to firms in the areas of project financing, loan syndication, issuing house or investment banking operations, investment management and financial advisory services. We shall discuss these services in some detail before considering the international activities.

Project Financing

Merchant banks in Nigeria rendered financial assistance to corporate customers by way of project financing. This involved the extension of credits for the construction, development and /or acquisition of capital assets or a group of interrelated assets which operate together in such a manner as to be able to repay the loan. This means, that the project so financed was looked upon as the ultimate source of repayment for the advance. By implication, the onus lied on the merchant banker to ensure that the vital stages of the project ranging from construction through implementation to successful operations were perfected, if he was to receive his money back. A further requirement was his direct or indirect participation in the management of the project, depending on the incipient agreements reached or eventual developments. It has been argued that project financing requires a proper understanding, careful supervision and follow-up of the project financing unit-an integral component of the corporate finance department (Osayameh,1986).

Premising on these and the need to guarantee prompt repayment of facility, merchant bankers, right from inception of loan proposal analysis, satisfied themselves that the project to be financed possessed certain essential attributes. First, the project should be technically feasible with all the engineering and production needs matched with available resources. This also implied that all the equipments, plants, raw materials, etc., were available. Second, there was the need for the project to be commercially viable. Among other requirements, the products manufactured or services rendered must be in good demand with a large market. It is only when this is right that repayment could be, at least, partly guaranteed. Further, the project must be economically desirable; where operations do not jeopardize the demands of any existing statute, nor injurious to the welfare and conscience of the citizens. It must be such that would add value to the economy. The banker also ensured that the management of the project was sound and poised for results. Poor management was considered the bane of any tangible economic progress and development. Lastly, the merchant bank made sure that the project was financially profitable. This means that it would be able to generate adequate cash flow to liquidate the loan while remaining some for the customer's benefits. These are the operational criteria of project evaluation which could be made manifest by the aid of feasibility analysis. Apart from these, merchant bankers equally employed the use of the tested cannons of lending such as the 5Cs of credit analysis. Projects to be finance may range from new projects to expansionary ones; from replacement of assets to a diversificatory; from manufacturing to service-oriented projects. Notwithstanding, the nature, the basic principles of lending and criteria for project evaluation were all applicable.

Loan Syndication

When a projects' financial requirement dictated a very colossal amount beyond the convenient financing of a single merchant bank; an arrangement was made to source the required funds from a number of other financial institutions. Merchant banks perform this crucial role of organizing and mobilizing consortium institutions so that the project implementation of valued customers did not fail. This is called loan syndication, representing the process whereby banks (two or more) come together and combining their financial muscles and service delivery abilities in a bid to assist a needy customer by injecting into the said client fresh *financial vitality.* It can be arranged for both new projects and existing ones. In the process, a typical merchant bank invited other banks and non-banking institutions for the purpose of considering and arranging a loan facility to a worthy borrower. It can also be seen as an agreement between two or more lending institutions to provide a borrower with a common credit facility. The arrangement presents a scenario where 'many' lenders, led by an institution known as a *lead bank* or *syndicate manager,* accommodating only one borrower financially into a form of *syndicate* or *consortium* suited for the above purpose. Some bankers prefer to call the arrangement-*consortium lending* or *consortium financing.*

*<u>Rationale for Syndication</u>*__*:*__ The reasons accounting for loan syndication among banks are legion, some of which are explained hereunder.

*<u>Diversification of Risk</u>*__*:*__ The first reason for this method of finance relates to the need to diversify risk attendant to a given credit proposal. Certain projects required huge investment outlay beyond the comfortable financial accommodation of any one merchant bank and yet they reserves immense potential benefits. Since no single bank could handle it, the need for a syndicate of lenders became apparent. For the lead bank, the risk which it would have carried alone; should it finance the proposed project single-handedly, was otherwise diversified or spread among many banks. In that case, it carried only a reasonable amount of credit risk that will not be too injurious to the banks operational and financial integrity.

*<u>Conservation of Liquidity</u>*__*:*__ As a result of the ability to share the financing burden with other financial institutions, a typical merchant bank would be in the position to conserve the much needed liquidity and meet customers' withdrawal needs. When depositors enjoy safety and stability of their deposits, being able to get their monies upon request or as agreed, their patronage is always ensured. This, in turn, stems the incidences of bank run and bank panic and their effects thereof to the particular bank. In situations of sudden events in the banking system, a liquidity conserving bank would not fall prey to the arising economic emergency. For instance, when the Federal Government of Nigeria commanded a shocking withdrawal of its funds and those of its agencies from banks, during the period May 1989 through 1990-, the urge to overcome the associated money market illiquidity was a just and rational behavior. It is argued that loan syndication is a veritable avenue to conserve liquidity while at the same time satisfying the demands of valued customers.

Following from the above arguments, and because of the long-term nature of, and volume of funds required by typical projects, no single bank is willing to tie its funds in one project. Syndication calls for a loan portfolio build-up which frees banks of that onerous task without failing to satisfy the huge funding requirements of profitable projects.

*<u>Retention of Valued Clientele</u>*__*:*__ A typical bank that is not able to meet the financial needs of its customers runs the risk of loosing same to more aggressive competitors. Thus, in order to retain the patronage of valued customers, even amidst poor funds base, merchant banks invited other financial agencies to form a consortium of lenders in order to meet the funding requirements of the particular client.

