Mekelle University

College of Business and Economics

Department of Accounting and Finance

Course Name: Banking Principles and Practices

Course Code: AcFn 2113

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Course Objectives

At the end of this course students will be able to;

- Understand those different services provided by banks for their customers
- Understand what basic will be performed by Central Bank
- Know the responsibility of the bank personal which serves a bank in different position
- Understand the asset &liability of the bank
- Enhance the knowledge about the function of the bank to the society
- Differentiate the balance sheet of the bank form other firms
- Identify items should be included in a loan policy
- Know the sequence of information flow within the bank
- Identify the basic operational differences among Development, Investment and Commercial Banks
- Identify basic service that should be provided by Development and Investment Banks

Course Description

This course is designed a to quaint students with the basic principles procedure and practice of banks. Throughout this course emphasis will be given to relationship between Banker and customer negotiable (credit) instruments Banking industry and formulation of bank loan policy specially opening and crossing of accounts and rule of negotiable instruments are given detail discussion so as to equipment students with the necessary regulation of bank for such instrument and accounts.

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Evaluation

Continuous Assessment………………….	35%
Assignments ………………………………	15%
Final Exam …………………………………	50%
Total………………………………	100%

Text Book:

- Fabozzi, Frank J, Franco Modigliani, Frank J. Jones. Financial Institutions and Markets. 3rd Edition, USA

Reference Books

- Saunders, Anthony and Marcia Millon Cornett. Financial markets and institutions
- Rose, Peter S. Money and capital markets: The financial system in an increasingly global economy. 5th Ed

CHAPTER ONE

AN OVERVIEW OF BANKS AND THEIR FUNCTIONS

1.1 Introduction:

Modern commercial banking, in its present form, is of recent origin. Though bank is considered to be an ancient institution just like money. Its evolution can be traced in the functions of money lender, the goldsmiths and the merchants.

A bank has been often described as an institution engaged in accepting of deposits and granting loans. It can also be described as an institution which borrows idle resources, makes funds available to. It does not refer only to a place of lending and depositing money, but looks after the financial problems of its consumers. In simple words, banking can be defined as the business activity of accepting and safeguarding money owned by other individual and entities, and then lending out this money in order to earn a profit.

This era is the age of specialization with the changing situation in the world economy, banking functions have broadened.

Financial institutions which are shaped by the general economic structures of the country concerned vary from one country to another. Banks are among the most important financial institutions in the economy and are the principle sources of credit.

1.2 . Meaning of Banking

Here are a few of definitions given by well known scholars:

- **Bank** is a manufacturer of credit and machine for facilitating exchanges.
- **A bank** is a person or corporation which holds itself out to receive from the public deposits and payable of demand by cheque.
- **Banks** are institutions whose debts usually referred to as 'Bank Deposits' are commonly accepted in final settlement of other people debts.
- **A bank** is an establishment which makes to individuals such advances of money as may be required and safely made and to which individuals entrust money when not needed by them for use.

All the above definitions are reflect the purpose of banks and function of banks that given by different scholars; however a single definition is needed to understand the corporate image of different banks in one definition; so that the definition provided below is concretely elaborate, what banking does it mean?

In simple words, banking can be defined as the business activity of accepting and safeguarding money owned by other individual and entities, and then lending out this money in order to earn a profit

Banking is defined as the accepting, for the purpose of lending, or investment of deposits, money from the public, repayable on demand or otherwise and withdraw able by cheque, draft, or order.

On the other hand a bank is a financial institution which deals with deposits and advances and other related services. It receives money from those who want to save in the form of deposits and it lends money to those who need it. It bridges the gap between the savers and borrowers. The provision of deposit and loan products normally distinguishes banks from other types of financial firms. Deposit products pay out money on demand or after some notice. Deposits are liabilities for banks, which must be managed if the bank is to maximize profit.

Likewise, they manage the assets created by lending. Thus, the core activity is to act as *intermediaries* between depositors and borrowers. Other financial institutions, such as stockbrokers, are also intermediaries between buyers and sellers of shares, but it is the taking of deposits and the granting of loans that singles out a bank, though many offer other financial services.

Banks are large and complex organizations. Their clients range from individuals and institutions, all the way up to the governments and central banks of entire countries. Banks don't produce physical things. They are not in the manufacturing business. The work they do simply involves money – their money, their clients' money: borrowing it, lending it, and many other related activities. The movement of capital handled by banks allows economies to grow and prosper. Businesses and governments cannot be completely self-sufficient. They need money to operate, and banks act as intermediaries (like ‘middlemen') between the suppliers of funds and users of funds.

Banking occupies one of the most important positions in the modern economic world. It is necessary for trade and industry. Hence it is one of the great agencies of commerce. Although banking in one form or another has been in existence from very early times, modern banking is of recent origin. It is one of the results of the Industrial Revolution and the child of economic necessity. Its presence is very helpful to the economic activity and industrial progress of afferent investment type and objective for the purpose of seeking the differences.

When the above ideas are summarized Bank has the following **roles**

♦ It encourages savings habit amongst people and thereby makes funds available for productive use.

♦ It acts as an intermediary between people having surplus money and those requiring money for various business activities.

♦It facilitates business transactions through receipts and payments by cheques instead of currency.

♦It provides loans and advances to businessmen for short term and long-term purposes.

♦ It also facilitates import export transactions.

♦It helps in national development by providing credit to farmers, small-scale industries and Self-employed people as well as to large business houses which lead to balanced economic development in the country.

♦It helps in raising the standard of living of people in general by providing loans for purchase of consumer durable goods, houses, automobiles, etc.

bank v_s banking

- **Bank** is an organization or a company like any other company, which sells and buys goods and services in the market. The main difference between other companies and banks is that, other companies are trading goods and services for money, but in the case of bank the trading item itself is money, instead of tangible goods or intangible services. How a bank works can simply be explained as accepting deposits from customers by paying interest to their deposits, while lending this money deposited to required parties for an interest rate, which is higher than that paid to depositors.

- **Banking** is the business activity of a bank. Simply, any activity carried out by a bank for business purposes is called banking. Accepting savings, Lending money, leasing properties to needy people, paying for cheques, providing mortgage facilities.

1.3. functions of bank

1. **Deposit of funds**: as their major function, banks deposit money of customers and pay interests to depositors. Such deposits will be used for borrowings.
2. **Bank transfers**: money can be transferred from one place to another through bank transfers.
3. **Deposit of securities**: such deposits include certificates and documents of title. The bank can act as the agent of a business person in consideration of a commission.
4. **Hiring of safes**: bank may have safe boxes so that clients can put things they value most in them.
5. **Discount**: when a negotiable instrument is due sometime in the future, banks may accept the instrument before maturity and give discounted payment to the holder.
6. **Lending**: initial capital of the bank and its deposits will be used for lending clients with some interest to the bank. Mostly the interest paid to the banks is higher than the interest paid to depositors that brings profit to the banks.
7. **Documentary credits**: the main documentary instrument is the letter of credit (LC). This is important in international sales transactions. A contract between a seller and a buyer; the buyer goes to an issuing bank and opens letter of credit; the issuing bank communicates with the payee bank; the seller goes to the payee bank and submits bill of lading and other documents that transfer ownership of the goods; payee bank checks documents and sends it to issuing bank; seller gets his money from payee bank; buyer gets his documents from issuing bank; contract is performed. In between there can be an advising/confirming bank which checks documents (check that documents are not discrepant).

1.4. TYPES OF BANK

There are various types of banks. The necessity for the variety among these banks is because each bank is specialized in their own field. Each bank has its own principles and policies. Different rates of interests are also noted among these banks.

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

1.4.1. Classifications of banks on the Basis of functions

On the basis of functions, banks can be classified as bellow:

A. Commercial Banks: The banks, which perform all kinds of banking business and generally finance trade and commerce, are called commercial banks. Since their deposits are for a short period, these banks normally advance short-term loans to the businessmen and traders and avoid medium-term and long-term lending.

However, recently, the commercial banks have also extended their areas of operation to medium-term and long-term finance. Majority of the commercial banks are in the public sector. However, there are certain private sector banks operating as joint stock companies. Hence, the commercial banks are also called joint stock banks.

B. Industrial Banks: Industrial banks mainly meet the medium-term and long-term financial needs of the industries. Such long-term needs cannot be met by the commercial banks, which generally deal with short-term lending.

C. Agricultural Banks: Agricultural credit needs are different from those of industry and trade. Industrial and commercial banks normally do not deal with agricultural finance. The agriculturists require:

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

D. ExchangeBank

Exchange bank deals mainly in the finance of the foreign trade of the country. It deals in foreign exchange. On other wards, the main function of such bank is to buy and sell foreign currencies.

