ARBA MINCH UNIVERSITY

COLLEGE OF BUSINESS AND ECONOMICS

DEPARTMENT OF ACCOUNTING AND FINANCE

BANKING PRINCEPLE AND PRACTICE MODULE (AcFn 2113)

PREPARED BY: PRINCIPAL AUTHOR

SEBLE TADESSE (MSC)

CO-AUTHOR

ABREHAM KASSIE (MSC)

JANUARY 2020

ARBA MINCH: ETHIOPIA

Prepared By:

Principal Author: Seble Tadesse (Msc)

Co-author: Abreham Kassie (Msc)

Printed By: Arba Minch University Printing Press

No Part of this material is allowed to be reproduced and sold without the prior written

Permission of the university

2020

© Arba Minch University

PREFACE

We have continually strived to improve this of The Economics of Money, Banking, and Financial Markets is no Exception. The module has undergone a new preparation, but it retains the basic terminologies and principles. Firstly, we have updated the material where necessary. Since we have always had great faith in the power of illustration and example both to motivate and to explain, we have always used copious extracts from the Financial Times (and other sources) with the result that updating is a major task. While finding more recent illustrations involved a lot of work, it was not particularly difficult. In producing this module, we have left the structure untouched. There are, however, some significant changes to content and some of these may influence the way in which tutors and students wish to use the module. A careful, step-by-step preparation of module (an approach found in the best Banking principles and practice), which makes it easier for students to learn

Table Contents

Content **page**

CHAPTER ONE AN OVERVIEW OF BANKS AND THEIR FUNCTION…….....….1
1. Introduction…….....1
1.1. Historical Background Of Banking 7
1.1.1. World Banking History.....7
1.1.2. Development Of Banking In Ethiopia 9
1.2. Meaning Of Bank.....11
1.3. Classifications & Functions Of Banking.....12
1.3.1. Classifications Of Banking.....12
1.3.1.1. Based On Their Functions 12
1.3.1.2. Based On Ownership.....13
1.3.1.3. Based On Domicile 13
1.3.2. Functions Of Banking 14
1.3.3. General Utility Function 20
CHAPTER TWO: CENTRAL BANKING……..……23
2.1. Introduction 29
2.2. Meaning Of A Central Bank.....30
2.3. The Main Functions Of A Central Bank Can Be Listed As Follows: 30
2.4. Functions Of Central Banks 31
2.4.1. Primary Functions Of Central Bank 33
2.4.2. Secondary Functions Of Central Banks 34
2.5. Non-Traditional Functions Of Central Banks 34
2.6. Central Bank As The Government's Bank.....34
2.7. The Government's Bank 35
2.8. Monitory Policy Objectives.....37
2.9. Central Bank Independence.....40
2.10. Establishment Of The NBE 41
CHAPTER THREE: COMMERCIAL BANKING……..38
3.1. Introduction.....44
3.2. Types Of Deposits.....44

3.2.1. Current Account (Demand Deposit) 45
3.2.2 Fixed Deposit Accounts 48
3.2.3. Borrowed Funds 54
3.2.1.1. Federal Funds Purchased 54
3.2.1.3. Repurchase Agreements 56
3.2.1.4. Eurodollar Borrowings 56
3.2.2. Long-Term Sources Of Funds 57
3.3. Special Types Of Banker's Customers 58
3.4. Ancillary Or Subsidiary Services Of A Banker 63
3.5 Commercial Bank Management And Profitability 64
3.5.1 Basics Of Commercial Bank Management 64
3.5.1. The Role Of Bank Capital 70
3.5.2. Commercial Bank Balance Sheet 72
3.5.2.1. Commercial Bank Assets 72
3.5.2.2. Commercial Bank Liabilities 74
3.5.3.Non-Deposit Sources Of Funds 75
3.6. Commercial Bank Equity Capitals 78
3.7 Commercial Bank Income Statement 79
3.8. Commercial Bank Lending Function 85
3.9. Commercial Bank Credit Analysis 87
3.10. Interest Rate Risk Management 90
CHAPTER FOUR: BANK CUSTOMER RELATIONSHIP 97
4.1. The Banking Business And Definition Of Banking Business 102
4.2. Classification Of Relationship 102
4.3. Agent And Principal 103
4.4. Requirements For The Definition Of A Customer 106
4.5. Relationship Between A Banker And Customer 107
4.6. General Relationship Between A Banker And Customer 109
4.7. Obligations Of A Banker 113
4.8. Right Of The Banker 116
4.9. Duties Of A Customer 120
4.10. Closure Of An Account By A Customer 120

4.11. Closure Of Account By Bank 121
CHAPTER FIVE: BANK SERVICE: INTRODUCTION……..…….……211
5.1. The Paying Banker 126
5.3. The Collecting Banker 134
5.3.1. Banker As A Holder For Value: 134
5.3.2. The Clearing House System 135
5.4. The Revolution Of Bank Clearing 137
5.4. Meaning Of Loans And Advances 146
5.5. Classification Of Loans And Advances 146
5.5.1. Based On The Nature Of The Loan 146
5.5.2. Based On The Purpose Of The Loan 148
5.5.3. Based On The Period Of The Loan Granted 149
5.5.4. Based On The Nature Of Security 149
5.6. Principles Or Guidelines For Secured Advances 150
5.8. Elements Of A Letter Of Credit 153
5.9. Letter Of Credit Characteristics 155
6.1. Meaning Of Development Banks: 165
6.1.1. Definition Of Development Banks: 165
6.1.2. Introduction Development Bank Of Ethiopia (DBE) 166
6.1.3. Banking Services 166
6.1.4. Economic Sectors Financed By The Bank 166
6.1.5. Loan Types Extended By The Bank 167
6.2. Investment Banking 168
6.2.1. Understanding Investment Banking 168
Key Takeaways 169
6.2.2. The Role Of Investment Bankers 170
6.2.3. Types Of Investment Bank Activities 171
6.2.4. Criticism Of Investment Banks 172
6.3. Cooperative Banking 172
6.3.1. The Difference Between Cooperative Bank And Commercial Bank 174
Activity 6.3 175

CHAPTER : 1
AN OVERVIEW OF BANKS AND THEIR FUNCTION

Learning objectives:

At the end of this unit lesson, you will be able to:

- Understand the historical background of banking
- Discuss the development of banking in Ethiopia
- Explain the meaning of bank and banking
- Understand the classifications & functions of banking
- Define banking.
- Identify the type of banking system appropriate to less developed countries like out's.
- Identify the purposes of different types of banks.

Introduction

This chapter is designed to introduce you with the history of banking both internationally and nationally. It also introduces the meaning of a bank. The chapter also identifies the types of banks as commercial banks, development banks, agricultural banks, investment banks, foreign exchange banks, etc. and banking systems like branch banking system, unit banking system, holding banking system, group banking system, investment banking system and mixed banking systems.

1.1. Historical Background of Banking

1.1.1. World Banking History

There are different assumptions as to the origin of the word "bank". One assumption is that it is derived from the French word 'Banque' or the Italian word "banco" which means in English a bench. This is derived from the experience of the merchants of Greece and Rome. They used to sit on a bench in the center of the market and receive deposits from the public and pay to the public from the deposit. They were referred as 'benchers'. Banking that time was mainly concerned with the services of currency exchange.

The merchants, goldsmiths and money lenders can be regarded as the ancestors of present day bankers. These people start the banking activity by accepting deposits from the depositors and pay whenever demanded. For the deposit they accepted they used to give written evidences.
Through time they see that the amount deposited is kept for a long period of time without being withdrawn. At the same time there were others who were looking for money to facilitate their trading activity. Hence these parties start to lend with an interest.

As such, the origin of commercial banking can be traced back to around 2000 B.C. by Babylonians who was performing the safe keeping and saving functions in its oldest form. In ancient Greece and Rome, the practice of safe keeping of gold's and coin at temples and granting loans for public and private purpose on interest was prevalent. Traces of credit by compensations and by transfer orders are found in Assyria, Phoenicia and Egypt before the system attained full development in Greece and Rome.

The bank of Venice, established in 1157, is supposed to be the first bank founded as a public enterprise. It was simply an office for the transfer of the public debt and originally it was not a bank in the modern sense. There were other banks emerged in the Italian cites perhaps a little before 1200AD. Some of these bankers were carrying out business on their own account. The activity was almost similar to the modern bankers. People used to settle their accounts with their creditors by giving a check or draft on the bank or through transfer order, if the creditor has an account in the same bank. These bankers also received deposits and lent money. As early as 1349 the drapers of Barcelona carried on the business of banking. They were required to give sufficient security before commencing this business i.e. they were under regulation. During 1401 a public bank was established in Barcelona. It was used to exchange money, receive deposits, and discount bills of exchange for both the citizens and for the foreigners.

During 1407 the Bank of Genoa was established in Italy. And in 1609 the Bank of Amsterdam was established to meet the needs of the merchants of the city. It accepts all kinds of specie on deposits.

Deposits could be withdrawn on demand or transferred from the account of one person to another. The bank also adopted a plan by which a depositor received a kind of certificate entitling him to withdraw his deposit within six months. These written orders, in course of time, came to be used in the same manner as the modern check.

In England, banking had its origin with the London goldsmiths, money lenders, merchants and money exchangers - during the reign of Queen Elizabeth-I. They accepted a seizure of large gold hoards in the 17th century during the reign of King Charles-I. They were scared to keep this sizable amount of gold with themselves. Hence they began to keep the gold at the "Exchequer" with the guarantee of the king. However they were suffered during the reign of King Charles-II, who imposed several restrictions on the business of goldsmiths, was finally ruined when the King closed the "Exchequer" without giving any compensation to the depositors. It is believed that many of these goldsmiths were converted into bankers and their activity is replaced with a large number of private bankers. Bank of England was established in 1694.

Actively 1.1

1. Who are the ancestors of present day bankers?
2. Discuss the World Banking History & Development of Banking in Ethiopia.
3. What are different assumptions about the development of banks?

1.1.2. Development of Banking in Ethiopia

Banking is relatively a new concept in Ethiopia. The history of banking in Ethiopia can be traced back to the establishment of Bank of Abyssinia in March 1905 in the premises of Ras Mekonnen, the present main campus of Addis Ababa University. It was established and owned by The National Bank of Egypt, an affiliate of the Bank of England, which was given monopoly position in banking with regard to other foreign banking companies and other privileges set up a bank. The bank of Abyssinia's headquarter in a new building was inaugurated on 1st January, 1910.

Bank of Abyssinia has opened Branches at Dire Dawa, Gore and Dessie and agencies at Harrar and Gambella with the construction of Franco-Ethiopia railway.

The bank was purchased by the order of the Emperor from the foreign company and was chartered on 29th August 1931 as Bank of Ethiopia. During the Italian occupation branches of Banco di'Italia, Banco di'Roma, Banco di'Napali and Banco Nationale del Lavoro were established. In 1941 Barclays Bank and Dominion colonial & overseas came to Ethiopia with the British troops and organized Banking services in Addis Ababa. They withdraw in 1943 with the British troop. The same year Banco di Indo China was established. National and commercial Bank proclamation, August 1942 was entrusted to the state Bank of Ethiopia for; controlling the issue of currency holding the foreign reserves of the country and acting as a fiscal agent of the government. Since the economy was highly under –developed the monetary situation was quite confused and credit was practically non-existent.

In 1945, Agricultural bank was established to help the rehabilitation of the agricultural sector. Four years later the name was changed as agricultural and commercial bank. On the recommendation and assistance of the World Bank (the IBRD), the bank was further converted in 1951 into the development bank of Ethiopia. Imperial Savings and Home Ownership Public Association (ISHOPA) was established in 1961 as a building society for encouraging thrift schemes in residential construction by the effective mobilization of the sources in Ethiopia.

The Banking activity was reorganized in Ethiopia in December 1963. It splits the functions of Central Banking and Commercial Banking activities, which until this time were carried out by the State Bank of Ethiopia. Commercial bank of Ethiopia was incorporated as Share Company with the following activities and business purposes.

1) The carrying out of all types of banking business and operations.
2) Attracting public deposits of all kinds including savings and
3) Promoting the banking habit and facilitating transactions.

On the same year, 1963 Development bank of Ethiopia was reorganized as Agricultural and Commercial Bank of Ethiopia. On the same year, Ethiopian Investment Corporation (1963) was established with the objectives of rendering services, which are beyond the scope of the exiting banking institutions, and conducting all operations incidental to a general investment banking business. Addis Ababa Share Company the first private domestic bank was established in October 1964.

Mortgage Company of Ethiopia was established in July 1965 to make available financial means and credit facilities for the construction of commercial, industrial and residential buildings against mortgage of immoveable properties. In the year 1974, with the change in the government, all private banks were nationalized and there were only three banks: Commercial Bank of Ethiopia Agricultural and Industrial Bank and Mortgage Bank of Ethiopia, were functioning. Again, after the fall of dreg regime and with the free market economy many private banks were established. These are Bank of Abyssinia S.C., Awash International Bank S.C., Dashen Bank S.C., United Bank S.C. Wogagen Bank S.C., Nib International Bank S.C.

Activity 1.2

1. What was the major objective of commercial banks of Ethiopia while established as Share Company?
2. Describe short history of banking in Ethiopia and in the world as well?
3. List all banks established during the regime Derg.

1.2. MEANING OF BANK

A Bank is a financial institution organized in a form of joint company basis so as to create value to the society and profit to the shareholders in a form of dividends. It is an institution, which deals with money and credit. The term bank in the modern times refers to an institution which: (1) deals with money; it accepts deposits and advance loans (2) deals with credit; it has the ability to create credit, (3) is a commercial institution; it aims at earning profits, and (4) creates a demand deposits

which serve as a medium of exchange, and as a result, the bank manages the payment system of the country. A bank as a financial institution is the creator of money in the form of credit money i.e. cheque.

1.3. CLASSIFICATIONS & FUNCTIONS OF BANKING

1.3.1. CLASSIFICATIONS OF BANKING

Banks can be classified into various types on the basis of their functions, ownership, domicile, etc.

1.3.1.1.BASED ON THEIR FUNCTIONS

i. **Commercial Banks**:-They perform all kinds of banking business. They generally finance trade and commerce. They usually accept short-term deposits and advance short-term loans to the businesspersons and traders and avoid medium- term and long term loans.

ii. **Industrial Banks**: - Also known as investment banks, they mainly meet the medium-term and long-term financial needs of the industries. The main functions are;

- Accept long-term deposits.
- Grant long-term loans to the industrialists to enable them to purchase land, construct factory building, purchase heavy machinery, etc.
- Help selling or even underwrite the debenture and share of industrial firms.
- Provide information regarding the general economic position of the economy.

iii. **Agricultural Banks: -** They are banks that finance agriculture. Agricultural credit needs are different from those of industry and trade. The agriculturists require:

- Short –term credit to buy seeds, fertilizers, and other inputs
- Long-term credit to purchase land, to make permanent improvements on land, to purchase agricultural machinery and equipment, etc.

iv. **Exchange Banks: -**They deal in foreign exchange and specialize in financing foreign trade. They facilitate international payment through the sale and purchase of bills of exchange.

v. **Savings Banks**: - The main purpose is to promote saving habits among the general public and mobilize their small savings.

vi. **Central Bank**:-It is the apex institution, which controls, regulates and supervises the monitory and credit system of the country. Functions of the central bank are:

- It has the monopoly of note issue.
- It acts as the banker, agent and financial advisor to the state.
- It is the custodian of member bank's reserves.
- It is the custodian of nation's reserves of international currency.
- It serves as the lender of the last resort.
- It functions as the bank of central clearance, settlement, and transfer.
- It acts as the controller of credit.

vii. **World Bank**: - It refers to an institution that provides financial assistance to the member countries of the world. After the worldwide depression and World War II, two international institutions were founded in 1944. International Monitory Fund (IMF) to provide short term loans to overcome the balance of payments difficulties.

viii. **International Bank of Reconstruction and Development** (IBRD) or **World Bank** organized to achieve the following two objectives.

- Reconstructing the war-damage economies, and
- Developing the less developed economies.

1.3.1.2. BASED ON OWNERSHIP

On the basis of ownership, banks can be classified into three

i. **Public Sector Banks**:-These are owned and controlled by the government.

ii. **Private sector Banks**:-These are owned and controlled by the private individuals or corporations and not by the government or co-operative societies.

iii. **Cooperative banks**:- They are operated on the cooperative lines.

1.3.1.3. BASED ON DOMICILE

On the basis of domicile the banks are divided into two

i. **Domestic Bank**s:-They are registered and incorporated within a country.

ii. **Foreign Banks**: - These are foreign in origin and have their head offices in the country of origin.

1.3.2. FUNCTIONS OF BANKING

A modern bank performs a variety of functions. It is difficult to discuss all functions here. However, some basic functions performed by the banks are discussed as follows:

1. Accepting Deposits

Accepting deposits is the primary functions of a bank. The bank accepts deposits from those that can save but cannot profitably utilize them. People consider it more rational to deposit their savings in a bank because by doing so they, on the one hand, earn interest and on the other, avoid the danger of theft. To attract savings from all sorts of individuals, the banks maintain different types of accounts:

i. Fixed Deposit Account
ii. Current Deposit Account
iii. Saving Deposit Account

i. Fixed Deposit Accounts

They are money deposited for a specific period of time. They are also known as time liabilities. Interest is calculated for the whole amount for the same period. If the depositor withdraws the deposit before the expiry date, the depositor will pay penalty rate plus the banker should be willing to pay before the expiry date.

ii. Current Deposit Accounts

Current accounts are checkable accounts or demand deposit accounts. Current accounts are operated through cheques. Here the bank undertakes the obligation of paying all cheques drawn against it by the customer till it has adequate funds of the customer with it. The main purpose of current accounts is connivance of payments. Current account is owned by businesspersons and firms. In Ethiopia individuals are not allowed to open current accounts.

iii. Saving Deposit Accounts

Saving deposit accounts are opened by individual savers and small business owners. It is opened for saving purpose- to keep the money away from oneself and form thieves. Those savers with huge money are advised to open current accounts. Frequent withdrawals are not allowed from saving accounts. Interest is generally calculated on monthly basis on the minimum balances that remains in the account.

2. Advancing Loans

After keeping certain cash reserves the bank lend their deposits to the needy borrowers. Before advancing loans, the banks satisfy themselves about the credit worthiness of the borrowers. The credit analysis and other related issues about loans and lending practices will be discussed in another chapter. The various types of loans granted by the bank are:

a) Money at call
b) Cash credit
c) Overdraft facility
d) Discounting of bills of exchange
e) Term loan

A. Money at Call

This type of loan is granted for a period of an overnight to a maximum of fourteen days. It is an interest-bearing loan. Interest is calculated on daily basis. It usually granted without collateral.

B. Cash Credit

A certain amount of money is granted for a customer. The customer can use any part of it and pay interest only for that amount. The agreed interest rate is not applied on the unused amount of loan. However, a penalty rate, usually very minimum and up to 1%, is applied. This loan is granted against collateral.

C. Overdraft Facility

This is also a type of loan granted to business owners whenever they face temporary financial shortage. This loan is granted against collaterals. Interest is calculated on daily basis on the debit balance of the customers' account. It is a permission granted to over draw his current account.

D. Discounting Bills

Bills are negotiable instruments issued to facilitate trade and transaction. Bills may be time or demand bill. Demand bills are payable on demand whereas time bills are payable at the expiry of the period. Therefore, the holder of time bill has to wait until the time expires in order to get the balance. Here the banker to facilitate this transaction buys the bill before the maturity date with a lesser value than its face value or maturity value, if the bill is non-interest bearing and interest bearing bill respectively. An interest rate will be applied while discounting and such rate is known as discount rate. The amount given to the holder of the bill (the difference between the face value and the discount amount) will be known as proceed and the amount deducted from the value of the bill is known as discount amount.

E. Term Loans

They are loans granted for a fixed period of time. The time period may be short-term, intermediate and long-term loans. Short-term loan is usually a loan granted up to one year, and intermediate loans are from one to five years and long term loan is a loan granted for above five years. The purpose of the loan may be for commercial, industrial, merchandise, consumer, educational medical, etc.

3. Credit Creation

It is a unique function of the bank. Credit creation is the natural outcome of the process of advancing loans as adopted by the banks. When a bank advances a loan to its customer, it does not lend cash but opens an account in the borrower's name and credits the amount of loan to this account. Thus, whenever a bank grants a loan, it creates an equal amount of bank deposit. Creation of such deposits is called credit creation, which results in a net increase in the money stock in the economy.

4. Promoting Cheque System

In the modern business transaction, cheques have become much more convenient method of settling debts than the use of cash. Through a cheque, the depositor directs the bankers

to make payment to the payee. Cheque is the most developed credit instrument in the money market.

5. Agency Service

Banks perform certain agency functions for and on behalf of their customers besides their main functions such as:

a) Collection and payment of credit instruments like cheques, bills of exchange, promissory notes, etc

b) Execution of standing orders.

Banks execute the standing instructions of their customers for making various periodic payments against his account. They pay:

- Insurance premiums
- Subscriptions on clubs and societies, and
- Similar payments of a regularly recurring nature

c) Purchasing & sale of securities

Banks undertake purchase and sale of various securities like shares, stocks, bonds, debentures, etc. on behalf of their customers. They perform a broker function.

d) Collection of dividends on shares on behalf of his customer.

e) Income Tax Consultancy

Banks employ income tax experts to prepare income tax returns for their customers and to help them to get refund of income tax.

f) Acting as Trustee and Executor.

They administer properties of their customers, as they are deceased. Banks are assigned by either the deceased customer before his death or may be nominated by the court.

g) Acting as representative and correspondent

They get passports, traveler's tickets, book vehicles and plots for their customers and receive letters on their behalf.

h) Remittance of funds

Remittances of funds by banks are simple, convenient, safe and inexpensive. This service is available to both customers as well as non- - customers of the bank.

The important methods of transferring funds from one place to another through banks are:

i. Bank draft

ii. Telegraphic and Mail Transfers

i. Bank Draft

It is an order to pay money drawn by one branch/ office of the bank upon another branch of the same bank to pay a specific sum of money to a person named therein or to his order.

Essential Features of a Bank Draft

A bank draft possesses the following important features.

- It is drawn by one branch of a bank upon some other branch of the same bank
- It is payable on demand, not payable to the banker
- It is equivalent to a bill of exchange

The person who intends to remit the money through a bank draft has to deposit the money to be remitted together with the commission, which the banker charges for its services. A bank draft has three parties. They are;

- The drawer branch (the branch that receives money to be remitted).
- The drawee branch (the branch that is ordered to pay the remitted money to a person named in the draft); and
- The Payee (the party in whose favor money is transferred)

The remitter does not remain a party to the instrument.

Activity 1.3

Discuss the basic functions performed by the banks, various types of loans granted by the bank and different types of accounts.

Difference between a Cheque and a Bank Draft

The negotiable instruments act has taken that they are similar. However a bank draft is different from a cheque in several respects. The points of differences are:

a) A draft cannot be made payable to the bearer while a cheque can be so drawn.
b) A banker is under a legal obligation to pay the money of a draft. Its payment cannot be stopped except in cases where loss or theft of the draft has been reported. While the drawer can easily get payment of ac stopped, if he so likes.
c) In case of a draft, the banker has a direct liability to pay. The remitter after he purchases the draft is not part of the instrument and the drawer is under obligation to transfer the fund to be paid by the drawee branch to the payee - whose name is in the draft.

   In case of a cheque, the banker has indirect liability. The primary liability is that of the drawer of the cheque. The banker will make payment of the cheque only when it has sufficient funds of the drawer with it for payment and the cheque in order.

ii. Mail/Telex Transfers

A mail transfer is an internal message sent through ordinary postal channel advising the payee branch or bank to pay a specifically stated amount of money to a specified payee or to his order. As the banker accepts money to transfer, it has to consider certain requirements. This method is commonly used between two branches of same bank. The following are the necessary requirements.

- The name of the beneficiary
- His/her account number, if any
- The amount to be transferred, and
- The name of the branch where the account is maintained or the beneficiary can receive.

In case of telex transfer the message for transfer of funds is communicated through telex machine instead of postal channel. The remitting bank generally recovers from the transferor the telex charges in addition to the usual service expenses.

1.3.3. General Utility Function

A. Traveler's cheques

Banks to avoid the risk of loss or inconvenience in to carrying large amount of cash while traveling issue Traveler's cheques. These cheques are issued in variable denominations and are cashable on any office of the issuing bank or corresponding bank. They are usually used foreign purposes.

The following are their essential features of traveler's cheques:

1) Traveler's cheques can be purchased by any one. He need not be a customer of the bank
2) A person may buy any number of traveler's cheques. The equivalent amount of money must be deposited.
3) Each travelers cheque should be signed by the purchaser at place marked. "When counter signed below with this signature." Before the official who issues the cheques.
4) The purchaser in English script should sign the cheque
5) The travelers' cheques are issued in single name i.e. not in joint names or names or clubs, societies and companies etc.
6) The travelers' cheques are generally encashable only at the branches of the issuing bank or the branches of the other banks with which the issuing bank may have arrangement.
7) The purchaser of the traveler's cheques has to sign the traveler's cheques again at the time of encashing the traveler's cheques at the place marked "counter-sign here in presence of person cashing"

8) There is no expiry period for the travelers' cheque. Unused cheques can be returned back to the issuing bank and the payment can be returned back to the issuing bank and the payment can be obtained for them.

Loss of the travelers' cheques

In case the travelers' cheques are reported lost the following precautions should be taken by the issuing branch of the bank entertaining any claim regarding lost travelers' cheques:

- The bank should satisfy itself that the purchaser did not endorse the cheques before they were lost.
- A letter of indemnity together with sureties should be obtained for the amount involved.

B. Safe custody of valuable and securities

Banks accept valuables for safe custody purpose. Valuables such as: negotiable securities, jewelers and documents of the title to property, etc. The modern bank being equipped with safe and strong rooms is naturally a very safe and convenient depository of valuables. There are two ways through which a modern banker ensures safe custody of its customer's valuables.

I. By accepting the valuable from the customers for safe custody.
II. By hiring out safe deposit vaults or lockers to the customers.

I. Accepting of valuables for safe custody

A banker may accept delivery of valuables from its customers for safe custody. The rules regarding accepting of the valuables for safe custody and their redelivery can be summarized as follows.

a) The safe custody facility should be extended only to the bank's customers
b) The safe custody facility should be confined only to:

i. Securities such as government promissory notes, stock/share certificates, bonds, debentures, certificates, title deeds, wills and post office national savings certificate, etc…
ii. Envelopes and packets, which are properly sealed with customers' distinctive seals, markings, etc. with instructions regarding delivery.
iii. Locked boxes with customers' names painted on the top thereof or otherwise adequately identifiable.

The banker is not supposed to have any precise information about the contents of the box or envelope.

c) The banker should maintain a register of the articles accepted for safe custody and the customer should be given a receipt for the articles accepted under safe custody from the safe custody receipt book.
d) On delivery of the valuables to the customer, the fact should be duly recorded in the safe custody register maintained by the bank.
e) It should be noted that the articles received for safe custody are not subject to general lien of the banker.

Liability of a Banker

A banker is bound to take reasonable care of the valuables entrusted to him. In case the banker has taken such care, he will not be liable for any loss or damage to the valuables in the absence of any contract to the contrary. The customer may hold the banker liable for loss suffered by him in each of the following cases.

a. Negligence by the banker

The banker can be held liable for negligence. For example, if the safe deposit vaults are not as strong as they should have been and if the banker leaves the safe deposit vaults unlocked and the valuables are removed by someone, etc.

b. For conversion

In case the banker delivers the valuables accepted by it for safe custody to a wrong person, it shall be liable for the loss suffered by the customer.

c. Fraud by its own employees

In case any of the bankers' employees concerned with safe custody found guilty of fraud resulting in loss to the customer, the banker shall be held responsible.

II. Hiring of safe Deposit Vaults

The banks facilitate strong rooms, which are equipped with safe deposit locker for hiring purpose. The lockers are of different size and they are hired out to the public. The rent for the lockers may vary depending on the size of the locker. The following rules are applied.

a) Any person can take or hire a safe deposit locker from the bank.
b) The person taking a locker on rent has to fill in a proper lease document which contains the terms and conditions of hiring the locker.
c) The bank maintains safe deposit vaults register in which all transactions relating to each of the rented out lockers are recorded on a separated page. A pass word or code word is chosen by the hirer.
d) In case of a locker being hired in joint names, specific instructions should be obtained as to the mode of operation and access to the lockers from joint lessees.
e) Two keys are used for opening the lockers, one of which is kept by the hirer in his possession, while the other remain with the banker i.e. the master key will remain with the banker.
f) The bank does not know the contents of the locker.
g) In the event of death of the hirer the contents of the locker should be redelivered to the legal representative of the deceased only after his producing a valid succession certificate from the court.
h) No locker should be leased out to minors, blind and illiterate persons

i) The manager or any other authorized person should examine the locker soon after its operation, in order to ensure that it has been properly locked by the visitors and that no articles are left behind him inadvertently.

j) The master key should remain in the custody of the manager or any other authorized officer during the day. It should be kept in the safe under dual control of the manager/head cashier overnight.

k) The duplicate key of the safe deposit vaults should be kept for safe custody with another branch of the bank and where there is no other branch of the bank with other bank.

C. Letters of credit

A letter of credit is a document issued by a banker, authorizing some other banker to whom it is addressed, to honor the cheques of a person named in the document, to the extent of a sated amount in the letter and to charge the same to the account of the guarantor of the letter of credit.

Letters of credit may be either personal or commercial. Personal Letters of credit is usually a clean one i.e. no trade document is attached, whereas, commercial letters of credit is a documentary letter of credit. Letter of credit has three parties: the customer, the issuing bank, the advisory bank and the seller. The customer may be the debtor or the one who buy on credit. The issuing bank is the one that guarantees the credit sale through the letter. The advising bank is the bank that accomplishes payment to the seller on behalf of the issuing bank. The last party is the beneficiary, who sells goods on credit.