Low Capitalization: Low capitalization among merchant banks necessitated consortium financing. Also, in the advent of statutory regulation of bank lending, such as the institution of credit limits, sectoral allocation, a bank may be constrained to meet a typical project need. This limitation is satisfactorily eradicated by loan syndication. No matter the reason accountable for the syndication of loans, decisions to join a syndicate are left with the individual banks. There are no legal demands on the part of banks and other financial institutions to compulsorily become a consortium lender. Individual decisions are predicated on such considerations as:

(i) The syndication arrangement and financial implications suiting the bank's portfolio philosophy, policies and strategy.

(ii) The ability of the syndicate manager, the lead bank, to adequately manage the transaction unto successful re-payments;

(iii) The personal characteristics of both the customer and the credit being right and acceptable;

(iv) Other normal lending cannons and principles being satisfied.

Syndicated Loan Administration

It is the responsibility of the lead bank to 'shop' around with the client and sell the credit proposal to interested bankers and financiers. In the process, the syndicate manager sends the *placement memorandum* to prospective lenders interested in the consortium to make their respective *in-principle commitments.* The forwarding of the placement memorandum should be followed by aggressive marketing on the part of the credit officers of the lead bank in order to convince them to participate in the syndicate. Follow-up calls, visits and correspondences are necessary actions to follow. When the required amount implicated in the syndicate is completely sourced, the lead bank then calls a meeting of the syndicate. When issues of mutual and professional interest are discussed, the obligor customer does not need to be in the meeting. In a situation of over-subscription of the required amount, the lead bank reserves the rights to either pro-rate the amount to selected banks or to remove some banks from participation.

In the course of the financial arrangement, the credit officers would involve their legal department in a meeting to agree on the modalities for securing the loan, the general nature of the loan agreement with the Obligor, and the inter-bank agreements. These are properly documented and those that need legal perfection are so done. Occasionally, a separate trustee (a trust company) other than the lead banks is appointed to be in-charge of perfecting documents and enforcing conditions agreed upon in the event of the default of the Obligor. The offer letter specifying the terms and conditions of the loans are issued to the borrower and can either be signed by the lead bank on behalf of other syndicate members or singed jointly by every participating bank. The security may take such forms as fixed-charge debentures, mortgage debentures, guarantees, insurance policies, warehousing arrangements, or any combination thereof that suits the purpose of the loan and the lenders. Where no trustee is appointed, the lead bank undertakes to perfect the security and realizes same in event of default in a manner agreed by the syndicate. The *inter-bank agreement* is the document that shows the details and nature of the relationship substituting between parties involved in the consortium.

When the documentation requirements are fully fulfilled, with all parties executing their respective documents, and all conditions precedent to drawn-down met then disbursement of funds to the borrower, according to schedule, would start. All members of the syndicate would then open loan accounts for the customer, write cheques to the lead bank for the benefit of the Obligor. The lead bank also opens a memorandum account for each of the participating lenders. This memorandum accounts among other things, indicates the date of draw-downs from each bank, the amount contributed, interest rates involved, loan repayment to the each party to the syndicate.

The lead banker goes to the borrower to collect relevant installments as they fall due – repayment of interest and principal as agreed and updates the memorandum accounts accordingly. Another responsibility of the lead bank is to obtain all necessary documentary information required from the borrower, periodically and makes them available to fellow syndicates for control and monitoring purposes. In case a disturbing situation emerges or unfavourable trend noticed, the manager summons a syndicate meeting immediately where necessary actions are discussed and subsequently taken. If default scenario presents itself, the lead bank, after putting heads together with other banks, goes ahead to take needed steps for loan recovery. Such processes may involve calling back of loans, foreclosure, realization of collaterals, and even bankruptcy, should the situation arise. However, if the wisdom of the syndicate so suggests, a loan walkout procedure can be effected by the lead bank. It may even, and in most cases it is, mean more advance to be made to save the life of the project so embarked upon and guarantee their repayments.

Problems of Loans Syndication and Customer's Assessment

Loan syndication has been criticized for delays in packaging the loan. It is argued that it takes a rather long time before the typical borrower draws the loan. Another argument is that borrowers may be uncooperative in meeting terms and conditions spelt out in the loan agreement simply because too many financiers are involved. He can elect to cash in on the apparent difficulties encountered in arranging a syndicate meeting promptly. The repayment of interest and principal may be so irregular to the detriment of the syndicate members in view of nonchalance and negligence on the part of the customer.

However, on the part of the customer, he judges a syndication arrangement efficient if it meets his objectives along the lines of prompt delivery and on a good time; and minimal cost implications. When these are achieved, the customers as well as independent assessors would consider the arrangement efficient.