E. **Saving Banks:** The main purpose of saving banks is to promote saving habits among the general public and mobilize their small savings. These banks are suited for employees with a monthly salary. Low waged people may open an account in the savings bank.

F. **Central Bank:** Central bank is the top institution, which controls, regulates and supervises the monetary and credit system of the country.

G. Islamic banking: is a banking system that is based on the principles of Islamic or Shariah law. As such, banks that wish to offer Islamic banking services have to develop products and services that do not charge or pay interest. Their solution is to offer various profit-sharing-related products whereby depositors share in the risk of the bank's lending. Depositors earn a return (instead of interest) and borrowers repay loans based on the profits generated from the project on which the loan is lent.

An example of a commonly used profit-sharing arrangement in Islamic banking is known as Musharakah, which is an arrangement where a bank and a borrower establish a joint commercial enterprise and all contribute capital as well as labor and management as a general rule. The profit of the enterprise is shared among the partners in agreed proportions while the loss will have to be shared in strict pro- portion of capital contributions.

H. World Bank: - It refers to an institution that provides financial assistance to the member countries of the world. World Bank organized to achieve the following two objectives.

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

1.4.2. Classifications of bank on the Basis of Ownership:

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

(a) Public Sector Banks: These are owned and controlled by the government. They usually need to emphasis on social objective than profitability

(b) Private Sector Banks: These banks are owned by the private individuals or corporations and not by the government or co-operative societies,

(c) Cooperative Banks: Cooperative banks are operated on the cooperative lines. Cooperative credit institutions are organized under the cooperative society's law and play an important role in meeting financial needs in the rural areas.

Cooperative bank is a financial entity which belongs to its members, who are at the same time the owners and the customers of their bank

Co-operative banks are often created by persons belonging to the same local or professional community or sharing a common interest.

1.4.3. Classification of Banks on the Basis of Domicile:

On the basis of domicile, the banks are divided into two categories:

(a) Domestic Banks: These are registered and incorporated within the country,

(b) Foreign Banks: These are foreign in origin and have their head offices in the country of origin.

CHAPTER TWO

CENTRAL BANKING

INTRODUCTION

A central bank is a financial institution that is owned by the government, which has a central role of managing the currency.

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. The central bank might be or might not be independent the government.

Some of the well-known **central banks** are the US Federal Reserve, Bank of England, Bank of Canada, Reserve Bank of Australia, and the European Central Bank. Some central banks are responsible for single's country monetary policy, for example the Bank of Canada, while others manage the monetary policy of group of countries like the European Central Bank.

The core functions of central banks in any countries are to manage **monetary policy** with the aim of achieving **price stability**; to prevent liquidity crises, situations of money market disorders and financial crises; and to ensure the smooth functioning of the payments system. This chapter will examine some basic concepts as they relate to central banking theory. Specifically, the chapter investigates the following fundamental areas:

1.2 FUNCTIONS OF CENTRAL BANK

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

1. **REGULATOR OF CURRENCY: MONOPOLY POWER OF NOTE ISSUE**

The central bank controls the issue of notes and coins usually; the central bank will have a monopoly of the issue. The notes issued by the central bank are considered as legal tender money of the country and form the cash basis of the credit of commercial banks

The monopoly of issuing notes vested in the central bank guarantees the following

♦ Uniformity in the notes issued which helps in facilitating exchange and trade within the country.

♦It brings stability in the monetary system and creates confidence among the public.

♦The central bank can restrict or expand the supply of cash according to the requirements of the economy i.e. pumping in more money when market is dry of cash, and pumping out money when there is excess of credit.. Thus, it provides elasticity to the monetary system.

♦ controls the banking system by being the ultimate source of cash. Being the sole supplier of money in the economy, the central bank regulates the volume of currency of the country. It has also the power to withdraw worn and torn notes from circulation in exchange for new ones, so that good quality notes and coins circulate in the

♦ the government is able to earn profits from printing notes whose cost is very low as compared with their face value.

Seignior age: profit made by a government by issuing currency, especially the difference between the face value of coins and their production costs

Central banks have been following different methods of note issue in different countries.
The most common methods used in issuance of note are

A. Fixed Fiduciary System
B. Maximum Fiduciary System
C. Proportional Reserve System
D. The Minimum Reserve System

A. Fixed Fiduciary System

Under this method of note issue, central bank of the country is allowed to issue currency notes of a specified amount without presenting gold and silver to cover it. Once this limit is reached, additional amount of notes can be issued by hundred percent backed by gold. The advantages claimed for this method is that it gives elasticity in the money supply. It also grant maximum care due to the excess issuance of notes of the “Fiduciary Limit” except they are sheltered by hundred percent of gold. The possibility of inflation is effectively checked. However, this system is objected on the ground that judiciary limit is open to change by amendment in the Act and is raised will lose the confidence of the people.

B. Maximum Fiduciary System

According to this method of note issue, the fiduciary system's limit is fixed above the normal requirements of the country. Beyond the maximum no note is issued without legal sanction. This system is defective in the sense that, if the limit is too low, the currency system becomes inelastic and if the limit is too high, there is danger of over issue of notes.

C. Proportional Reserve System

Under this method of note issue, the central bank is mandatory by law to maintain a permanent percentage from 25% to 40% adjacent to issuance of notes. It is often called percentage system. The remainder of the notes is to be covered by trade bills and government securities. This system is easily operated and it gives needed elasticity to the currency note system. But the system is uneconomic as huge amount of gold is kept idle as reserve. Moreover, the value of money is not stable, but this system is elastic up to a certain limit.

D. Minimum Reserve System

Under this method of note issue, the reserve limit is permanently fixed and the volume of the notes has no connection with the amount of the reserve. To meet the ever- increasing demand for currency, government can issue notes up to any amount against the reserve but it is faced with the danger of the inflation.

2. CONTROLLER OF CREDIT: MONETARY POLICY

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. The most important function of the central bank is to control the credit creation power of commercial bank in order to control inflationary and deflationary pressures within an economy. To control the credit central banks adopts **quantitative** methods and **qualitative** methods.

I. **Quantitative methods**:

This methods used by the central bank to influence the total volume of credit in the banking system, without any regard for the use to which it is put. These methods regulate the lending ability of the financial sector of the whole economy and do not discriminate among the various sectors of the economy.aim at controlling the cost and quantity.

The important quantitative methods of credit control are bank rate policy, open market operations, and by variations in reserve ratios of commercial banks.

(A). Bank rate: Bank rate is the rate at which the reserve bank is prepared to buy or rediscount bills of exchange or other commercial paper eligible for purchase under the act. Increase in the bank rate reduces the credit creation power of banks and decrease in bank rate increases the credit creation power of the banks.

(B). Open market operations: The term open market operation refers to purchase or sale of government securities by the central bank. when the banks and the private individuals purchase these securities they have to make payments for these securities to the Central Bank.

This gives result in the fall in the cash reserves of the Commercial Banks, which in turn reduces the ability of create credit. Through this way of working the Central Bank is able to exercise a check on the expansion of credit.

Further, if there is deflationary situation and the Commercial Banks are not creating as much credit as is desirable in the interest of the economy. Then in such situation the Central Bank will start purchasing securities in the open market from Commercial Banks and private individuals.

With this activity the cash will now move from the Central Bank to the Commercial Banks. With this increased cash reserves the Commercial Banks will be in a position to create more credit with the result that the volume of bank credit will expand in the economy.

(C). Cash-reserve ratio: The central bank can control credit by variation of cash reserve ratio. A raise in this ratio reduces the credit creation ability of the banks and a decrease in this ratio results in increasing the credit creation ability of the banks.

II. **Qualitative methods (selective methods):**

Unlike the quantitative methods, which affect the total volume of credit, the qualitative methods affect the types of credit extended by the commercial banks; they affect the composition rather than the size of credit in the economy. It controls the use and direction of credit. These involve selective credit controls and direct action. By adopting such methods, the central bank tries to influence and control credit creation by commercial banks in order to stabilize economic activity in a country. This method use by the central bank to regulate the flow of credit into particular directions of the economy.

The main instruments used for this purpose are:

A. Varying margin requirements for certain bank:

While lending commercial banks accept securities, deduct a certain margin from the market value of the security. This margin is fixed by the central bank and adjusts according to the requirements. This method affects the demand for credit rather than the quantity and cost of credit. This method is very effective to control supply of credit for speculative dealing in the stock exchange market. It also helps for checking inflation when the margin is raised. If the margin is fixed as 30%, the commercial banks can lend up to 70% of the market value of security.