For example, Ato Zeberga wants to import goods on credit from an Italian exporter known as Maldini. Now Mr. Maldini may not be willing to sell his goods on credit to an Ethiopian importer, Ato Zeberga, he rather prefers the credit to be guaranteed by a known bank in Ethiopia. Here Commercial Bank of Ethiopia, who is the banker to Ato Zeberga, writes a letter to another banker in Italy, may be Bank of Italy, to pay the agreed sum of money in the transaction, when the goods are arrived to the buyer, which might be communicated as

it is realized. Then, the Italian banks will advise Mr. Maldini to deliver goods according to the agreement with Ato Zeberga. As the arrival of the goods is reported to Bank of Italy through Commercial Bank of Ethiopia, Bank of Italy will pay the amount or credit Mr. Maldini's account, if he has an account in the same bank, or may transfer to another bank where he has an account, if it is instructed to do so.

Here, Ato Zeberga is the customer, Commercial Bank of Ethiopia is the issuing bank, Bank of Italy is the advisory bank and Mr. Madini is the seller or creditor or beneficiary in the instrument.

There are different types of letters of credit, which can be discussed as follows;

a) Clean letter of credit:-Under this form acceptance of bills is unconditional
b) Documentary L.C:- Bills acceptance is conditional on the receipt of the documents of title to goods.
c) Revocable L.C:- The bill (l.c.) can be canceled at any time by the issuing banker
d) Irrevocable L.C: - The bill (l.c.) Can't be canceled before expiry of the period.
e) Confirmed irrevocable L.C: - The bill (l.c.) cannot be canceled before expiry of the period. In addition, a correspondent bank with in which the issuing bank has an account to the advisory bank confirms the position of the issuing bank. Therefore, payment is 100% guaranteed.

D. Foreign exchange

In assisting foreign trade by discounting foreign bills of exchange and facilitating foreign currency, a bank has sometimes arrange for the payment of costs to the transport, insurance and warehousing of goods.

E. Collection of statistics

Banks collect statistics relating to industry, trade and commerce, money and banking and publish journals and bulletins containing research articles on economic and financial matters.

F. Underwriting securities

They underwrite securities issued by the government, public or private bodies.

Activity 1.3

1) Define & discuss what is meant by a bank.

2) Identify & discuss the classification of a bank.

3) Identify the functions of a bank. Discuss.

Question for self-Test Exercise

Part I. Choose the best alternatives

_____1. The first bank in Ethiopia is:

a) Commercial Bank of Ethiopia
b) Bank of Abyssinia
c) Bank of Ethiopia
d) State bank of Ethiopia

_____2. Which one of the following is the function of a commercial bank?

a) Accept deposits
b) Grant loan
c) Provide agency services
d) Note issuing
e) All except d

_____3. Central bank and Commercial banks differ in

a) The Central Bank is the apex institution of the monetary and banking structure of the country. The commercial bank is one of the organs of the money market.

b) The Central Bank is profit-making institution while Commercial bank is not.

c) The Central Bank does not engage itself in ordinary banking activities while commercial bank engaged in ordinary banking activities.

d) The Central Bank has the monopoly of note issue, while the commercial bank can issue only cheques..

e) The Central Bank controls credit in accordance with the needs of business and economy. The Commercial Bank creates credit to meet the requirements of business.

f) All

g) All except

_____4. National bank of Ethiopia issue _____ notes

a) Birr 100
b) Birr 50
c) Birr 1
d) Birr 500
e) Birr 10
f) All
g) All except d

_____5. Which one of the following is a technological innovation in banking industry?

a) online delivery of bank brochures and marketing information
b) electronic access to bank statements;
c) ability to request the transfer of funds between accounts;
d) electronic bill payment and presentment; ability to use
e) All

Part II. Write true if the statement is correct and false if the statement is incorrect

_____1. NBE is engaged in pay, remit, collect or take custody of funds in Ethiopia.

_____2. The bank of Venice was the first banking institution established in Italy.

_____3. Central bank is one which constitutes the apex of monetary and banking structure of the country and performs several functions in the national economic interest.

_____4. The commercial banks need not keep only reserve with the central bank.

UNIT TWO
CENTERAL BANKING

CHAPTER LEARNING ONJECTIVES:

On completing of this chapter, you will be able to identify:

After completing this chapter, you should be able to:

- Define central banking
- Describe the historical evolution of central banks
- Identify the functions of central banks

2.1. INTRODUCTION

The world's leading central banks played a key role in bringing the financial system and the economy back to safe harbor after the peak of the financial crisis in 2008. They acted in unprecedented fashion to prevent the financial system from capsizing and, over time, to restore financial and economic stability. Central banks' work is vital to the day-to-day operation of any modern economy.

• Today there are roughly 170 central banks in the world e.g.

National Bank of Ethiopia (Ethiopia) (established in 1963)

Federal Reserve (USA) (established in 1914)

Bank of England (UK) (established in 1694)

European Central Bank (European Union)

The central bank started out as the government's bank and over the years added various other functions. A modern central bank not only manages the government's finances but provides an array of services to commercial banks. King William of Orange created the central bank to finance wars. Napoleon Bonaparte did it in an effort to stabilize his country's economic and financial system. These examples are more an exception because central banking is largely a 20th century phenomenon.

Activity 2.1

- How did Central Banks Originate and Their Role Today?

2.2.Meaning of a central bank

• A Central Bank is a financial institution that controls country's monetary policy, and usually has several mandates including, but not limited to issuing national currency, maintaining the value of the currency, ensuring financial system stability, controlling credit supply, serving as a last-resort lender to other banks and acting as government's banker.

• Monetary policy includes currency issuing (most world currencies are fiat currencies not backed by silver or gold), maintaining the country's FOREX and gold reserves, managing money supply, and managing the cost of credit by setting interest rates. The monetary policy enforced by a central bank is used in general to influence the economic activity (avoid recessions, facilitate economy growth, etc.) and control inflation.

A central bank can generally be defined as a financial institution responsible for overseeing the monetary system for a nation, or a group of nations, with the goal of fostering economic growth without inflation (Casu, Girardone, & Molyneux, 2006)

2.3. The main functions of a central bank can be listed as follows:

1) The central bank controls the issue of notes and coins (legal tender). Usually, the central bank will have a monopoly of the issue, although this is not essential as long as the central bank has power to restrict the amount of private issues of notes and coins.

2) It has the power to control the amount of credit-money created by banks. In other words, it has the power to control, by either direct or indirect means, the money supply.

3) A central bank should also have some control over non-bank financial intermediaries that provide credit.

4) Encompassing both parts 2 and 3, the central bank should effectively use the relevant tools and instruments of monetary policy in order to control:

a) Credit expansion;

b) Liquidity; and

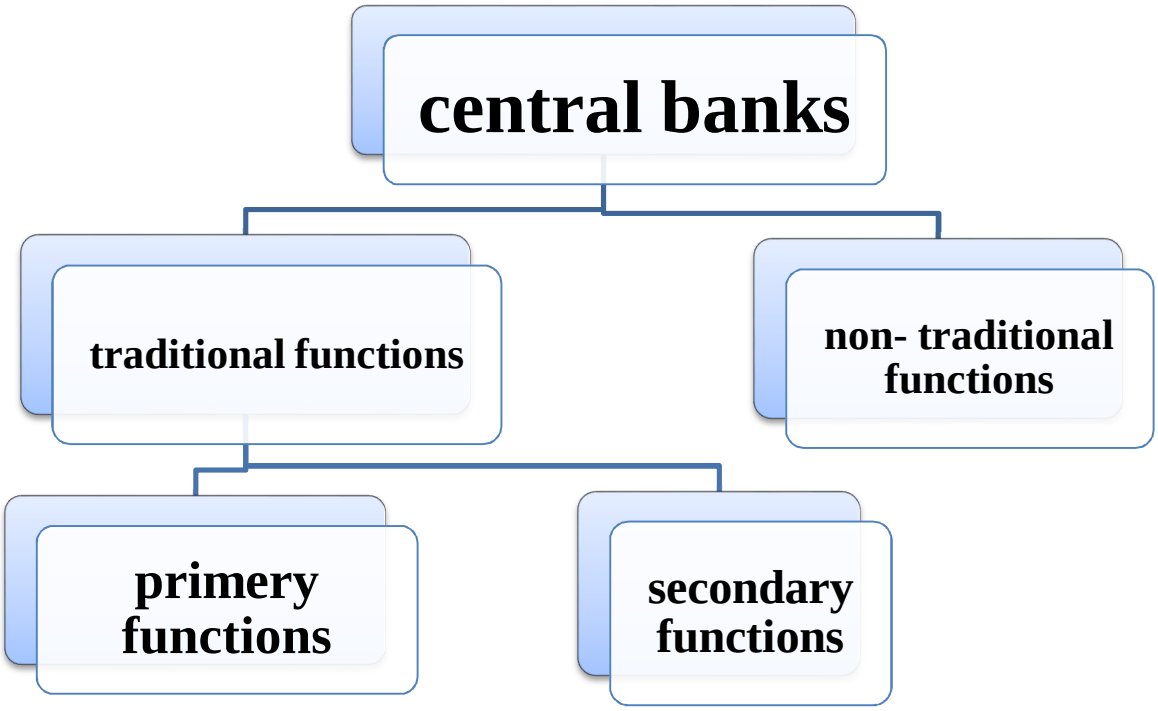
c) The money supply of an economy.

5) The central bank should oversee the financial sector in order to prevent crises and act as a **lender-of-last-resort** in order to protect depositors, prevent widespread panic withdrawal, and otherwise prevent the damage to the economy caused by the collapse of financial institutions.

6) A central bank acts as the government's banker. It holds the government's bank account and performs certain traditional banking operations for the government, such as deposits and lending. In its capacity as banker to the government it can manage and administer the country's national debt.

7) The central bank also acts as the official agent to the government in dealing with all its gold and foreign exchange matters. The government's reserves of gold and foreign exchange are held at the central bank. A central bank, at times, intervenes in the foreign exchange markets at the behest of the government in order to influence the exchange value of the domestic currency.

2.4. Functions of Central Banks



The traditional functions of the central bank include the following:

(i) Bank of issue:

Possesses an exclusive right to issue notes (currency) in every country of the world. In the initial years of banking, every bank enjoyed the right of issuing notes. However, this led to a number of problems, such as notes were over-issued and the currency system became disorganized. Therefore, the governments of different countries authorized central banks to issue notes. The issue of notes by one bank has led to uniformity in note circulation and balance in money supply.

(ii) Government's banker, agent, and advisor:

Implies that a central bank performs different functions for the government. As a banker, the central bank performs banking functions for the government as commercial banks performs for the public by accepting the government deposits and granting loans to the government. As an agent, the central bank manages the public debt, undertakes the payment of interest on this debt, and provides all other services related to the debt.

As an advisor, the central bank gives advice to the government regarding economic policy matters, money market, capital market, and government loans. Apart from this, the central bank formulates and implements fiscal and monetary policies to regulate the supply of money in the market and control inflation.

(iii) Custodian of cash reserves of commercial banks:

Implies that the central bank takes care of the cash reserves of commercial banks. Commercial banks are required to keep certain amount of public deposits as cash reserve, with the central bank, and other part is kept with commercial banks themselves.

The percentage of cash reserves is deeded by the central bank! A certain part of these reserves is kept with the central bank for the purpose of granting loans to commercial banks Therefore, the central bank is also called banker's bank.

(iv) Custodian of international currency:

Implies that the central bank maintains a minimum reserve of international currency. The main aim of this reserve is to meet emergency requirements of foreign exchange and overcome adverse requirements of deficit in balance of payments.

(v) Bank of rediscount:

Serve the cash requirements of individuals and businesses by rediscounting the bills of exchange through commercial banks. This is an indirect way of lending money to commercial banks by the central bank. Discounting a bill of exchange implies acquiring the bill by purchasing it for the sum less than its face value.

Rediscounting implies discounting a bill of exchange that was previously discounted. When owners of bill of exchange are in need of cash they approach the commercial bank to discount

these bills. If commercial banks are themselves in need of cash they approach the central bank to rediscount the bills.

(vi) Lender of last resort:
Refer to the most crucial function of the central bank. The central bank also lends money to commercial banks. Instead of rediscounting of bills, the central bank provides loans against treasury bills, government securities, and bills of exchange.

(vii) Bank of central clearance, settlement, and transfer:
Implies that the central bank helps in settling mutual indebtness between commercial banks. Depositors of banks give checks and demand drafts drawn on other banks. In such a case, it is not possible for banks to approach each other for clearance, settlement, or transfer of deposits.

The central bank makes this process easy by setting a clearing house under it. The clearing house acts as an institution where mutual indebtness between banks is settled. The representatives of different banks meet in the clearing house to settle inter-bank payments. This helps the central bank to know the liquidity state of the commercial banks.

(viii) Controller of Credit:
Implies that the central bank has power to regulate the credit creation by commercial banks. The credit creation depends upon the amount of deposits, cash reserves, and rate of interest given by commercial banks. All these are directly or indirectly controlled by the central bank. For instance, the central bank can influence the deposits of commercial banks by performing open market operations and making changes in CRR to control various economic conditions.

Nontraditional Functions:
Refer to the functions that are related to the promotion of banking system and economic development of the country. These are not compulsory functions of the central bank.

2.4.1. Primary Functions of Central Bank

- Sole authority (monopoly) to issue notes (currency).
- Conduct of monetary policy & credit policy.
- Supervision of financial system (on-site and off-site).
- Banker's Bank (Lender of the last Resort).
- Banker to Government (It holds the government's bank account and performs certain traditional banking operations for the government, such as deposits and lending. In its

capacity as banker to the government it can manage and administer the country's national debt).

2.4.2. Secondary functions of Central Banks

- Public Debt Management.
- Management of foreign Exchange.
    - ❖ Foreign Exchange Reserves.
    - ❖ Foreign Exchange control.
    - ❖ Foreign Exchange Rate Stability.
- Advisor to Government.
    - ❖ Help in monetary policy, Economic & Foreign exchange policy, fiscal policy (imports & exports).
- Relationship with international Financial Institutions.

2.5. Non-Traditional Functions of central banks

- Development of the Banking System
- Training facilities to Bankers
- Development of specialized Financial Institutions
  E.g. Microfinance institutions
- Credit to priority sectors
- Credit for agriculture
- Export Finance Scheme

Activity 2.2

1. What is a central bank?
2. What are the primary functions of central banks?
3. List the secondary functions of central banks.
4. Identify the non-traditional functions of central banks.
5. What is the primary objective of a central bank?

2.6. Central Bank as the Government's Bank

In 1900, only 18 countries had a central bank. As the importance of a government and the financial system grew, the need for a central bank grew along with it. As the government's bank, the central bank has a privileged position: It has the monopoly on the issuance of currency. The central bank creates money. Early central banks kept sufficient reserves to redeem their notes in gold. The central bank can control the availability of money and credit in a country's economy through monetary policy.

- **Why would a country want to have its own monetary policy?**

1. At its most basic level, printing money is a very profitable business.

- A bill only costs a few cents to print.

2. Government officials also know that losing control of the printing presses means losing control of inflation.

- A high rate of money growth creates a high inflation rate.

2.7. The Government's Bank

The primary reason for a country to create its own central bank, then, is to ensure control over its currency. Giving the currency-printing monopoly to someone else could be disastrous. In the European Monetary Union, 16 European countries have ceded their right to conduct independent monetary policy to the European Central Bank (ECB). This was part of a broader move toward economic integration.

2.7.1. Central Bank as the Banker's Bank

The political backing of the government, together with their sizeable gold reserve, made early central banks the biggest and most reliable banks around. The notes issued by the central bank were viewed as safer than those of smaller banks. The safety and convenience quickly persuaded most other banks to hold deposits at the central bank as well. As the banker's bank, the central bank took on the roles it plays today:

- To provide loans during times of financial stress,
- To manage the payments system, and
- To oversee commercial banks and the financial system.

The ability to create money means that the central bank can make loans even when no one else can. No bank, no matter how well managed, can withstand a run. To stave off such a crisis, the central bank can lend reserves or currency to sounds banks. By ensuring that sound banks and

financial institutions can continue to operate, the central bank makes the whole financial system more stable.

Every country needs a secure and efficient payments system. Financial institutions need a cheap and reliable way to transfer funds to one another. The fact that all banks have account at the central bank makes it the natural place for interbank payments to be settled. Finally, someone has to watch over commercial banks and nonbank financial institutions so that savers and investors can be confident these institutions are sound. Those who monitor the financial system must have sensitive information. Government examiners and supervisors are the only ones who can handle such information without conflict of interest.

As the government's bank and the banker's bank, central banks are the biggest, most powerful players in a country's financial and economic system. However, an institution with the power to ensure that the economic and financial systems run smoothly also has the power to create problems. It is essential that we understand what a central bank is not. It does not control securities markets, though it may monitor and participate in bond and stock markets. It does not control the government's budget. That is determined by the parliament (in Ethiopia) and the MoFEC through fiscal policy. The central bank only acts as the Treasury's bank.

There are five major forms of economic policy (or, more strictly macroeconomic policy) conducted by governments that are of relevance. These are a.

A. **Fiscal policy** relates to changes in the level and structure of government spending and taxation designed to influence the economy. As all government expenditure must be financed, these decisions also, by definition, determine the extent of public sector borrowing or debt repayment. An expansionary fiscal policy means higher government spending relative to taxation. The effect of these policies would be to encourage more spending and boost the economy. Conversely, a contractionary fiscal policy means rising taxes and cutting spending.
B. **Exchange rate policy** involves the targeting of a particular value of a country's currency exchange rate thereby influencing the flows within the balance of payments.
C. **A prices and incomes policy** is intended to influence the inflation rate by means of either statutory or voluntary restrictions upon increases in wages, dividends and/or prices.

D. National debt management policy is concerned with the manipulation of the outstanding stock of government debt instruments held by the domestic private sector with the objective of influencing the level and structure of interest rates and/or the availability of reserve assets to the banking system.

E. Monetary policy is concerned with the actions taken by central banks to influence the availability and cost of money and credit by controlling some measure (or measures) of the money supply and/or the level and structure of interest rates. Monetary policy relates to the control of some measure (or measures) of the money supply and/or the level and structure of interest rates.

Activity2.3.

- How does monetary policy work?

2.8. Monitory Policy Objectives

The primary objective of modern central banks (and monetary policy) is stability

Low, Stable Inflation	Inflation creates confusion and makes planning difficult. When inflation is high, growth is low.
High, stable growth	Stable, predictable growth is higher than unstable, unpredictable growth.
Financial system stability	Stable financial market and institution are necessary for economy to operate efficiently.
Stable interest rates	Interest rate volatility creates a risk for both lenders and borrowers.
Stable exchange rates	Variable interest rate makes the revenues from foreign sales and the cost of purchasing imported goods hard to predict.

Monetary Policy Instruments (tools)

1. **Direct Instruments**

Central banks may exercise direct controls on bank operations by setting limits either to the quantity of deposits and credits (e.g., ceilings on the growth of bank deposits and loans), or to their prices (by setting minimum/maximum bank lending or deposit rates). e.g. In Ethiopia,

- The minimum saving rate is 5% (no limit on the maximum)
- The minimum lending rate is 7.5% (no maximum limit)
- 40% of the loan should be working capital loan

2. Indirect instruments

Indirect instruments influence the behavior of financial institutions by affecting initially the central banks' own balance sheet. In particular, the central bank will control the price or volume of the supply of its own liabilities (reserve money) that in turn may affect interest rates more widely and the quantity of money and credit in the whole banking system.

Indirect Monetary Policy Instruments (tools)

A. Debt securities and open market operations

Debt securities are mainly represented by Treasury securities (i.e., government debt) that central banks use in open market operations. These operations are the most important tools by which central banks can influence the amount of money in the economy. Although the practical features of open market operations may vary from country to country, the principles are the same: the central bank operates in the market and purchases or sells government debt to the non-bank private sector. In general, if the central bank sells government debt the money supply falls (all other things being equal) because money is taken out of bank accounts and other sources to purchase government securities. This leads to an increase in short-term interest rates. If the government purchases (buys-back) government debt this results in an injection of money into the system and short-term interest rates fall. As a result, the central bank can influence the portfolio of assets held by the private sector.

B. Loans to banks and the discount window

It is an instrument that allows eligible banking institutions to borrow money from the central bank, usually to meet short-term liquidity needs. By changing the discount rate, that is, the interest rate that monetary authorities are prepared to lend to the banking system, the central bank can control the supply of money in the system. If, for example the central bank is increasing the discount rate, it will be more expensive for banks to borrow from the central bank so they will borrow less thereby causing the money supply to decline. Vice versa, if the central bank is decreasing the discount rate, it will be cheaper for banks to borrow from it so they will borrow more money.

Direct lending to banks can also occur through the central bank's lender-of-last resort (LOLR) function. By acting as a lender-of-last resort the central bank provides liquidity support directly to individual financial institutions if they cannot obtain finance from other sources. Therefore it can help to prevent financial panics.

C. Reserve requirements

Banks need to hold a quantity of reserve assets for prudential purposes. If a bank falls to its minimum desired level of reserve assets it will have to turn away requests for loans or else seek to acquire additional reserve assets from which to expand its lending. The result in either case will generally be a rise in interest rates that will serve to reduce the demand for loans. The purpose of any officially imposed reserve requirements is effectively to duplicate this process.

If the authorities impose a reserve requirement in excess of the institutions' own desired level of reserves (or else reduce the availability of reserve assets) the consequence will be that the institutions involved will have to curtail their lending and/or acquire additional reserve assets. This will result in higher interest rates and a reduced demand for loans that, in turn, will curb the rate of growth of the money supply.

• The advantage of reserve requirements as a monetary policy tool is that they affect all banks equally and can have a strong influence on the money supply. In Ethiopia, the reserve requirement is 5% in the sense banks are required to maintain 5% of all Birr and foreign currency deposit liabilities held in the form of demand deposits, saving accounts, and time deposit (Directive No 55/2013).

D. **Direct borrowing**/lending in interbank money market

E. **Moral suasion**. A persuasion tactic used by central banks to influence and pressurize banks to adhere to policy. **e.g**. closed discussion with bank directors, severe supervision

2.9. Central Bank Independence

Globally, in recent years there has been a significant trend towards central bank independence in many countries and the issue has generated substantial debate all over the world. Theoretical studies seem to suggest that central bank independence is important because it can help produce a better monetary policy. For example, an extensive body of literature predicts that the more independent a central bank, the lower the inflation rate in an economy. Central bank independence can be defined as independence from political influence and pressures in the conduct of its functions, in particular monetary policy.

It is possible to distinguish two types of independence: **goal independence**, and instrument independence.

• Goal independence refers to the ability of the central bank to set its own goals for monetary policy (e.g., low inflation, high production levels).

• Instrument independence is the ability of the central bank to independently set the instruments of monetary policy to achieve monetary policy goals.

• It is common for a central bank to have instrument independence without goal independence; however, it is rare to find a central bank that has goal independence without having instrument independence

• In general, today there is a trend in both developed and developing countries towards the increased independence of central banks from political pressure. Typically, a central bank is conferred instrument independence but not goal independence; this means that the central bank can independently set the instruments of monetary policy to achieve the macroeconomic goals determined by the government of the day.

In the United Kingdom, for example, the Bank of England is currently granted instrument independence and practices what is known as inflation targeting. This means that it is the government that decides to target the inflation rate (e.g. 2 per cent) and the Bank of England is allowed to independently choose the policies that will help to achieve that goal. Such a situation is only acceptable in a democracy because the Bank is not elected and thus goals should only be set by an elected government.

While central bank independence indicates autonomy from political influence and pressures in the conduct of its functions (in particular monetary policy), dependence implies subordination to the government. In this latter case, there is a risk that the government may 'manipulate' monetary policy for economic and political reasons. It should be noted, however, that all independent central banks have their governors chosen by the government; this suggests that to some extent central banks can never be entirely independent.

In general, today there is a trend in both developed and developing countries towards the increased independence of central banks from political pressure. Typically, a central bank is conferred instrument independence but not goal independence; this means that the central bank can independently set the instruments of monetary policy to achieve the macroeconomic goals determined by the government of the day.

2.10. Establishment of the NBE

The National Bank of Ethiopia was established in 1963 by proclamation No 206 of 1963 and began operation in January 1964. Prior to this proclamation, the Bank used to carry out dual activities, i.e. commercial banking and central banking. The proclamation raised the Bank's capital to Ethiopian dollars 10.0 million and granted broad administrative autonomy and juridical personality.

Following the proclamation No 206 of 1963, the National Bank of

Ethiopia was entrusted with the following responsibilities.

- To regulate the supply, availability, cost of money and credit.
- To manage and administers the country's international reserve.
- To supervise commercial banks, hold commercial banks reserve and lend money.
- To supervise loans of commercial banks and regulate interest rates.
- To issue paper money and coins.
- To act as an agent of the Government.
- To fix and control the foreign exchange rates.

However, monetary and banking proclamation No. 99 of 1976 came into force on September 1976 to shape the Bank's role adoring to the socialist economic principle that the country adopted. Hence, the Bank was allowed to participate actively in national planning, specifically financial planning, in cooperation with the concerned state organs. The Bank's supervisory area was also increased to include other financial institutions such as insurance institutions, credit

cooperatives and investment-oriented banks. Moreover the proclamation introduced the new Ethiopian currency called 'birr' in place of the former Ethiopia Dollar that eased to be legal tender thereafter.

Proclamation No. 99 of 1976 was in force till the new proclamation (83/1994) issued in 1994 to reorganize the Bank according to the market-based economic policy so that it could foster monetary stability, a sound financial system and such other credit and exchange conditions as are conducive to the balanced growth of the economy of the country.

Powers and duties of National Bank of Ethiopia

Accordingly by proclamation 83/1994, the powers and duties vested in NBE are:

- Regulate the supply and availability of money & credit and applicable interest and other changes.
- Set limits on gold and foreign exchange assets which banks and other financial institutions authorized to deal in foreign exchange and hold in deposits.
- Set limits on the net foreign exchange position and on the terms and amount of external indebtedness of banks and other financial institutions.
- Make short and long-term refinancing facilities available to banks and other financial institutions.

Moreover, the proclamation has also raised the paid-up capital of the Bank from
Birr 30.0 million to Birr 50.0 million

Goals of the NBE

i. Carry out extensive and sound institutional transformation tasks.
ii. Maintain price and exchange rate stability.
iii. Maintain adequate international reserves.
iv. Improve the soundness of the financial system.
v. Play a decisive role in economic research and policy advice to the Government.
vi. Create efficient Payment System.
vii. Improve the currency management of the Bank.

Services of NBE to the Banking Sector

1. Issuance of banking business license
2. Approval to commence operations
3. Renewal of license.

4. Approval of branch license.
5. Approval of branch opening and relocation.
6. Reopening of a closed current account.
7. Approval of external auditor.
8. Approval of minutes of Annual General Assembly (AGM).
9. Approval of amended memorandum of Association and Article of Association.
10. Approval of influential shareholdings.
11. Approval of appointment of Chief Executive Officers (CEO) and Directors.
12. Approval of new banking products.

Activity 2.4.

- As a government's bank, indicate three key functions of a central bank
- Identify at least three functions of a central bank as the banker's bank
- Should central banks independent of the government? Provide your argument
- Identify the monetary policy instruments used by central banks
- What are the key roles of the National Bank of Ethiopia?

CHAPTER THREE

COMMERCIAL BANKING

Learning Objectives

At the end of this chapter you will be able to:

- Describe various types of deposit services offered by the banks

- Identify the requirements and procedures in opening different types of accounts
- Identify the special types of banker's customers
- Compare and contrast the Non-Resident Transferable Birr Accounts and Non-Resident Foreign Currency Account
- Identify ancillary or subsidiary services of a banker
- Describe the concept of commercial bank management and profitability

3.1. Introduction

The most non-financial business, a fairly large percentage of their assets are brought with the funds supplied by the owners of the corporation. But in the case of the bank or other financial intermediary, majority of the assets are brought with funds obtained from depositors and others but not from owners.

The most important function of bank is borrowing money from the public. It borrows by accepting deposits in various forms on the ground that it will repay the amount in accordance to the terms of agreement with the depositor. Deposits constitute a major liability on a bank's balance sheet. The size of a bank and the amount of profit depends on the total deposits received from the public. So a bank offers many facilities and incentives to different types of depositors in order to attract funds the general public.

3.2. Types of deposits

There are three types of deposits:

1. Savings Deposit
2. current Deposit
3. Fixed Deposit

In pursuant to the provision of national bank of Ethiopia on interest rate directives the commercial bank offers interest on various types of deposits as follows:

Type of Deposit	Interest per annum
1. Demand Deposits	1%
2. Savings	3%
3. Fixed Deposits	3%

Note: there are some special types of accounts for with CBE is not offering any interest.

Saving Deposits:

These deposits are mostly of a small amount and are accepted by banks to encourage persons of small means to make savings. Frequent withdrawals are not allowed and interest is generally allowed on monthly minimum balance of birr 5 and above. Salaried people and small income earning people generally open savings accounts. Deposit could be made by cash, cheques, C.P.O (cash payment orders) and drafts. But cheques of other banks or branch banks are accepted subject to collection. Depositor's account is credited with the proceeds after claims are responded.

3.2.1. Current Account (Demand Deposit)

In case of current or demand deposits the bank undertakes the obligation of paying all cheques drawn against it by the customer till it has adequate funds of the customer with. The current account is a running account therefore, it never becomes time barred.

There are cost involved in maintaining, managing and servicing current accounts. This includes the cost of processing checks, sending account statements and responding to the depositor's for various other banking needs. These checking deposit costs are related a large part the typical bank's operating costs. Therefore, banks were not paying interest on current deposits. However, these days, banks are paying interest even on demand deposits so as to attract customers on competitive basis.

There is certain addition privileges enjoyed by current account holders namely;

I. Over draft facilities
II. Collection of third party cheques for the customer

III. Loans and advances are given through current accounts

IV. Cheques drawn may be payable at branches where the account is not maintained

The primary objective of current account facility is to save big customers such as joint stock companies, public enterprises etc, from the risk of handling cash by themselves.

Procedure for opening Current and Savings Accounts

The person desiring to open an account with the bank has to make application in the prescribed form. The applicant is required to have his name, address, initial amount of deposit and other necessary information on the form. A passport size photograph is required for applicants of saving deposit accounts and the customer has to declare that he or she shall comply with the rules in force from time to time for the conduct of the account.