Investment Banking Services

Merchant banks performed investment banking services to their corporate customers. When, for instance, a corporate customer fails to secure credit facilities for its operations (i.e. where term loans, long-term loans, leasing, project financing or loan syndication arrangement became difficult or inappropriate), it may approach a merchant bank in order for the latter to take it to the capital market (market for long-term funds) to obtain the needed financing. This arrangement calls for the fresh issue of new securities (common stock, debentures, or preferred stock) in the Nigerian capital market. The new issues are called *primary issues* and the market for such issues is called the *primary market.* In this arrangement, the merchant bank became an agent who reserved the duty to source for buyers for these new securities. In performing this function they were branded *investment bankers or underwriters.* The entire activity of merchant banks in this respect can also be referred to as *issuing house operations.* Thus, merchant banks were *issuing houses* when they performed investment banking activities. What was peculiar in this aspect of their services was that they did not necessarily make permanent investments of their own funds, nor did they provide a place for the safe-custody of funds as a typical commercial banker would. At best they could only mop up the newly issued securities from the corporate client or even the government (if applicable), and subsequently arranged immediate resale to the investing public (Francis, 1986:48). The process is known as securities underwriting. It can easily be seen that merchant banks, in carrying out issuing houses', (underwriting, or investment banking) services were mere intermediaries between issuers and the ultimate purchasers of their securities. They were also called *securities brokers* and *dealers.* As brokers, they brought together buyers and sellers of securities either on the Nigerian Stock Exchange (NSE) or on an over-the counter (OTC) market without assuming the price risk of inflation personally. As dealers (their usual domain), they held an inventory of securities with the readiness to sell same at one price (the asked price), as well as to buy these securities at a lower price (the bid price); the difference of which accounts for their profit on the transactions. There was equally a risk of capital loss since the securities so held as inventory by the merchant banks might decline in price.

The Issues of Income and/or Floatation costs

A point that would be easily appreciated at this juncture is that a merchant banker engaged in issuing house activities to earn his income in the same manner as ordinary merchant would. They made profit as long as their selling price was greater than their buying price. The difference between the two prices is called the spread. The spread compensated the banks for the various costs attendant to the transaction: investigation costs, discount given to the under-writing syndicate, and the additional discount given to the selling group members. To the corporate customer who was raising funds through the capital market, this spread represent what is called floatation cost or cost of issue to the firm. As would be expected floatation costs for small issues are usually higher than those for large issue. This was not unconnected with the fact that small issues were usually made by less known companies which required that merchant banks engaged in taking them to the market would involve more cost of investigation of the issuing firm as well as more difficulty and cost of marketing the new issue. This makes the per unit floatation costs to be higher for them. Fragmentary evidences seemed to show that floatation costs for bonds were usually lower than those of ordinary share or preference shares. The explanation for this trend has been advanced in respect of the selling costs for ordinary shares or preferred stock being usually higher than those of bounds. Francis (1986:54) affirmed that “it seems reasonable that floatation costs of bonds would be less than for preferred or common stock because bonds are usually sold in large blocks to a small number of large institutional investors, whereas a stock issue may be sold to millions of stockholders. Thus, marketing costs and risks are significantly greater with common stock issues”. These should be of further research interest especially in the light of the Nigerian experience.

Before delving into the details of the functions of merchant banks in taking a corporate customer to the “public”, let us quickly add that this issuing house operations were carried out in Nigeria, not only be merchant banks but also by other finance houses and investment companies who were registered with the Securities Exchange Commission (SEC) and the Nigerian Stock Exchange (NSE) as issuing houses. They were stockbrokers, dealers and investment advisers all put in one. With this development, merchant bankers did not retain the monopoly of investment banking operations in Nigeria; but amply represented the banking industry in this all-important area of operation.

Merchant Banks as Investment Bankers

From our discussions thus far, the following functions were implicated for merchant banks in their capital market or investment banking operations: advisory, administrative, underwriting, marketing, syndicate participation and management, use of own selling group, pricing of securities, and market stabilization. We shall briefly examine these duties in turns.

Advisory Service ***:*** Perhaps the first set of function merchant banks performed to its corporate customer at the point of first meeting is largely advisory. The banker advised the client on whether or not to go public or to make new issues, in case it is already listed on the exchange. Where other means of financing are more appropriate to the relevant situation, suggestions to that effect were made. Generally, investment bankers render such advisory services as representation of clients before financial market authorities, advice on relevant regulations, drafting work, advice on proper terms, timing and pricing on new issue (Okafor, 1983). In some instances, these investment bankers are appointed 'permanent' financial consultants to the Board and Management so as to ensure that, following an issue, the client maintains a good financial outlook and competitive posture; and, secretly on a selfish note, "to help protect the underwriter's reputation as the sponsor of profitable, financially sound firms" (Francis, 1986:54)

Administrative Function: Merchant banks as issuing houses undertook to conduct necessary investigations on the client and its operations. It was noted earlier that the extent of work done here was subject to whether or not the prospective issuer of the new securities was already well known or reputed. More reputed companies required less investigation, ceteris paribus. Further, investment banks handled the paperwork, and "general protocols" attending to the primary issue. These could be very technical, voluminous and demanding, and are generally not easily comprehendible by the uninitiated; especially when these paper works had to comply with the dictates of the prevailing regulations. Of note is that the introduction of the computer into business has gone a long way to reduce the manual requirements of issuing houses documentation and paperwork.