B. Regulation of consumer's credit: Apart from trade and industry a great amount of credit is given to the consumers for purchasing durable goods like houses, motor cars, refrigerator etc on purchase or installment credit system. Central seek to control such credit in several ways. E.g.

(I) By regulating the minimum down payments on specific goods.

(II) By fixing the coverage of selective consumer’s durable goods.

(III) By regulating the maximum maturities on all installment credit and

(IV) By fixing exemption costs of installment purchase of specific goods.

C. **Control through Directives**: Under this system, the central bank can issue directives for the credit control. There may be a written or oral voluntary agreement between the central bank and commercial banks in this regard.

D. **Rationing of credit:** The amount of credit to be granted is fixed by the central bank. Credit is rationed by limiting the amount available to each commercial bank.

E. **Direct Action**: It is an extreme step taken by the central bank. Direct action implies measures like refusal by central bank to extend credit facilities, denial of permission to open new branches etc.

F. **Publicity:** under this method Central Bank publishes various reports stating what is good and what is bad in the system. This published information can help commercial banks to direct credit supply in the desired sectors. Through its weekly and monthly bulletins, the information is made public and banks can use it for attaining goals of monetary policy.

G. **Moral suasion**: Central bank uses persuasion to influence lending activities of banks. It sends letters to banks periodically, advising them to follow sound principles of banking. Discussions are held by central bank with banks to control the flow of credit to the desired sectors. The central bank may request and persuade member banks to refrain from increasing their loans for speculative or non-essential activities.

The main objectives of monetary policy include:

A. **Economic growth:** Economic growth can be enhanced by investment in capital, such as more or better machinery. A low interest rate implies that firms can loan money to invest in their capital stock and pay less interest for it. Lowering the interest is therefore considered to encourage economic growth and is often used to alleviate times of low economic growth.
B. **High employment –** Monetary policy affects the national money supply and the availability of credit for business and consumers. This leads to the demand for the employees who produce those goods and services hence leads to a decrease in unemployment rate.
C. **Price stability-** Price stability means that one year from now a birr/dollar will buy roughly the same as it buys today. Strong rising (inflation) or falling (deflation) prices leads to

insecurity and will harm the economy. Hence price stability is a necessary precondition for a healthy economy. Rapidly rising prices erode purchasing power. People will start demanding higher wages. Companies will, in turn, factor the higher wages into the prices of their products. In such an environment, where all goods and services keep growing more and more expensive, consumers and business are left without solid ground to base sound economic decisions on. Price stability offers them security and confidence, which contribute to sustainable economic growth. This is why the central bank is directed at maintaining price stability.

D. Stability of Financial Markets

Financial crises can interfere with the ability of financial markets to channel funds to people with productive investment opportunities and lead to a sharp contraction in economic activity. The promotion of a more stable financial system in which financial crises are avoided is thus an important goal for a central bank.

E. Interest-Rate Stability

Interest-rate stability is desirable because fluctuations in interest rates can create uncertainty in the economy and make it harder to plan for the future. Fluctuations in interest rates that affect consumers' willingness to buy houses, for example, make it more difficult for consumers to decide when to purchase a house and for construction firms to plan how many houses to build.

F. Stability in Foreign Exchange Markets

Preventing large changes in the value of the dollar makes it easier for firms and individuals purchasing or selling goods abroad to plan ahead. Stabilizing extreme movements in the value of the dollar in foreign exchange markets is an important goal of monetary policy. In other countries, which are even more dependent on foreign trade, stability in foreign exchange markets takes on even greater importance.

3. BANKERS BANK and BANKING SUPERVISION

Besides the above noted functions, the central banks in a number of developing countries have been entrusted with the responsibility of developing a strong banking system to meet the expanding requirements of agriculture, industry, trade and commerce.

Central bank acts as banker's bank in three capacities:

(I) It is the custodian of their cash reserves. Banks of the country are required to keep a certain percentage of their deposits with the central bank; and in this way the central bank is the ultimate holder of the cash reserves of commercial banks

(II) Central bank is lender of last resort. Whenever banks are short of funds, they can take loans from the central bank and get their trade bills discounted. The central bank is a source of great strength to the banking system.

(III) It acts as a bank of central clearance, settlements and transfers.

Its moral persuasion is usually very effective so far as commercial banks are concerned.

Central banks also possess some additional powers of supervision and control over the commercial banks. They are the issuing of licenses; the regulation of branch expansion; to see that every bank maintains the minimum paid up capital and reserves as provided by law; inspecting or auditing the accounts of banks; to approve the appointment of chairmen and directors of such banks in accordance with the rules and qualifications; to control and recommend merger of weak banks in order to avoid their failures and to protect the interest of depositors; to recommend nationalization of certain banks to the government in public interest; to publish periodical reports relating to different aspects of monetary and economic policies for the benefit of banks and the public; and to engage in research and train banking personnel etc.

4. **BANKER,FISCAL AGENT AND ADVISER TO THE GOVERNMENT:**

Central banks everywhere act as bankers, fiscal agents and advisers to their respective governments. As banker to the government, the central bank keeps the deposits of the central and state governments and makes payments on behalf of governments. But it does not pay interest on governments deposits. It buys and sells foreign currencies on behalf of the 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.

Moreover, it keeps the stock of gold of the government. Thus it is the custodian of government money and wealth. The central bank 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 (order) of the government in order to influence the exchange value of the domestic currency. As a fiscal agent, the central bank makes short-term loans to the government for a period not exceeding 90 days. It floats loans, pays interest on them, and finally repays them on behalf of the government. Thus, it manages the entire public debt. The central bank also advises the government on such economic and money matters as controlling inflation or deflation, devaluation or revaluation of the currency, deficit financing, balance of payments, etc. Central banks everywhere operate as bankers to the state not only because it may be more convenient and economical to the state, but also because of the intimate connection between public finance and monetary affairs

5. **LENDER OF THE LAST RESORT:**

By granting accommodation in the form of re-discounts and collateral advances to commercial banks, bill brokers and dealers, or other financial institutions, the central bank acts as the lender of the last resort. 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.

The central bank lends to such institutions in order to help them in times of stress so as to save the financial structure of the country from collapse. It acts as lender of the last resort through discount house on the basis of treasury bills, government securities and bonds at "the front door". The other method is to give temporary accommodation to the commercial banks or discount houses directly through the "back door". The difference between the two methods is that lending at the front door is at the bank rate and in the second case at the market rate. Thus the central bank as lender of the last resort is a big source of cash and also influences prices and market rates.

The main advantages of the central bank's functioning as the lender of the last resort are:

a. It increases the elasticity and liquidity of the whole credit structure of the economy.
b. It enables the commercial banks to carry on their activities even with their limited cash reserves.

c. It provides financial help to the commercial banks in times of emergency.
d. It enables the central bank to exercise its control over banking system of the country.

6. CUSTODIAN OF CASH RESERVES OF COMMERCIAL BANKS:

Commercial banks are required by law to keep reserves equal to a certain percentage of both time and demand deposits liabilities with the central banks. It is on the basis of these reserves that the central bank transfers funds from one bank to another to facilitate the clearing of cheques.

Thus the central bank acts as the custodian of the cash reserves of commercial banks and helps in facilitating their transactions. There are many advantages of keeping the cash reserves of the commercial banks with the central bank,

In the first place, the centralization of cash reserves in the central bank is a source of great strength to the banking system of a country. Secondly, centralized cash reserves can serve as the basis of a large and more elastic credit structure than if the same amount were scattered among the individual banks.

Thirdly, centralized cash reserves can be utilized fully and most effectively during periods of seasonal strains and in financial crises or emergencies. Fourthly, by varying these cash reserves the central bank can control the credit creation by commercial banks. Lastly, the central bank can provide additional funds on a temporary and short term basis to commercial banks to overcome their financial difficulties.

7. CUSTODY AND MANAGEMENT OF FOREIGN EXCHANGE RESERVES:

The central bank keeps and manages the foreign exchange reserves of the country. It is an official reservoir of gold and foreign currencies. It sells gold at fixed prices to the monetary authorities of other countries. It also buys and sells foreign currencies at international prices. Further, it fixes the exchange rates of the domestic currency in terms of foreign currencies.

It holds these rates within narrow limits in keeping with its obligations as a member of the International Monetary Fund and tries to bring stability in foreign exchange rates. Further, it manages exchange control operations by supplying foreign currencies to importers and persons visiting foreign countries on business, studies, etc. in keeping with the rules laid down by the government.