A customers can open a saving account with a minimum of birr 5 and subsequent deposit to less than that amount plus the minimum initial allowable deposit. For a current account depositor is birr 500-700.

1. **Introduction:** applicant is required to furnish in the application form his I.D, occupation, Keble and house number. The counter clerk interviews him before opening an account.
2. **Specimen signature:** every customer is required to supply to his banker with one or more specimens of this signature. These signatures are taken on cards and are indexed and filed in an alphabetical order.
3. **Mandate:** The operation of the account by an agent authorized signatories of a business entity. In the case a customer desires to get his account operated upon by other person designate, the bank will obtain a mandate in writing to that effect as well as the specimen signature of the person in whose flavor the mandate is given.
4. **Opening the account**: After observance of all the necessary formalities the a bank opens an account in the name of the applicant. He is required initially to deposit a minimum of birr 250 in a savings account and birr 500 in cause of a current account.

5. **Pay-in slip**: with a view to make deposits the customer fills in a deposit slip. The counter foil (file) will be returned to the customer by the teller with his initials and stamp, on the receipt of the money. Separate pay-in-slips are used for savings and current account as well as for withdrawal and cash deposits.
6. **Pass-Book**: pass book is an authenticated copy of the customer's account with the bank. It is written by the bank and records all dealings between the bank and the customer. The customer presents the passbook at all times of withdrawals or make subsequent deposits or to update entries. The bank may record all the transactions of the customer. In Ethiopia a passbook is issued to customers who enjoy saving account facilities.
7. **Cheque Book**: a cheque book to the customers who are having current accounts.
8. **Withdrawal vouchers**: In case of savings account withdrawal vouchers are used for drawing from the account. Third parties should not be allowed to withdraw (but possible to make deposits) from an account of another savings account holder. However, payments to a third party (legal heir) may be made on presentation of court order up on the death of a customer.
9. **Counter Cheque**: This service a customer at the counter when he/she demands payment without having a cheque on payment of service charge.
10. **Bank statement**: To advice the dealings with a customer, a bank supplies current account holders with a monthly statement of account. All debit and credit advices will be attached with. Deposits without a pass book should not be encouraged, upon customer's notification and application of loss of a pass book the old account will be closed and transfers the balance amount with up to date interest to a new savings account. Customer is charged for the cost of passbook. Stock of un issued passbook should be kept by the bank with precautions.

Inactive Accounts

Dormant accounts are those accounts which are without any transactions by the customer for a long time. Current accounts which remain idle or dormant without a single transaction for a period of six consecutive months should be considered as “Inactive accounts” regardless of their balances for control purpose. However, such inactive accounts may be transferred to active ones provided a given customer draws a cheque once in a month three for consecutive months. In such cases, it is at the discretion of the supervisor to retain or transfer the account in to active account by gathering circumstantial evidence.

Likewise, savings accounts which have been dormant for two consecutive years except interest credits are transferred into inactive accounts. A Control ledger account should be established for the whole inactive savings accounts balance. Moreover, a list should be prepared at the time of transferring the balances from active to inactive accounts and remain attached to the debit ticket.

Inactive saving accounts with amounts below birr 40 must be closed and transferred to other income account “in order to minimize handing of too much accounts. A list of such accounts is prepared and any claim is paid by the debit of general expenses and collect the pass-book from the customers

Activity 3.1

- Describe the various types of deposit services of banks
- What are the primary objectives of current account facility?
- Describe the procedures for opening different types of account
- What are the special a type of accounts for which bank is not offering interest? Why?
- What are Inactive or Dormant accounts? Discuss.

3.2.3 Fixed Deposit Accounts

They are also known as time liabilities or term deposits. These are deposits, which are made with the bank for a fixed period specified in advance.

Opening and operation of a fixed Deposit Account

The deposition has to fill an application form where in mentions the amount of deposit, the period for which deposit is to be made and name/names in which the fixed deposit receipt is to be issued. In case of a deposit in joint names the banker also takes the instructions regarding payment of money on the maturity of the deposit i.e. whether payable jointly or payable to either or survivor etc. The banker also takes the specimen signatures of the depositor. A fixed deposit receipt is then issued to the depositor acknowledging the deposit.

Payment of interest

It usually paid at the time maturity of the fixed deposit. But the bank may pay interest to depositors every three or six months or as agreed with the customer.

A banker is legally not bound to pay interest on a fixed deposit after its maturity.

Interest may be paid on overdue period on such deposits subject to:

1) Renewal of deposit with effect form date on which it matured for payment.
2) Confirmation of renewals by the bank at a stated rate of interest.
3) Advance against Fixed Deposits

At the time of getting a loan, the deposit receipt has to be surrendered to the bank. The bank note down its line on the deposit receipt. The receipt is returned to the borrower on repayment of the loan and the fact that the bank has lifted its line over the deposit receipt is noted down on the receipt.

Surrender of Deposit receipt before Maturity Date

A banker is not bound to accept surrender of a deposit before its maturity date. A fixed deposit receipt is not a negotiable instrument. Cheques cannot be drawn against fixed deposit. If the deposits receipt is lost the payment of the amount due under the receipt may be made to the beneficiary. Fixed deposit accounts are the major source of funds to commercial bank. The procedure for the operation of fixed deposits is as follows:

Fixed/Time Deposit

1. **Opening application form**

When a customer wishes to open a fixed deposit account he must be directed by the staff at the counter to the branch manager or to his designate. The manager or his designate in turn should interview the customer and requests him to fill the application form and affix 0.25 cent revenue stamp.

2. Preparation of Deposit Ticket and issuing the certificate

The printed application form for fixed deposit must be completed by the depositor before the preparation of the certificate of deposit. The customer then may make the fund available in the form of cash cheque or through authority letter to debit his account. Thereafter, the necessary credit ticket with an advice is prepared and stamped with a teller's receiving rubber stamp. But if the fixed deposit is to be established by the debit of the applicant's account debit and credit tickets with respective advices are originated. Upon the fulfillment of the above procedures a certificate of fixed deposit is issued in the name of the depositor in line with the request contained in the opening application form. The manager or his designate handover the certificate and credit advice duly signed by two authorized bank signatories. The manger or his designate must ensure that the customer signs on the register copy confirming receipt of the certificate of time deposit.

3. Preparing Ledger card

For each individual depositor a separate ledger card must be established and all the necessary details must be established and all the necessary details must be completed in the card.

4. Custody CD(certificate of deposit) Register Copy, Leger card Application form

These documents must be kept under the custody of the manager or his designate must be balanced against the general ledger position every month.

5.Interest Calculation

Interest should be calculated monthly and be marked in pencil in the appropriate column of the ledger card. However, on the due date the interest due must be credited to the account or paid to the depositor depending on his instructions.

6. Renewal of Deposit

The time deposit will be renewed as per customers instructions in the application form confirmations of such renewal which will be part and parcel of the certificate of time deposit will be sent to the customer.

The format of the confirmation will be as follows:

_____Branch

Date_____

Mr./Mrs./M/S _____

_____

Dear _____

We confirm having renewed your fixed time deposit with evidenced by certificate of deposit no. _____up to _____

One Month notice Deposit: Procedures

This deposit made for a periods not fixed in duration but in respect of which the depositor must give an agreed period of notice of withdrawal. This notice normally require a period of 30 days' notice.

Regulation of Deposit at One -Month: Notice

a) There is no restriction with regard to initial deposit.

b) The current rate of interest is stipulated in the terms and Tariff manual.

c) Interest will be calculated and credited to the principal amount at the end of each month unless otherwise instruction is received from the customer

d) The Bank is entitled to one month's notice of withdrawals. The bank, at its discretion, waive the whole or any part of the period of notice, then interest payable will be reduced by a penalty equal to interest on the sum withdrawn for the number of days for which notice has been waived. A request for transfer from indicates the date on which the transfer is to be passed. When calculating interest all debit entries must be carefully scrutinized to seen if any interest should be deducted in lien Notice.

Deposit Account should be numbered with a separate serial number "D.N/1 and upward"

An "Open and Closed Book" is kept and as a register Containing the following Details:

First half of the book:

1. Number of Deposit Account
2. Date of Opening
3. Name of the Customer
4. His Current Account Number
5. Date of Closing

Second half of the book:

1. Date of closing
2. Number of Deposit Account
3. Name of the Customer
4. Number of Accounts opened

When an account is closed an entry should be passed in the second half of the book and then, using the Account Number to find the opening entry, the date of closing will be placed in the first half. In the fourth column of the second half, Whenever the Deposit Accounts are run- up to agree with the General lager, the previous total number of accounts opened since last ledger trial added and those closed subtracted and finally the new total will be shown. It is Important to see that this figure actually agrees with the number of accounts opened.

All debit entries must show the date, the instruction of withdrawal received by the Bank (clearly shown on debit ticket) in the "particular" column. Then, if the date of debit entry is less one calendar month after the date the instruction was received, multiply the amount of the debit entry by the number of the days it is less and deduct the result from the whole interest period of one month.

If interest has already been credited to a deposit account which is being closed without the full months' notice, the appropriate amount of interest in lieu of notice can be debited to the current account in the event there is a current account (and re credited to "Interest paid") at the same

time the balance is transferred from the Deposit Account. For example, if on the 15th June, the monthly interest is credited to a Deposit Account, the Bank accepts the customer's instruction to transfer the balance of birr 10,000 to his current account on the 25th June, debit the customer in current account interest at the current rate allowed from 24 days on Birr 10,000 where the account is not closed, the interest in lieu of notice can be deducted from the next amount of interest to be credited. Statement of account will be dispatched to account holders at the close each month and at such other as may be required by the Bank's auditors.

Transferable Accounts, Non- Resident Transferable Birr account and Non- Resident Foreign Currency Account.

With the authorization of exchange control, N.B.E, Banks may maintain the above accounts for corporate bodies, institutions and diplomatic organization dealing within the following categories.

A. Foreign embassies, legations and Consulate
B. U.N. Organizations and O.A.U
C. Official members of diplomatic crops holding diplomatic passports and their equivalent Nationals.
D. Non-Residents whose permanent places of domiciles are in foreign country and who are actually residents outside Ethiopia.
E. Residents of Ethiopian a who qualify to the remittance of funds abroad and
F. Non-Resident Ethiopian nationals working in various fields outside Ethiopia, for the duration of their assignment.

Non-Residents- Transferable Birr Account: All funds credited to these accounts may be transferred without the necessity of obtaining exchange control permit. Overdrawing of the accounts is prohibited. Authorized banks shall ensure that all cheques issued for use by N.R. account holding are distinctively marked "**N.R**"

There non-residents hold accounts, which can be used only for needs of requirement to be met within a given country, such as rent, utilities and other expenses. Such accounts are also opened with the approval of the exchange control.

Entries to Transferable Accounts

Non-resident transferable Birr and foreign currency accounts are credited with foreign currency from abroad, payments from residents of Ethiopia effected under specific authorization of exchanges control (an exchange commission of 1-5% is charged by authorized Banks), and payments from other non-residents accounts.

The same accounts are debited with payments to residents of Ethiopia in birr, drawings in birr notes and coins, sale of any foreign currency by authorized bank, payment to other non-resident accounts, and changes drawing in favor of any person resident outside Ethiopia. An exchange commission of 5% is change against payment to residents of Ethiopia in birr and drawings in birr, notes and coins.

3.2.1. BORROWED FUNDS

3.2.1.1. Federal Funds Purchased

The federal funds market allows depository institutions to accommodate the short-term liquidity needs of other financial institutions. Federal funds purchased (or borrowed) represent a liability to the borrowing bank and an asset to the lending bank that sells them. Loans in the federal funds market are typically for one to seven days. Such loans can be rolled over so that a series of one-day loans could take place. Yet, the intent of federal funds transactions is to correct short-term fund imbalances experienced by banks. A bank may act as a lender of federal funds on one day and as a borrower shortly thereafter, as its fund balance changes on daily basis.

The interest rate charged in the federal funds market is called the federal funds rate. Like other market interest rates, it moves in reaction to changes in the demand or the supply or both. If many banks have excess funds and few banks are short of funds, the federal funds relative to a small supply of excess funds available at other banks will result in a higher federal funds rate. Whatever rate ket, although a financially troubled bank may have to pay a higher rate to

obtain federal funds (to compensate for its higher risk). The federal funds rate is quoted in multiples of one-sixteenth, on an annualized basis (using a 360-day year). Exhibit 16.2 shows that the federal fund rate is generally between 25 percent and 1.00 percent above the Treasury bill rate. The difference normally measures when the perceived risk of banks increases.

The federal funds market is typically most active on Wednesday, because it is the final day of each particular settlement period for which each bank must maintain a specified volume of reserves required by the Fed. Those banks that were short of required reserves on the average over the period must compensate with additional required reserves before the settlement period ends. Large banks frequently need temporary funds and therefore are common borrowers in the federal funds market.

3.2.1.2. Borrowing from the Federal Reserve banks

Another temporary source of funds for banks is the Federal Reserve System which serves as the U.S. central bank. Along with other bank regulators, the Federal Reserve district banks regulate certain activities of banks yet, they will also provide short-term loans to banks (as well as to some other depository institutions). This form of borrowing by banks is often referred to as borrowing at the discount window. The interest rate charged on these loans is known as the discount rate.

Loans from the discount window are short term, commonly from one day to a few weeks. Banks that wish to borrow at the discount window must first be approved by the Fed before a loan is granted. This is intended to make sure that the bank's need for funds is justified. Like the federal funds market, the discount window is mainly used to resolve a temporary shortage of funds. If a bank needed more permanent sources of funds, it would develop a strategy to increase its level of deposits.

When a bank needs temporary funds, it must decide whether borrowing through the discount window is more feasible than alternative no depository sources of funds, such as the federal funds market. The federal funds rate is more volatile than the discount rate because it is market determined, as it adjusts to demand and supply conditions on a daily basis. Conversely, the discount rate is set by the Federal Reserve and adjusted only periodically to keep it in line with other market rates (such as the federal funds rate).

Banks commonly borrow in the federal funds market rather than through the discount window, even though the federal funds rate typically exceeds the discount rate. This is because the Fed offers the discount window as a source of funds for banks that experience unanticipated shortages of reserves. If a bank frequently borrows to offset reserve shortages, these shortages should have been anticipated. Such frequent borrowing implies that the commercial bank has a permanent rather than a temporary need for funds and should therefore satisfy this need with rater than a temporary need for funds and should therefore satisfy this need with a more permanent source of funds. The Fed may disapprove of continuous borrowing by a bank unless there were extenuating circumstances, such as if the bank was experiencing financial problems and could not obtain temporary financing from other financial institution.

3.2.1.3. Repurchase Agreements

A repurchase agreement (repo) represents the sale of securities by one party to another with an agreement to repurchase the securities at a specified date and price. Banks often use a repo as a source of funds when they expect to need funds for just a few days. They would simply sell some of their government securities (such as their Treasury bills) to a corporation with a temporary excess of funds and buy those securities back shortly thereafter. The government securities involved in the repo transaction serve as collateral for the corporation providing funds to the bank.

Repurchase agreement transactions occur through a telecommunications network connecting large banks, other corporations, government securities dealers, and federal funds (wish to sell and later repurchase their securities) with those who have excess funds (are willing to purchase securities now and sell them back on a specified date.) transactions are typically in blocks of $1 million. Like the federal funds rate, the yield on repurchase agreements is quoted in multiples of one-sixteenth on an annualized basis (using a 360-day year). The yield on repurchase agreements is slightly less than the federal funds rate at any given point in time, because the funds loaned out are backed by collateral and are therefore less risky.

3.2.1.4. Eurodollar Borrowings

If a U.S. bank is in need of short-term funds, it may borrow dollars from those banks outside the United States that accept dollar-denominated deposits, or Eurodollars. Some of these so-called Euro banks are foreign banks or foreign branches of U.S. banks that participate in the

Eurodollar market by accepting large short-term deposits and making short-term loans in dollars. Because U.S. dollars are widely used as an international medium of exchange, the Eurodollar market is very active. Some U.S. banks commonly obtain short-term funds from Euro banks.

3.2.2. LONG-TERM SOURCES OF FUNDS

1. Bonds Issued by the Bank

Like other corporations, bank own some fixed assets such as land, buildings, and equipment. These assets often have an expected life of 20 years or more and are usually financed with long-term sources of funds, such as through the issuance of bonds. Common purchasers of such bonds are households and various financial institutions, including life insurance companies and pension funds. Banks do not finance with bonds as much as most other corporations, because their fixed assets are less than those of corporations that use industrial equipment and machinery for production. Therefore, they have less of a need for long-term funds.

2. Bank Capital

Bank capital generally represents funds attained through the issuance of stock or through retaining earnings. Either form has no obligation to pay out funds in the future. This distinguishes bank capital from all the other bank sources of funds that represent a future obligation by the bank to pay out funds. Bank capital as defined here represents the equity or-net worth of the bank. Capital can be classified into primary or secondary types. Primary capital results from issuing common or preferred stock or retaining earnings, while secondary capital results from issuing subordinated notes and debentures.

A bank's capital must be sufficient to absorb operating losses in the event that expenses or losses have exceeded revenues, regardless of the reason for the losses. Although long-term bonds are sometimes considered as secondary capital, they are a liability to the bank and therefore do not appropriately cushion against operating losses.

When banks issue new stock, they dilute the ownership of the bank because the proportion of the bank owned by existing shareholders decreases. In addition, the bank's reported earnings per share are reduced when additional shares of stock are issued, unless earnings increase by a

greater proportion than the increase in outstanding shares. For these reasons, banks generally attempt to avoid issuing new stock unless absolutely necessary.

Bank regulators are concerned that banks may maintain a lower level of capital than they should and have therefore imposed capital requirements on them. Because capital can absorb losses, a higher level of capital is thought to enhance the bank's safety and many increase the public's confidence in the banking system. In 1981 regulators imposed a minimum primary capital requirement of 5.5 % of total assets and a minimum total capital requirement of 6 percent of total assets. Because of regulatory pressure, banks have increased their capital ratios in recent years.

In 1988, regulators imposed risk-based new capital requirements that were completely phased in by 1992, in which the required level of capital for each bank was dependent on its risk. Assets with low risk were assigned relatively low weights, while assets with high risk were assigned high weights. The capital level was set as a percentage of the risk-weighted assets. Therefore, riskier banks were subject to higher capital requirements. The same risk-based capital guidelines were imposed in several industrialized countries. Additional details are provided in the following chapter.

3.2. Special types of banker's customers

Every person who is competent to contract can open an account with a bank provided the bank is satisfied regarding the capacity and is willing to enter into necessary business relations with him. But there are certain types of persons whose capacity to enter into valid contracts is subject to certain legal restrictions

1. Minors: A persons who has not completed 18th year of age is considered to be a minor. It will not be advisable to open a current account for a minor since in case of an overdraft the minor does not have any personal liability. The savings account may be opened in the name of the minor followed by the word "Minor" or in the name of the "minor" or the name of the minor and his/her guardian.

2. Accounts of liquidators: The Consideration affecting the accounts of liquidation depend upon member's voluntary winding up, a creditors' winding up or a compulsory winding up. In any case, document of liquidation are submitted to the legal department for examination and written approval. When approval of authority is given by the department a signature card with the name of liquidator followed by the words "In bankruptcy" or "In liquidation" will be maintained.

3. Trustees: A trust may be defined as the relationship which arises wherever a person (called the trustee) is compelled in equity to hold property whether real or personal for the benefit of some persons called beneficiary for some object permitted by law.

4. Joint Accounts: A joint account is a bank account operated with two or more parties who are partners, executors or trustees. Husband and wife frequently open a joint account but may also be opened by other. A joint account may be opened as "**and**" or "**and/or**". If it is **"and" accounts** either parties or any other may deposit in the account but both parties are allowed for withdrawals. If it is **"and/or" accounts** either party can deposit or make withdrawals.

5. Joint stock companies/ Accounts of companies: In modern times most large bank accounts whether in credit or overdraft are these companies engaged in production of goods or services. Therefore, it is essential for bank officials to possess a general knowledge of company law as a whole and more specialized knowledge of those aspects of the subject which are of direct concern to bankers. The legal status of company is a separate entity created under the law. Accordingly, whenever a bank is asked to open an account for a company, the following document should be required.

1. Certificate of incorporation
2. Trading Certificate/certificate of commencement
3. Memorandum and article of association.
4. Copy of the board's resolution, stating the names of signatories of the account.

A mandate file is opened by the opening branch comprising the documents mentioned above together with a certified copy of a resolution of the board of directors (a letter of authority from the respective Minster of the minatory in case of state enterprises)

6. Illiterate persons: An illiterate may generally open a savings account with a bank. The banker should take the following:

1. Thumb print-attested by witnesses
2. Identification mark
3. Passport size photograph

7. Blind persons: Normal procedures are applied with opening an account for a blind customer. Payment have to be made in the presence of two known witness and these witness have to observe the transactions and put their signatures on deposit or withdrawal vouchers attesting that the transactions have been carried out as directed by the blind customer.

8. Accounts of executors and Administrators: Both are persons appointed to settle the accounts of person after his death. Executor is appointed by the depositor before his death. The person appointing him is called "testier". The executor has to act according to directives given in the "will". Official confirmation of the will is technically called as "Probate" form the court. The administrator is appointed by the court in the situations named as executor has died or refuses to act. He disposes of the assets and makes payment of the liabilities of the deceased as per the direction given in the will or in the absence in the letter of administration issued by the court appointing him as administrator.Example "Hagos Tesfay and Kelali Gemechu executors or administrators of the estate of Amare Mesfin in the deceased."

9. Lunatics: All contracts made by lunatics are void. Therefore, no banker would knowingly like to open an account in the name of a person with unsound mind as it would involve him in risks. But a customer may become a lunatic after opening his accounts with the bank. A bank should suspend all operations on the account of a person who to its knowledge has become lunatic till it receives a proof of his sanity or get an order of the court to this effect.

A banker should take the following precautions on receiving notice of customer's this insanity.

1. Return all cheques on customer's account with the words " refer to drawer" and not" customer insane"
2. Make a careful note of the "insane order as and when received form the court
3. Allow operation of the account as per lunacy order.
4. Allow customer operate the account only when certified by the court to be sane.

10. Account of state enterprises: Any public enterprise is established by relevant proclamation. The authority to open an account emanates from the relevant Board of Directors and given these facts a branch bank should obtain the following documents from the public enterprise to set-up their mandate file

a) The relative "Negarit Gazzeta"
b) Letter of authority from the board of directors
c) Copy of relevant documents

11. Accounts of mass-organizations: Co-operatives are organized by the relevant government agency and a certificate is issued by the concerned agency, the organization is considered as a legal entity. Therefore bank must follow the following procedures whenever an account is to be opened for co-operative.

a) Obtain certificate of registration
b) Obtain copy of co-operative rules and regulations
c) Obtain copy of minutes of members; resolution at the last general assembly.

12. Accounts of Urban Dwellers association (Kebelles): As per existing rules for the establishment kebelles, branches could open accounts subject to the following requirements.

a) Certificate of registration
b) A copy of rules and regulations of the association.
c) A copy of minute during the last general assembly of members' resolution.

13. Trade unions: Bank branches are authorized to open accounts for trade unions provided that they produce the following documents:

a) Copy of a certificate or registration from the ministry of labor and social affairs.
b) Resolution of general assembly appointing the executive committee of the trade union.
c) Rules and regulations of the trade union.

14. Housing co-operatives: such co-operatives are organized and formed by the Bureau of Urban Development and Housing. Bank branches may open an account in the name of the co-operatives provided the following documents are produced:

a) A copy a certificate of registration
b) A copy of co-operative rules and regulations.
c) Resolution of the general Assembly appointing the executive committee.

15. Joint Venture: considerable prudence must be exercised in the opening of accounts which may relate to joint venture.

a) Joint venture is not made known to third parties.
b) It need not be in writing is not subject to registration in the ministry of domestic trade tourism of Hotel commission not to publication as required of other business organizations.
c) A joint venture does not have legal personality
d) If the joint ventures is made known that the principals of partnership arise and we may be needlessly confronted with complications of this account.

Consequently the basis of opening an account should be that

a) A simple joint account in the names of the parties
b) Use of the title " Joint venture Account" should be avoided;
c) Precise instructions as to the operation of the account the credit of funds and the endorsement of cheques etc, should be taken but it is not necessary to take cognizance of any document in respect of the internal arrangements between parties to the joint venture.

3.4. Ancillary or Subsidiary Services of a Banker

1. Remittance of Funds

Banks have their branches speeded throughout the country and therefore they serve as the best mediums for remittances of funds from one place to another. This service is available to both customers and non- customers of the bank. There are various modes of transferring funds.

a) Mail transfers- are orders issued by mail for the transfer of funds between the branches of a bank by order of an applicant to a specified beneficiary

b) Telegraphic transfers - these are orders issued for the transfer of funds telegraphically between branches of a bank.

c) Draft- is an order to pay money drawn by one office of a bank upon other office of the same bank for a sum of money payable to order or on demand

d) Cash payment orders (C.P.O) - are modes of transferring funds and such instruments are payable by the originating branch bank or another bank.

2. Safe custody of Valuables

Banks also accept valuables for safe custody, such as negotiable securities, Jewelry and documents of title to property etc. This modern banking activity being equipped with safe and strong rooms and is obviously a very safe and convenient place for depositing valuables. There are two ways through which a modern banker ensures safe custody of its customers' valuables

i. Accepting valuables from the customers for safe custody: A bank may accept delivery of valuable from its customers for safe custody. The banker should maintain a register of the article accepted for safe custody and the customer should be given a receipt for the articles accepted under safe custody. On the delivery of the valuable to customer; the fact should be duly registered in the register book.

ii. Hiring of safe deposit vaults/boxes: this public service is provided at selected branches and for the purpose of this, strong rooms equipped with safe deposit lockers are prepared. The lockers may be hired to the public on fee basis.

Two keys are used for operating the deposit vaults/boxes. One of which is kept by the hirer under his possession, while the other (Master key) is kept with the bank supervisor. The contents of the box may not be known to the supervisor. But simply the details of the hire's visits for the operations of the locker will be recorded in the safe deposit vaults register.

3. Agency Services: Commercial Bank performs various agency services ranging from Payment and collection of dividends, subscription fees, insurance premium, rent, salaries, and credit instruments. They may also underwrite shares, or help in preparation of income- tax returns and claims for the recovery of overpaid tax and assist in checking assessments.

4. Others Services.

Commercial Banks also serve as a source of information to other banks deal in foreign exchange and finance of foreign trade, issue bulletins or journals that may give valuable business information to users, act as correspondent or representative of their customers, other banks and financial institutions.

Activity 3.2

- Discuss the special types of Banker's customers**.**
- What are the subsidiary services of a banker?

3.5 Commercial Bank Management and Profitability

3.5.1 Basics of Commercial Bank Management

Commercial bank offers the public both deposit and credit services, as well as a growing list of newer and more innovative services, such as investment advice, security under writing, and financial planning. The name commercial implies that banks devote most of their resources to meeting the financial needs of business firms. In recent years however, commercial banks have significantly expanded their offering of financial services to consumers and units of government around the world.

Thus, the banking business mainly boils down to one of granting bank deposit credits or issuing paper IOUs (I Owed You) to individuals or firms in exchange for their holdings or other claims

to base money (coins or fiat, paper money) and using the base money thus obtained, or that part of it not needed as cash reserves, to purchase other IOUs. The business may be most readily understood by considering the elements of simplified bank balance may be most readily understood by considering the elements of a simplified bank balance sheet, where a bank's available resources its "assets" are reckoned alongside its obligation or "**liabilities.**" Bank liabilities consist mainly of various kinds of deposit credits (or simply "deposits "), including money that can readily be spent and there by transferred in whole or in part by their holders, by means of checks or instructions conveyed to the bank's computer using a debit card. Bank assets consist mainly of various kinds of loans and marketable securities, and of reserves of base money, which may be held either as actual central bank notes and coins or in the form of a credit (deposit) balance at the central bank. The difference between the fair market value of a bank's assets and the book value of its outstanding liabilities represents the bank's net worth. A bank lacking positive net worth is said to be **"insolvent**," and generally cannot remain open unless it is kept a float by means of central bank support.

The fact that a bank must stand ready to convert a significant portion of its liabilities, including all of its **checkable** or" **debatable" deposits** , into cash on demand poses a fundamental challenge: because most bank loans have definite maturity dates (the exception being so- called "**call loans**, which are repayable at the lender's discretion). Banks, unlike some other financial intermediaries, cannot avoid having to "borrow short and lend long," that is, they cannot avoid having to exchange IOUs that may be redeemed at any time for ones that will not come due until some definite future date. Banks are for this reason uniquely subject to **"liquidity risk"**– the risk of not having enough cash (base money) on hand to meet liability holder's demands for immediate payment – even though they may be perfectly solvent.

Asset management

There was a time when bankers limited themselves to what has come to be known as asset management "as means for limiting their exposure to various risks, including liquidity risk. That is, they concentrated on adjusting the composition of bank's assets- its portfolio of loans,

securities, and cash – while exercising little if any direct control over its liabilities and overall size, which were strictly a matter of the number of customers who were prepared to lodge part of their savings with it. In general bank managers sought to maintain a mix of assets capable of earning the greatest interest revenue consistent with keeping risks within acceptable bounds. To achieve this goal in practice meant holding average cash reserves sufficient for meeting routine demands(including, in many instances, the demand for reserves to satisfy minimum statutory requirements) while devoting remaining funds mainly to short- term (and supposedly "self-liquidating") commercial loans. The presence of many short term loans among a bank's assets meant that some bank loans were always coming due, so that a bank could meet exceptional cash with drawls or settlement dues through the simple device of refraining from renewing or replacing some maturing loans.