Underwriting Function: Merchant banks performed this function when they purchased the securities from the issuer at a specific price in anticipation of reselling them at a higher price. In a sense, securities underwriting refers to the guarantee by the issuing house (in this case the merchant bank) that the corporate client issuing the securities will receive a certain amount of naira for its new securities. The underwriting process underlines the automatic acceptance by the bank some degree of price risk associated with the transaction. Thus, by underwriting, corporate issuers shift a proportion of the risk of market failure. If, however, the entire security issue is underwritten by the investment banker (and, perhaps, other members of the purchasing group), the issuing firm receives the public offering price less a stated percentage spread. It is also possible for the issuing firms to compensate the underwriters with shares, warrants, and other valuable securities. The underwriters, on the other hand, sell the securities at the public offering price or less and may take some of the securities themselves, if legally permitted. In his own words, Shape (1985) explained that "underwriters who provide this sort of *firm commitment* bear all the risk, once the price and underwriting spread have been determined" (Sharpe, 1985:45). Firm commitment underwriting arrangement, which requires the issuing house to mop up all unsold securities, also implies that full risk of market failure is assumed by the dealer. In view of this risky nature, it attracts a somewhat higher underwriting spread. The spread as earlier stated represents some percentage differential off the offer price (Okafor, 1983).

Arguable, it is true that, at times, underwriting risk-transfer may be partial. This means the securities dealer may decide not to commit himself to fully assume the risk of market failure. A situation can arise when he may be required to buy at a predetermined price all the securities not taken up by current stockholders. This kind of underwriting is called a *standby underwriting agreement.* The plan is usually associated with *rights offering.* A right offering is the mechanism that suggests that all newly offered securities be sold exclusively to existing stockholders without any contemplation to invite the public for subscription. However, Okafor (1983:82) defined it to have a general application when he said that “the standby underwriting plan is an arrangement whereby the underwriter contracts to take up the balance of a given issue not subscribed to by the public”. Notwithstanding, where the issue is not exclusively reserved for existing shareholders, in which case, non-rights offering, it is usual for underwriters to assume more of the role as an agent as opposed to being a dealer. Here, the agreement would be to handle the new issue on a *best-effort basis.* This precludes any financial responsibility on the part of the merchant bank should part of the securities remain unsold. In such a *public offering,* he refrains from serving as an underwriter and only agrees to use certain specialized facilities and workable strategy to distribute the new issue. The *commission on sale or service charge* of merchant banks on best efforts would usually be lower than that on rights offering.

It is equal true that not all new issues are underwritten. A merchant bank that located one or more buyers for the new securities and arranged a direct exchange between the corporate customer and independent investor was performing a *private placement* function. Here, the merchant banks’ work was basically that of linking or bringing together the issuer and the investor. He also inputed some special skill and speed in determining a fair price and execution of the business. These formed the basis for their remuneration.

Marketing Function: Another cardinal function of merchant banks in their capital market operations was the marketing of securities. This involves the physical distribution of new issues. Distribution took one of two forms; (a) either they were participating in buying and selling directly or (b) they served as intermediaries bringing the issuer and investors together. As indicated earlier, an example of participatory distribution is the marketing activities involved in an arrangement such as firm commitment; whereas private placement typifies the agency or intermediating distribution. It had been underscored that the distribution of new securities needed elaborate selling organization which the corporate firm would not be able to establish considering its cost implications. Thus, merchant banks with well trained and specialist personnel, as well as a permanent dealership organization became the rightful choice in this respect. We have seen commercial banks serving as selling agents for new issues on behalf of investment bankers in Nigeria.

Syndicate Participation and Management: Merchant banks (especially the originator) reserved a duty of coordinating a syndicate of underwriters and selling groups for the purposes of new issues. The originator is the investment banker that first agrees with the issuer on the transaction. It is the duty of this originator to liaise with the corporate issuer and determine how much should be sourced, the method and manner to raise the funds, (such as equity versus debt), and the financial standing of the issuer. Afterwards, the bank constructs a tentative underwriting agreement with the issuer which stipulates all the terms of the issue, except perhaps, the specific price that will be set on the debenture (Francis, 1986). On establishing the basic elements of an offering, the merchant banker filed a *registration statement* with SEC, and issues a *preliminary prospectus* disclosing materials relevant to the prospective buyer. Actual price was not indicated on this preliminary prospectus until the *final prospectus* was issued after SEC's registration becomes operative.

Having established these necessary processes, the merchant banks went ahead to form a purchase syndicate made up of a group of investment banking houses. This was especially true when the arrangement involved very large issues. The syndicate or purchase group, were simply investment bankers that buy the security from the issuing company and underwrite the offering. Francis (1986) pointed out three advantages of such a syndicate. First, it spreads around the purchase cost, a factor that prevents the originator or lead investment bank from facing a lot of cash drain while the sale of the security tarries. Second, it reduces the risk of loss in view of the fact that many investment banks would bear the loss should market failure results instead of only the originator. Finally, using several underwriters and their *selling groups* affords the new issue a wider participation of ultimate investors. Figure 5a shows a flowchart for a primary offering made through a syndicate of investment bankers.