8. Clearing House for Transfer and Settlement:

As bankers' bank, the central bank acts as a clearinghouse for transfer and settlement of mutual claims of commercial banks. Since the central bank holds reserves of commercial banks, it transfers funds from one bank to other banks to facilitate clearing of cheques. This is done by making transfer entries in their accounts on the principle of accounting. To transfer and settle claims of one bank upon others, the central bank operates a separate department in big cities and trade centers. This department is known as the "clearing house" and it renders the service free to commercial banks.

When the central bank acts as a clearing agency, it is timesaving and convenient for the commercial banks to settle their claims at one place. It also economizes the use of money. "It is not only a means of economizing cash and capital but is also a means of testing at any time the degree of liquidity which the community is maintaining."

9. COLLECTION OF DATA

Central banks in almost all the countries collects statistical data regularly relating to economic aspects of money, credit, foreign exchange, banking etc. from time to time, committees and commission are appointed for studying various aspects relating to the aforesaid problem.

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

CHAPTER THREE

COMMERCIAL BANKING

3.1. INTRODUCTION

Banking occupies one of the most important positions in the modern economic world. It is necessary for Trade and industry. Hence it is one of the great agencies of commerce. Although banking in one form or another has been in existence from very early times, modern banking is of recent origin. It is one of the results of the Industrial Revolution and the child of economic necessity. Its presence is very helpful to the economic activity and industrial progress of a country. Commercial banking play a great role for this contribution and this chapter focuses on the issues of commercial banking. Commercial banks gives short term, medium-term and long-term loan to business enterprises.

3.2. MEANING OF COMMERCIAL BANKING

A commercial bank is a profit-seeking business firm, dealing in money and credit. It is a financial institution dealing in money in the sense that it accepts deposits of money from the public to keep them in its custody for safety. So also, it deals in credit, i.e., it creates credit by making advances out of the funds Received as deposits to needy people. It thus, functions as a mobiliser of saving in the economy. A bank is, therefore like a reservoir into which flow the savings, the idle surplus money of households and from which loans are given on interest to businessmen and others who need them for investment or productive uses.

3.3. FUNCTIONS OF COMMERCIAL BANKS

Commercial banks perform a variety of functions which are common to both developed and developing countries. These are known as 'General Banking' functions of the commercial banks. The modern commercial banks perform a variety of functions. These can be broadly divided into two categories: 1. Primary functions and 2.Secondary functions.

1. Primary Functions

Primary banking functions of the commercial banks include:

A. Acceptance of deposits

B. Advancing loans

C. Promote cheques facilities

D. Remittance of funds

A. **Acceptance of Deposits:** Accepting deposits is the primary function of a commercial bank. Banks generally accept three types of deposits (I) Current Deposits (II) Savings Deposits, and (III) Fixed Deposits.

I, Current Deposits: These deposits are also known as demand deposits. These deposits can be withdrawn at any time. Generally, no interest is allowed on current deposits, and in case, the customer is required to leave a minimum balance undrawn with the bank. Cheques are used to withdraw the amount. These deposits are kept by businessmen and industrialists who receive and make large payments through Banks. The bank levies certain incidental charges on the customer for the services rendered by it.

II. Savings ***Deposits:*** This is meant mainly for professional men and middle class people to help them Deposit their small savings. It can be opened without any introduction. Money can be deposited at anytime but the maximum cannot go beyond a certain limit. There is a restriction on the amount that can be withdrawn at a particular time or during a week. If the customer wishes to withdraw more than the specified amount at any one time, he has to give prior notice. Interest is allowed on the credit balance of this account. The rate of interest is less than that on fixed deposit. This system greatly encourages the habit of thrift or savings.

III. Fixed Deposits: These deposits are also known as time deposits. These deposits cannot be withdrawn before the expiry of the period for which they are deposited or without giving a prior notice for Withdrawal. If the depositor is in need of money, he has to borrow on the security of this account and pay a slightly higher rate of interest to the bank. They are attracted by the payment of interest which is usually higher for longer period. Fixed deposits are liked by depositors both for their safety and as well as for their interest.

B. ADVANCING LOANS: The second primary function of a commercial bank is to make loans and advances to all types of persons, particularly to businessmen and entrepreneurs. Loans are made against personal security, gold and silver, stocks of goods and other assets. The most common ways of lending by commercial banks are:

I. overdraft facilities: In this case, the depositor in a current account is allowed to draw over and above his account up to a previously agreed limit. Suppose a businessman has only Birr 30,000/- in his current account in a bank but requires Birr 60,000/- to meet his expenses. He may approach his bank and borrow the additional amount of Birr 30,000/-. The bank allows the customer to overdraw additional money. The bank, however, charges interest only on the amount overdrawn from the account.

II. *Cash Credit*: Under this account, the bank gives loans to the borrowers against certain security. But the entire loan is not given at one particular time, instead the amount is credited into his account in the bank; but under emergency cash will be given. The borrower is required to pay interest only on the used amount. He will be allowed to withdraw small sums of money according to his requirements through cheques, but he cannot exceed the credit limit allowed to him.

III. Discounting Bills of Exchange: This is another type of lending which is very popular with the modern banks. Banks provide short-term finance by discounting bills that is, making payment of the amount before the due date of the bills after deducting a certain rate of discount. The holder of a bill can get it discounted by the bank, when he is in need of money. After deducting its commission, the bank pays the present price of the bill to the holder. Such bills form good investment for a bank. They provide Avery liquid asset which can be quickly turned into cash. The commercial banks can rediscount the discounted bills with the central banks when they are in need of money. These bills are safe and secured bills. When the bill matures the bank can secure its payment from the party which had accepted the bill.

IV. Money at Call: Bank also grant loans for a very short period, generally not exceeding 7 days to the borrowers Against collateral securities like stock or equity shares, debentures, etc., offered by them. Such advances are repayable immediately at short notice hence; they are described as money at call or call money.

V. Term Loans*:* They are loans granted for a fixed period of time. A **term loan** has a set maturity date and usually has a fixed interest rate. It has fixed periodic (Scheduled) payment.

Term loan can be classified as

Short-term loans: A short-term loan is a type of advance offered for duration up to 12 months.
- Intermediate-term loans: Financial institutions generally classify intermediate or mid-term loans as the ones that come usually with a tenor ranging between 1 to 5 years.

- Long-term loans: Available at attractive term loan interest rates; long-term loans come with an extended tenor that can reach up to 25 years.

VI. Consumer Credit: Banks also grant credit to households in a limited amount to buy some durable consumer goods such as television, sets, refrigerators, etc., or to meet some personal needs like payment of hospital bills etc.

3. CREATION OF CREDIT: When a bank grants a loan to its customer, it does not pay cash. It simply credits the account of the borrower. He can withdraw the amount whenever he wants by a cheque. In this case, bank has created a deposit without receiving cash. That is, banks are said to have created credit.

4. **Promote the Use of Cheque:** The commercial banks render an important service by providing to their customers a cheap medium of exchange like cheques. It is found much more convenient to settle debts through cheques rather than through the use of cash. The cheque is the most developed type of credit instrument in the money market.

5. **Remittance of Funds:** Commercial banks, on account of their network of branches throughout the country, also provide facilities to remit funds from one place to another for their customers.

2. Secondary Functions

Secondary banking functions of the commercial banks include:

A. Agency Services
B. General Utility Services

These are discussed below.

A. Agency Services: Banks also perform certain agency functions for and on behalf of their customers. The agency services are of immense value to the people at large. The various agency services rendered by banks are as follows:

(I) Collection and Payment of Credit Instruments: Banks collect and pay various credit instruments like cheques, bills of exchange, promissory notes etc., on behalf of their customers.

(II) Purchase and Sale of Securities: Banks purchase and sell various securities like shares, stocks, bonds, debentures on behalf of their customers.

(III) Collection of Dividends on Shares: Banks collect dividends and interest on shares and debentures of their customers and credit them to their accounts.

(IV) Execution of Standing Orders: Banks execute the standing instructions of their customers for making various periodic payments. They pay subscriptions, rents, insurance premium etc., on behalf of their customers.

B. **General Utility Services:** In addition to agency services, the modern banks provide many general utility services for the community as given.

(I) Locker Facility: Bank provides locker facility to their customers. The customers can keep their valuables, such as gold and silver ornaments, important documents; shares and debentures in these lockers for safe custody.

(II) Traveler's Cheques and Credit Cards: Banks issue traveler's cheques to help their customers to travel without the fear of theft or loss of money. With this facility, the customers need not take the risk of carrying cash with them during their travels.

(III) Letter of Credit: Letters of credit are issued by the banks to their customers certifying their creditworthiness. Letters of credit are very useful in foreign trade.