The practice among early bankers of focusing on short- term commercial loans, which was reasonable enough given the assets they had to choose from, eventually became the basis for the so- called "**real bills doctrine**," according to which there could be no risk of banks overextending themselves, or generating inflation, so long as they stuck to the short- lending rule of thumb, and especially if they limited themselves to discounting commercial bills or promissory notes supposedly representing real goods in various stages of production. Critics of the doctrine, starting with the London banker **Henry Thornton** (in his 1802 Inquiry into the Nature and Effects of the paper credit of Great Britain) fault if for treating both the total value of outstanding commercial bills and the proportion of such bills presented to banks for discounting as set low enough, the critics observe, both the volume of loans and discounts will increase and the outstanding quantity of bank money will expand; and this expansion may in turn cause the general price level to rise . As prices rise, the **nominal stock of** "**real bills**" will tend to grow as well. Inflation might therefore continue forever despite bank's strict adherence to the – bills rule.

Although the bills doctrine continues to command a small following among academic economists, by the late 19th century bankers themselves had generally abandoned the old-

fashioned practice of limiting themselves to short–term commercial loans, instead preferring to mix such loans with longer term investments, where the latter tend to offer higher yields. This change in emphasis to a considerable extent has been a response to substantial improvements in the marketability of long term investment securities, which makes it easy for an individual bank to find buyers for such securities, whenever it seeks to exchange them in hurry for cash. Banks also have been able to make greater use of so- called money–market assets, such as Treasury bills, which combine short- maturities with ready marketability and are also a favored form of collateral for central bank loans.

Commercial banks in some nations, including Germany, also make long- term loans to industry despite the fact that such loans are **neither "self–liquidating" nor readily marketable**. These banks must ensure their liquidity by maintaining relatively high levels of capital (including conservatively - valued shares in the enterprises they are helping to fund) and by relying more heavily on debentures). In other nations, including Japan and the United States, the long- term financing of industry is mainly handled by specialized financial institution rather than by banks in strict sense of the term.

Liability and Risk Management

The asset management approach to banking is on the assumption that a bank's liabilities are both relatively stable and unmarketable: a bank relies on a market for its deposit IOUs that is largely a function of the bank's location, with changes in the extent of the market (and hence in the total amount of the resources available to fund the bank's loans and investments) being largely beyond of its immediate control. Beginning in the 1960,s however, this assumption was gradually abandoned, first in North America and then else where as well. In the United States rising interest rates, together with regulations limiting interest payments on bank deposits, made it increasingly difficult for banks to attract and maintain deposits. Consequently bankers began to make use of a variety of alternate devices for acquiring funds, including repurchase agreements (the selling of a variety of alternate devices for acquiring funds, including

repurchase agreements (the selling of securities on condition that buyers agree to repurchase them at stated date in the future) and negotiable CDs (certificates of deposit) which can be traded in a secondary market. In short, banks discovered ways in which to buy funds, instead of simply waiting for fund to flow to them in the normal course of business, and were thus able to manage the liability as well as the asset side of their balance sheets. Such active purchasing and selling of funds by banks, which has come to be known as **"liability management,"** makes it easier for bankers to fully exploit profitable lending opportunities without being precluded from doing so by a lack of funds to lend out for this reason it quickly spread beyond the united states, first to Canada and the united kingdom, and eventually to banking systems in other nations.

Summary of Liability Management

Liability management supplements assets management but does not replace it as a source of bank liability. Asset management still remains the primary source of liquidity for banks, particularly smaller banks. If used properly, liability management allows banks to reduce their secondary reserve holdings and invest these funds in higher yield assets, such as loans or long-term municipal bonds. Liability management is not well suited to smaller banks, because they do not have direct access to the wholesale money markets where liability management is practiced. Liability management is not a panacea for bank liquidity problems. There may be a times when banks are unable to attract or retain funds through liability management because of tight credit periods or because of uncertainty about the soundness of a particular bank. Because of some large bank failures, in recent years, lenders have become particularly sensitive to the issue of bank safety.

A still more recent approach to bank management, the so-called **"risk management**". The novelty of the risk management approach rests in its treatment of banks as "bundles of risks' and of the primary challenge facing bank manager's as being that of establishing an acceptable overall degree of risk exposure to various risks, and then adjusting the bank's portfolio to

achieve both an acceptable overall risk level and the greatest shareholder value consistent with that risk level.

Modern banks are exposed to a wide variety of risks, including credit risk (the that borrowers will fail to repay their loans on schedule), interest –rate risk (the risk that market interest rates will rise relative to rates being earned on outstanding long term loans), market risk (the risk of suffering losses in connection with asset and liability trading), foreign –exchange risk (the risk of a foreign currency in which loans have been made being devalued during the loans' duration) and sovereign risk (the risk that a government will default on its debts) as well as liquidity risk. The risk management approach differs from earlier approaches to bank management in advocating , not simply the avoidance of most of these risks, but their "optimization ," which is often best accomplished , not by avoiding certain kinds of assets (and special risks they carry) but by mixing and matching various risky assets , including traditionally " forbidden" assets such as forward and futures contracts, options, and other so-called "derivative") which , despite being risky themselves, can also be designed to hedge losses on other risky assets. Suppose, for example, that bank manager wishes to project his bank against the possibility of a fall in the value of its bond holdings owing to a rise in market interest rates during the next three months. The manager might do so by using a three–month forward contract- that is, by selling the bonds for delivery in three months time- or, more likely , by taking a short position in bond futures. In the event that interest rates really do rise, profits from the forward contract or short futures position should serve to completely offset the loss in the bond's value.

A shortcoming of the risk management approach is its reliance upon techniques for measuring overall risk exposure, such as "value at risk" (which measures the maximum likely loss on a portfolio deducting the next 100 days or so) that generally fail to allow for the high- impact, low probability events, such as the bombing of central bank of Sri Lanka in 1996 or the 2001 attack on the world Trade Center. In the end, traditional bank of management tools, including

reliance upon bank capital, must continue to play a role, and even then responsibly managed banks are likely to fall victim to unforeseen events.

3.4.1. The Role of Bank capital

Because even the best risk management techniques can not altogether insulate banks from losses, banks cannot rely on deposits alone to fund their investments, but must be funded in part by their owner's equity or share capital, and bank managers must concern themselves, not only with the composition of their assets and liabilities, but with the extent of their equity capital also. A bank's shareholders being residual claimants share in profits but are also the first to bear any losses stemming from poorly performing loans or investments. When the value of a bank's assets decline, shareholders bear the loss at least up to the point at which their shares become worthless, while depositors stand to suffer only if losses amount enough to exhaust the bank's equity, rendering it insolvent. In that case the bank, may be closed, and its assets liquidated, with depositors (and, after them if anything remains, other creditors) receiving pro- rated shares of the proceeds.

Where bank deposits are not insured or otherwise guaranteed by government authorities, bank quite capital serves as depositors' principal source of security against bank losses, and as such plays a crucial role in making bank deposits a viable substitute for other assets including base money. Historically, market incentives alone often sufficed to encourage banks to maintain substantial capital –asset ratios, to advertise those ratios, and even in some instances to forego limited liability status in favor of unlimited liability (which makes bank owners personally liable for losses suffered by their banks, instead of limiting their exposure to the value of their investments). Government authorities have, nonetheless, often felt compelled to regulate bank capital, by making a certain absolute level of capitalization a condition for entry into the Banking business, by specifying a minimum necessary ratio of capital to assets or liabilities, or by imposing extended (e.g. double or unlimited) liability on bank shareholders.

Government-sponsored implicit or explicit deposit guarantees have, however, tended to weaken market based incentives favoring the maintenance of substantial bank capital cushions, by making those cushions appear redundant to depositors, and there by making it easier for poorly capitalized banks to compete with well capitalized ones. Consequently, as the number of nations having deposit insurance schemes of some kind has increased , and as central banks have become more and more inclined to offer support to troubled banks, regulators have become more concerned than ever about inadequate bank capital ratios, and have become more aggressive in their endeavors to enforce minimal capital requirements. While central bank guarantees make it, for any given level of risk exposure, for banks to thrive deposit having low capital ratios, other aspects of central bank conduct can have a decided influence upon bank's exposure to risk. Central bank polices that result in substantial, unpredictable price level changes make it difficult for bank managers to correctly evaluate borrower's collateral and potential earning, while policies that lead to rising inflation and interest rates with tend to expose banks to losses on longer–term loans and investments take on when interest rates were still low. The worldwide increase in bank failure rates , was largely a result of 1980s, following an earlier postwar era markedly free of financial crises , was largely a result of unexpected changes in national inflation rates, which rose substantially throughout the industrialized world between the mid- 1960s and then fall again.

Activity 3.3

- What does Asset management approach state?
- Describe the novelty of Liability and Risk management approach
- Discuss the role of bank capital

3.4.2. Commercial Bank Balance sheet

3.4.2.1. Commercial Bank Assets

There are three basic types of assets on a bank's balance sheet: cash and form bank's marketable securities and loans.

(a) Cash and Due from bank (Primary Reserves)

All commercial bank hold a substantial part of their assets in primary reserves, consisting of cash and deposits held with other banks, these reserves are the banker's first line of defense against withdrawals by depositors and customer demand for loans. Banks generally hold no more than is absolutely required to meet short–term contingencies because the yield on cash assets is minimal. The deposits held with other banks to provide an implicit return for, however, because they are a means of 'paying 'for correspondent banking services. In return for the deposits of smaller banks the larger U.S correspondents provide such important services as clearing checks and processing records by computer. Thousand of smaller bank across the U.S. invest their excess cash reserves in loans to other banks, called **federal funds,** with the help of larger correspondent banks- referred to as federal funds sold.

(b) Marketable securities (Secondary Reserves)

Commercial banks hold securities acquired in the open market as investment and as a secondary reserve to help meet short-term cash needs. Most of the investment securities held by banks are money market instruments, which are liquid and have an original maturity of one year or less, or capital market instruments that the commercial bank intend to hold for one year or less. These include bankers' acceptances, commercial, U.S government securities (Treasury bills, notes, and bonds), U.S government agency securities, and municipal bonds

(c) Loans: Costumer & Industrial loans

The business loans often referred to as C&I loans (commercial and industrial) which fall into four main categories.

Transaction loans: is negotiated for a specific purchase and is tailored to the particular needs of the purchaser. The demand for these loans a particular borrower is typically infrequent and hence each loan is negotiated separately every time. The loan is usually secured by the assets being financed, and repayment is expected to come from the use of this asset.

Working capital loans: are used by firm to finance routine day to day transactions. Thus, they are general purpose, short- term borrowing and are often used either to purchase current assets (e.g., inventory) or to repay current liabilities incurred in purchasing current assets. These loans are also usually secured by collateral such as accounts receivable or inventory.

Term loans: they are longer maturity loans used to buy fixed assets requiring large outlay of capital. Maturities typically run from 3 to 10 years. Repayment is normally amortized because it comes out of the cash flows generated by the asset financed with the loan.

Combination

Working capital loans often include provisions that permit the conversion of short term borrowings in to term loans. This is one way banks combine various types of loans to satisfy the especial needs of their customers.

Consumer loans

The most important types of consumer loans are direct loans and bank credit card receivables. A direct consumer loan is typically financing for the purchase of durable goods (e.g., cars and appliances), and is secured with the asset being purchased. Bank credit card borrowings are a form of short- term, unsecured credit used to finance almost any time costing less than the customer's allowed credit limit. Credit cards were introduced by Franklin National Bank in 1951, but became widely used only in the mid- 1960s. Credit card lending has proved to be very profitable for banks. This profitability stems from two sources: (i) the discount at the bank purchases sales slips from merchants which(who) typically ranges from 2% to 6%, and (ii) the interest rate charged to a card user who chooses not to remain current in payments.

Mortgage loans

These are a specialized form of costumer and commercial lending. The purpose of a mortgage loan is to finance the acquisition or improvement of real estate. These loans are almost always secured by the real estate they finance. The three principal types of mortgage loans are residential, construction and commercial. Until the advent of securitization, mortgage loans were illiquid assets because the uniqueness of each property, the severity of private information problems, and the uncertain maturity of the loan due to the possibility of prepayment by the borrower. However, securitization took care of many of theses impediments to the marketability of mortgages and facilitated the liquidity of these instruments.

3.4.2.2. Commercial Bank Liabilities

To carry out their extensive lending and investing operations, commercial banks draw on a wide variety of deposits and non-deposit source of funds. The vast majority of commercial bank liabilities are in the form of deposits. However, non-deposit sources of funds include federal funds purchased from other banks, security repurchase agreements (repos), and the issuance of capital notes,

Deposits

The bulk of commercial bank funds more than three-fourths come from deposits. There are three main types of deposits: demand, savings and time.

Demand Deposits

Demand deposits, more commonly known as checking accounts, are the principal means of making payments because they are safer than cash and are widely accepted. Although outside the U.S smart cards, credit cards, and transfers by electronic means have generally outstripped demand deposits as payment media. During the past three decades, new forms of demand deposits appeared, combining the essential features of both demand and savings deposits. These transaction accounts include NOW accounts (Negotiable Orders of Withdrawal) and Automatic Transfer Services (ATS). NOW account may be drafted to pay bills but also earn interest, while ATS is a pre- authorized payment service in which the bank transfers funds

from an interest- bearing saving account to a checking account as necessary to cover checks written by customer.

Savings Accounts

Savings deposits generally are in small dollar amounts they bear a relatively low interest rate but may be withdrawn by the depositor with no notice.

Time Deposits

Time deposits carry a fixed maturity and usually the highest rate a bank can pay. Time deposits may be divided into non-negotiable certificates of deposit (CDs), which are usually small, consumer-type accounts, and negotiable CDs that may be traded in the open market in million–dollar amounts and are purchased mainly by corporations.

3.4.3. Non-Deposit sources of funds

One of the most marked trends in commercial banking in recent years is greater use of non-deposit funds, especially as competition for deposits increases. Principal non- deposit sources of fund for commercial banks today include federal funds purchased from other banks, security repurchase agreements where securities are sold temporarily by the commercial bank and then bought bank later, and the issuance of capital notes. Capital notes are of particular interest because many of these securities may be counted under current regulation as capital for purposes of determining a commercial bank's loan limit. Both state and federal laws limit the amount of money a commercial bank can lend to any one borrower to a fraction of the bank's capital. To be counted as capital, however, capital notes must be subordinated deposits, so that if a bank is liquidated, the depositors have first claim to its assets.

Borrowed Funds

They are typically short-term borrowings by commercial banks from the wholesale money markets or a national bank reserve. They are economically similar to deposits but are not insured by the national bank. Borrowed funds are a source of funds primarily for large banks. The principal types of borrowed funds are: Borrowed Federal Funds, Repurchase Agreements, Eurodollar, Banker's Acceptances, Federal Reserve Bank Loans etc.

i) **Federal Funds**

For liquidity reasons, banks may hold reserves in excess of those required by law. A bank with more excess reserves than it desires may lend reserves to another bank that does not have its required level of reserves or that desires additional reserves to make more loans. The buying (borrowing) and selling (lending) of reserves on deposit at the Federal Reserve banks (National Bank Reserve in our case) is called trading in Federal Funds (or Fed Funds).

The maturity of federal funds is usually one day, but the loan may be continuously reserved with the same or other banks in the federal funds market:- Federal Funds have the characteristics that they are transferred immediately, with the central reserve giving the receiving bank credit the same day. By contrast, a cheque may take at least a day to clear. Important components of central funds are reserves of a bank that are borrowed by another bank.

Apart from banks a few other institutions, such as central government agencies, savings and loan association, and mutual savings banks, are active in this market. A market for a Federal fund is a large market, and the big money market banks use it at times, not just to obtain the funds to meet their reserve requirements, but also to obtain funds for additional lending.

ii) **Repurchase Agreements**

Repurchase agreements (RPs) are a form of loan in which the bank sells securities (usually government securities) to the lender but simultaneously contracts to purchase the same securities either on call or on a specified date at a price that will produce an agreed yield.

Repurchase agreements pay explicit interest and natures with an over night, which are subject continuous renewal on a day-to day basis. There are also term RP transactions that are written for maturities up to 30 days.

iii) **Banker's Acceptances**

A banker's acceptance is a draft drawn on a bank by a corporation to pay for merchandise. The draft promises payment of a certain sum of money to its holder at some future date. What makes such drafts unique is that a bank accepts them by prearrangement, there by guaranteeing their payment at the stated time. In effect, the bank has substituted its credit standing for that of the issuer.

Acceptances arise in a rather complicated way. A firm selling to another firm on credit may not know enough about the buyer to feel safe in accepting its promise to pay. This is particularly likely to be the case with a foreign customers (foreign trade transaction), in part because it is more difficult to sue in a foreign court than in a court in one's own country, but while the seller does not want to take the customer's promise to pay (I owe you (IOU), rather appreciates to accept the IOU of the customer's bank. Hence a financial instrument called a banker's acceptance was developed. To explain this let us take an example.

1st Without Banker's involvement

The seller, who resides in Italy, draws up an order to pay by a certain date on the buyer, who resides in Ethiopia, and releases ownership of the merchandise to him or her when the buyer "accepts" the order to pay by writing "accepted" across its face. It is now a trade acceptance and is legally binding. However, if the buyer fails to pay the amount according to the agreement, the problem arises as to where the case shall be presented: -at the seller's country court or at the buyer's country court or on the international court-which all have their own drawbacks.

2nd With the involvement of the bank

Alternatively, the buyer can make an arrangement with his or her bank allowing the seller to draw the order to pay not on the buyer, but on the buyer's bank. When the bank writes

"accepted" on this order to pay, it becomes a banker's acceptance. Since the bank is liable to make the payment on it, when it accepts an order to pay , it is listed on the bank's balance sheet as a liability . However, the bank is not making a loan to the buyer when it gives him or her documents, a letter of credit, stating that it will accept draft drawn on the banker. The buyer is supposed to make payment to the bank by the date the bank has to make its payments on the acceptance. An equal amount is recorded on asset side, as contra item. The bank lends its name and reputation, not funds, to the buyer who usually has to pay a small fee for this service. The seller, when he receives the bank's acceptance needs to hold it to maturity. Often he wants to obtain his funds right away, and will therefore sell the acceptance (at a discount from its value) in the money market.

The buyer of such an acceptance, frequently another bank, obtains an extremely safe and liquid asset.

Capital Notes and Bonds

Issuing bonds to raise funds is a common practice of most industrial firms. It is only in recent years that a few large commercial banks began raising funds by selling short-term capital notes or longer-term bonds.

3.5. Commercial Bank Equity Capitals

Equity capital (or net worth) supplied by a bank's stockholders only a minor portion (only about **8**% on average) of total funds for most commercial banks today. One of the most important functions of equity capital is to keep a banks open in the face of operating losses until management can correct its problems. Recently federal law has mandated minimum capital-to-asset ratios for commercial banks and many banks have recently expanded their equity capital positions. There is also a set of cooperative international capital regulations for major banks in the U.S, Great Britain, japans, and the nationals of Western Europe. The Basle Agreement, reached in 1988, now imposes common minimum capital requirements on all banks in leading industrialized countries based on the degree of risk exposure that each banks faces.

There are three principal types of equity capital that make up the capital account: capital stock (preferred and common), retained earning and special reserve accounts.

Capital stock represents the direct investments into commercial bank and typically includes par value and surplus. Surplus can be defined as the proceeds of from the sale of equity in excess of their par value, plus earnings retained until the surplus account equals the common stock account.

Retained earnings comprise that portion of the bank's profit that is not paid out to shareholders as dividends.

Special reserve accounts are set up to cover anticipated losses on loans and investment. They involve no transfers of funds setting aside of cash, they are merely a form of retained earnings designed to reduce tax liabilities and stock holders' claims on current revenues.

3.7 Commercial Bank Income Statement

Total Revenues

FIRST SAMPLE BANK
BALANCE SHEET
December 31,19x2 and 19x1

Assets	19x2	19x1
Cash and due from banks	$11,820,189	15,009,846
Investment securities (approximate market value		
$50,405,000 and $39,162,000 respectively)	51,172, 385	41,284,011
Federal funds sold	2,040,000	5,000,000
Loans, net	73,983,971	68,475,492
Direct lease financing	1,897,025	1,113,423
Bank premises and equipment,	3,663,495	3,565,897
Accrued income receivable	1,378,072	1,121,050
Other real state owned	95,000	50,000
Prepaid expenses and other assets	180,270	148,200
Total Assets	**146,330,407**	**135,767,889**
LIABILITES AND STOCKHOLDERS' EQUTIY		
Liabilities:		
Deposits:		
Demand	$35,694,104	$ 36,304,092
NOW a/c	25,957,283	18,763,947
Savings	29,346,911	29,569,947
Time 5100.000 and over	8,304,600	6,488,800
Other time	28,460,224	27,001,136
	$127,763,122	**$118,127,657**
Federal funds purchased	1,000,000	1,000,000
Notes payable	5,000,000	5,000,000
Accrued expenses and other liabilities	511,401	728,339
Deferred income tax credits	884,000	726,000
Subordinated debentures	1,196,000	1,196,000
	$136,354,523	**$126,777,996**
Commitments and contingencies		
Stockholders' equity:		
Capital stock:		
Preferred no par value; authorized 20,000 shares:	$ _	$ _
issued none		
Common, $5 par value: authorized and		
issued 600,000 shares	3,000,000	3,000,000
Surplus	3,000,000	2,000,000
Retained earnings	3,875,884	3,989,893
	9,875,884	8,989,893
	$146,230,407	**$126,777,996**

The majority of bank revenues come from interest and fees on loans. Recently fee income from loans has risen faster than interest income as banks have resorted to fewer direct loans to customers and instead earned fee income by guaranteeing customer borrowing elsewhere or advising and assisting customers with new

135,767,889

security offerings. Interest and dividends on security holdings are the second most important source of commercial bank revenues after loan income. Other minor sources of income include earnings from trust (fiduciary) activities and service charges on deposit accounts.

Total Expenses

Bank expenses have risen rapidly in recent years, threatening to squeeze the industry's operating income. Greater competition from bank and non bank financial intermediaries has resulted in dramatic increases in the real cost of raising funds, and the expense of upgrading computer, automated equipment and other technology has placed an added drain on bank revenues. Interest on deposits and other borrowed funds is the principal expense item for most commercial banks followed by the salaries and wages of employees.

The Interest Margin

First commercial bank income statements record all of their bank's interest income from loans and security investments. Then the total interest paid out on borrowed funds is subtracted to derive a commercial bank's net interest income or interest margin. This interest margin measures how efficiently a bank is performing its function of borrowing and lending funds. For many banks the interest margin is the principal determinant of their profitability.

The Non- interest Margin

Of increasing importance in the commercial banking industry is the non interest margin, which is the difference between total non-interest income (e.g., trust department income and service fees on deposits) and non interest expenses (e.g., employee salaries/wages and occupancy expense- i.e. charge for brick and mortar). The non-interest margin is growing in importance as a determinant of commercial bank profits because banks are developing in more new services that generate non-interest fees (e.g., security underwriting, managing pension plans, and a host of other off-balance sheet activities). Because bankers face stiff competition they

work especially hard minimize their non-interest expenses, particularly employee costs, by substituting automated equipment and computerization for labor.

FIRST SAMPLE BANK

STATEMENTS OF STOCKHDLDERS EQUITY

Years Ended December31, 19X2 and 19X1

	Preferred Sock	Common Stock	Surplus	Retained Earnings	Total
Balance Decber 3119x 0					
Net income	$ _	$3,000,000	$2,000,000	$3,000,000	$8,000,000
Cash dividends declared	_	_	_	1,486,103	1,486,103
	_	_____	_____	(600.000)	(600.000)
Balance.Decemer 31, 19x1	$ _	$3,000,000	$2,000,000	$3,989,893	$8,989,893
Net income	_	_	_	1,557,991	1,557,991
Cash dividends declared	_	_	_	(672,000)	(672,000)
Transfer to surplus	_____	_____	1,000,000	(1,000,000)	_____
Balance December 31.19x2	**$**	**$3,000,000**	**$3,000,000**	**$3,875,884**	**$9,875,884**

FIRST SAMPLE BANK
STATEMENTS OF INCOME
Years Ended December 31.19x2 and 19x1

	9x2	19x1
Interest income		
Interest and fees on loans	$6,182,453	$5,822,016
Lease financing income	125,204	74,599
Interest on investment securities		
U.S. Treasury	693.252	596.179
U.S.Government agencies and corps.	501,479	451,738
States and political subdivision	1,157,170	959,094
Other	351,959	355,042
Interest on federal funds sold	382,895	537,412
	$9,394,413	$8,796,080
Interest expense		
Interest on deposits	$4,381,893	$3,780,690
Interest on securities sold agreements to repurchase and sold federal funds purchased	405,992	549,745
Interest on capital notes	89,000	96, 000
	$4,887,587	$4,420,135
Net interest income	$4,516,828	$4,375,945
Provision for possible loan losses	89,000	96,000
Net interest income after provision for possible loan losses	$4,427,828	$4,279,945
Other income		
Trust department income	$147,270	$236,583
Service fees	410,584	412,110
Other	154,441	115,843
Securities gains (losses)	105,827	(16,998)
	$5,818,122	$5,747,538
Other expenses:		
Salaries and wages	$1,668,093	$1,593,427
Pensions and other employee benefits	291,373	237,997
Occupancy expenses	198,374	166,868
Equipment rentals, depreciation and maintenance	243,487	301,255
Other operating expense	954,632	775,333
	$3,355,959	$3,020,880
Income before income taxes	$1,889,991	$2,006,603
Applicable income taxes (Note 9)	332,000	520,000
Net income	$1,557,991	$1,486,103
Net income per share of common stock	$ 2.60	$ 2.48

FIEST SAMPLE BANK

STATEMENTITS OF CASH FLOWS

Years Ended December 31,19X2 and 19x1

Cash flows from operating activates:	**19x2**	**19x1**
Interest received from		
Loans and leases	$6,125,042	$6, 030,872
Interest counties	2,509,887	2,290,103
Federal funds sold	383,462	637,412
Trust department income	147,270	236,583
Service fees	410,584	412,110
Other income	154,441	115,843
Interest paid to depositors	(4,598,831)	(3,589,933)
Interest paid on federal funds purchased	(405,992)	(549,745)
Interest paid on capital notes	(89,700)	(89,700)
Cash paid to suppliers and employees	(3,193,922)	(2,806,158)
Income taxes paid	(174,000)	(430,500)
Net Cash provided by operating activates	**$1,268,241**	**$2,156,887**
Cash flow from investing activates:		
Proceeds from sales of investment securities	$10,610,000	$ 9,321,000
Purchase of investment securities	(20,273,547)	(7,996,125)
Federal funds sold, net	2.960,000	(2,150,000)
Principal collected on loans	25,316,540	(13,695,098)
Loans made to customers	_	(30,959,019)
Purchase of assets to be leased	(1,457,204)	(568,520)
Principal payments received under leases	673,602	278, 356
Capital expenditure	(914, 041)	(697,315)
Proceeds from sale of capital items	622,306	_
Net cash used in investing activities	**$(13,421,363)**	**$(3,094,540)**
Cash flows from financing activities:		
Net increase in demand deposits, NOW accounts and		
Savings accounts	$6,360,577	$ 858,770
Proceeds from sales of time deposes	40,218,400	39,857,412
Payments for maturing time desists	(36,943,512)	(33,942,480)
Dividends paid	**(672,000)**	**(600,000)**
Net cash provided by financing activities	**$8,963,465**	**$6,173,702**
Net increase (decrease) in cash and cash equivalents	$(3,189,457)	$5,236,049
Cash and cash equivalents, beginning	15,009,846	9,773,797
Cash and cash equivalents, ending	**$11,820,189**	**$15,009,846**

Activity 3.4

- Describe the basic types of assets on bank's balance sheet
- What constitutes major liability on a bank's balance sheet? Discuss
- Discuss the commercial bank non-deposit sources of funds
- What are the three principal types of equitable accounts that make up the capital account?

3.8. Commercial Bank lending function

For many commercial banks' lending is the heart of the business. Loans dominate asset holdings and account for a large share of revenues and costs. Lending takes place in both spot and forward credit markets. We begin here with a review of spot lending.

What is a bank loan? Simply it is the purchase of an asset (the borrower's indebtedness) that is typically an illiquid and highly customized financial claim against the borrower's future cash flows. In effect, the bank is obtaining from the borrower legal right to a pre-specified portion of the borrower's future cash flows over a pre- specified period of time, and paying the borrower the present value of these cash flows. The banks claim represents the borrower's repayment obligation and the loan amount represents the present value of these future obligations, assuming no extraordinary profit for bank. The subtlety of lending transactions is often blurred in the building together of distinct services relating to credit transactions. The typical commercial bank loan is logically decomposable into origination (the broker) funding (the lender), servicing (the collector), and risk-processing (the guarantor).

Lending can be thought of largely as credit risk management that includes these other activities as well as the bank's credit culture.

Origination involves the activity of initiating a loan to a borrower. It is often described as the initial solicitation of the borrower and the screening of the loan application by the bank. Origination includes credit analysis and the design of the loan contract.

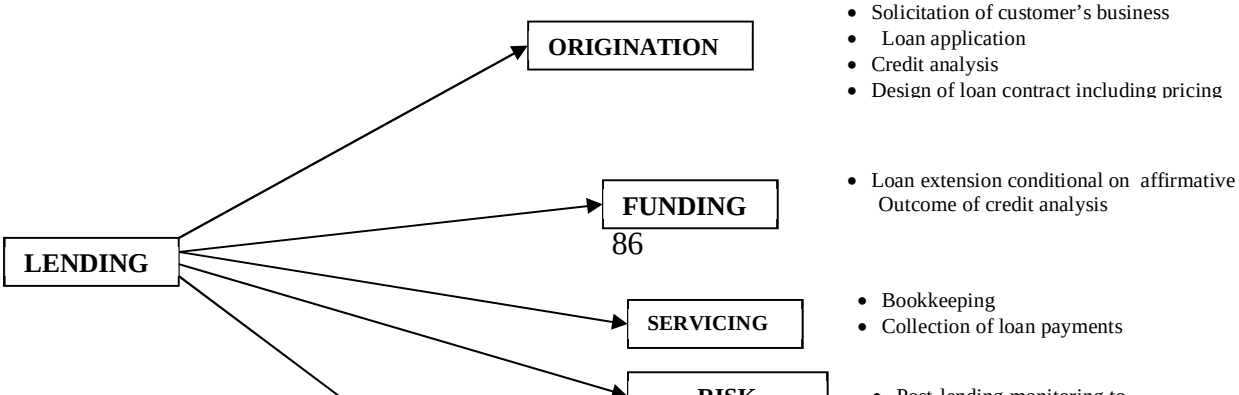
Funding is the actual extension of the loan after an affirmative decision is reached in the credit analysis process. That is, once the credit analysis is complete and the commercial loan officer's as well as the loan committees, decision is that the borrower should be extended credit, the loan is granted.