Using selling organization. Apart from the establishment of a syndicate, the originator merchant bank puts together a selling group. As indicated, each participating syndicate would come along with own selling group to ensure successful disposal of the securities. A selling group would include all the agencies or firms that contact potential buyers and do the actual selling, usually on a commission basis (Sharpe, 1985:44). Each participating member of the syndicate uses its own selling group to market its own securities after completing purchase from the corporate issuer. Basically, the selling group comprised investment banker, finance and investment companies, dealers, and brokers. We earlier posited that in most cases, commercial banks were used as outlets to market the new issue.

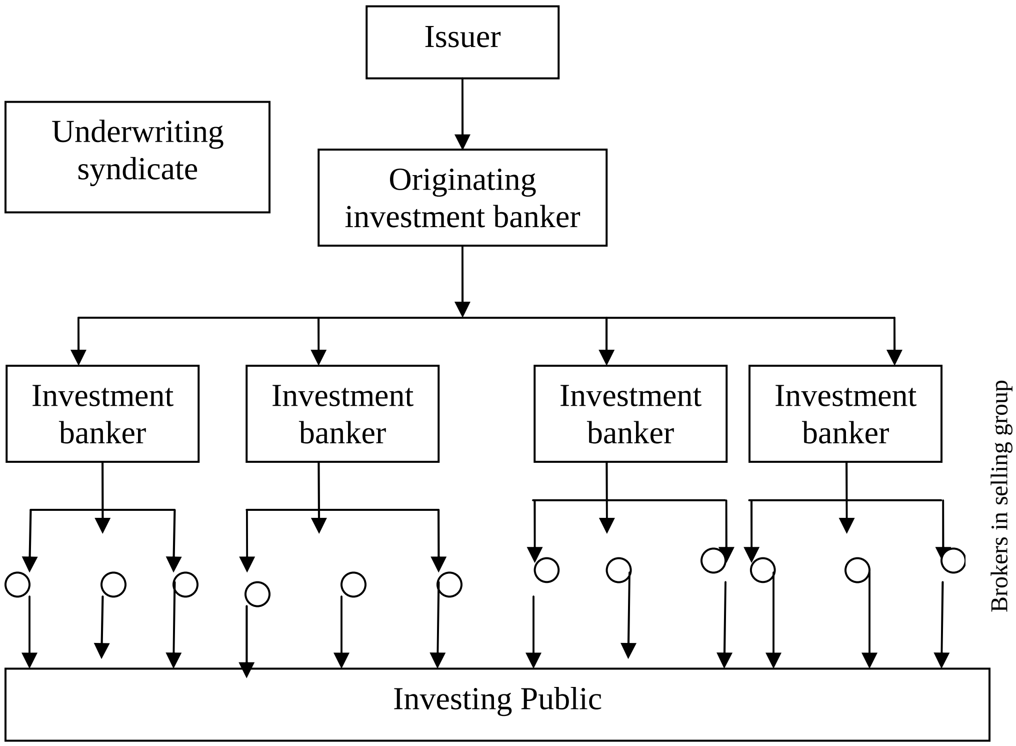

Figure 1: Flowchart for a primary offering made through a syndicate of Investment bankers.

Pricing of Securities and Market Stabilization: This is a very challenging task in the floatation process which the merchant banks undertook in collaboration with the SEC and with due consultations with the issuing company. In Nigeria, before the advent of stock market deregulation, in the mid '90s, initial price of new securities was fixed by the SEC in collaboration with the issuing house (the later mainly representing the interest of issuer). With the deregulatory trend, the issuing house now decides on the price with the issuing company in consultation with the SEC. SEC no longer fixes the price, as before the deregulatory regime. The decision to establish an appropriate and competitive price is quite critical. For one thing efforts must be made to ensure the prices are neither too high nor too low. When very low, the floatation exercise becomes unnecessarily costly to the issuer; while when too high, the underwriters may suffer loss. This calls for a balanced price which is referred to as the optimal price. To determine the optimal price requires the application of a lot of analytical tools beyond the appreciation of those ignorant of financial theory. The main body of Security Analysis or Valuation covers this problem, and this present paper will not treat it.

It is enough to note that merchant banks assisted in setting the price of new issues; and that the price is generally set at the end of the registration period. The registration of new securities offerings has taken a new turn with new procedure. *Shelf registration* is the name for these expeditious new procedures (Francis, 1985). A typical investment syndicate usually chooses to wait to set the final price until the new issue is ready for distribution on the market condition. An amalgam of right pricing, good market conditions, issuer and underwriters being reputable, the selling of the new issue would be a rather fast and interesting event. The marketing of the new issue will become sticky if any one of the above bare heads is lacking.

Further, in the course of marketing, with the availability of unsold securities, the investment banker reserved the duty to 'stabilize' the price of the issue to stem any downward sliding. The syndicate manager here pegs the price by placing orders to purchase the newly issued security as a desired price on the stock exchange (the secondary market). He simply stands ready to buy at or above the offering price. Such *pegging,* as Sharpe (1986) argues, may continue for up to ten days after the official offering date. The moral or ethical content of this practice have been questioned by certain authorities. The author of this paper has no intention to delve into this controversy but it is enough to underscore that merchant bank, as investment bankers, performed very many specialized functions in their capital market activities.