(IV) Collection of Statistics: Banks collect statistics giving important information relating to trade, commerce, industries, money and banking. They also publish valuable journals and bulletins containing articles on economic and financial matters.

3.4. CREATION OF CREDIT

Credit creation is one of the most important functions of the commercial banks. Like other

Financial institutions, they aim at earning profits. For this purpose they accept deposits and advance loans by keeping small cash in reserve for day-to-day transactions**.** Bank deposits represent an IOU between a commercial bank and their customers, with customers including both individuals and organizations.

•It is an open secret that banks advance a major portion of their deposits to the borrowers and keep smaller part of them for the payment to the customers on demand. Even then the customers of the banks have full confidence that their deposits lying in the banks are quit safe and can be withdrawn on demand. The banks exploit this trust of the customers and expand loans several times than the amount of demand deposits possessed by them. This tendency on the part of the commercial banks to make loans several times of the excess cash reserves kept by the bank is called creation of credit. Credit creation means that on the basis of primary deposits commercial banks make loans and expand the money supply. It results in multiple expansions of banks demand deposits. Credit money represents the total amount of money that is owed to banks by borrowers.

Process of money (credit) creation:

Suppose a man, say **X**, deposits $ 2,000 with a bank and the Legal reserve ratio (LRR) is 10%, which means the bank keeps only the minimum required $200 as cash reserve (LRR). The bank can use the remaining amount $1800 (= 2000 – 200) for giving loan to someone. (Mind, loan is never given in cash but it is red posited in the bank as demand deposit in favor of borrower.) The bank lends $ 1800 to, say, **Y** who is actually not given loan but only demand deposit account is opened in his name and the amount is credited to his account. This is the first round of credit creation. In the form of secondary deposit ($1800), which equals 90% of primary (initial) deposit? Again 10% of Y's deposit (i.e., $180) is kept by the bank as cash reserve (LRR) and the balance $1620 (=1800 – 180) is advanced to, say, **Z**. The bank gets new demand deposit of $1,620. This is second round of credit creation which is 90% of first round of increase of $1800.

The third round of credit creation will be 90% of second round of 1620. This is not the end of story.

The initial deposit at a commercial bank is called a primary deposit. To make a profit for its investors, the bank loans this money out. Derivative or active deposits are created by the bank by opening a deposit account in the name of the person concerned who contacts bank to borrow money.

The process of credit creation goes on continuously till derivative deposit (secondary deposit) becomes zero. In the end, volume of total credit created in this way becomes multiple of initial (primary) deposit. The quantitative outcome is called money multiplier. If the bank succeeds in creating total credit of, says $18000, it means bank has created 9 times of primary (initial) deposit of $ 2000. This is what is meant by credit creation.

In short, money (or credit) creation by commercial banks is determined by (i) amount of initial (primary) deposits and (ii) LRR. The multiple is called credit creation or money multiplier.

Symbolically:

Total Credit creation = Initial deposits x 1/LRR.

Money Multiplier: Money Multiplier or Deposit multiplier measures the amount of money that the Banks are able to create in the form of deposits with every unit of money it keeps as reserves.

It means the multiple by which total deposit increases due to initial (primary) deposit. Money multiplier (or credit multiplier) is the inverse of Legal Reserve Ratio (LRR). If LRR is 10%, i.e., 10/100or 0.1, then money multiplier = 1/0.1 = 10.

Smaller the LRR, larger would be the size of money multiplier credited to his account. He is simply given the cheque book to draw cheques when he needs money. Again, 20% of Sohan’s deposit which is considered a safe limit is kept for him by the bank and the balance Rs 640 (= 80% of 800) is advanced to, say, Mohan. Thus, the process of credit creation goes on continuously and in the end volume of total credit created in this way becomes multiple of initial cash deposit.

The bank is able to lend money and charge interest without parting with cash because the bank loan simply creates a deposit (or credit) for the borrower. If the bank succeeds in creating credit of, say, $15,000, it means that the bank has created credit 15 times of the primary deposit of$1,000. This is what is meant by credit creation.

Similarly, the bank creates credit when it buys securities and pays the seller with its own cheque. The cheque is deposited in some bank and a deposit (credit) is created for the seller of securities. This is also called credit creation. As a result of credit creation, money supply in the economy becomes higher. It is because of this credit creation power of commercial banks (or banking system) that they are called factories of credit or manufacturer of money.

3.5. BALANCE SHEET OF THE BANK

The business of a bank is reflected in its balance sheet and hence its financial position as well. The balance sheet is issued usually at the end of every financial year of the bank.

The balance sheet items of commercial bank is listed & explained as follows:

THE BANK'S LIABILITY ACCOUNTS

Liabilities are those items on account of which the bank is liable to pay others. They denote other's claims on the bank.

Now we have to analyze the various items on the liabilities side.

1. **Deposits:** The deposits of the public like demand deposits, savings deposits and fixed deposits

Constitute an important item on the liabilities side of the balance sheet. The success of any banking business depends to a large extent upon the degree of confidence it can instill in the minds of the depositors. The bank can never afford to forget the claims of the depositors. Hence, the bank should always have enough cash to honor the obligations of the depositors.

2. **Borrowings from Other Banks:** Under this head, the bank shows those loans it has taken from other banks. The bank takes loans from other banks, especially the central bank, in certain extraordinary circumstances.

3. **Bills Payable:** These include the unpaid bank drafts and telegraphic transfers issued by the bank. These drafts and telegraphic transfers are paid to the holders thereof by the bank's branches, agents and correspondents who are reimbursed by the bank.

4. **Acceptances and Endorsements:** This item appears as a contra item on both the sides of the balance sheet. It represents the liability of the bank in respect of bills accepted or endorsed on behalf of its customers and also letters of credit issued and guarantees given on their behalf. For rendering this service, a commission is charged and the customers to whom this service is extended are liable to the bank for full payment of the bills. Hence, this item is shown on both sides of the balance sheet.

5. **Contingent Liabilities:** Contingent liabilities comprise of those liabilities which are not known in advance and are unforeseeable. Every bank makes some provision for contingent liabilities.

6. **Profit and Loss Account:** The profit earned by the bank in the course of the year is shown under this head. Since the profit is payable to the shareholders it represents a liability on the bank.

8. **Bills for Collection:** This item also appears on both the sides of the balance sheet. It consists of drafts and hundies drawn by sellers of goods on their customers and are sent to the bank for collection, against delivery documents like railway receipt, bill of lading, etc., attached thereto. All such bills in hand at the date of the balance sheet are shown on both the sides of the balance sheet because they form an asset of the bank, since the bank will receive payment in due course, it is also a liability because the bank will have to account for them to its customers.

The Bank's Capital Accounts

Bank capital represents the equity or ownership funds of a bank, and it is the account against which bank loans and security losses are charged. The greater the proportion of capital to deposits, the greater the protection to depositors. Banks maintain much lower capital accounts than other businesses. Capital is a more important source of funds for small banks than for large banks.

There are three principal types of capital accounts for a commercial bank.

1. **Capital stock**: represents the direct investments in to the bank

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

3. **Special reserve accounts:** are set up to cover un-anticipated losses on loans and investments.

Reserve accounts involve no transfers of funds or setting aside of cash. They are merely a form of retained earnings designed to reduce tax liabilities and stockholder's claims on current revenues.

The Bank's Asset Accounts

According to Crowther, the assets side of the balance sheet is more complicated and interesting. Assets are the claims of the bank on others. In the distribution of its assets, the bank is governed by certain well defined principles. These principles constitute the principles of the investment policy of the bank or the principles underlying the distribution of the assets of the bank. The most important guiding principles of the distribution of assets of the bank are liquidity, profitability and safety or security. In fact, the various items on the assets side are distributed according to the descending order of liquidity and the ascending order of profitability.

Now, we have to analyze the various items on the assets side.

1. **Cash:** Here we can distinguish cash on hand from cash with central bank and other banks cash on hand refers to cash in the vaults of the bank. It constitutes the most liquid asset which can be immediately used to meet the obligations of the depositors. Cash on hand is called the first line of defense to the bank. In addition to cash on hand, the bank also keeps some money with the central bank or other commercial banks. This represents the second line of defense to the bank.

2. **Money at Call and Short Notice:** Money at call and short notice includes loans to the brokers in the stock market, dealers in the discount market and to other banks. These loans could be quickly converted into cash and without loss, as and when the bank requires. At the same time, this item yields income to the bank. The significance of money at call and short notice is that it is used by the banks to affect desirable adjustments in the balance sheet. This process is called 'Window Dressing'. This item constitutes the 'third line of defense' to the bank.