Servicing involves collecting loan repayments and keeping records (i.e., the loan file). Servicing may also involve making adjustments to loan contract over time as the situation change and the borrower requests adjustments to loan terms and conditions.

Risk-processing involves post-lending monitoring to control default risk, as well as activities designed to control the bank's interest rate risk arising from a loan duration that differs from the duration of the bank's liabilities.

The credit culture involves the bank's organizational design, reporting arrangements, communication practices, and incentive schemes for credit officers. Credit culture has changed considerably over time, and differs significantly from one commercial bank to another.

Decomposition of the commercial Bank Lending Function



3.9. Commercial Bank Credit Analysis

Bank Credit analysis has traditionally referred to the **"five Cs of credit":** capacity, character, capital, collateral and conditions. Since rules of thumb are usually the distillate of accumulated experience they should bear a relationship to theoretical prescriptions. We therefore interpret each of these factors in terms of the underlying economics of bank lending.

Capacity

This refers to the borrower's legal and financial capacity to borrow. The first consideration in assessing a loan request is whether the person requiring the loan is legally capable of borrowing or not. For example in the case of partnerships it is important to know whether all signing partners have the legal authority to borrow on behalf of the partnership. In the case of corporations, the bank should check the corporate charter bylaws to determine who has the authority on behalf of corporation.

Apart from the legal considerations, capacity refers to the borrower's financial capability. Future cash flows are generally used to service debt and therefore need to be carefully estimated. Evaluating borrower's future cash flows available to service debt is a major part of any credit analysis. Sometimes the bank may have to demand that the borrower subordinate

the claims of others to ensure that the borrower has sufficient capacity to repay the bank. An example is a small firm that has borrowed significant amounts from its major shareholders. Another example may be that the bank requires the subordination of claims of earlier creditors; however this is usually difficult as covenants on existing loans will generally prevent the borrower from taking such actions.

Character

The concept of character embraces the borrower's ability to repay debts and the desire to settle all obligations within the terms of the contract. Judging character requires a careful examination of the borrower's past record in debt repayment and related behaviors. Including character in credit analysis makes sense because the better a borrower's credit history or reputation, the less incentive the borrower has to default. The rationale behind this statement is simple. Suppose a borrower knows that a single default will lead to denial of credit for a long period of time. The gain from defaulting is the amount the borrower does not repay the bank, but the gain from repayment is the net present value of all the investment projects that might be financed with future bank loans. Therefore, defaulting on a single bank loan leads to a loss of Net Present Value (NPV) of all these future projects. Clearly this NPV increases as the interest rates on future loans decline. And the longer the borrower keeps repaying its loans the better its reputation gets and the lower are its future loan interest rates. Consequently, the benefit of repaying the loan is greater for borrower with a better reputation.

Capital

How much equity capital the borrower has invested in the firm is an important factor in the assessment of the firm's credit risk. There are two effects. First, a higher amount of capital lessens the moral hazard problem. Capital helps to resolve moral hazard by imposing a greater loss on the borrower for poor project outcomes. This is because capital acts as the first line of defense against project losses and provides a cushion of protection for the lender. Second, the

higher the capital, the better is the signal sent by he firm's owners about the confidence they have in the firm's future prospects. This helps to resolve the asymmetric information problem. The entrepreneur's own contribution of equity can signal the profitability of future projects. The entrepreneur's own contribution of equity can signal the profitability of future projects. The standard argument relies on the entrepreneur's being risk averse. All else equal, the bank should charge an interest rate that is inversely related to the borrower's equity-to-total asset ratio. Less capitalized borrowers are more risky.

Collateral

Most commercial and consumer lending is secured with collateral. Once a loan is secured by a specific asset that serves as collateral the lender has first claim to that asset in the event of default. There are two types of collateral: inside and outside collateral. **Inside collateral** consists of assets owned by the firm to which loan is being extended (e.g. inventory, accounts receivable, fixed assets, etc**). Outside collateral** consists to assets the bank would never have a claim to unless they were specifically designated as collateral (e.g. the personal assets of the owners of a closely held corporation or of a guarantor). Using collateral is not costless, however, since the borrower may undertake actions that undermine the value of the collateral to the bank, ongoing monitoring of the collateral is required. Such monitoring costs are absorbed at least in part by the bank. Moreover, when collateral is transferred to the bank upon default, there are liquidation costs. These include the legal costs of ownership transfer as well as the bank's cost of initially carrying and selling the collateral.

There are at least three reasons for the popularity of secured lending: **risk reduction, signaling instrument, and moral hazard.** An obvious reason to secure a loan is that it provides the lender greater protection against loss in the event of default. But collateral can also convey valuable information to the bank. A borrower's willingness to offer collateral is inversely related to its default risk on the loan, all else equal. Finally, using collateral can help resolve a variety of moral hazard problems including asset substitution (the borrower's incentive to

choose a riskier project after obtaining the loan), underinvestment (the borrower's incentive to choose a riskier project after obtaining the loan), underinvestment (the borrower's unwillingness to invest additional funds in the project even though doing so increases the total return on the project) and inadequate effort (the borrower failing to expend sufficient effort in managing the firm when its assets are highly leveraged).

Conditions

By condition we mean the economic conditions that affect the borrower's ability to repay the loan. Debts are repaid from four sources: income, sale of assets, sale of stock, and borrowing from another source. All of these should be assessed in determining the desirability, price, and other terms of the loan. The borrower's ability to generate income depends on: the selling prices of its goods/services, costs of inputs, competition, quality of goods/services, advertising effectiveness, and quality of management. Analysis of the borrower's financial statements as well as its management should inform the bank about the borrower's ability to create income.

Factors Considered in Credit Analysis

Management of Opportunity and Risk

The management of risks and opportunities can be classified as (1) day-to-day management, (2) crisis management, and (3) strategic planning. Day-to-day management refers to the continuous monitoring and management of risks and the routine management of opportunities related to existing markets and relation ship with existing customers. Crisis management deals with infrequent adverse events (e.g., hostile takeovers, large-scale frauds, and similar misfortunes). Strategic planning involves the development of plans for the exploitation of new market opportunities.

3.10. Interest Rate Risk Management

1. Rationale for Interest Rate Risk Management

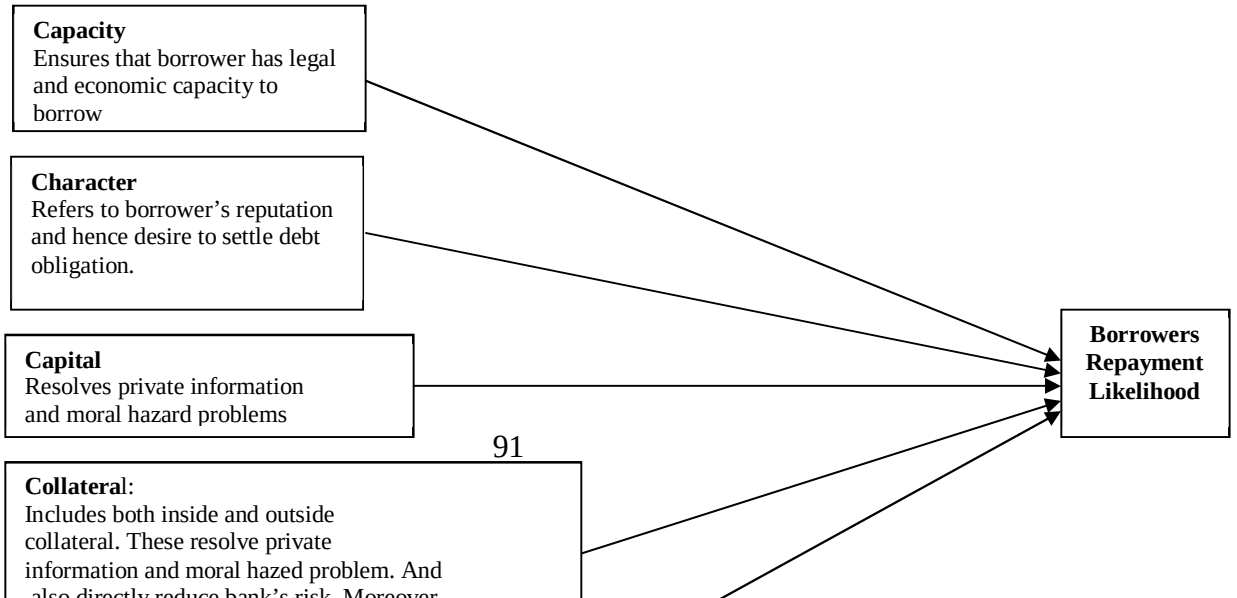
Interest rate risk is the exposure of a bank to financial loss through movements in interest rates. Most banks are in the business of maturity transformation as they largely take deposits on a

demand or short-term basis and use these deposits to fund longer-term credit facilities to clients often on a fixed interest basis (this is termed as "**general risk"**).

However, any deal that affects a bank's position at a future date gives rise to an interest rate exposure as well as a position in an underlying instrument (as example above), unless it is fully hedged. This is because the present value of the cash flow when the position changes at a future date is calculated by discounting bank to arrive at the net present value. Any changes in interest rates before the future date will alter the discount factor and hence the net present value of the future changes in the position. Therefore, interest rate risk is present for a bank across a far wider range of activities than those that may be headlined as interest rate instruments. This is termed "***specific risk"***

Accepting interest rate risk is a normal part of banking. However, where the amount of risk is a normal part of banking. However, where the amount of risk is excessive, or where it is not properly monitored and controlled, it can produce a significant threat to a bank's earnings by producing fluctuations in:

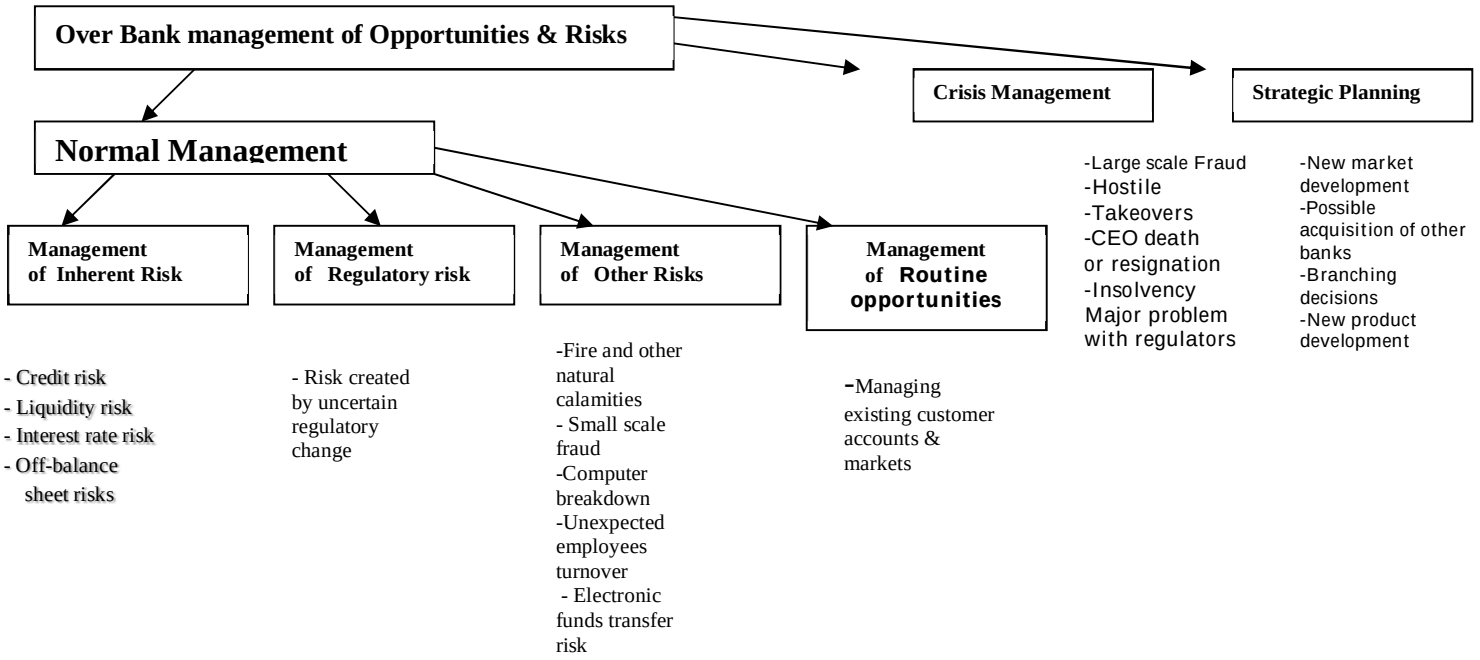
a) Its net interest income and the level of other sensitive income and operating expenses, and
b) The underlying value of a bank's assets, liabilities and off balance sheet instruments, because the present value of future cash flow (and in some cases, the cash flows themselves) changes when the interest rates change.



An effective risk management process maintains interest rate risk within prudent levels are therefore essential to the safety and soundness of banks. The interest risk management policy should take into account the nature of the bank's business and the various types of interest rate risk that arise from it.

Banks may wish to consider the following limits when formulating interest rate risk policy:

a) Listing the products and instruments that traders are authorized to use in the management of interest rate risk.
b) Specific limits for some specified risks or instruments
c) An overall interest rate capital limit set in accordance with the bank's appetite for risk


Over Bank management of Opportunities & Risks
Crisis Management
Strategic Planning
Normal Management
-Large scale Fraud
-Hostile
-Takeovers
-CEO death
or resignation
-Insolvency
Major problem
with regulators
-New market development
-Possible acquisition of other banks
-Branching decisions
-New product development
Management of Inherent Risk
Management of Regulatory risk
Management of Other Risks
Management of Routine opportunities
- Credit risk
- Liquidity risk
- Interest rate risk
- Off-balance sheet risks
- Risk created by uncertain regulatory change
-Fire and other natural calamities
- Small scale fraud
-Computer breakdown
-Unexpected employees turnover
- Electronic funds transfer risk
-Managing existing customer accounts & markets

2. Nature of risk

The nature of the various aspects of interest rate risk should also be considered, and the following paragraphs provide examples of how interest rate risk can arise; the list is not intended to be exhaustive, and should be considered for guidance only.

Re-Pricing risk

This is the primary form of interest rate risk and arises where there are timing differences in the maturity (for fixed rate) or re-pricing (for floating rate) of a bank's assets, liabilities and off-balance sheet positions. It can arise if a bank's positions are fixed rate, but have different maturities or re-pricing dates, and also if floating positions are "matched" against fixed positions. For example, a bank that funded a long-term fixed rate loan with short-term deposits could face a decline in both the future income arising from the position and its underlying value if interest rates increase. The decline arises because the cash flows on the loan are fixed over its lifetime, while the interest paid on the funding is variable, and increases after the initial short-term deposit matures.

Yield Curve risk

Re-Pricing mismatches can also expose a bank to loss in the event of changes in the slope and shape of the yield curve. Yield curve risk is the risk that unanticipated shifts in the yield curve will have adverse effects on a bank's income or underlying value.

For example, the underlying economic value of a long position in ten-year government bonds hedged by a short position in five-year government bonds could decline sharply if the yield curve steeps even if the position is hedged against parallel movements in the yield curve.

Basis risk

This risk arises when there is an imperfect correlation in the adjustment of the rates earned and paid on different instruments with otherwise similar repricing characteristics.

When interest rates change these differences may give rise to unexpected changes in the cash flow and earnings spread between assets, liabilities and off-balance sheet instruments of similar maturities repricing frequencies.

For example, a strategy of funding a 1-year loan that re-prices monthly based on the 1 month U.S Treasury Bill rate; with a 1-year deposit that re-prices monthly based on 1 month LIBOR and exposes the bank to the risk that the spread between the two index rates may change unexpectedly.

Embedded Option

Risks arise from the options embedded in many bank's assets, liabilities and off-balance sheet portfolios. Interest rate risk is present in a far wider range of activities. An option may be embedded within an otherwise standard instrument; this is more common within non-trading activities. The instruments include various types of bonds and notes with call or put provisions loans that give the borrowers the right to prepay balance (e.g. some mortgages and mortgage backed securities) and various types of deposit that give the depositor the right to withdraw funds prior to maturity without penalties. If not adequately managed, the asymmetrical pay-off characteristics of such instruments can pose significant risks, particularly to those who sell them, since the options; both implicit and embedded are generally exercised to the advantage of the holder and the disadvantage of the seller. Moreover, increasing arrays of options involve significant leverage that can magnify the influences (both negative and positive) of option positions on the financial condition of the bank.

3. Measuring & reporting

The interest rate risk management policy needs to identify who is responsible for measuring and reporting interest risk internally within the bank, the frequency of internal reporting and how senior management monitors interest rate risk.

4. Procedures and System

The banks need to monitor their interest rate risk on a frequent and timely basis. In practice most major retail banks are able to measure and monitor their liquidity continuously and most banks are expected to be in a position to measure their interest profile daily. It follows from this that a bank must have adequate procedures and systems for monitoring interest rate risk.

This means:

a) A clear allocation of the responsibility for measuring and reporting interest risk
b) The maintenance of reliable systems that can produce accurate interest rate risk reports promptly.
c) Active senior management involvement in and clearly allocated responsibility for interest rate risk reporting and monitoring
d) Regular reporting to group or parent companies.
e) Adequate segregation of duties between front, middle and back offices. interest rate risk

The system that produces the interest rate risk reports should be linked to the bank's core system and the data used in the interest rate risk reports should be capable of being reconciled back to base financial date. Such reconciliations should be a regular part of the bank's quality control procedures over the accuracy of its interest rate risk reports. Interest rate risk reports should follow the principles of good management information, for example:

a) Clarity
b) Highlight key information, in particular breaches or exceptions
c) Explicitly highlight trends and anomalies.

Activity 3.5

- Discuss the decomposition of bank lending functions.
- What does the bank credit analysis state?
- What is interest rate risk management? What does it state?

Question for self-Test Exercise

Part I multiple choice

1. Among the bank's credit analysis, _____ requires a careful examination of the borrower's past record in debt repayment and related behaviors.

A) Capacity
B) Character
C) Capital
D) Conditions

2. These days, banks are paying interest even on _____ so as to attract depositors/customers/ on competitive basis.

A) Saving account
B) Demand deposits
C) Fixed deposits
D) None of the above

3. As cheque book is to customers who are having current account to facilitate with drawls and payment to third parties, _____ are used for drawing from saving account

A) Pay-in-slip
B) Cheque book
C) Withdrawal vouchers
D) Pass-book
E) Neither of the above

4. A bank branches may open an account for Co-operatives if and only if they produced:

A) A copy of co-operatives rules and regulation

B) A copy of a certificate of registration

C) Resolution of the general assembly

D) All of the above

5. Which one is different from the others?

A) Cash payment orders(C.P.Os)

B) Remittance of funds

C) Safe custody of valuables

D) Agency services

E) All of the above

6. All of the following are under the category of assets section in the bank's balance except one. Which one?

A) Marketable securities

B) Cash and due from banks

C) Deposits

D) Deposits held with other banks

E) None of the above

7. _____, are merely a form of retained earnings designed to reduce tax liabilities and stock holder's claims on current revenue.

A) Capital stock

B) Special reserve account/system/

C) Retained earnings

D) All of the above

E) None of the above

8. Among the following which one is described as the initial solicitation of the borrower and the screening of the loan application by the bank?

A) Origination

B) Risk processing

C) Servicing

D) Funding

E) None of the above

9. Interest rate risk management approach includes

A) The rationale for interest rate risk management

B) The nature of risks

C) The measurement and reporting of risk

D) The procedures and system for monitoring interest rate risk

E) All of the above

10. The non-deposit sources of funds for commercial banks include all of the following except one. Which one?

A) Federal funds purchased from other banks

B) Security repurchase agreements

C) The issuance of capital notes

D) Time deposits that carry a fixed maturity

E) Neither of the above.

Part II. Blank Space

1. The _____ measures how efficiently bank is performing its function of borrowing and lending funds.

2. The three reasons for the popularity of secured lending include

A) _____

B) _____

C) _____

3. _____ refers to a portion of bank's profits that is not paid out to shareholders as dividends.

4. _____ is negotiated for a specific purchase and the demand for these loans for a particular borrower is infrequent.

5. As Asset management approach was to maintain a mix of assets capable of earning the greatest interest revenue consistent with keeping risk within acceptable securities, the novelty of _____ rests in its treatment of establishing an acceptable over all degree of risk exposure to various risks, and then adjusting the bank's portfolio to achieve both an acceptable overall risk level and the greatest shareholder value consistent with that risk level.

Part III Match the following items which are under column "B" with column "A"

Column A	**Column B**
_____ **1**. Running account	A) Monitoring to control default risk and interest rate risk
_____ **2**. Mandate	B) Bank assets/ secondary reserves
____ **3**. Lunatics	C) The risk of not having base money
____ **4**. Liquidity risk	D) Special type of banker's customer
_____ **5**. Marketable securities	E) Procedures for opening saving/current account
_____ **6**. Risk processing	F) Current accounts
	G) Collecting loan repayments & keeping records
	H) Bank liabilities

Part IV. Discussion Questions

1. Discuss the commercial bank management with regard to:
   a) Asset management
   b) Liability management
   c) Risk management
2. Describe the following items
   a) Transferable accounts
   b) Non-resident transferable birr account
   c) Non- Resident foreign currency account
3. Discuss Decomposition of the commercial bank lending function
4. A branch bank can open an account for co-operatives and illiterate persons subject to certain requirement. Discuss these requirements.
5. Describe the following items
   a) Bank statement
   b) Inactive accounts
   c) Minors and transferable accounts

UNIT FOUR
BANK CUSTOMER RELATIONSHIP

THE BANKING BUSINESS AND OTHER ACTIVITIES

Learning Objectives

On completing of this chapter, you will be able to identify:

- The definition of the banking business
- The chief characteristics of banking business
- The requirements for the definition of a customer
- The relationship between a banker and a customer
- The traditional and new services of a banker as a base for the determination of the relationship between the banker and the customer

INTRODUCTION

A bank's job is to deliver customers with financial services that help people better manage their lives. As technology advances and competition increases, banks are offering different types of services to stay current and attract customers. Whether you are opening your first bank account or have managed a checking account for years, it helps to know the different types of banking services available. This ensures you get the most out of your current financial institution. Deciding which services are most important can lead you to the bank that best fits your needs.

Lending is one of the most important functions of banks. It is one of the oldest functions of a bank just next to the function of accepting deposits. Actually, both accepting deposits and advancing loans are known as the main functions of the bank. Accepting deposits is to create loan able funds to borrowers. Therefore, they are supportive functions of a bank. The bank creates loans on funds it accepts from the public in a form of deposits. Hence, the bank is lending, in practice, not his own money, but the public money. Therefore, the bank should take the necessary precautions while lending money so as to insure the repayment of once advanced money. Otherwise, it will be closed

if the loan is not collected and money is not available at his possession to honor cheques issued by customers. In order to avoid this problem banks develop loan policies. This enables them to follow uniformity and minimizes possible errors while lending.

4.1. The Banking Business and Definition of Banking Business

It is difficult to give a precise definition to the term "Banking". The meaning may not be uniform to day in countries of different habits and different degrees of civilization. Every country or jurisdiction has to determine what it will define as banking activity and hence seek to control.

In U.K, banking has generally been identified with the acceptance of deposits withdraw able by cheques by customers **In U.S.A,** Federal-banking legislation lays emphasis on discounting and accepting of deposits.

In France, persons accepting funds from the public for use on their own account or for discounting or granting of credit or rendering assistance to others generally came under the banking legislation. But it has been accepted universally that accepting of deposits in current accounts for customers and paying and collecting cherubs for them are the essential requisites of banking.

The Banking Regulations Act (B R Act) 1949 does not define the term 'banker' but defines what banking is ¬H.L. HART – the banker is one who receives money, collects cheques and drafts, for customers, with an obligation to honour the cheques drawn by customers from time to time subject to availability of amounts in the account.

A customer means a person who seeks to open account which banker accepts with proper introduction. The relationship is not based on frequency of transactions, and durations.

Banker and a Customer Relationship

- The relationship between a banker and a customer depends on the type of transaction.
- These relationships confer certain rights and obligations both on the part of the banker and on the customer.

4.2. Classification of Relationship



1. General Relationship

Creditor-Debtor

The relationship between the customers having a deposit is the lender and the banker is the borrower. Depositor is the creditor and the banker is the debtor. The money handed over to the bank is a debt. The money once deposited in the bank becomes the money of the bank and it is prerogative of the bank to use that money as it deems fit. The depositor remains a creditor that too an unsecured creditor. When the customer avails a loan or an advance then his relationship with the banker undergoes a change to what it is when he is a deposit holder. Since the funds are lent to the customer, he becomes the borrower and the banker becomes the lender. The relation is the debtor- creditor relation, the customer being a debtor and the banker a creditor.

2. Special Relationship

Bank as a Trustee

A "trust" is an obligation annexed to the ownership of property, and arising out of a confidence reposed in and accepted by the owner, or declared and accepted by him, for the benefit of another, or of another and the owner. Thus trustee is the holder of property on behalf of a beneficiary.

Bailee – Bailor

A "bailment" is the delivery of goods by one person to another for some purpose, upon a contract that they shall, when the purpose is accomplished, be returned or otherwise disposed of according to the directions of the person delivering them. The person delivering the goods is called the "bailor". The person to whom they are delivered is called, the "bailee". Banks secure their advances by obtaining tangible securities. In some cases physical possession of securities goods (Pledge), valuables, bonds etc., are taken.

Lessor and Lessee

A lease of immovable property is a transfer of a right to enjoy such property, made for a certain time, express or implied, or in perpetuity, in consideration of a price paid or promised, or of money, a share of crops, service or any other thing of value, to be rendered periodically or on specified occasions to the transferor by the transferee, who accepts the transfer on such terms.

4.3. Agent and Principal

This can be defined as a person employed to do any act for another or to represent another in dealings with third persons. The person for whom such act is done or who is so represented is called “the Principal”. Banks collect cheques, bills, and makes payment to various authorities viz., rent, telephone bills, insurance premium etc., on behalf of customers.

As a Custodian

A custodian is a person who acts as a caretaker of something. Banks take legal responsibility for a customer’s securities.

A modern bank performs many functions. It renders many services to its customers and also to the public. So, it is difficult to define the term bank or banker exactly in a few words.

Dr. Herbert L.Hart in his "law of banking " says that" A banker is a person or company carrying on the business of receiving money and collecting drafts for customers, subject to the obligation of honoring of cheques drawn upon them from time to time by the customers to the extent of the amounts available on their accounts. The ordinary relationship between a banker and a customer is that of a debtor and creditor.

Sir John Paget, another authority of banking, says that no one can be a banker who does not take deposits, current accounts, issue and pay cheques, crossed and uncrossed, for his customers. According to this definition a person or an association performing the above functions can be called a banker. He considered that the four tests of banking business are:

a) Taking of deposits
b) Taking of current accounts
c) Payment of cheques
d) Collection of cheques.

Chief Characteristics of banking business

Generally, the following are the chief characteristics

I. There should be acceptance of deposits

There is a difference between the term "loans" and deposits". Generally, when the amounts are borrowed on condition that they should be repaid on the expiry of a term, they are regarded as

loans rather than deposit. **In case of deposit**, the liability to repay arises only when a demand for repayment has been made.

However, in practice it has been found to be very difficult to observe such distinction. It has to be observed that two terms (i.e. loans and deposit) are not mutually exclusive. In the case of **Hirabi V.Dhgnibai, Kemp J**.said, "There is no distinction between a deposit and loan because they are both moneys lent by the customers to the bank." Thus, the deposits accepted by the banks are really "loans" through usually not so called.

II. Deposits should be from public

Thus, acceptance of deposit by an instantiation from its own members does not constitute banking. This means that Idir, mutual benefit societies etc., which collect deposit only from their members, are not banks. However, in the case of many cooperative credit institutions a substantial portion of their deposits arise from their members. Thus, the expression "**from the public**" should also include acceptance of such deposit by a body from its members or shareholders that would amount to acceptance of deposit from the public.

III. Withdraw able by cheque, draft, order or otherwise

This means that withdrawal of deposit need not be made by means of negotiable instruments like cheque- withdrawal may be permitted in any other form, **e.g**. a request may be made to transfer funds from one account to some other account.

IV. Purpose of acceptance of Deposit

The purpose of accepting deposits should be for “lending and investment". Thus, neither companies which accept deposit for financing their trading or manufacturing business will not come within the definition of banking companies. No banking companies can combine **manufacturing or trading** activities along with the banking business.

Prohibition of Trading

A banking company can neither itself nor on behalf of the others, deal in buying or selling or bartering of goods except in connection with realization of property.

Goods are moveable property other than stock, shares, money, bullion and spice and other instruments as bills of exchange, promissory notes, railway receipts etc.

Activity 4.1

- List down the four tests of banking business according to Sir John Paget?
- Explain why trading or manufacturing business will not come in the definition of banking business?

4.4. Requirements for the definition of a customer

Definition of Customer

Although there is no statutory definition for the word “customer" in common sense, it means a person who has an account with the bank. Old banking experts used to lay emphasis on the duration for which a person maintained an account with the bank. For example, according to **Sir John Paget**,” to constitute a customer there must be some recognizable course of habit of dealing in the nature of regular banking business. Thus, according to this view, a person does not become a customer simply by opening an account with the bank unless there is some measure of continuity in the dealings with the bank. This view was popularly known as "**duration theory."**

Lord Dunedin observed, “The word customer signifies a relationship in which duration is no essence. A person whose money is accepted by the bank on the footing that the bank undertakes to honour cheques up to the amount standing to his credit, is a customer of the bank irrespective of whether his connection of long or short standing."