Investment Management Services

Merchant banks also carried out investment management services for its clients. These services ranged from diversifying portfolio (holding many different securities); tailoring portfolio (selecting investments, meeting a specified set of criteria such as high yield and medium risk); controlling a portfolio (ensuring that the specified set of conditions or criteria are continually met); to selecting securities that seem to be mispriced, in an attempt to "out-perform" – by implication, achieving a higher return relative to risk than available elsewhere (Sharpe, 1985:55). This being the case, investment bankers also undertakes the known functions of investment companies.

For the mutual benefits of the clients and themselves, Nigerian merchant banks have been known to have involved themselves with unit trust and investment trust schemes. For instance, among the nine (9) unit trusts established in 1991, six of them were directly pioneered by merchant banks (See Table 1). The first known of such a scheme was established in 1990 under the name, ABACUS Unit Trust Scheme. The first proposal to introduce the scheme into the Nigerian Capital Market was officially made in 1980. It was not until 1984 that the modalities for the Scheme were articulated in the form of a Unit Trust Decree which was afterwards incorporated into part xvii. Chapter 3 of the Companies and Allied Matters Decree (CAMD),1990. CAMD requires that both the Trustee and the Trust Manager must be corporate bodies registered with the Corporate Affairs Commission (CAC) (Federal Government of Nigeria, 1990).

Table 1: New Unit Trusts Introduced in the Nigerian Financial Market in 1991.

S/No	**Name of Unit Trust**	**Number of Investments**	**Unit Price**
1	Gloria Unit Trust	50 million units	50 k per unit
2	* Rims Unit Trust	20 million units	₦1 per unit
3	* Lead Unit Trust	25 million units	₦1 per unit
4	Public Finance Unit Trust	25 million units	₦1 per unit
5	*MBA Mutual Trust	100 million units	50k per unit
6	*First Interstate Unit Trust	40 million units	₦1 per unit
7	Cash Link Investment Trust	50 million units	₦1 per unit
8	*Devcom Mutual Trust	25 million units	₦1 per unit
9	*Continental Unit Trust	40 million units	₦1 per unit

* Directly pioneered by merchant banks.

Source: CBN, Annual Report and Statement of Account, 1991.

From the table above, it seems that the distinction between a unit trust and investment trust; or between unit trust, and mutual funds in Nigeria are immaterial. However, it is important to define them in their own lights. Before we do this it is worthy of notice that “the function of investment trusts and unit trusts is to raise collective capital from the public and to direct it to where it will do most good – into profitable investment outlets” (Perry, 1978: 168-169).

Unit Trust and Investment Trust

As in Perry (1978:168-169) a *unit trust,* as a scheme, “is a method of investment whereby money subscribed by many people are pooled in a fund, the investment management of which is subject to the legal provisions of a trust deed. The fund is invested in securities on behalf of the subscribers by a management company. The investments so acquired are held by a trustee, usually a well-known bank or insurance company”. A Unit Trust Scheme, as in NDIC 1991 Annual Report and Statement of Accounts, is simply an arrangement designed with the sole purpose of mobilizing funds from small investors in many sectors of the economy. The scheme is aimed at boosting the development of the Nigerian Capital Market. Unit Trusts are allowed to invest their funds in quoted securities and government treasury securities: The CAMD gives the Securities Exchange Commission powers to list other investment outlets from time to time for the investment of trust funds. Such private money market instruments as bankers' acceptance and certificates of deposits are also veritable outlets to boost investments For Trust Managers. Merchant Banks in Nigeria served also as trustees to the unit trusts; subject to the requirement that the management company must be independent of the trustee.

Viewed from a corporate angle, a unit investment trust is seen by the British as an open-ended investment company which is a management investment company that stands prepared to redeem shares at a near net asset value at all times. This is simply a mutual fund. In America, the term is used to describe a company with a portfolio that is, in essence, fixed for the life of the fund – i.e. a fixed unit trust (Sharpe, 1985: 566). A fixed trust, it has been argued, spread risk over a period of ten to twenty years with serious restrictions on the management's ability to vary the investments. This kind of arrangement has its profitable dimension: to keep securities whose dividends are not maintained; or which has slumped in the market, or ceased to be quoted simply because the unit trust arrangement must be of the fixed nature. The trend indicated that some emerging companies began to empower their managers to substitute securities as they deem fit subject to a given list of desirable securities. This development tries to narrow the line of demarcation between unit trust and investment trust schemes which gives their managers very wide latitude of power to buy and sell securities as they consider most profitable.

The formation of a unit trust requires a sponsor or pioneer (in this case, a merchant bank) to buy a specified set of securities, deposit same with a trustee (let's say, a large commercial bank or another merchant bank); and subsequently receives a number of shares representing proportional interest in those financial assets. These shares, called redeemable trust certificates, are afterwards sold to investors by the sponsor. All income receipts from the portfolio are paid out by the trustee to shareholders. As and when due repayments are made of the principal. The portfolio is not usually altered, a point that lessens the need for active management of unit trusts. The only relevant functions – custody and administrative services – can be provided by the trustees. Certain benefits are claimed for unit trust namely; good yield, security, regular income distribution, and, more importantly, spread of risk. It has been advanced as an advantage for the scheme that there is an assured market for those wishing to realize their investment since the management company undertakes to purchase all sub-units offered to it.