3. **Bills Discounted:** The commercial banks invest in short term bills consisting of bills of exchange and treasury bills which are self-liquidating in character. These short term bills are highly negotiable and they satisfy the twin objectives of liquidity and profitability. If a commercial bank requires additional funds, it can easily rediscount the bills in the bill market and it can also rediscount the bills with the central bank.

4. **Bills for Collection:** As mentioned earlier, this item appears on both sides of the balance sheet.

5. **Investments:** This item includes the total amount of the profit yielding assets of the bank.The bank invests a part of its funds in government and non-government securities.

6. **Loans and Advances:** Loans and advances constitute the most profitable asset to the bank. The very survival of the bank depends upon the extent of income it can earn by advancing loans. But, this item is the least liquid asset as well. The bank earns quite a sizeable interest from the loans and advances it gives to the private individuals and commercial firms.

7. **Acceptances and Endorsements:** As discussed earlier, this item appears as a contra item on both sides of the balance sheet.

8. **Fixed Assets:** Fixed assets include building, furniture and other property owned by the bank. This item includes the total volume of the movable and immovable property of the bank. Fixed assets are referred to as ‘dead stocks’. The bank generally undervalues this item deliberately in the balance sheet. The intention here is to build up secret reserves which can be used at times of crisis. Balance sheet of a bank acts as a mirror of its policies, operations and achievements. The liabilities indicate the sources of its funds; the assets are the various kinds of debts incurred by a bank to its customers. Thus, the balance sheet is a complete picture of the size and nature of operations of a bank.

CHAPTER FOUR

Bank Customer Relationship

INTRODUCTION

This unit is designed so as to create awareness of the students about banker and customer and the relationship that exists between them.

A ‘‘customer relationship’’ means a continuing relationship between a consumer and a bank under which the bank provides one or more financial products and services to the consumer (primarily for personal, family, or household purposes). This chapter discussed on the bank customer relationships.

What is the meaning of a Customer?

A customer is a person who maintains an account with the bank, without taking into consideration the duration and frequency of operation of his account. To constitute a customer of the bank one should have an account with the bank; one should deal with the bank in its nature of regular banking business and one should deal with the bank without consideration of the duration and frequency of operation of his account

The new concept lays down opening a bank account as a crucial test of banker- customer relationship. Duration of relationship is not given any importance. A person becomes a customer as soon as he opens an account with a bank and the latter undertakes to honor the cheques drawn by the former up to the amount deposited in the account. A single transaction is sufficient to constitute a person a customer of the bank “so far as banking transactions concerned, a customer is a person whose money has been accepted on the footing that the banker will honor up to the amount standing to his credit, irrespective of his connection being of short or long standing. “The dealing with the bank should be in the nature of regular banking business. Thus, to constitute a customer the following essential requisites must be fulfilled: -

1, a bank account must be opened in his name by making necessary deposit of money.

2, the dealing between the banker and the customer must be of the nature of banking business.

Occasionally getting a cheque or enchased, purchasing stamps or depositing valuables for safe custody doesn't constitute a customer. A customer of a bank need not necessarily be a person. A firm, Joint Stock Company, a society or any other legal entity may be a customer of a bank.

What is a Banker?

Banker is simply the one who works in a bank.

THE RELATIONSHIP BETWEEN A BANKER AND A CUSTOMER

The relationship between the bank and customer is very important. Both serve the society to grow and the economy to expand. It is generally studied under the following two categories.

- ✓ General Relationship
- ✓ Special Relationship

General Relationship

A, **Debtor and Creditor:** The general relationship between bank and a customer is that of a debtor and a creditor i.e. borrower and lender. Sir John Paget remarks, "the relation of a banker and a customer is primarily that of debtor and creditor, the respective positions being determined by the existing state of account. Instead of the money being set apart in a safe room, it is replaced by the debt due from the banker. The money deposited with him becomes his property, and is absolutely, at his disposal, and, save as regards the following of the trust funds into his hands, the receipt of money by a banker from or on account of his customer constitutes him merely the debtor of the customer with 'super added' obligation to honour his customer's cheques drawn upon his balance, in so far the same is sufficient and available"

The true relationship between banker and customer is primarily of a debtor and creditor. When customer deposits money with a bank, the bank then is the debtor and the customer is the creditor. The customer expects from the bank that His money will be kept safe by the bank, it will be returned on demand within business hours and the money will be intact and safe and will give return (interest).

B, **Creditor and debtor relationship:** The position is reversed if the customer is advanced loan. In the case of loan, cash credit and overdraft the banker acts as a creditor or banker becomes a creditor and the customer becomes debtor.

4.3.2. Special Relationship

We all know about the general relations that the banks have with their customers. But along with this normal relation the banks have special relation. With special relationship we mean to say that the banks involve-ness with a third party along with the customers. So here are those third party relationship in other words special relationships.

1. **Principal and agent:**

The special relationship between the customer and the banker is that of principal and agent. The customer (principal) deposits checks, drafts, dividends for collection with the bank. He also gives written instructions to the bank to purchase securities, pay insurance premium, installments of loans etc on his behalf. When the bank performs such agency services, he becomes an agent of his customer

2. **PLedger and Pledgee**

Pledge means the delivery of goods as security for payment of a debt or performance of a promise when credit facility is provided by a bank to its customers against collateral security.

The relationship between customer and banker can be that of Pledger and Pledgee. This happens when customer pledges (promises) certain assets or security with the bank in order to get a loan. In this case, the customer becomes the Pledger, and the bank becomes the Pledgee. Under this agreement, the assets or security will remain with the bank until a customer repays the loan.

3. **Bailer and Bailee relationship**

A bailment is the delivery of goods in trust. A bank may accept the valuables of his customer such as jewelry, documents, and securities for safe custody. In such a case the customer is the Bailer and the bank is Bailee. The bank (bailee) charges a very small amount as service charges for safe custody of the valuables from his customer (bailer). This relationship between the bank and the customer as bailee and bailer started from the days of earlier goldsmiths.

4. Trustee and Beneficiary Relationship

Where a banker, pursuant to instructions, express or implied has credited the proceed of a bill or other document entrusted to him for collection, the relationships of debtor and creditor arises from the time of his doing so. Where, however, the banker has suspended his business before receipt of such amount, he holds the money as a trustee for the customer, irrespective of whether or not the latter had an account with him on the date of the receipt of money and whether or not the money has been credited in the account. The banker acts as a trustee for his customers in those cases where

1. He accepts securities and other valuables for safe custody.
2. If money is deposited to the bank with a special instruction to retain it till the customer gives further instruction.
3. When a cheque or bill is deposited with the bank for collection until it is collected and credited to the customer's account In such cases the customer continues to be the owner of the valuables or securities or cheque or bills deposited with the bank and they are not available for distribution among the bank's creditors in the event of bank going into liquidation.

5. Lessee and lessor(licensee and licensor)

When a customer hires a locker in the bank's safe deposit vault, the bank undertakes to take necessary precaution for the safety of the articles in the locker. The relation between the parties is that of a lessor and lessee.

RIGHTS AND OBLIGATIONS OF THE BANKER AND THE CUSTOMER

Rights and duties of the customer towards the banker

The main rights and duties of a customer towards the banker in brief are explained as follows below:-

Rights of a customer:

- ✓ A customer who has deposited money can draw check on his account up to the extent of his credit balance or according to overdrawing limit sanctioned by the bank.

- ✓ A customer has the right to receive statement of accounts from the bank.
- ✓ A customer has the right to sue the bank for compensation of a wrongful dishonor of his check. A cheque is said to be dishonored when the payment is not made.
- ✓ A customer has a right to sue and demand compensation if the bank fails to maintain the secrecy of his account.

Duties of a customer

- ❖ It is the duty of the customer to present checks and other negotiable instruments during the business hour of the bank.
- ❖ The instruments of credit should be presented by the customer with in due time from their dates of issue.
- ❖ A customer must keep the check books issued by the bank in safe custody. In case of theft or loss, it is the duty of the customer to report the matter immediately to the bank.
- ❖ A customer should fill the check with utmost care, if a customer finds any forgery in the amounts of the check issued by him. It should then immediately be reported to the bank.

4.4.2. **Rights and duties of the banker towards the customer**

The main rights and duties of a banker towards the customer in brief are explained as follows below:-

Duties of a banker

1. To honor a customer’s cheque: The banker is bound to honor his customer’s cheques

The bank has the obligation to honour customer’s cheque as and when they are presented. A banker must honour the customer’s cheque drawn on him provided

A. Sufficient funds

B. Correctness of the cheque

C. Proper drawing of the cheque

D. Proper application of funds

E. Proper presentation

F. Reasonable time for collection

A cheque is said to be dishonored when the payment is not made.