The above view was broader and thus in order to constitute customer a person should satisfy two conditions.

I. He should have an account with the bank, whether fixed, saving or current.

II. The dealing should be of a banking nature- borrowing and lending (i.e. deposit and withdrawals of money, issuing, paying and collection of cheques). One bank could itself be a customer of another bank if the first bank has an account with the second bank and sends its cheques for collections.

Dealings not of a Banking nature

If a person pays insurance premium or deposits valuables for safe custody without having an account, he cannot be called a customer. Occasionally, getting a cheque cashed or purchasing stamps, exchange notes from a teller, etc, do not rank one as a customer. These are only some of the services rendered to its customers and the public in general.

4.5. Relationship between a Banker and customer

The nature of relationship between a banker and customer is a contractual one. A remarkable feature of the creation of the contract between banker and customer is that the terms of the contracts are not usually embodied in any written agreement executed by the parties. Thus, there is no formal agreement, which prevent that customers must exercise care when drawing a cheque so as to prevent the amounts from being frequently increased. It is true, of course, that when certain accounts of limited companies for example, a mandate is executed which gives the bank express instructions concerning operations on the account, but even in those cases no attempt is made to prepare a comprehensive list of the respective rights and duties of a banker and customer. Therefore, the contractual relationship which exists between banker and customer is a complex one founded originally upon the customs and usages of bankers which they must be regarded as implied terms of contract between a banker and customer. Many of those customs and usages have been recognized by courts and to the extent that they have been so recognized, they must be regarded as implied terms of the contract. These implied terms are of vital importance although little does a new customer realize when, with a minimum of formality, he opens a bank account that he is entering into a contract the implied terms of which, if reduced to writing, run into several pages.

The nature of relationship between a banker and customer depends upon the type of service rendered by the banker. The services rendered could be classified into two categories.

i. Traditional Services

ii. New services.

I. Traditional Service

These services mainly relate to

a) Maintenance of different type of deposit accounts, e.g. saving, fixed and current deposit accounts.

b) Grant of advances through purchasing /discounting demand and time bills/

c) Collection of cheques, bills of exchange and other instruments (inland and foreign).

d) Issue of performance and financial guarantees.

e) Provision of remittance facilities of safe custody and safe deposit and

f) Purchase and sale of securities

II. New Services

A bank may introduce a number of new services with the accent on deposit mobilization and grant of credit to weaker to sectors of society these days, some important new services could be as follows:

1. Scheme of Deposit Mobilization

A large number of new deposit schemes could be introduced for deposit mobilization

a) Cash certificates

These are fixed deposit which if necessary are encashable before maturity at appropriate discount. Interest is included in the final repayment.

b) Daily saving scheme

Under this scheme small depositors are expected to deposit their money with the bank every day. It is especially meant for daily wage earners.

c) Ladies Department

In order to attract women as depositors and conduct special courses so as to acquaint them with banking habit, a department of ladies may be maintained where necessary.

d) Farmers Deposit Schemes.

This scheme is intended for the benefit of those farmers, who can save once and twice a year when their income is received after harvest. Under this scheme farmers can deposit their money as and when they receive the proceeds of their crop and they can be let to withdraw a certain percentage (e.g.10%) of the deposit at agreed period (e.g. every month).

2. Housing Deposit schemes

These schemes are suitable for those wishing to acquaint their own houses. Account holders have to deposit monthly installments for a fixed period and at maturity the depositor can obtain a loan equal to twice the account of deposit at a concessional rate of interest.

3. Personal Loan scheme

Under this scheme, individuals either employed or engaged in business and having steady income are granted loans to purchase durable goods such as furniture, refrigerators, sewing machines etc.

4. Loan participation

Some of the large borrowers are financed by more than one institution on a participation basis. This is done either because the amount involved is very large and beyond the resources of a single institution would like to risk on a single borrower.

4.6. General Relationship between a banker and customer

The implied terms of the contract between a banker and customer in the ordinary course of business bring about their relationship; can be put as follows;

1. Debtor and Creditor

The relationship between a banker and its customer is primarily of that of a debtor and a creditor. The respective positions being determined by the existing states of account, e.g. if the account is overdrawn, the banker becomes the creditor. The money so received becomes at once the property of the bank and absolutely at its disposal whether it pays interest or not. The bank there up on is indebted to its customer for the equivalent sum deposited. Hence, it does not hold the money as

the customer's agent or trustee. The customer has no right what so ever to claim identical coins or notes deposited by him with the banker. The banker has the right to pay in kind of legal tender money.

However, this relationship of debtor and a creditor between a banker and its customer differs from similar relationship arising out ordinary commercial debt, in the following respects.

a. Demand for repayment necessary

The general rule that demand for repayment by creditor or a debtor must seek out a creditor is necessary and applicable in the case of ordinary commercial debts, does not apply in case of banks. The customer must make an express demand for repayment to make the debt actually due for payment by the bank. This because the banker offers money to the customer without any demand for, it would amount to summarily closing the customer's account without notice. This may damage its customer credit on account of possible dishonor of cheques already its customer credit on account of possible dishonor of cheques already issued by him.

b. Demand should be made at proper time and place.

The demand for repayment of money should be made during normal working where working hours of bank on a working day. In case the banker makes payment during any other time, it shall not be taken to be a payment in due course and it may be held liable to the customer for loss. Moreover, the demand should be made at the branch of the bank where the customer has his account unless agreed otherwise. Though branch from part of one legal entity. Yet the banker's obligation to repay is confined to the palace where the account is kept.

c. Demand must be made in the proper manner

The demand for repayment of money should be made through cheque or any other written order as per the common usage among the bankers. A verbal or telephone demand will not be taken as a proper demand.

In case a customer has two or more accounts with the same branch of banks, the banker cannot generally combine these accounts unless it obtains prior approval of the customer or has given prior notice to the customer. Similarly, the customer cannot also treat two different accounts at the

same branch as one. He cannot draw a cheque on one with insufficient balance presuming that the banker will pay it since the balance in the other account is sufficient.

2. Trustee and Beneficiary

The banker acts as a trustee for the customer in those cases where he accepts securities and other valuables for safe custody. In such cases, the customer continues to be the owner of the valuables securities deposited with bank and they are not available for distribution among the bank's creditors on the event of bank going into liquidation.

The position of a banker as a trustee or debtor depends upon the particular circumstance of each case. This has to be viewed in the light of money entrusted to the banker. If specific instructions are given at the time of money the banker is taken as trustee for the money and not as a debtor. For example, when the money is paid to a bank with special instruction to retain it till further instruction, the banker will be considered as a trustee for the funds but not as a mere debtor. Similarly, when a cheque or a bill deposited with the bank for collection the banker acts as a trustee of the cheque or bill till it is collected. But once the cheque or bill is collected and the proceeds are credited to the customer’s account, the bank becomes the customer's debtor. But if before the collection of the cheque or bill the bank goes into liquidation, such instrument, will not be available for distribution among the creditors of the bank.

3. Principal and Agent

Banker acts as the agent of the customer in those cases where it performs agency functions such as collection of cheques, bills of exchange; purchasing and selling securities; pays insurance premium, etc.on behalf of his customer. The banker will charge commission for rendering these services.

Terms of contract between banker and customer

1. The banker must receive cash and collect the proceeds of such items as cheques, money orders and bills of exchange for his customer's account.

2. The money so received becomes at once the property of the banker, and he is indebted to his customer for an equivalent sum; hence the banker does not hold the money as his customer's agent or his trustee.
3. Although the banker becomes indebted to his customer as explained above, the ordinary rule that a debtor must seek out his creditor does not apply; the bankers' duty is to repay the money or any part of it upon demand being made by the customer at the branch of the bank where the account is kept and during working hours.
4. The obligation to honor cheques (unless there are no legal bars for payment) is the most important of the banker's duties. The breach of this duty may involve the banker in a claim for damages.
5. The banker has the right to charge his customer a reasonable sum for the services rendered.
6. If customer maintains two or more accounts with his banker:

   a) It is usually an implied term of the contact between banker and customer that the banker will keep the accounts separate.

   b) If the customer makes a payment to credit to his account, he has the right to appropriate the funds to whichever account he chooses.
7. The banker must not disclose to third persons, without the customer express or implied, either the state of the customer's account, or any of his transaction with the banker or any information relating to the customer acquired through the keeping of his account, unless the banker is compelled to do so by order of a court, or the circumstances give rise to a public duty of disclosure, or the protection of the banker's own interest requires it.
8. The customer must exercise reasonable care in drawing his cheques so as not to mislead his banker or to facilitate forgery.
9. If the customer discovers that cheques purporting to have signed by him have been forged, he must inform his banker, and likewise, it would seem that if the banker becomes aware the forged cheques are being presented for payment, he must inform his customer.

10. There is probably an implied term in the contract between banker and customer that the banker will supply his customer with either a pass- book or statement containing a copy of the customer's account with banker.
11. The relationship between banker and customer may be terminated by mutual consent, or unilaterally, by either party.
12. Finally, there are certain events which affect, to a greater or lesser degree the relationship between banker and customer, the death, mental incapacity, and bankruptcy of the customer; the winding up of a company customer; the winding up of the bank; the service of garnishee order or summons; the issue of a unit of sequestration; and the outbreak of war.

Activity 4.2

- List down at least five traditional or subsidiary services of a banker
- Discuss a number of new services with the accent on the schemes of deposit mobilization.

4.7. Obligations of a Banker

The primary relationship between a banker and customer is that of a debtor and creditor. This relationship imposes the following special obligations on the banker.

1. Obligations to Honour Cheques

A banker must honour the customer's cheque drawn on him provided:

a) He has sufficient funds of the customer
b) The funds are properly applicable to the payment of such cheque
c) Banker has been duly required to pay
d) The cheque has been presented within a reasonable time after the apparent date of its issue.
e) No Prohibitory order of the court or any other competent authority.

Example; Tax authority is standing against the account of the customer.

The above point may be illustrated as follows:

a. Sufficiency of funds

Banker's obligation to honour the customer's cheque will arise only when the banker has customer funds at least equal to the amount of the cheque. While determining the sufficiency of funds, the customer's funds which the banker may have in different other braches, the negotiable instrument which have not yet been collected are not to be taken in to account. Even the funds which the customer may have in account other than against which the cheque has been drawn, are not be taken into account for this purpose.

The obligation to honour the customer's cheque may be extended to the extent of the account of overdraft, which the banker may have expressly or impliedly agreed to sanction to the customer. For example, where the banker in the past had been honoring customer's cheque to certain limit in spite of insufficiency of funds and later on asking the customer to make good the deficiency, the banker should not dishonor the customer's cheque in a similar case without giving him proper notice, because in such a case an implied agreement to grant overdraft will be presumed.

b. Applicability of Funds

The funds must be available for the cheque drawn. In case, a customer has drawn a cheque against one account having insufficient funds, the banker cannot debit it to his other account where he has sufficient funds unless the customer asks for it.

c. Banker duly required paying

This means that cheque is complete in all respects and presented during banking hours. The cheques should not be post dated. A banker is also not bound to pay a cheque which does not bear the date of its issue or in case of a joint account it is not signed by all joint signatories.

d. Presentment with in a reasonable time

A cheque is meant for immediate payment and, therefore, it should be presented within a reasonable time of its issue. A cheque becomes stale in case it is not presented with in six (twelve by some banks) months of its issue.

e. No Garnishee or Attachment order

A banker will be justified in refusing payments in case a Garnishee or Attachment has been issued against the customer's account with the bank.

Garnishee order

In case a debtor fails to pay the money due to his creditor, the latter may apply to the court to issue a garnishee order, on the debtor's banker. As a result of this order, the debtor's account with the bank is frozen and the bank cannot make any payment out of the account. The creditor, on whose request such an account is frozen, is called judgment creditor. The debtor, whose account is frozen, is called judgment debtor and the banker, who has the customer's account, is called the Garnishee. The Garnishee order is issued by the court in two parts.

1. **Order Nisi:** by this order the court;
    a) Asks the banker to freeze the debtor's account.
    b) Asks the banker to explain why the funds in the account, so freezed should not be used for payment of judgment creditor.

On receipt of such an order the bank should immediately inform the customer so that he may make the necessary arrangements for payments of the debts due by him.

2. **Order Absolute:**

This order directs the banker to pay either the whole or a part of the funds lying in the account against which "order Nisi" has been issued to the judgment.

3. Obligation to Maintain Secrecy

It is obligatory for the banker not to disclose the state of the customer's account since such disclosure may adversely affect the customer's credit and business. These obligations continue even after the customer has closed his account with banker.

However, in the following circumstances the banker may dispense with the above rule.

a. Where such disclosure is a legal necessity.

E.g.1. Tax authority may ask the bankers to finish information about their clients of or assessment purposes.

2. Inspectors of the customer

3. Banks are free to exchange credit information mutually among themselves or to the Central Bank.

4. Police authority may ask banks to produce books of account for criminal investigation.

b. Disclosure is permissible on account of banking practice

E.g.1.Where customer's consent has been obtained expressly.

2. Customer may direct his employee or messenger of any person acting as an agent to collect information.

3. In the interest of the banker where a banker has to recover money from the customer, the banker- may disclose information to its lawyers.

4. Where credit information is require by other banks.

c. Disclosure in Public Interest

1. Where bank considers that the customers is involved against the interest of the Country.

2. Where sizeable funds are received from foreign countries.

Activity 4.3

- Enumerate at least three conditions under which a banker's obligation to honor the customer's cheques will arise?
- Describe those circumstances under which the banker may dispense with the rule of maintaining secrecy?

4.8. Right of the Banker

1. Right of General lien

A banker has a right of general line in respect of the amount due to it by the customer. Lien is the right of person to retain goods that which is in his possession and which belongs to another until the demands of the person in possession are satisfied.

Lien gives a right to a person only to retain the possession of the goods and not to sell unless such a right is expressly conferred.

There are two kinds of lien

a. Particular

It is rights retain possession over particular good in connection with which the debt arose.

It is restricted to those goods, which are the subject matter of the contract. They are liable for certain demands of the person in possession of those goods.

b. General lien (banker lien)

This entitles a person to retain possession of goods belonging to another for a general balance of account. It will entitle a person in possession of the good to retain them until all claims of accounts are satisfied.

The banker's general lien entitles banker to retain in its possession securities etc. in respect of the general balance due by the owner to the banker. The banker does not have the right on the following properties of the customer.

a. **Safe custody deposits**: The banker accepts valuable things, etc. as a trustee (bailee) not as a banker and it is for a specific purpose. They are not therefore, subject to banker's general lien unless contrary is implied.

b. **Money deposited for a special purpose**.

c. **Amounts not due**. The right of lien is available only in respect of debts which have become due unless the customer has become insolvent.

2. Right of set off

A debtor has a statutory right to set off any money due by the creditor to him before the debtor is required to pay the creditor's claim. A banker also has aright which enables him to set off a debt

balance in one account of the customer with the credit balance in some other account. This right can be exercised by the banker subject to the following conditions.

i. There must not be a contract to the contrary

ii. Customer is given notice of banker's intention to exercise the right of set off.

iii. Capacity of the customer in all the accounts is the same.

Example.

A banker cannot set off any credit balance of partnership account against money due from one or more or its partners on their individual account. But, in case of a sole trader, the accounts in his personal name and that of the firm's name are deemed to be the same in capacity.

iv. The amount must be due. It should not be in respect of future or contingent or un matured debts.

v. The amount must be certain.

vi. The banker has the option to exercise this right.

Example:

Accounts in different branches of the same bank are treated as accounts in the same entity

Thus the banker can set off debt in **x** branch against credit **y** or **z** branch.

vii. The bank may exercise this right even after a garnishee order has been made. It may hand over the remaining balance to the judgment creditor

viii. The account should not be a trust account or that meant for a special purpose.

3. The right to charge incidental charges

A banker is entitled to charge commission- Rules governing appropriation of payments.

Rules Governing Appropriation of payment

1. The general rule is that party who pays money has a right to apply that payment as he thinks fit. If there are several debts due from him, he has a right to say to which of those debts the payment shall be made.

2. If he does not make a specific application at the time of payment, then the right of application generally devolves on the party who receives the money.

3. The debtor's intention to appropriate may be shown by the course of dealing or other circumstance, but an entry in the debtor's is not of itself evidence of appropriation by him.

4. If the right appropriation devolves on the creditor, he may appropriate to a debt, which is statue-boned, though such appropriation will not revive the debt. He may not, however, appropriate to an illegal debt.

5. The creditor need not exercise his right of appropriation at the time of payment; thus, it has been held that he may make an appropriation when he is being examined as a witness, in an action by him against debtor. But, once the creditor has made an appropriation, it is made once for all, and it does not lie in the month of the creditor afterwards to seek to vary that appropriation.

6. Money paid into a bank account to meet a particular bill or cheques must be applied accordingly.

7. In the absence of any specific appropriation, it is presumed, in the case of a current account, (i) that the first sum paid in is first drawn out, and (ii) that the first item on debit side of the account is discharged or reduced by the first item on the credit side.

Example: **X** and **Y** are partners and are sanctioned an overdraft to the extent of birr 40,000 and the statement shown as follows.

Date	Withdrawal	Deposit	Dr./Cr.	Balance
July 1 1986	---	----	Dr.	30,000
5		20,000	Dr.	10,000
7	16,000		Dr.	26,000
10		18,000	Dr.	8000
12	10,000		Dr.	18,000

Assume Mr. X died on July 4, 1986 and on July 12, if the banker requests for adjustment of the account, the banker can claim this amount only from Y as the 30,000 birr debit balance is offset by the credit of 20,000 on July 5 and 10 respectively.

The banker closes such accounts sooner receives such information in order to protect itself.

Activity 4.4

- What are the different kinds of lien?
- Describe at least four conditions under which the banker can exercise the right of set off

4.9. Duties of a customer

To prevent forgery and fraud, customers' attention is necessary for the following:

1. Daily to draw cheques carefully

a. All bank cheques should be kept in safe place under lock and key.

b. All cheques should be written in Ink.

c. The amounts in words and figures should begin and close to the printing.

d. Any alteration should be confirmed by the full signature of the drawer.

2. Due discloses forgeries

Determination of relationship between customer and banker- closure of an account

In theory, the relationship a banker and customer may like other contractual relationship be terminated by mutual agreement. In practice, however, it nearly always the one party or other who wishes to put an end to the relationship and the contract is usually terminated unilaterally. Accordingly, it is convenient to discuss closure of an account under two headings; namely closure of an account by a customer and closure of an account by a banker.

4.10. Closure of an Account by a customer

A) Current Account

This account may be closed if the customer demands repayment of the credit balance due less accrued bank charges. But, it is prudent for the banker to ensure that the customer.

I. States in writing that he is closing the account but not merely withdrawing the available balance. If the customer withdraws the balance in case it is sound to obtain signature to a

cheque for the balance made payable to "self, to close the account." If otherwise, some other evidence of his intention to close the account must be maintained.

II. If a customer wished to close the account at a time it is overdrawn, he may do so by repaying the overdraft together with accrued bank charges.

III. Make provision for the payment of outstanding cheque by him; if the bank fails to do this, it will be justified by dishonoring cheque by responding as" **Account closed**".

IV. Hand over any unused cheque forms.

Finally, any credit facility should be cancelled and securities retained against credit and or for safe custody should be returned to him.

Other Accounts

B) Fixed deposit it is closed at maturity period by personal application.

C) Saving account could be closed without prior notice and the bank pays the balance with up to date interest.

4.11. Closure of Account by Bank

A banker who wishes to cease transacting business for a customer must give reasonable notice having regard to all the surrounding circumstances to make alternative arrangements. But, if he is using his account for unlawful purpose, the bank is not legally obliged to give sufficient time or notice.

Circumstance under which a banker may close an account:

1. Death of customer

The general rule is to pass to his personal representative. Any money received after the customer's death passes to his personal representative.

2. Mental Incapacity of customer

A banker should treat the account of a lunatic customer as per lunacy order.

3. Bankruptcy of customer

A banker should cease to honour his customer's cheques as soon as he learns that a bankruptcy petition has been presented.

4. Winding - up company customer

When a company is wound up, it ceases to have any legal existence and all its contractual relationship come to an end. In that respect, the winding up of a company may be like a death of an individual.

5. Winding up of a bank.

The winding up of a bank will like wise put an end to the contract between banker and customer.

E.g. AID bank is liquidated as per legislation 200/87 and the relationship of the bank and the customer is terminated and pursuant to the law the rights and obligations of the bank are transferred to the newly established Development bank of Ethiopia.

6. Garnishee order

A banker will be justified in refusing payments in case a Garnishee or Attachment has been issued against the customer's account with the bank. In case a debtor fails to pay the money due to his creditor, the latter may apply to the court to issue a garnishee order, on the debtor's banker.

7. Outbreak of war

The banking services cannot be performed when there is an outbreak of war. The right of a customer to be paid his credit balance is suspended and not destroyed.

Question for self-Test Exercise

Part I. Multiple Choices

1. All of the following are the circumstances under which a banker may close customer's account except one. Which one?

a) Mental incapacity of the customer
b) Winding up of a company customer
c) Winding up of a bank
d) No Garnishee order
e) All of the above

2. In commercial code of Ethiopia," a banking business includes the carrying on all of the following activities except one. Which one?

a) The taking or receipt of deposits from its public
b) The payment of cheques
c) The receipt of deposits from it members
d) None of the above

3. The implied terms of contract between a banker and customer in the ordinary course of business bring about their relationship, which include

a) Principal and Agent
b) Trustee and Beneficiary
c) Debtor and Creditor
d) All of the above

4._____ it will entitles the banker to retain in its possession securities, until all claims of accounts are satisfied

a) General Lien
b) Particular Lien
c) Rights of set off
d) Order absolute

5. As cash certificates are fixed deposits which if necessary are en cashable before maturity, _____ is meant for daily wage earners.

a. Ladies departments
b. Daily savings schemes
c. Farmers deposit schemes
d. Cash certificates

e. None of the above

Part II. Fill in the blank space

1. According to _____, the customer refers to a relationship in which duration is no essence.
2. _____ Schemes are suitable for those wishing to construct their own houses.
3. When the money is paid to a bank with special instruction to retain it till further instruction, the banker will be considered as a _____ for the funds but not as a mere debtor.
4. Banker acts as the agent of the customer in those cases where it performs agency function such as _____

_____

_____

_____

Part III. Discussion Questions

1. Describe the terms of contract between banker and customer

2. Explain rules governing appropriation of payments.

3. Discuss the closure of an account under the following conditions:

a. Closure of an account by a banker

b. Closure of an account by a customer

4. Discuss the requirements for the definition of a customer under the following situations

I. As per the concept of duration theory

II. According to banking author Lord Dunedin

5. Discuss the certain situations under which a banker may close the customer's account.

BANK SERVICE

Learning objectives:

Up on completing of this chapter, you will be able to:

- Explain what is paying and collecting banker
- Identify the precautions to be under taken by a paying banker
- Identify circumstances under which a banker may refuse payment of a cheques
- Describe the responsibilities of the collecting banker to his customer
- the concept of clearing house system
- Identify the reasons behind a firm's loan request

5. Introduction

Banks and deposit- taking institutions are at the heart of the world's financial system. Not only are they an important source of credit for people and businesses, but also they provide the transmission system for money, which lubricates the world's trading and payments systems. They are major repository institutions for people's savings, and this needs to be managed in a prudent manner.

The activities of banks and deposit- takers are thus closely supervised and controlled in every country. The government is the financial supervisor in every country, should be well aware of the political, economic and social damage that can occur as the result of bank failure. Furthermore, because of the possibility of damage spreading through a reduction of confidence, banking supervision should aim to be a seamless robe across borders.

5.1. The paying banker

The relation between a banker and his costumer is that of a debtor and a creditor that banker does not enjoy the position trustee of the money deposits with him by the customer. Money deposited will always belong to the customer and the bank will be bound to return its equivalent to the customer or any person to his order on demand thus the banker under takes to honour his customer's cheques up to the amount of credit balance in the current or up to the limit of any agreed overdraft. This implied duty of a paying banker is dependent

on certain important conditions. In other words a banker has to be very cautions both at the time of honoring as well dishonouring his customer's cheques.

5.3.1. Precautions to be taken by a paying banker

In order to protect its own as well as the customer's interests, the paying banker should take following precaution while making payments of his customer's cheques.

1. Open or crossed cheques

A banker should examine whether the cheques presented for payment is open or crossed. If it is general crossing, special crossing or restrictive crossing, if it bears general crossing he will not pay the amount across the counter. The holder must be told to get the amount through some account either in the bank or through some other bank. If it bears a special crossing the banker should pay only the bank whose name is mentioned in the crossing or its agent for collection. If it bears a restrictive crossing the cheques amount must be credited to the payees account. If he pays contrary to the instructions as indicated by the crossing, he may be asked to pay the amount to the true owner for any loss sustained by the banker's action.

2. The cheques must be in proper from

It must satisfy the conditions in a negotiable instrument.

3. Drawer's signature must correspond with the specimen's signature.

Signature of the drawer on the cheques must correspond with the signature obtained by the banker at the time if opening the account. A banker is expected to know, therefore, the signature of his customers and if the drawer's signature has been forged and makes the payment it shall not be entitled to debit the customer's account with the payment. The loss will be borne by the banker. When there is a joint account, both or all the signatures on the cheques should be genuine. In case any one of the signatories is forged, the bank should not make payment. It is also expected from the customers to remain reasonably vigilant render all possible assistance to the bank when asked confirmation of the cheques.

4. The cheques must not be either stale or post dated

The banker should refuse to honor an undated cheque which has been presented to it for payment.

A stale cheque is one, which has been in circulation for an unreasonably long period. The custom of banker in this respect varies. Generally, a cheque is considered stale when it has been in circulation for more than six- months, and bankers return such cheques for the drawer's confirmation.

A post-dated cheque is one, which bears a date later than the one, which the cheque is actually drawn. A banker should not pay post-dated cheques before it is due for payments. As observed by Sir John Paget; a banker, who pays post- dated cheques before the ostensible date, stands a very poor chance of being able to debit his customer with in any conceivable circumstances if his customer chooses to object to be debited. In case a banker honours a post-dated cheque, it runs the following risks.

a) The drawer may countermand the payment before the date mentioned on the cheque and then the banker will not be entitled to debit the customer's account, with the amount of the cheques

b) The drawer may make the banker liable for dishonoring of other cheques on account of insufficiency of funds resulting because of payment of the post-dated cheques

c) In case of insolvency or death of the drawer before the date mentioned on the cheques, the banker shall not be entitled to debit the customer's account, if it has already made payment of the cheques.

5. The amounts expressed in words and figures should agree

The banker should see that the amount mentioned both in figures and words in the cheque are the same. If there is any difference he should return the cheque with the remarks amount in words is payable but in practice bankers pay lower of the two amounts

6. Mutilated cheques

A cheque is said to be mutilated when it is torn in to two or more pieces. Such a cheque should not be paid unless the banker is satisfied that mutilation was unintentional and it also obtains confirmation of the drawer.

7. Material Alteration

An alteration is material which in any way alters materially or substantially the operation of the instrument and the liabilities of the parties. Material alterations include the alteration of the date, crossing, place of payment, amount, and the name of the payee.

Material alterations make a cheque void. Hence, a banker honoring a cheque with material alterations is not allowed to debit the account of the drawer. The paying banker should see that material alterations are confirmed by the drawer. In case cheque is signed by more than one person, material alterations should be confirmed by the signature of all the parties.

8. Presented at the office hours

The banker should, make payment of only such cheques which have been presented to it for payment during its banking hours.

9. Presented at the office where the account is kept

The banker should examine whether the cheque is drawn on the particular branch at which it is presented for payment. The reason is that a banker undertakes to pay cheques only at the branch where the account is kept. He may pay if special arrangements are made for payment at the other branches in advance.

10. Endorsement

He should see whether the cheques require endorsement and whether the endorsements on the cheques are regular or not. If they are not proper and the amount is paid he will be guilty of negligence in case of loss to the holder. He cannot vary the genuineness' of the signatures of the endorsers as he does not have their specimen signatures. So he is granted legal protection in case of forged endorsements.

11. Sufficient funds

There should be sufficient fund in the account of the customer for payment of the cheques. Cheques has to be paid in full and not in part and, therefore, inadequacy of funds will result in dishonour of the cheques unless the banker has granted loan or advances to the cautioner to that extent or more than the amount of deficit.

5.3.2. Circumstances under which a banker may refuse payment of a cheques

A banker promises to honour cheques drawn up on him by his customer. If a banker dishonors or fails to pay a cheque without sufficient reason, he will be liable to pay damages to the customer. But a banker is not bound to honour customer's cheques under certain circumstances under which a banker can refuse payment of a cheque issued by his customer.

1. **Countermanding of payment by the drawer**

The customer (the drawer) may ask his banker not to pay a particular cheque issued by him. In other words the drawer may countermand or stop the payment. He should give notice to stop payment in writing. The notice should contain the number, date, amount and the name of the payee of the cheque. When such a notice is received by the banker, he is justified in dishonouring the cheque the payee can not claim the amount as the stopped cheque is useless it is said a stopped cheque become a piece of west paper in the hands of the payee. A banker should return the cheque with remarks orders not to pay or payment countermanded by the drawer.

To:

The commercial Bank of Ethiopia

Arbaminch Branch

November 20, 2019

Please stop payment of the cheque no. HB 265283, dated November 1, 2000 for Birr 30,000 signed by me to Mr. YARED which has been list

Mr. X

.

A notice should be placed in the customer's account in the ledger, so that anyone referring to the account may at once observe particulars of the "stop payment". To prevent the notice of being overlooked, it is good plan to insert in the lewder a red colored slip, with the word "stop" Printed in the ledger a red giving particular of the stopped cheque. A list of all orders to stop payment should be kept in some convenient form for ready reference by those officials who are concerned with the payment of cheques. Where payment of a cheque is countermanded by telephone or telegram, the written confirmation of the drawer should be obtained without delay.