*Investment Trusts**:*** on the other hand, are organizations established to hold investments; under the management of a professional management company that takes policy initiatives and decisions on what investments to be held. The managing company also overseas the actual buying and selling of the securities and pays interest and dividends to shareholders. Merchant bank who organized an investment trust scheme usually sourced the management of the scheme from its own personnel or any other specialized trust management organization. Management remuneration was in a form of stated proportion of the value of net assets. It was usually based on the market value of the fund's total assets; with the percentage varying inversely with the assets value.

Financial Advisory Services

Investment bankers rendered varying forms of financial advisory services to their corporate clients. These took the form of consultancy operations that required the merchant bank to prepare feasibility and viability reports, strategic plans, and business plans for clients for the purpose of securing needed facilities or improving performance. They also took the form of corporate reorganizations, reconstructions and turn-around. They merchant bankers functioned as advisors in mergers, acquisitions, and refinancing operations.

The International Dimension

At the international setting, merchant banks, like commercial banks carried out useful services intended to the benefit of their customers. These would include services related to international financial market operations and international banking services. These are briefly discussed hereunder:

International Financial Market Operations

International Financial Market Operations of merchant banks would include all activities geared towards taking the corporate customer to source needed funds in the international money and capital market, where the domestic market proved incapable of providing such funds. Various large companies and government corporations at one time or the other, have needed such funds to finance their projects and it behooves such specialized institution as merchant banks to reach out to the international financial market for the benefit of these corporate bodies. However, the Nigerian experience had shown that merchant banks were not very active in this area of operation during their years of existence on the Nigerian banking system.

International Banking Services

Merchant banks performed a host of relevant international banking services to their corporate customers. A list of such services would include foreign exchange services, international transfer of funds, financing international trade, participation in the international financial markets and financing operations of the multinationals. We shall briefly examine these services in turns. It is only important to underline that international banking is an integral component of the international monetary system and that the banking industry provides liquidity to the system and helps finance imbalances that develop among countries. By implication, merchant banks being members of the system among other things acted as international financial intermediaries in the system.

Foreign Exchange Services

Merchant banks were active participants in the foreign exchange market. As intermediaries they mobilized or generated foreign exchange from the surplus units (those individuals, firms and government agencies that possessed more foreign currently than they immediately needed) and channel same to deficit units (those, whose immediate foreign exchange needs were higher than what they had) through the instrumentality of the foreign exchange market. A foreign exchange market has been defined as the institutional framework for buying and selling, and, in the process, determining the rate of conversion of foreign exchange. It was seen in Ezirim (1995: 492) as “the mechanism or medium through which foreign exchange dealings and transactions are conducted”. In a regime of deregulation, the rates of exchange are determined by the market forces of demand and supply. When the system is regulated, the government would fix the rate for which various currencies are exchanged. The regulation can be partial where monetary authorities allow some latitude of market interactions, but not without at least pegging the rates of the domestic currency in respect of tan international vehicle currency such as the dollar.

What merchant banks did was to mobilize foreign exchange from those who possessed foreign currency (but need conversion to domestic currency) and then represented them in the market and obtained the conversion at a good rate. Similarly, those who needs foreign currency (but had domestic currency) got the assistance of these banks who attempted to act on their behalf to secure the needed foreign exchange also at a good rate of conversion. It is easy to see that these banks also carried out the intermediation role even in the international setting.

International Transfer of Funds

Merchant banks were important conduits for the international transfer of funds as well as key private institutions that furnished liquidity to the international monetary system. It is true that economic agents engaged in one international transaction or the other are not expected to cross their national borders decorated with suitcases stuffed with raw money; except of course, the currency smuggler. On the contrary, most international payments are done by drawing on deposits (or accounts) with banks. Merchant banks facilitated the process of international payments and transfers. Transfer took one of two forms: (i) Transfer of funds in the traditional banking system and (ii) Transfer of funds in the Eurocurrency system. These two systems are somewhat interlinked. The first method is the traditional correspondent banking system. In this kind of arrangement merchant banks maintained deposits in the home currency of the country in which they were located and are subject to local banking regulations affecting deposits. That means the use of the services of *correspondent bank.* In the second method, their deposits could be denominated in any currency, notwithstanding the country in which the banks were located, but these deposits are not subject to domestic regulation affecting the cost and nature of deposit (Rodriguez and Carter, 1984:62). Cooper and Fraser (1990:600) observed that “banking system contributes to the operation of the international payment mechanism by holding deposits in banks abroad by accepting deposits of foreign banks, and by debiting and crediting the accounts as payments are made across international borders”.

A corollary to the transfer of funds function is their role in the international adjustment process. As argued by Rodriguez and Carter (1984:235), when imbalances develop between the international supply of and demand for the currencies of different countries, the banking system, of which merchant banking is a part, perform two primary functions to adjust the imbalance: (i) the banks constitutes the avenues through which pressures for changes in rates of exchange are brought to bear; and (ii) they can further assist to finance imbalance by serving as intermediaries between the surplus and deficit countries. By making international financial intermediation possible, merchant banks assisted in global capital mobility.