Circumstance for dishonour of cheque

1. Insufficiency of funds

2. Notice of the customer's death

3. Notice of the customer's Insolvency

4. Trust accounts

5. Suspicion about the title over the cheque

6. Presentation of a post dated cheque

2. Standing orders: It is the duty of the bank to abide by the standing orders of the customers in making periodical payments on his behalf such as club, library, insurance premium etc. and receive receipts on behalf of customer.
3. Secrecy of the customer's account. When a customer opens an account in a bank, the banker must not give information about the customer's account to others.
4. Obligation to give reasonable notice before closing the customer's accounts
5. The bank owes a contractual duty not to disclose the customer's financial position without his consent. However, the obligation of secrecy is not considered essential on the following occasions.
   - When a banker is required to give evidence in the court.
   - When there is national emergency and disclosure is essential in the public interest.
   - When there are clear proofs of treason to the state
   - When consent is given by the customer to provide information for the preparation of balance sheet.

Rights of a banker:

1. **Right to set off**: It is a right of the banker to adjust his outstanding loans in the name of the customer from his credit balance of any of the accounts he is maintaining with the bank.

   Conditions for exercising right to setoff

   ♦ Two or more account should be in the name of same customer.

   ♦ the amount of debts must be certain

2. Right to charge interest, commission etc:

   A. Rights to charge interest: As a creditor the banker has the implied right to charge interest on the advance granted to the customer.

   B. Right to charge commission: A banker render several services to the customers and they cannot be offered free hence the banker has an implied right to levy certain charges known as commission

3. Right to lien: A banker has the right to retain the property belonging to the customer until the debt due from him has been paid.

   The objectives of the banker lien are to ensure the safety of the banker fund by serving as a protection against the loss that may arise on a loan, overdraft or any other advance to a customer.

   A banker's lien empowers the bank not only to retain the securities but also to sell them without getting any orders from the court so the banker lien is considered as an implied pledge

4. Right to close account: Bankers also enjoy the right to close customers account and discontinue operation. This process terminates the relationship between bank and customer .this is done if continuation of relationship seems unprofitable to the bank.

5. The right to garnishee order:

   This order warms the holder of money of judgment Debtor, noy to make any payment out of it till the court directs. It is an order issued by competent court of low addressed to bankers instructing him to stop or withhold payment of money belonging to the particular person who has committed a default in satisfying the claim of his creditors. Therefore when banks receive such order, the banker has to obey the order fully.

CHAPTER FIVE:

BANKING SERVICES

5.1. INTRODUCTION

Modern banks offer a wide range of financial services, including: Deposit services, Payment and lending services, letter of credit services, foreign exchange service, Investment, pensions and insurance services. Different services which is provided by the banking industry is discussed under this chapter.

5.2. SERVICES PROVIDED BY BANK TO CUSTOMER

5.2.1, DEPOSIT SERVICES

The relationship between a bank and a customer begins when the customer opens an account with the bank. The customer open accounts with a deposit of cash money and that are why, they are also known as deposit account. As we know that it is the most important function of a modern bank to borrow money or to receive deposits from the public. The bulk of the resources of a bank are mobilized by accepting deposits from the public. Banks borrow money from the public by accepting deposits. Different banks for the benefit of different types of people have introduced various deposit schemes. These include: current/demand deposit accounts, savings deposit accounts and time /fixed deposit accounts. The rates of interest offered by different banks under different schemes do not vary much because these are governed by the central bank.

Current Account It is also known as demand deposit account. A businessperson or an organization can open current account with a bank by making an initial deposit, which may vary from bank to bank. There is no upper limit to the amount, which can be deposited in this account. The amount can be withdrawn by drawing cheques on this account. There is no restriction regarding the number of withdrawals and the amount of withdrawal so long as there is sufficient balance in the account. That is why, it is also knows as a running and active account. A customer may be permitted to withdraw more than what he has deposited in his account, if he has entered into an agreement with the bank in this regard. Current account suits the requirements of commercial, industrial and other organizations.

Advantages of Current Deposit Accounts

The customer derives the following advantages from current accounts:-

- It enhances business transaction: - Demand deposits are treated at par (similar) with cash. They constitute cheque currency. Cheques are readily accepted in business for making and receiving payments.
- It decreases circulation of legal tender money. This decreases the printing cost of currencies.
- It minimizes the risk and inconveniencies of carrying of huge money. Businesspersons have to receive and make a large number of payments every day. It is difficult to handle cash. The cheque facility removes this difficulty i.e. you can issue a cheque with single leaf having huge value
- It facilitates Payment. There is no restriction on the number of cheques or on the amount to be drawn at a time by on cheque.
- It strengthens the credit system: - Cheques save the use of legal tender money, which in turn save the reserve of the bank. As the reserve at the bank increases, its credit creation power also increases. It also helps to multiply derivative deposits without affecting each bank‟s reserves.
- It Facilitates Overdraft Loans. The banks allow overdraft facilities to the current account holders.

Savings Deposit Account

Savings deposit account is meant for small businesspersons and individuals who wish to save a little money out of their current incomes to safeguard their future and also to earn some interest on their savings. A savings account can be opened with a small sum and small amounts can be withdrawn. There are restrictions on the maximum amount that can be deposited in this account and also on the withdrawal from this account. The bank may not permit more than one or two Withdrawals during a week and may lay down a limit on the amount that can be withdrawn at one time. This is always described on the inside part of the outer part of the passbook. Savings account holders are allowed to deposit cheques, drafts, dividend warrants, etc., which stand in their name only. However, the bank does not accept cheques or instruments payable to third party for deposit in the saving deposit account. Banks allow interest on deposits maintained in savings account according to the rates prescribed by the National Bank.

Savings deposit account is very popular among the general public because of the following advantages:

- ❖ A savings deposit account can be opened with little sum of money: It helps the people of small means to save for their future
- ❖ The balance lying in the savings account earns some interest: The customer is benefited as his money grows with the bank.
- ❖ The money lying with the bank is quite safe. There is no fear of theft.
- ❖ The money can be withdrawn concurrently from the saving account.
- ❖ The customer may get the cheque book facility in order to facilitate payment to third parties by issuing cheques.

Fixed Deposit Accounts

The term ' Fixed deposit' means the deposit repayable only after the expiry of a specified period, which ordinarily varies from fifteen days to five years. Since it is to be repayable only after a fixed period of time, which is to be determined at the time of opening the account, it is also known as time deposit. Deposit: -People, who can afford to keep their money with banks for a certain period without withdrawing it, meanwhile go in for fixed deposits. Fixed deposits are the most suitable form of raising resources for a commercial bank. Since they are repayable only after a fixed period of time, the bank need not keep cash reserves more than the statutory requirement against these liabilities. It may employ these funds more profitably by lending at higher rates of interest and for relatively longer periods. It is because of this reason that banks offer higher rates of interest on such deposits.

The rate of interest on fixed deposits depends upon the length of the time of the deposit and the amount of deposit. The longer the period, the higher is the rate of interest offered and vice versa.

Advantages of fixed or term deposits

- ✓ The rate of interest on fixed deposits is higher than that allowed on savings deposit account.
- ✓ It enables to depositors to get loans from the bank up to 90% of the fixed deposit
- ✓ Even though, it is not withdrawn on demand, depositors are allowed to enact their deposit receipts before maturity by forfeiting a part of the interest accrued on the deposit, with the agreement of the bank.

5.2.2. LENDING/ADVANCE&LOAN)SERVICES

Lending money is one of the primary functions of the bank. Every business is run with an objective of earning profits. Even the banks are profit oriented and they also invest their funds to earn profits. Advances are credit provided by banks to their customers, traders, businessmen and industrialists against security of assets or on the basis of personal security of the borrower.

CLASSIFICATIONS OF LENDING/ADVANCES

A. Based on Nature of Loan

Banks grant loans for different periods- term for different purposes. According to their nature banks Loan and Advances can be divided into following categories

1. Short-Term Loans: Short term loans are granted by banks to meet the working capital needs of business. The working capital needs refer to financial needs for such purposes as, purchase of raw materials, payment of wages, electricity bill, taxes etc. Such loans are granted by banks to its borrowers to be repaid within a short period of time not exceeding 12 months. Short term loans are normally granted against the security of tangible assets like goods in stock, shares, debentures, etc.
2. Long Term Loans: These loans are granted for more than5years but not more than 15 year
3. Medium term loans: In case of medium term loan, the period ranges from 12 months to less than 5 years. These loans are generally granted for repairs, expansion of existing units, modernization/renovation etc. Such loans are sanctioned against the security of immovable assets.