2. Notice of customer's death

A banker may receive formal notice of customer's death. But it is sufficient notice of the death if he sees an announcement in the papers or hears of it from a reliable source. A mere rum that his customer X is supposed to be dead is not sufficient to warrant a banker returning a bill or cheque unpaid. Though a banker in that case would usually take steps to confirm or disprove the rum our. After notice where a banker has, prior to the death made himself responsible i.e. by making a cheque for payment at the request of the drawer, or another bank or making a purchase of stock or shares according to the customer's order.

3. Insanity of the customer

Where a banker receives notice of a customer's mental disorder, he should not pay the cheques drawn by the insane customer. A customer suffering from mental disorder should be verified as soon as possible. The entry of patient into a hospital is not itself a sufficient ground for a banker to stop his customer's account. However he can honour the cheques drawn by the customer before becomes insane.

4. Insolvency

A person is insolvent who is unable to pay his debts, and he is said to be in a state of insolvency. When a banker comes to know that his customer has become insolvent or receives notice of prevention of insolvency petition he should not honour the cheques drawn by the customer.

5. Garnishee order

One who has received notice will not be pay any money which he owes to a third party, who is indebted to the person giving the notice. When a banker receives an order from the count attaching the money belonging to the customer, he should not honour the cheques drawn.

6. Notice of assignment

The act of assigning allotment, allotment allocation, and legal transfer of right or property is known as assignment. When a banker receives notice that his customer has assigned the credit balance in his account to another he should not honour the cheques.

7. Knowledge of breach of trust

If a trustee acts contrary to the conditions in the deed or will under which he appointed or invests the trust funds in securities other than those authorized or appointed by law-It is a breach of trust and he is personally liable.

8. Knowledge of defective in title of the holder

When a banker has knowledge that person presenting the cheques is not owner (has a defective title), he should refuse payment.

9. Insufficient funds

If the balance to the credit of customer's account is not sufficient to pay the cheque, the banker should refuse payment. In case of overdraft arrangements the banker should return the cheques with the words "**Insufficient funds**". This means that banker does not have sufficient funds at his disposal to honour the cheques. When cheques deposited for collection are not collected and credited and the amount in the account is not sufficient the banker should return the cheque with the words "**Effects not cleared"**

10. Post-dated cheques

If a cheque contains a future date he must not honour the cheque. That is, he should not pay post-dated cheques. However he can pay the cheque on the date stated on it.

11. Stale cheques

If a cheque is in circulation for more than six moths it is regarded as stale or out-of dated. A banker must dishonour stale cheques.

12. Drawer's signature differ

If there is any difference between the signature of the drawer on the cheque and spacemen signature with the bank he should not honour the cheque. However, he may pay the cheque after the signature is confirmed by the teller/counter clerk.

13. Irregular endorsements

If the endorsement is not proper order the banker is dishonoring the cheque

14. Amounts differ

If the amount in words on a cheque differs from amount in figures, the cheque is usually returned by the banker with answer Words and Figure Differ (**W & F D**) or amounts differ.

15. Form of the cheque

If a cheque is not properly drawn he is justified in refusing payment.

16. Drawn on another branch

If a cheque is presented for payment at a branch other than the one where the account is kept the banker is justified in refusing payment unless there is a previous arrangement.
So it is safe for a bank to refuse to honour a cheque on itself under this circumstance.

17. Notice of company's winding up

When a company is wound, it ceases to have any legal existences and all its contractual relationship come to an end. So it is safe for a bank to refuse make a payment of a cheque

5.3. The Collecting Banker

Activity 5.1

- Enumerate at least six precautions to be taken by a paying banker while making payments of his customer's cheques.
- Describe certain circumstances under which a banker is not bound to make the payment of customer's cheque drawn against it.

Although collection of cheque and bills is not a legal duty of the banker yet they generally act as collection bankers for their customers. This function is especially important since crossed cheques can be collected only through a banker. Therefore, a collecting banker is one who undertakes to collect the amount of a cheque for his customer from the paying banker.

5.3.1. Banker as a holder for value:

- In collecting a cheque the banker can act in two capacities namely;
- As a holder for value
- As an agent for collection

Responsibilities of the collecting banker to his customer

A banker is bound to show reasonable care and skill in the collection of his customer's cheques and bills. Other wise, he may be held liable for any loss suffered by the customer. In the case of a cheque entrusted with the banker for collection, he is expected to present the drawee banker within a reasonable time.

- Exercise reasonable care and diligence in his collection work.
- Present the cheque for collection without any delay
- Notice to customer in the case of dishonor of a cheque.

- Present the bill for acceptance at an early date 28.
- Present the bill for payment.
- Protest and note a foreign bill for non-acceptance

5.3.3. Categories of chqeues

Cheques which are collected by bankers may be divided in to three categories. Namely;

a) Cheques drawn on the collecting bank
b) Cheques drawn on other braches of collecting bank
c) Cheques drawn on other banks

a) **Cheques drawn on collecting branch**: In case the collecting bank and the paying bank are the same, when a cheque falling into this category is received at the counter it is the usual practice for the collecting branch to accept the cheques on collection basis if they are crossed cheques. In certain instances a collecting bank may pay cash or credit account of the beneficiary by blocking.

b) **Cheques drawn on other braches of collecting bank**: These cheques are first crossed and are sent to the braches upon which they are drawn through the clearinghouse.

Activity 5.2

- Explain the responsibilities of the collecting banker to his (its) customer.
- What are the different categories of cheques collected by collecting banker?

5.3.2. The Clearing House System

If there is only one bank in the community, people will deposit all their money in that particular bank. Since every body maintains an account with the bank the transfer is effected by a mere book entry. That is, by debiting the account of the payee. But the case would be different if there are number of banks having different customers.

Let us begin with two banks say Banks A and B. Everyday the customers of Bank A will be receiving cheques drown on Bank B by its customers. The customers of Bank A will deposit these cheques with their bank for collection. So also the customers of Bank B will be receiving cheques drawn on Bank A by its customers, which they will deposit with their bank, Bank B for collection. The simplest method for the bank is to send their office messengers to the drawer bank and to receive cash over the counter. This method appears simple. But at the same time it is very cumbersome and costly. Every banker has to keep a larger amount of legal tender to meet the cheques drawn on them, which affects its profit earning capacity and consequently its efficiency.

At the end of every working day, each bank would find that it had paid a certain amount of cash from the other. So it would be much better if the accountants between these two banks were settled at the end of each day on the principle of setting-off a debt which one owes to another by a claim against him and paying the difference in cash. Where there are many banks, business will be easily facilitated in this principle to extended so that the cross obligations are offset through a central organization. We may say that the "**clearing house**" is such a central organization.

A clearing house may be defined as an organization of various banks constituted for the purpose of off-setting the inter-bank indebtedness arising from the transfer of deposits by a customer of a particular bank to another.

The mechanism of offsetting inter-bank indebtedness operates as follows. Clerks representing various banks meet at a common place, the clearinghouse, and very day. Every clerk delivers to the others the cheques and other claims which their respective banks hold against his bank. Cheques and other documents dishonored will be returned to the representative bank. The various amounts of receipts deliveries are now added up by the supervisor of the clearinghouse by transferring balances kept at the central bank by these various clearing banks.

The advantageous which a clearinghouse confers on society are manifested. It prevents the cost and waste involved in collecting each and every cheque and claim, which a banker holds against another, across the counter with all the danger of loss in transit incumbent up on it. Great economy also achieved in the employment of liquid cash by settling the difference thereby minimizing the necessity of holding large cash balances.

With the full-fledged development of banking institutions, various systems of commercial banks have emerged. The typical commercial bank functioning in most countries is the branch banking type. Under this system, banking is conducting by institutions with Head Office in large cities operating numerous branches throughout the country.

The Commercial Bank of Ethiopia is a branch type. The claims and indebtedness of each branch with the other and the Head Office with the other branches is off-set with a clearing system.

Activity 5.3

- What is a Clearing House System?

5.4. The Revolution of Bank Clearing

During the 1970's the technology was fully developed for rapid expansion of the Electronic Funds Transfer System (EFTS), Automated Teller Machine System (ATMS) and Point of Sale Terminals (POS) were ready.

During the early 1980's the electronic banking revolution actually began to materialize. There was rapid growth of installed ATMS and EFTS automated clearing houses are used for transferring funds among financial institutions.

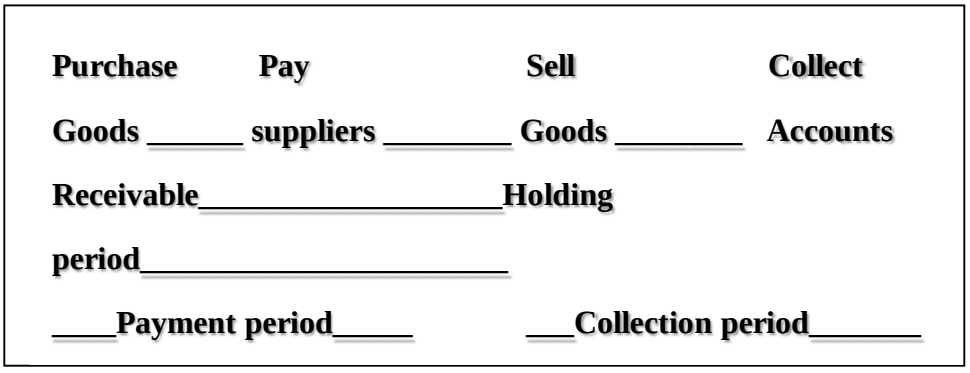
Why do businesses borrow?

Asset conversion cycles

In order to understand the reasons or purposes behind a firm's loan, it is first important to understand the business's **asset conversion cycle**. This cycle is made up of two components: **the operating cycle** and **the capital investment cycle**. The operating cycle consists of the day- to- day, month –to-month activities related to the production and sale of goods/services and the collection of cash from those sales. This cycle includes purchasing of goods or raw material, production of goods or services for sale, selling the goods/ services, and collection of cash from customers. The capital investment cycle consists of the purchase and use of fixed assets required to support operating cycles for several years. Every business has an operating cycle and a capital investment cycle, the cycles in some businesses are longer than others, and some require more cash

Timing differences

A difference in the timing of cash outflows and cash inflows can cause a company to borrow. This difference between cash inflows and outflow is called **a cash flow timing difference**. Cash flow timing differences can generally be viewed with in the operating cycle of the business. To illustrate this point, a linear representation of the operating cycle appears below:



As you can see, the time between buying good/ raw material and selling these goods/finished products is called the **holding period**. The time between selling the goods /finished products and collecting cash from customers is the **collection period**, and the time between buying the good/ raw material and paying the suppliers/ vendors is the **payment period**.

The longer the holding period (inventory turnover) and /or the collection period (accounts receivable turnover), or the shorter the payment period (accounts payable turnover), the more likely a cash flow timing difference will occur. Reviewing the trend of inventory, accounts receivable, and accounts payable on the financial statement will provide clues when you are looking for cash flow timing difference; an increase in the level of inventory or accounts receivable, or a decrease in accounts payable could signal a possible increase in cash flow timing differences.

Why businesses borrow – Sales growth

Increases in the volume of sales causes many firms to borrow by creating the firm's demand for additional assets. As sales increase, accounts receivable and inventory usually increase proportionately in order to perpetuate the growth in sales. If this sale growth is slow or moderate, the company may be able to finance the increase in assets internally through profit; if the growth in sales is fast, internal financing may not be enough and additional funds may be necessary from outside the business.

We will discuss two types of sales growth: **seasonal sales growth and long- term sale growth.**

Seasonal sale growth is defined as sales surges with in a year's time frame. This type of sales growth occurs when sales grow rapidly during certain months or seasons, and then decline rapidly after the peak selling period. Examples of this type of sales growth would include toy manufactures (the Christmas season) and pool builders (summer). Seasonal sales growth leads to seasonal increases in inventory and account receivables to support the higher sales level. A seasonal business' financing needs increase/ decrease directly with

sale levels; seasonal financing needs are created by the build up of inventory before and during the surge period, and by the higher level of accounts receivable from sales during the surge period. Seasonal sales growth can most effectively financed by a line credit or short term draw note (short- term financing).

Long –term sales growth occurs over a period of several years. You must first begin by examining recent year- end sales figures to calculate the rate of sale growth. With **x** representing the current year and **y** the previous year, the formula for determining rate of sale growth follows

$$\frac{(X-Y)}{Y \times 100}$$

Growth rates in excess of 10 percent annually will usually indicate potential financing needs. Large growth rates usually create the biggest problem financially for businesses with low profit margins and/ or businesses with large percentage of total assets in accounts receivable or inventory balance.

As mentioned before, long-term sales growth cause increases in account receivable and inventory. This type of growth may also lead to increased requirements of fixed assets. It is important to determine the actual cause of the increase the term of the financing should match the duration of the need. You, as a commercial banker, must match the term of the financing to the rate at which the asset converts to cash or the rate at which the asset converts to cash or the rate at which the company generates profit. You must also be able to determine the **core** or **permanent** level of current assets. Unlike seasonal sales growth where the level of account receivable and inventory rise and fall with the level of sale during the year, as the company's sale grow over the long- term, the amount of core current assets it needs will also grow. This core or permanent level of current assets should be financed with term loan (long term financing) or equity rather than a **line of credit**. To determine the amount of core current assets you must look for the low point of the

company's asset conversion cycle. Looking at twelve consecutive monthly financial statements for the company's fiscal year, the one with the lowest level of current assets will provide you with the past year's core amount of current assets.

Why do businesses borrow – Slowdowns in the Operating Cycle

Inventory Turnover Slowdowns

Inventory turnover is the number of time per year that firm's inventory turn over, and can be calculated two different ways as follows:

1. **Cost of Goods sold** 2. **Sales**

   Inventory **Inventory**

Different source of industry averages utilize different method of calculation; it is important to determine and understand which method is being employed (i.e. **RMA-** Robert Morris Associate uses the first method and **D**& **B-** Dun & Bradstreet uses the second). If inventory is turning less frequently than in previous years, the company is experiencing an inventory slowdown. An increase in the holding period also indicates a slowdown; the formula used to determine the holding period is called **the inventory Days on Hand (DOH)** and is calculated as follows:

$$\frac{\text{Inventory}}{\text{Cost of Goods Sold}} \times 365$$

Inventory can be further subdivided into components accounts such as **raw material**, **work- in progress**, **finished parts** or **finished goods**. By analyzing each component, the banker can determine where the inventory slowdown or build- up is occurring and ask why?

If an inventory slowdown has caused a financing need, the term of the loan and its source of repayment depend on the reason for the slowdown. If the showdown is due to a planned build–up of inventory in case of material shortage or to obtain a significant discount, the loan need should be only temporary and should probably be short- term. However, if the slowdown is the result of inefficient production methods, low plant productivity, poor product quality, or excessive obsolete inventory, the loan request should be treated as long term financing

Accounts Receivable slowdown

Previously mentioned, the collection period equals the time between "mailing the invoice" and "receiving the check" to and from the customer. Two major reasons a firm's collection period can increase are:

1. Customers are paying the firm slower than in the past.
2. Management has increased the trade terms offered to customers.

The following formula used to calculate accounts receivable turnover:

$$\frac{\text{Sales}}{\text{Accounts Receivable}}$$

To estimate the collection period, the formula is:

$$\frac{\text{Accounts Receivable}}{\text{Sales x 365}}$$

There are a multitude of causes or reasons for an accounts receivable slowdown. A few include changes in economic condition which cause customers to pay slower, insufficient collection efforts on the part of firm's credit department, credit sales to financially weak customers, billing disputes, customers' dissatisfaction causing the customer return the product, the firm's decision to increase trade terms, or a customer seeking to delay payment in order to enhance its operating cycle.

As a commercial banker, you will need to determine the reason for the slowdown. One way of achieving this goal would be to obtain several recent monthly **Accounts receivable aging**. An accounts receivable aging is a list of unpaid balances broken down into categories that indicate how long the invoices have been outstanding; this list should include a break down by each customer's name as well as by days from date of invoice i.e. **1-30 days**, **31- 60 days**, etc.This document should provide the necessary information to analyze the slowdown, it may become necessary to request permission from the to call customers with large late unpaid balances to uncover existing problems.

In conclusion, sales growth generally requires more cash than it produces. This is paradox of sales growth. An astute banker will realize that as long as a business is seasonal or growing rapidly, that business will require the bank's assistance. An additional paradox can be found in the saying, "Rapid growth spells the worst financial disaster for a new firm." The reason for truth behind this statement is that a new firm does yet have a financial "track record" with which to obtain financing from a bank and usually not adequately generate this financing internally.

Why businesses borrow- Fixed Assets

Fixed Asset Replacement

Fixed assets support the activities of the operating cycle, but unlike the raw material used in the operating cycle, are not converted to cash in the normal course of business. Almost all fixed assets (with the exception of land) will eventually wears out or become obsolete necessitating the reinvestment into replacement by the company. The company fully expects to recover the cost of these replacements over the fixed assets useful life. This process of using cash to purchase fixed assets and converting the fixed assets back to cash again is referred to as the **capital investment cycle**.

In most cases, the bank's commercial or corporate clients should be aware of deteriorating or obsolete fixed assets; however, you (as a commercial banker) should also be able to anticipate a customer's needs to replace fixed assets. One way to determine possible future replacement needs is to examine the company's financial statement. If the firm requires substantial fixed assets and the balance sheet indicates that most of these are fully depreciated, it is highly probable that at least some fixed assets will need to be replaced in the near future. Likewise, if the income statement shows that repair expenses have grown rapidly in recent year, this could be a clue that fixed assets are functioning poorly or breaking down frequently, and need to be replaced.

Two rations can provide guidelines concerning the replacement of fixed assets. Sine land and construction in process are not depreciable assets and therefore will not need to be replaced; they should not be included in either ratio calculation. These ratios include **fixed asset usage** and **fixed asset life**. A fixed asset usage ratio of 60% or higher is cause for investigation. It is calculated as follows:

$$\frac{\text{Accumulated Depreciation}}{\text{Gross Depreciable fixed Assets}} \times 100$$

The fixed asset life ratio estimates the average reaming life of the fixed assets in years. This ratio reveals the average useful life years of the company's depreciable fixed assets, and is calculated as follows:

$$\frac{\text{Net Depreciable fixed Assets}}{\text{Depreciation Expense}}$$

Loans for the purpose of purchasing fixed assets are normally long- term in nature. The actual term will depend on the financing and the useful life of the asset being purchased

Fixed Asset Expansion

If the company is dealing with experiencing long- term sale growth that will require an increase in the firm's production capacity, fixed assets may have to be expanded. Expansion of fixed assets due to sales increase is characterized by jumps and plateaus rather than a continuous, steady increase typify by the growth pattern of inventory and/ or accounts receivable. Each new and higher plateau represents the periodic expansion of production capacity to keep pace with sales. It should be noted that although fixed assets and trading assets (inventory and accounts receivable) growth at different rates, they both grow in direct proportion to sales.

The ratio of **sales to gross fixed assets** indicates how many dollars of sales are generated by each dollar of fixed assets. A high ratio reflects more efficient use of fixed assets, a low figure, a less efficient use. Beyond a certain point, however, a high ratio may mean that productive capacity is being strained. Another reason for an unusually high ratio may be that the company is leasing a substantial amount of its property and equipment via operating leases that do not appear on the balance sheet. The formula for this ratio is:

$$\frac{\textbf{Sales}}{\textbf{Gross Fixed Assets}}$$

When utilizing this ration it is important to realize the difference between capital- and labor- intensive industries. In labor – intensive, much lower level of fixed assets are required to generate sales.

Note: Another way of determining the need for replacing or expanding a company' fixed assets is to visit the production facilities. There is no substitute for viewing the situation first hand.

Why businesses borrow- Other Factors

We have just examined the primary reasons/ purposes that cause businesses to borrow from a bank. A multitude of other reasons may cause a company to borrow, and although these

factors may be legitimate and justifiable, the commercial banker should be ever prudent and careful to fully understand the entire situation before approving the loan request.

Some of these factors could include the following:

1. Growth in assets not linked to asset conversion cycle
2. Restructuring of liabilities and equity
3. Excessive outlays for dividends or owner's draw
4. Heavy non recurring expenses
5. Unprofitable or marginally profitable operations

For such cases, you first determine the exact cause of the loan request, state the estimated loan term, and define the probable repayment source(s).

5.4. Meaning of Loans and Advances

Loans are money granted by creditor to a debtor to be paid in a future fixed period with an interest. To the debtor, loan means getting the purchasing power (i.e., money) now by a promise to pay at some time in future. In a sense, the words credit, debt and loan are synonymous: credit or loan is the liability of the debtor and the asset of the bank(creditor). The word credit is derived from a Latin word 'credo' which means "I believe". This indicates that loans are granted on the bases of trust and belief. Advancing credit or loan essentially depends upon the confidence, character, capacity, capital and collateral of the debtor.

5.5. Classification of Loans and Advances

The main question of Banks is advancing loans to customers in different ways for different purposes and for different time span. Hence Bank Loans and advances can be classified into different categories using different criterion such as nature purpose, time, security and method of repayment.

5.5.1. Based on the Nature of the Loan

A bank may make advances to traders and industrialists and others in many ways. But the main forms in which money is advanced by the bank are: loans, cash credits, overdrafts, purchase and discounting bills and call/notice loans.

Call/Notice Loans: are types of loans that are granted for a customer for a period of from an overnight to a maximum of 14 days. It is used for temporary purposes and are granted without securities.

Cash Credit: it is an arrangement under which a borrower is allowed to borrow up to a certain limit against the security of tangible assets or guarantees. Thus, cash credit may be regrouped as a secured cash credit and a clean cash credit. Under secured cash credit, the customer is required to provide tangible assets as security to cover the amount borrowed from the bank. In case of clean cash credit, the customer provides the bank with a promissory note, which is signed by one or more security or securities.
In case of a cash credit, the customer need not withdraw the entire amount as in case of a loan. He can withdraw from his cash credit account any amount within the limit specified as and when required and can deposit any amount of money, which he finds surplus with him.

Overdrafts: a person is said to be availing overdraft from a bank, when his account with the bank shows a debit balance. Under this arrangement, the bank allows its customer to overdraw his current account so that it shows a debit balance. Any business person can enter into this arrangement to tide over a temporary shortage of funds. The bank may take some tangible security of the borrower. Overdrafts are the withdrawals made according to the convenience of the customer. A sudden spurt in withdrawals will reverse the plans of the banker.

Purchase and Discounting of Bills of Exchange: the bank provides the customers with the facility of purchasing and discounting their bills receivable. This is a method of financial accommodation offered by the banker to the customer. The bank permits the customer to discount his bills receivable and have the value of the bills credited to his account. The bank charges on the face value of the bills. It waits till the maturity of

the bill and presents it on the due date to the drawee for payment. After collection, the proceeds of the bill are appropriated towards the loan and interest due by the customer. If the bill is dishonored, the amount will be recovered from the customer.

Loans: when a bank makes an advance in lump sum the whole of which is withdrawn in cash immediately by the borrower who undertakes to repay it in installments, it is called a loan. Here advance is made on a separate loan account to which the whole amount of loan is immediately credited. The borrower is required to pay the interest on the whole amount from the date of sanction withheld draws the full amount from the loan account or not. If he does not withdraw the entire amount, the real rate of interest will be higher than the rate of interest on cash credits and overdrafts. In some cases, the bank may also agree for the repayment of loan in installments.

5.5.2. Based on the Purpose of the Loan

On the bases of the purpose, the loan is granted for, loans can be sorted out in to the following groups.

Commercial Loans: they are types of loans granted for commercial purposes i.e., to facilitate transactions being made between different firms. They have a short-term life i.e., such loans are granted to fulfill short term financial problems of firms so they have short duration. They may be given to businesses so as to pay salaries, to buy raw materials, to pay expenses, or to buy commodities to be resoled.

Industrial Loans: they are loans granted to industrialists for the purpose of constructing or buying industrial buildings and to buy other fixed assets. Therefore, they have a long-term life.

Agricultural Loans: they are types of loans to be granted to the agriculturalists. They may be given for the purpose of buying land, cultivating and developing the land, buying tractors, fertilizer, insecticide, selected seeds, etc. They have both short life and long life. Those loans granted to acquire land to cultivate and develop the land and to buy tractors

have long repayment life. Whereas loans granted for fertilizers, insecticides, selected seeds have short repayment life.

Educational Loans: they are granted to finance education expenses of a customer.

Medical Loans: they are granted to a customer in order to finance his medication expenses.

5.5.3. Based on the Period of the Loan Granted

Loans may be granted for different span of time. Some may given for short time span and others for long time span and others for intermediate time span. Accordingly loans are divided into three groups.

Short-term loans: they are loans usually granted for a period of time up to and less than one year.

Intermediate loans: they are loans usually granted for a period of time of from one up to five years.

Long-term loans: they are granted for a period of time above five years.

Note: that this way of classification seem a bit practice, otherwise there is no general rule that dictates loans to be classified on the bases of this time horizon. Different banks can set different time horizon so as to classify as short, intermediate, and long-term loans.

5.5.4. Based on the Nature of Security

Loans may be classified based on their level of guarantee as secured and unsecured loans.

A. Unsecured or Clean Loans/Advances: the loan, cash credit, overdraft allowed by a bank to a business person without any security of tangible assets is known as unsecured or clean loans/Advances. It is allowed to the customer against his personal security or promissory note. When the customer is a man of outstanding reputation and sound financial

position, he may be granted a loan or allowed on overdraft by the bank on personal security. Such an advance is known as clean or unsecured advance and is granted against the promissory note of the borrower.

B. Secured Advances/Loans: by secured advances we mean those advances which are granted against some tangible securities apart from the promissory note of the borrower. Secured loan or advance means a loan or advance made on the security of assets, the market value of which is not at any time less than the amount of such loan or advance. The securities against advances are also known as "collaterals". Collateral means additional and securities offered by the borrower and called collaterals because they are offered in addition to the personal security of the borrower. They can be disposed of only in the event of the failure of the borrower to repay the loans.

The value of the securities is to be taken at market price and not at the cost price or book value for the purpose of making an advance. If a customer applies for a loan of Br 400,000.00 and offers shares of the nominal value of Br 300,000.00 as security. The bank should immediately try to know the market value of the shares. Let us suppose the real value of the share is Br 200,000.00. In such a case, it is advisable for the bank to advance loan of Br 200,000.00. Bank cannot be called partly secured in this case because there is no such term in the banking practice.

5.6. Principles or Guidelines for Secured Advances

An important function of a bank is lending of money to commerce and industry. Money is generally lent to the individuals and organizations in the form of secured advances.

Liquidity is important to ensure that the demands of the depositors are met easily. Profitability is essential to meet the expenses of the bank and to earn sufficient profits. Lastly, the advances should be made to those parties, which are likely to repay them along with the interest. Safety of the funds is very essential for the survival of the bank. In order to follow this principle, banks insist on securities against the various types of advances. But, however, a bank is not merely guided by the security. To cover up the advance, it is guided by many other considerations. These considerations can be discussed as follows:

Credit-worthiness of the borrower: the fundamental principles on which credit is based is the credit worthiness of the borrower. Credit-worthiness of the borrower is based on his reliability, responsibility and resources. The bank should give loan to the person who is reliable and a man of integrity and has the intention to repay the loan. He must be a responsible person, otherwise he will mis-utilize the loaned and will not repay it. Mere reliability and responsibility are not enough. He must have adequate resources also. If some loss takes place, he should have the capacity to bear it. Thus, the first principle requires that a bank must satisfy itself that the proposed borrower is honor, reliable, responsible and financially sound.

Financial position of the borrower: a bank must examine the financial position of the prospective borrower. It should ask for the profit and loss account and balance sheet of the last few years. This will help the bank to know the nature of the business and liquidity position of the assets of the borrower. Sound financial position of the borrower is necessary to be sure that the borrower has the capacity to repay the loan.

Purpose of the loan: a bank must examine the purpose for which the loan is required. The loan must be granted to increase the income earning capacity of the borrower because, otherwise, he will not be able to pay back the loan. If a loan is granted to repay an existing debt, it will not increase the income earning capacity of the borrower and it will be difficult for him to repay the loan.

Amount and Period of Loan: a bank cannot grant big loans to a few individuals or concerns. It has to meet the requirements of many persons. Similarly, a bank cannot grant loan for unduly long periods because a major portion of its deposits represents demand deposits which are repayable on demand, so the bank must consider the period of loan while examining the proposal from the borrower.

Security Offered: the bank should also consider the nature of security offered for the advance. A bank should accept that type of security, which is easily marketable and stable in value. A bank should keep adequate margins in case of securities whose prices fluctuate widely. The bank should also verify that the borrower is the real owner of the security offered. The bank must take the possession of the security. The borrower must pledge the

security, if it is movable, and mortgage it, if it is immovable, pledge or mortgage must be executed by way of legal documents as far as possible.

Adequate Margin: a bank should not lend up to the full value of the security provided because its value may go down with the passage of time. It must keep a sufficient margin so that it does not suffer loss because of loss in its value due to depreciation or fall in its price when the borrower makes difficult in making the payment. The margin should also be sufficient to cover the cost of realizing the asset and the interest charges in case of default by the borrower. It is clear that if the loan is not paid regularly its outstanding balance go up, but the value of the collateral may go down due to depreciation and other reasons. Therefore, the gap between the loan amount and the value of its collateral must be enough to cover this uncertainty.

Diversification: the advances of the banks must be spread over different regions, industries and sectors. The bank should not grant loan only to a few persons or concerns. If the advance portfolio of the bank is diversified, the bank will not suffer heavy loss if a firm fails to repay the loan. So a bank should grant short and medium term loans to a number of persons and business organizations whose projects are sound and who offer sufficient security of tangible items. In other words, the bank should avoid keeping all eggs in one basket.

Letters of credit

Letter of credit accomplish their purpose by substituting the credit of the bank for that of the customer, for the purpose of facilitating trade. There are basically two types: commercial and standby. The commercial letter of credit is the primary payment mechanism for a transaction, whereas the standby letter of credit is a secondary payment mechanism.

Commercial letter of credit

Commercial letters of credit have been used for centuries to facilitate payment in international trade. Their use will continue to increase as the global economy evolves.