Financing International Trade

Recalling the origin and evolution of merchant banking from rudimentary merchanting (international trade) to acceptance business to hardcore banking practice of financial intermediation, we have not difficulty seeing the suitability of these banks in financing international trade transactions. However, they extended credits directly to importers and exporters to finance international trade. Whereas some were doing these using conventional forms of short-term lending, others were engaged in the use of export draft or import draft. In turn, these drafts were refinanced in the domestic money market when they took the form of bankers’ acceptances. When direct financing of a typical importer was involved, it was used for the bank to control the goods so financed through what is known as a trust receipt. A little explanation of some of these instruments is hereunder done.

Loans to Importers and Trust Receipts: When a typical merchant advanced short-term loan to a customer who imported goods from Japan, for instance; upon payment for the goods, the importer signed a trust receipt for the goods. This simply implied that the merchant bank retained ownership and title of the merchandise while the importer was just a trustee. This trust receipt made the stock of the merchandise a kind of security for the loan. Sales receipts were regularly lodged with the bank until the bank was fully paid. In a situation where the exporter from Japan issued a time draft, the merchant bank would have to honor payment to the Japanese company when the draft got due. Ceteris paribus, part of the money used to pay the time draft would be from the lodgments made to the bank by the importer. If, however, the draft issued by the Japanese exporter was a sight draft, the merchant bank paid at sight upon presentation of appropriate documents. Suppose a preference was indicated by the trading parties for sight draft, the Nigerian importer may decide to borrow directly from a local bank against an import draft, together with a trust receipts. This makes the loan to be supported with an import draft (secured by the goods). These import drafts can be transformed into bankers' acceptances if the bank and the trading parties so agrees Cooper and Fraser, 1990).

Direct Loans to Exporters: Merchant banks also rendered financial assistance to exporters by lending to them against outstanding drafts. This was implicated when, for instance, an exporter wanted immediate payment for goods although the initial arrangement involved a time draft. In which case, the exporter may use the time draft as collateral for money borrowed. A variant of this would be for the exporter to talk the bank into turning the export draft into a bankers' acceptance.

Bankers' Acceptances: Both import drafts and export drafts are capable of being turned in to banker's acceptances. Such trade drafts (also called bills of exchange); became bankers' acceptances if accepted by the merchant bank. When, on the other hand, the time drafts was accepted by a business firm (the importer) they are called trade acceptances. Bankers' acceptances, as opposed to trade acceptances are readily marketable and are often sold by exporters who have needs for immediate liquidity.

Letters of Credit: Merchant banks also opened letters of credits to their customers. Letters of credits issued by banks are of immense importance in international transactions in Nigeria. Since 1994, for instance, the Federal Government required that all foreign trade arrangements be done through the letter of credit vehicle. Thus, bankers' acceptance for international trade purposes would of necessity be created under a letter of credit arrangement. By definition, a letter of credit is a written promise by an importer's bank (in our case a merchant bank) to effect payment to the exporter should the importer defaults in paying as agreed. Very many international businesses have been arranged using this instrument over the years in Nigeria.

Other Activities: Merchant banks were known to participate in the international money and capital markets' either by investing in foreign money or capital markets or by sourcing funds through these mechanisms. Some aggressive merchant banks and new generation commercial banks had been known to engage in international treasury operations to their benefits. Further, quite a number of multinational operations operating in the areas of domicile of these banks had received one form of financial assistance or the other from merchant banks. These facilities may be to finance working capital needs, bridging facilities, and raw materials financing.

Concluding Remarks

Merchant banks were in existence basically to carter for the needs of their corporate customers. Corporate finance services included such activities as project financing and loan syndication. These are actually extensions of the banks credit services. When a merchant could not accommodate a corporate customer financially, whether wholly or partly as in consortium lending, it elected to take the customer to the capital market to generate the needed funds. The capital market operations of merchant banks included rendering advisory services to prospective issuers of securities; administrative, underwriting, marketing services; syndicate participation and management; use of own selling group, pricing of securities, and market stabilization of investment and unit trusts. The international operations of merchant banks included foreign exchange services, transfer of funds, financing of international trade, participation in the international financial market and also financing the activities of multinational corporations.

Notwithstanding, we must underscore some salient points: It is true that all banks service corporate customers but not all banks go the extra mile that merchant banks went to serve this class of customers. They did not stop at such services involving extension of credits of all types but also went to the extent of taking these customers to the capital market where financial accommodation was not possible or appropriate. They could do this because of their investment banking orientation. A major challenge for today universal or even the consolidated banks is to develop this investment banking unit and skills to furnish the corporate customers total financing alternatives. They can equally invoke the spirit of the defunct merchant banks and reap benefits that only investment banking experiment can provide.

A policy and action programmer along this line would suggest that the consolidated banks should tend towards becoming financial supermarkets, by expanding their operational horizons. It also suggests that banks should brace up to reflect more rewarding competitive posture that reinforces the ability to be strategically relevant in the midst of growing globalization. This is a major action program that banks currently operating in the country should pursue. An amalgam of investment and traditional banking modes can only to strengthen the strategic position a typical bank who would dare to inculcate them. It is of note that this is not just an amalgam of British and American experiments to merchant banking but an addition of the rich elements of traditional banking functions. The consolidated banks, by the deliberate policy of the Central Bank in 2005, have been fully armed with all the capital it takes to reap the underlying strategic benefits.

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