Letters of credit used in international transactions are governed by the International Chamber of Commerce Uniform Customs and Practice for Documentary Credits. The general provisions and definitions of the International Chamber of Commerce are binding on all parties. Domestic collections in the United States are governed by the Uniform Commercial Code.

A commercial letter of credit is a contractual agreement between a bank, known as the issuing bank, on behalf of one of its customers, authorizing another bank, known as the advising or confirming bank, to make payment to the beneficiary. The issuing bank, on the request of its customer, opens the letter of credit. The issuing bank makes a commitment to honor drawings made under the credit. The beneficiary is normally the provider of goods and/or services. Essentially, the issuing bank replaces the bank's customer as the payer.

5.8. Elements of a Letter of Credit

- A payment undertaking given by a bank (issuing bank)
- On behalf of a buyer (applicant)
- To pay a seller (beneficiary) for a given amount of money
- On presentation of specified documents representing the supply of goods
- Within specified time limits
- Documents must conform to terms and conditions set out in the letter of credit
- Documents to be presented at a specified place

Beneficiary

The beneficiary is entitled to payment as long as he can provide the documentary evidence required by the letter of credit. The letter of credit is a distinct and separate transaction from the contract on which it is based. All parties deal in documents and not in goods. The issuing bank is not liable for performance of the underlying contract between the customer and beneficiary. The issuing bank's obligation to the buyer, is to examine all documents to insure that they meet all the terms and conditions of the credit. Upon requesting demand for payment the beneficiary warrants that all conditions of the agreement have been

complied with. If the beneficiary (seller) conforms to the letter of credit, the seller must be paid by the bank.

Issuing bank

The issuing bank's liability to pay and to be reimbursed from its customer becomes absolute upon the completion of the terms and conditions of the letter of credit. Under the provisions of the Uniform Customs and Practice for Documentary Credits, the bank is given a reasonable amount of time after receipt of the documents to honor the draft.

The issuing banks' role is to provide a guarantee to the seller that if compliant documents are presented, the bank will pay the seller the amount due and to examine the documents, and only pay if these documents comply with the terms and conditions set out in the letter of credit.

Typically the documents requested will include a commercial invoice, a transport document such as a bill of lading or airway bill and an insurance document; but there are many others. Letters of credit deal in documents, not goods.

Advising bank

An advising bank, usually a foreign correspondent bank of the issuing bank will advise the beneficiary. Generally, the beneficiary would want to use a local bank to insure that the letter of credit is valid. In addition, the advising bank would be responsible for sending the documents to the issuing bank. The advising bank has no other obligation under the letter of credit. If the issuing bank does not pay the beneficiary, the advising bank is not obligated to pay.

Confirming loan

The correspondent bank may confirm the letter of credit for the beneficiary. At the request of the issuing bank, the correspondent obligates itself to insure payment under the letter of

credit. The confirming bank would not confirm the credit until it evaluated the country and bank where the letter of credit originates. The confirming bank is usually the advising bank.

5.9. Letter of Credit Characteristics

Negotiability

Letters of credit are usually negotiable. The issuing bank is obligated to pay not only the beneficiary, but also any bank nominated by the beneficiary. Negotiable instruments are passed freely from one party to another almost in the same way as money. To be negotiable, the letter of credit must include an unconditional promise to pay, on demand or at a definite time. The nominated bank becomes a holder in due course. As a holder in due course, the holder takes the letter of credit for value, in good faith, without notice of any claims against it. A holder in due course is treated favorably under the UCC.

The transaction is considered a straight negotiation if the issuing bank's payment obligation extends only to the beneficiary of the credit. If a letter of credit is a straight negotiation it is referenced on its face by "we engage with you" or "available with ourselves". Under these conditions the promise does not pass to a purchaser of the draft as a holder in due course.

Revocability

Letters of credit may be either revocable or irrevocable. A revocable letter of credit may be revoked or modified for any reason, at any time by the issuing bank without notification. A revocable letter of credit cannot be confirmed. If a correspondent bank is engaged in a transaction that involves a revocable letter of credit, it serves as the advising bank.

Once the documents have been presented and meet the terms and conditions in the letter of credit, and the draft is honored, the letter of credit cannot be revoked. The revocable letter of credit is not a commonly used instrument. It is generally used to provide guidelines for shipment. If a letter of credit is revocable it would be referenced on its face.

The irrevocable letter of credit may not be revoked or amended without the agreement of the issuing bank, the confirming bank, and the beneficiary. An irrevocable letter of credit

from the issuing bank insures the beneficiary that if the required documents are presented and the terms and conditions are complied with, payment will be made. If a letter of credit is irrevocable it is referenced on its face.

Transfer and assignment

The beneficiary has the right to transfer or assign the right to draw, under a credit only when the credit states that it is transferable or assignable. Credits governed by the Uniform Commercial Code (Domestic) may be transferred an unlimited number of times. Under the Uniform Customs Practice for Documentary Credits (International) the credit may be transferred only once. However, even if the credit specifies that it is nontransferable or non-assignable, the beneficiary may transfer their rights prior to performance of conditions of the credit.

Sight and time draft

All letters of credit require the beneficiary to present a draft and specified documents in order to receive payment. A draft is a written order by which the party creating it, orders another party to pay money to a third party. A draft is also called a bill of exchange.

There are two types of drafts: sight and time. A sight draft is payable as soon as it is presented for payment. The bank is allowed a reasonable time to review the documents before making payment.

A time draft is not payable until the lapse of a particular time period stated on the draft. The bank is required to accept the draft as soon as the documents comply with credit terms. The issuing bank has a reasonable time to examine those documents. The issuing bank is obligated to accept drafts and pay them at maturity.

Standby letter of credit

The standby letter of credit serves a different function than the commercial letter of credit. The commercial letter of credit is the primary payment mechanism for a transaction. The standby letter of credit serves as a secondary payment mechanism. A bank will issue a

standby letter of credit on behalf of a customer to provide assurances of his ability to perform under the terms of a contract between the beneficiary. The parties involved with the transaction do not expect that the letter of credit will ever be drawn upon.

The standby letter of credit assures the beneficiary of the performance of the customer's obligation. The beneficiary is able to draw under the credit by presenting a draft, copies of invoices, with evidence that the customer has not performed its obligation. The bank is obligated to make payment if the documents presented comply with the terms of the letter of credit.

Standby letters of credit are issued by banks to stand behind monetary obligations, to insure the refund of advance payment, to support performance and bid obligations, and to insure the completion of a sales contract. The credit has an expiration date.

The standby letter of credit is often used to guarantee performance or to strengthen the credit worthiness of a customer. In the above example, the letter of credit is issued by the bank and held by the supplier. The customer is provided open account terms. If payments are made in accordance with the suppliers' terms, the letter of credit would not be drawn on. The seller pursues the customer for payment directly. If the customer is unable to pay, the seller presents a draft and copies of invoices to the bank for payment.

The domestic standby letter of credit is governed by the Uniform Commercial Code. Under these provisions, the bank is given until the close of the third banking day after receipt of the documents to honor the draft.

Procedures for using the tool

The following procedures include a flow of events that follow the decision to use a Commercial Letter of Credit. Procedures required to execute a Standby Letter of Credit are less rigorous. The standby credit is a domestic transaction. It does not require a correspondent bank (advising or confirming). The documentation requirements are also less tedious.

Step-by-step process:

- Buyer and seller agree to conduct business. The seller wants a letter of credit to guarantee payment.
- Buyer applies to his bank for a letter of credit in favor of the seller.
- Buyer's bank approves the credit risk of the buyer, issues and forwards the credit to its correspondent bank (advising or confirming). The correspondent bank is usually located in the same geographical location as the seller (beneficiary).
- Advising bank will authenticate the credit and forward the original credit to the seller (beneficiary).
- Seller (beneficiary) ships the goods, then verifies and develops the documentary requirements to support the letter of credit. Documentary requirements may vary greatly depending on the perceived risk involved in dealing with a particular company.
- Seller presents the required documents to the advising or confirming bank to be processed for payment.
- Advising or confirming bank examines the documents for compliance with the terms and conditions of the letter of credit.
- If the documents are correct, the advising or confirming bank will claim the funds by:
    - Debiting the account of the issuing bank.
    - Waiting until the issuing bank remits, after receiving the documents.
    - Reimburse on another bank as required in the credit.
- Advising or confirming bank will forward the documents to the issuing bank.
- Issuing bank will examine the documents for compliance. If they are in order, the issuing bank will debit the buyer's account.
- Issuing bank then forwards the documents to the buyer.

Standard forms of documentation

When making payment for product on behalf of its customer, the issuing bank must verify that all documents and drafts conform precisely to the terms and conditions of the letter of

credit. Although the credit can require an array of documents, the most common documents that must accompany the draft include:

Commercial invoice

It includes a description of merchandise, price, FOB origin, and name and address of buyer and seller. The buyer and seller information must correspond exactly to the description in the letter of credit. Unless the letter of credit specifically states otherwise, a generic description of the merchandise is usually acceptable in the other accompanying documents.

Bill of leading

A document evidencing the receipt of goods for shipment and issued by a freight carrier engaged in the business of forwarding or transporting goods. The documents evidence control of goods. They also serve as a receipt for the merchandise shipped and as evidence of the carrier's obligation to transport the goods to their proper destination.

Warranty of title

A warranty is given by a seller to a buyer of goods that states that the title being conveyed is good and that the transfer is rightful. This is a method of certifying clear title to product transfer. It is generally issued to the purchaser and issuing bank expressing an agreement to indemnify and hold both parties harmless.

Letter of indemnity

Specifically indemnifies the purchaser against a certain stated circumstance. Indemnification is generally used to guaranty that shipping documents will be provided in good order when available.

Common defects in documentation

About half of all drawings presented contain discrepancies. A discrepancy is an irregularity in the documents that causes them to be in non-compliance to the letter of credit. Requirements set forth in the letter of credit cannot be waived or altered by the issuing bank without the express consent of the customer. The beneficiary should prepare and examine all documents carefully before presentation to the paying bank to avoid any delay in receipt of payment. Commonly found discrepancies between the letter of credit and supporting documents include:

- Letter of Credit has expired prior to presentation of draft.
- Bill of Lading evidences delivery prior to or after the date range stated in the credit.
- Stale dated documents.
- Changes included in the invoice not authorized in the credit.
- Inconsistent description of goods.
- Insurance document errors.
- Invoice amount not equal to draft amount.
- Ports of loading and destination not as specified in the credit.
- Description of merchandise is not as stated in credit.
- A document required by the credit is not presented.
- Documents are inconsistent as to general information such as volume, quality, etc.
- Names of documents not exact as described in the credit. Beneficiary information must be exact.
- Invoice or statement is not signed as stipulated in the letter of credit.

When a discrepancy is detected by the negotiating bank, a correction to the document may be allowed if it can be done quickly while remaining in the control of the bank. If time is not a factor, the exporter should request that the negotiating bank return the documents for corrections.

If there is not enough time to make corrections, the exporter should request that the negotiating bank send the documents to the issuing bank on an approval basis or notify the issuing bank by wire, outline the discrepancies, and request authority to pay. Payment cannot be made until all parties have agreed to jointly waive the discrepancy.

Tips for Exporters

- Communicate with your customers in detail before they apply for letters of credit.
- Consider whether a confirmed letter of credit is needed.
- Ask for a copy of the application to be fax to you, so you can check for terms or conditions that may cause you problems in compliance.
- Upon first advice of the letter of credit, check that all its terms and conditions can be complied with within the prescribed time limits.
- Many presentations of documents run into problems with time-limits. You must be aware of at least three time constraints - the expiration date of the credit, the latest shipping date and the maximum time allowed between dispatch and presentation.
- If the letter of credit calls for documents supplied by third parties, make reasonable allowance for the time this may take to complete.
- After dispatch of the goods, check all the documents both against the terms of the credit and against each other for internal consistency.

Summary

Modern Banks are loan providers. Loans are money or purchasing power given today for future repayment. It is postponement of today's consumption to the future by the creditor and the consumption of future income today by the borrower.

Banks offer different types of loans which are classified using different criteria. In order to guide the lending activity banks develop loan policies. A policy is a general guideline that directs decisions made by members of a certain company. It gives the boundaries within which decisions are to be made. Therefore, individuals and groups can have the authority to make their own decisions with n the boundaries of the policy. Hence, the quality of decisions made depends not only on the quality of decision makers, but also the quality of the policy designed. Likewise, loan policy developed by bankers gives guidance to the bank members as to what decision are to be made at different times and conditions. This helps, decision makers in particular and the bank in general, to maintain uniformity of activities and decisions.

Question for self-Test Exercise

Part I. Multiple Choices

1._____, is one which bears a date later than the one which the cheque is actually drawn.

a) Stale cheque
b) Post dated cheque
c) Mutilated cheque
d) None of the above

2. In order to protect its and customer's interest, the paying banker should under take all of the following except one. Which one?

a) Sufficiency of funds
b) Insanity of the customer
c) Insolvency
d) Material alteration
e) All of the above

3._____ includes the alteration of the date, crossing, place of payment, amount, and the name of the payee.

a) Mutilated cheques
b) Material alteration
c) Open or crossed cheque
d) Stale cheque
e) Neither of the above

4. A banker promises to honor cheques drawn up on him by his customer. But a banker can refuse payment of cheque issued by his customer under all of the following circumstances except one.

a) Notice of customer's death
b) Garnishee order
c) Insufficient funds
d) Regular endorsement
e) All of the above

5. A multitudes of justifiable reasons may cause a company to borrow and the banker should be careful to understand the entire situation before approving the loan request. The factors that may result in customer or company to borrow may include:

a) Un profitable operation
b) Excessive outlays for dividends or owner's draw
c) Growth in assets not linked to asset conversion cycle
d) Heavy non-recurring expenses
e) All of the above

Part II. Blank space

1. _____ and _____ are the two components of the businesses' asset conversion cycle.

2. Inventory can be classified in to component accounts such as _____,

_____, and

_____

3. _____and _____ are the types of sales growth.

4._____ is an organization of various banks constituted for the purpose of off-setting the inter-bank indebtedness arising from the transfer of deposits.

5. _____ is refers to one or cheque, which has been in circulation for an unreasonably long period of time.

Part III. Discussion Questions

1. Discuss common defects of documentation
2. Explain the elements and characteristics of letter of credit.
3. Differentiate various types of loan and advance.
4. Briefly discuss about loan policy and items Included in a Loan Policy.
5. Discuss why businesses borrow under the following circumstances;

a) Slow down in the operating cycle

   i. Inventory Turnover slow downs
   ii. Accounts Receivable slow downs
   iii. Fixed Assets replacement and Fixed asset expansion
   iv. Other Factors

UNIT SIX
DEVELOPMENT AND INVESTMENT BANKING

Development banks are those which have been set up mainly to provide infrastructure facilities for the industrial growth of the country. The Concept of Development Banks: Meaning of Development Banks, Definition of Development Banks, and Development Banking in India: Definition and Features! They provide financial assistance for both public and private sector industries.

6.1. Meaning of Development Banks:

Development banks are specialized financial institutions. They provide medium and long-term finance to the industrial and agricultural sector. They provide finance to both private and public sector. Development banks are multipurpose financial institutions. They do term lending, investment in securities and other activities. They even promote saving and investment habit in the public.

6.1.1. Definition of Development Banks:

There is no precise definition of the development bank. William Diamond and Shirley Bosky consider industrial finance and development corporations as 'development banks' Fundamentally a development bank is a term lending institution.

Development bank is essentially a multi-purpose financial institution with a broad development outlook. A development bank may, thus, be defined as a financial institution concerned with providing all types of financial assistance (medium as well as long-term) to business units, in the form of loans, underwriting, investment and guarantee operations, and promotional activities — economic development in general, and industrial development, in particular. "In short, a development bank is a development-oriented bank." The definition of the term 'development banks' can be stated as follows:

In General Sense:

As per Banking subject (mainly in the Indian context):

"Development banks are those financial institutions whose prime goal (motive) is to finance the primary (basic) needs of the society. Such funding results in the growth and development of the social and economic sectors of the nation. However, needs of the society vary from region to region due to differences were seen in its communal structure, economy and other aspects."

Working capital requirements are provided by commercial banks, indigenous bankers, co-operative banks, money lenders, etc. The money market provides short-term funds which

mean working capital requirements. The long-term requirements of business concerns are provided by industrial banks and the various long-term lending institutions which are created by the government.

Activity 6.1.

Define development banking briefly.

6.1.2. Introduction Development Bank of Ethiopia (DBE)

DBE is one of the state-owned financial institutions engaged in providing short, medium and long term credits over the last 107 years. The Bank has been playing central role in promoting the over-all economic development of the Country since its establishment. In its over a century old service, DBE has established recognition at the national and international levels. Nationally, it is the sole Bank with reputable experience in long-term investment financing. Internationally, it is recognized as an important on-lending channel for development programs financed by bilateral and /or multilateral sources. The recent focus of the government in relation to the revised credit policy of DBE is to provide medium and long term loans for investment projects in the Government priority areas such as Commercial Agriculture, Agro-processing, Manufacturing Industries, Mining and Extractive Industries preferably, export focused as well as lease financing for Small and Medium Enterprises.

6.1.3. Banking services

The Bank provides banking services such as deposit facilities in the form of time deposit and current accounts as well as money transfer services. These services are provided to its clients and funding institutions. The Bank also gives international banking service and related activities, providing L/C services to its clients to import capital goods and raw materials and to export produces.

6.1.4. Economic Sectors Financed by the Bank

- **Commercial Agriculture:** (All farming should be supported by irrigation sys- tem)
  - Commercial scale Horticulture products, vegetables, fruits, mushrooms

- Commercial scale improved seed multiplication.
- Commercial scale food grain farming (wheat, maize, rice, etc.)
- Commercial scale Coffee plantation & development.
- Commercial cotton farming rain fed with assurance of rainfall availability supported by meteorology data.
- Commercial scale bio-fuel plantation (Jatrophia, castor oil plant,

❖ **Agro-processing**:

- Commercial scale food processing plants including pasta production integrated with milling.
- Commercial scale cotton production & ginning.
- Commercial scale dairy products production (pasteurized milk, cheese & butter).
- Commercial scale animal feed production & processing.

❖ Manufacturing and Extractive Industries such as :

- Manufacture of Beverages
- Mineral and bottled water.
- Manufacture of textiles and fabrics.
- Industry scale wearing apparel factory (Garment factory).
- Tanning of finished leather and leather products.
- Paper and paper products (converting) factory.
- Chemical and chemical products factory.
- Rubber & rubber products factory.

6.1.5. Loan Types Extended by the Bank

The Bank extends credit to credit worthy borrowers and projects that have received a thorough appraisal and found to be financially and economically viable and socially desirable in terms of environment protection, employment generation capacity and other social benefit that may be included in the framework of development 5 regulation act of the Government. Although DBE extends long and medium term loans, it also extends loans to special line of credit. The term of loan is, however, to be determined based on the specific needs and requirements of projects. The terms of loans are explained below.

- **Long-Term Loans**

The maximum length of time the Bank advances long term loans is fixed at 20 years including any grace period. Any additional loans or rescheduling must also fall within the 20 years.

- **Medium Term Loans**

This type of loan is loan repayable within three to five years including any grace period.

- **Working Capital Loan**

I. The Bank provides permanent working capital as part of the long and medium term loans that will be recovered within the loan repayment period.

II. The short term working capital requirement of operational projects financed by DBE shall be catered by commercial banks through a tri-partite agreement entered among DBE, commercial banks and borrowers. However, the CBE would be used as a last resort in case of the borrowers could not get short term working capital from any commercial bank.

6.2. Investment Banking

Investment banking is a specific division of banking related to the creation of capital for other companies, governments and other entities. Investment banks underwrite new debt and equity securities for all types of corporations, aid in the sale of securities, and help to facilitate mergers and acquisitions, reorganizations and broker trades for both institutions and private investors. Investment banks also provide guidance to issuers regarding the issue and placement of stock.

6.2.1. Understanding Investment Banking

Many large investment banking systems are affiliated with or subsidiaries of larger banking institutions. Broadly speaking, investment banks assist in large, complicated financial transactions. They may provide advice on how much a company is worth and how best to structure a deal if the investment banker's client is considering an acquisition, merger or sale. It may also include the issuing of securities as a means of raising money for the client groups, and creating the documentation for the Securities and Exchange Commission necessary for a company to go public.

An investment bank is a financial institution that assists wealthy individuals, corporations, and governments in raising capital by underwriting and/or acting as the client's agent in the issuance of securities. An investment bank may also assist companies with mergers and acquisitions and may provide support services in market making and trading of various securities. The primary services of an investment bank include: corporate finance, equity research, sales & trading, and asset management. Investment banks earn profit by charging fees and commissions for providing these services and other kinds of financial and business advice.

Investment banks play an important role from the moment companies contemplate an acquisition to the final steps. When a buyer or seller contemplates an acquisition, the respective board of directors may choose to form a special committee to evaluate the merger proposal, and typically retains an investment bank to advise and evaluate the transaction's terms and price as well as help the acquiring company arrange financing for the deal.

To provide meaningful advisory, investment banks create different valuation models to determine valuation ranges for a company. They may also conduct accretion/dilution analysis to assess affordability to the acquirer and the effect of the consideration paid on projected earnings per share. Banks also help clients assess synergistic opportunities from acquiring other companies and how those synergies can create value and reduce costs in the future. A buy side M&A advisor represents the acquirer and determines how much the client should pay to buy the target. A sell side M&A advisor represents the seller and determines how much the client should receive from the sale of the target.

Key Takeaways

- Investment banking deals primarily with the creation of capital for other companies, governments, and other entities.
- Investment banking activities include underwriting new debt and equity securities for all types of corporations, aiding in the sale of securities, and helping to facilitate mergers and acquisitions, reorganizations, and broker trades for both institutions and private investors.

- Investment bankers help corporations, governments, and other groups plan and manage financial aspects of large project

6.2.2. The Role of Investment Bankers

Investment banks employ investment bankers who help corporations, governments and other groups plan and manage large projects, saving their client time and money by identifying risks associated with the project before the client moves forward. In theory, investment bankers are experts in their field who have their finger on the pulse of the current investing climate, so businesses and institutions turn to investment banks for advice on how best to plan their development, as investment bankers can tailor their recommendations to the present state of economic affairs.

Essentially, investment banks serve as middlemen between a company and investors when the company wants to issue stock or bonds. The investment bank assists with pricing financial instruments to maximize revenue and with navigating regulatory requirements. Often, when a company holds its initial public offering (IPO), an investment bank will buy all or much of that company's shares directly from the company. Subsequently, as a proxy for the company holding the IPO, the investment bank will sell the shares on the market. This makes things much easier for the company itself, as they effectively contract out the IPO to the investment bank.

Moreover, the investment bank stands to make a profit, as it will generally price its shares at a markup from the price it initially paid. In doing so, it also takes on a substantial amount of risk. Though experienced analysts use their expertise to accurately price the stock as best they can, the investment bank can lose money on the deal if it turns out it has overvalued the stock, as in this case it will often have to sell the stock for less than it initially paid for it.

Investment banks primarily help clients raise money through debt and equity offerings. This includes raising funds through Initial Public Offerings (IPOs), credit facilities with the bank, selling shares to investors through private placements, or issuing and selling bonds on behalf of the client.

The investment bank serves as an intermediary between investors and the company and earns revenue through advisory fees. Clients want to utilize investment banks for their capital raising needs because of the investment bank's access to investors, expertise in valuation, and experience in bring companies to market.

Often, investment banks will buy shares directly from the company and will try to sell at a higher price – a process known as underwriting. Underwriting is riskier than simply advising clients since the bank assumes the risk of selling the stock for a lower price than expected. Underwriting an offering requires the division to work with Sales & Trading to sell shares to the public markets.

6.2.3. Types of Investment Bank Activities

A. Financial Advisors

As a financial advisor to large institutional investors, the job of an investment bank is to act as a trusted partner that delivers strategic advice on a variety of financial matters. They accomplish this mission by combining a thorough understanding of their clients' objectives, industry and global markets with strategic vision trained to spot and evaluate short- and long-term opportunities and challenges facing their client.

B. Mergers and Acquisitions

Handling mergers and acquisitions is a key element of an investment bank's work. The main contribution of an investment bank in a merger or acquisition is evaluating the worth of a possible acquisition and helping parties arrive at a fair price. An investment bank also assists in structuring and facilitating the acquisition in order to make the deal go as smoothly as possible.

C. Research

The research divisions of investment banks review companies and author reports about their prospects, often with "buy", "hold" or "sell" ratings. While research may not generate revenue itself, the resulting knowledge is used to assist traders and sales. Investment bankers, meanwhile, receive publicity for their clients. Research also provides investment advice to outside clients in the hopes that these clients will take their advice and complete a trade through the trading desk of the bank, which would generate revenue for the bank. Research maintains an investment bank's institutional knowledge on credit research, fixed

income research, macroeconomic research, and quantitative analysis, all of which are used internally and externally to advice clients.

♠**Important**: Size is an asset in the investment banking business, where bigger banks have a greater opportunity to profit by matching buyers and sellers.

Activity 6.2.

- What is an investment bank?
- How do investment banks help companies in M&A transactions?
- How do investment banks help companies raise capital?

6.2.4. Criticism of Investment Banks

Because investment banks have external clients, but also trade their own accounts, a conflict of interest can occur if the advisory and trading divisions don't maintain their independence. Thus, most investment banks must maintain what's called a **Chinese wall**. The wall is a figurative barrier between the two investment banking departments to help prevent the sharing of information that would allow one side or the other to unfairly profit.

6.3. cooperative banking

A **cooperative** (also known as **co-operative**, **co**-op, or coop) is "an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly-owned and democratically-controlled enterprise".

Cooperative banking is retail and commercial banking organized on a cooperative basis. Cooperative banking institutions take deposits and lend money in most parts of the world. Cooperative bank is an institution established on the cooperative basis and dealing in ordinary banking business. Like other banks, the cooperative banks are founded by collecting funds through shares, accept deposits and grant loans.

Cooperative banks are banks for small people .They are formed by members initiative .Share capital deposits are mobilized by local people .They give loans to members only .Credit needs of people who have small means are supplied by cooperative banks .Agriculture and village credit needs are mainly provided by cooperatives .Since bank

national role of cooperatives have come down .Still cooperatives play important role in agricultural and rural sectors.

A Co-operative bank is an example of banking institutions established on co-operative basis. They operate in rural, semi urban and urban areas. These banks are supported by the government as they get financial assistance from Central and State Governments. Co-operative banks provide mainly short and medium term credit.

The co-operative banks are organized as a three tier structure:

A. Primary Agricultural Credit Societies (PACS) operate at the base level and deal directly with the farmers, catering to their short and medium term credit needs. They encourage savings among agriculturalists and gives loans to the needy farmers.

Their funds are raised by way of share capital, membership fees, deposits from members and nonmembers and loans from Central Co-operative Banks and the Government.

B. Central Co-operative Banks (CCBs) operate at the middle of the three tier structure. They operate at the district level and serve as a link between the base level PACs and the money market. Their main function is to provide loans to the PACS. They give loans to others also and provide remittance facilities. They shift surplus funds from surplus primary societies to the deficit ones.

They raise working capital mainly from deposits and borrowings. Deposits are mainly from individuals and co-operative societies.

Co-operative banks are the banks whose main objective is to provide financial assistance to economically weaker sections of the society. Such banks are registered under the Cooperative Societies Act.

There are three types of cooperative banks-

A. Primary Credit Societies- These institutions are formed at village level or town level. The operations of such banks are limited to a very small area

B. District Central Cooperative Banks- These banks operate at the district level. They act as a link between primary credit societies and state cooperative banks

C. *State Cooperative Banks*- State Cooperative Banks are biggest forms of cooperative banks. They operate at the state level. Some of State Cooperative banks operate in multi States.

Public Sector Bank is generally referred to as government bank. Co-operative Banks and Public Sector Banks are different types of banks**.** Public Sector Banks fall under the category of Commercial Banks

6.3.1. The difference between cooperative bank and commercial bank

Commercial banks- Commercial banks are the banks which do the banking business with the aim of earning profits. They accept deposits from the public and lend them to traders, manufacturers, and businessmen.

There are three types of commercial banks-

A. *Public sector banks*- These are banks where the majority of the shares are held by the Government.

B. *Private sector banks*- These are the banks where the majority of shares are held by private individuals/entities. Example, HDFC Bank, ICICI Bank, Axis Bank etc.

C. *Foreign banks*- These are the banks which are registered outside of India, but have their branches in India. Example, Citibank, Standard Chartered Bank, HSBC etc.

Co-operative banks - Co-operative banks are the banks whose main objective is to provide financial assistance to economically weaker sections of the society. Such banks are registered under the Cooperative Societies Act.

There are three types of cooperative banks-

A. *Primary Credit Societies*- These institutions are formed at village level or town level. The operations of such banks are limited to a very small area.

B. *District Central Cooperative Banks*- These banks operate at the district level. They act as a link between primary credit societies and state cooperative banks.

C. ***State Cooperative Banks-*** State Cooperative Banks are biggest forms of cooperative banks. They operate at the state level. Some of State Cooperative banks operate in multi States.

Activity 6.3

1. What are the functions of cooperative banks?
2. Is Cooperative Bank a government bank?

Appendix

Answer Key

Chapter one

Part I

1. b
2. e
3. g
4. g
5. e

Part II

1. False
2. True
3. True
4. True

Chapter three

Part I

1. B
2. B
3. C
6. C
7. B
8. A
4. D
5. A
9. E
10. E

Part II

1. Interest margin
2.
   A) Risk reduction
   B) Signaling instruments (convey valuable information)
   C) Reduce moral hazard problems
3. Retained earning
4. Transaction loan
5. Risk management

Part III

1. F
2. E
3. D
4. C
5. B
6. A

Chapter four

Part I: Multiple Choices

1) E
2) E
3) B
4) E
5) A

Part II: True or False

1) False
2) False
3) True
4) False

Chapter five

Part I

6. B
7. A
8. B
9. D
10. E

Part II

1. The operating cycle and the capital investment cycle
2. _____
    a) Raw material
    b) Work-in-progress
    c) Finished goods(parts)
3. Seasonal sales growth and Long-term sales growth
4. A clearing house system
5. Stale cheque