B. Based on security

On the basis of personal security of the borrower, advances can be broadly classified into two heads.

1. Unsecured Advances: According to Banking regulations "Unsecured Advances or loans means a loan or advances not secured" In such kind of advances the customer is not required to offer bank any tangible security. These kind of advances are given to those customers who have sound financial backing, high business reputation and capacity to manage business, because general capacity of such customers act as a security itself for the bank.

2. Secured Advances: Secured advances are those which can be taken against certain security of tangible assets like land, building etc. According to banking regulation, Secured loan or advances 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 loans or advances".

This definition highlights two essential features of secured advances

 Advances must be made against tangible security.

 Market value of security must not be less than the amount of loan granted.

Types of Securities: there are two types of security

1. **Primary Security**: Asset which has been bought with the help of bank finance.
2. **Collateral Securities:** In narrow sense collateral securities can be said as securities deposited by third party to secure advance for the borrower and in wider sense – any type of security on which the creditor has a personal right of action on debtor in respect of advance.

PRINCIPLES OF LENDING

Banks should follow some basic principles at the time of lending. This ensures efficient and long term working of the banks. Some of the basic principles of lending are as follows

1. Safety: The most important rule for granting/lending loans is the safety of funds. This is so because the banks earn income through these loans and advances. In case the bank does not get back the loans granted by it, it might fail. A bank cannot and must not sacrifice the safety of its funds to get higher rate of interest. Banks must ensure the creditworthiness of the borrower before lending.

2. Liquidity: The second important principle of granting loan is liquidity. Liquidity means possibility of converting loans into cash without loss of time and money. Funds with the bank out of which he lends money are payable on demand or short notice. As such a bank cannot afford to block its funds for a long time. Hence the bank should lend only for short-term requirements like working capital. The bank cannot and should not lend for long-term requirements.

3. Return or Profitability: Return or profitability is another important principle. The funds of the bank should be invested to earn highest return, so that it may pay a reasonable rate of interest to its customers on their deposits, reasonably good salaries to its employees and a good return to its shareholders. However, a bank should not sacrifice either safety or liquidity to earn a high rate of interest.

4. Diversification: One should not put all his eggs in one basket‟ is an old proverb which very clearly explains this principle. Abank should not invest all its funds in one industry. In case that industry fails, the banker will not be able to recover his loans. Hence, the bank may also fail. According to the principle of diversification, the bank should diversify its investments in

Different industries and should give loans to different borrowers in one industry. It is less probable that all the borrowers and industries will fail at one and the same time.

5. Object of Loan (Purpose): A banker should thoroughly examine the object for which his client is taking loans. This will enable the bank to assess the safety and liquidity of its investment. A banker should not grant loan for unproductive purposes.

6. Security: A banker should grant secured loans only. In case the borrower fails to return the loan, the banker may recover his loan after realizing from the sale of security. In case of unsecured loans, the chances of bad debts will be very high. Security conditions are different in different banks.

7. Margin Money: In case of secured loans, the bank should carefully examine and value the security. There should be sufficient margin between the amount of loan and the value of the security. If adequate margin is not maintained, the loan might become unsecured in case the borrower fails to pay the interest and return the loan. The amount of loan should not exceed 60 to 70% of the value of the security. If the value of the security is falling, the bank should demand further security without delay. In case he fails to do so, the loan might become unsecured and the bank may have to suffer loss on account of bad debt.

8. Character of the Borrower: Last but not the least; the bank should carefully examine the character of the borrower. Character implies honesty and capacity of the borrower to return the loan. In case he fails to verify the character of the borrower, the loans and advances might become bad debts for the bank.

9. **Public interest**: The banker should grant advances to those industries which require development in the countries planning program.

5.2.3. PAYMENT SERVICES

An important service offered by banks is that they offer facilities that enable customers to make payments. A payment system can be defined as any organized arrangement for transferring value between its participants. Heffernan (2005) defines the payment systems as a by-product of the intermediation process, as it facilitates the transfer of ownership of claims in the financial sector. These payment flows reflect a variety of transactions: for goods and services as well as financial assets. Some of these transactions involve high-value transfers, typically between financial institutions. However, the highest number of transactions relates to transfers between individuals and/or companies. If any of these circulation systems failed, the functioning of large and important parts of the economy would be affected. Banks play a major role in the provision of payment services. For personal customers the main types of payments are made by writing cheques from their current accounts. Note that the importance of different types of cashless payments varies from country to country is discussed as follows:

A. **Cheques:** are widely used as a means of payment for goods and services. If individual A buys goods and gives a cheque to individual B, it is up to B to pay the cheque into their own bank account. Individual B‟s bank then initiates the request to debit individual A‟s account. Individual A‟s bank authorizes (clears) the cheque and a transfer of assets (settlement) then takes place. Cheque payments are known as debit transfers because they are written requests to debit the payee’s account.

B**. Credit transfers**: are payments where the customer instructs their bank to transfer funds directly to the beneficiary's bank account. Consumers use bank credit transfer payments to pay invoices or to send payment in advance for products ordered.

C. **Standing orders**: are instructions from the customer (account holder) to the bank to pay a fixed amount at regular intervals into the account of another individual or company. The bank has the responsibility for remembering to make these payments. Only the account holder can change the standing order instructions.

5.2. 4. LETTERS OF CREDIT SERVICES

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 4 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 AtoZeberga, 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 advice Mr. Maldini to deliver goods according to the agreement with AtoZeberga. 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, AtoZeberga is the customer, Commercial Bank of Ethiopia is the issuing bank, Bank of Italy is the advisory bankor payee bank and Mr. Madini is the seller or creditor or beneficiary in the instrument.

Types of letters of credit

A. revocable and irrevocable: A revocable letter of credit can be changed or cancelled by the bank that issued it at any time and for any reason. An irrevocable letter of credit cannot be changed or cancelled unless everyone involved agrees. Irrevocable letters of credit provide more security than revocable ones.

B. Confirmed and Unconfirmed Letters of Credit: When a buyer arranges a letter of credit they usually do so with their own bank, known as the issuing bank. The seller will usually want a bank in their country to check that the letter of credit is valid. For extra security, the seller may require the letter of credit to be confirmed" by the bank that checks it. By confirming the letter of credit, the second bank agrees to guarantee payment even if the issuing bank fails to make it. So a confirmed letter of credit provides more security than an unconfirmed one. this is called **confirmed letter of credit**.

If the letter of credit reaches to beneficiary with only issuing bank payment undertaking, without any confirmation added by another bank, then the credit becomes **unconfirmed letter of credit.**

C. Transferable Letter of Credit is a credit facility in which the first beneficiary has the right to pass on the available credit to another party i.e. secondary beneficiary. This is possible only when the Letter of Credit is marked as transferable by the issuing bank upon the instructions of the buyer or the importer of goods.

D. A standby letter of credit (SLOC) is a legal document that guarantees a bank's commitment of payment to a seller in the event that the buyer–or the bank's client–defaults on the agreement

An exporter sells goods to a foreign buyer, who promises to pay within 60 days. If the payment never arrives, the exporter can collect payment from the foreign buyer's bank per the terms of the SBLC

E. Revolving Letters of Credit: Single L/C that covers multiple-shipments over a long period of time, Instead of arranging a new L/C for each separate shipment.

A single revolving letter of credit can cover several transactions between the same buyer and seller. This letter of credit is issued only once for a certain period of time or a certain number of transactions.

5.2.5. INVESTMENT, PENSIONS AND INSURANCE SERVICES

● Investment products offered to retail customers include various securities-related products including mutual funds (known as unit trusts in the UK), investment in company stocks and various other securities-related products (such as savings bonds). In reality there is a strong overlap between savings and investments products and many banks advertise these services together.

● Pensions and insurance services are nowadays widely offered by many banks. Pension services provide retirement income (in the form of annuities) to those contributing to pension plans. Contributions paid into the pension fund are invested in long-term investments with the individual making contributions receiving a pension on retirement. The pension services offered via banks are known as private pensions to distinguish them from public pensions offered by the state. Usually there is tax advantages associated with pensions contributions as most governments wish to encourage individuals to save for their retirement. Insurance products protect individuals (policyholders) from various adverse events. Policyholders pay regular premiums and the insurer promises compensation if the specific insured event occurs. There are two main types of insurance – life insurance and general (or property and casualty) insurance. The latter is insurance that does not involve death as the main risk. It includes home, travel, medical, auto and various other types of insurance. Banks offer both life and non-life insurance products with the latter mainly being travel, property, mortgage repayment and other types of protection. In the UK, there has also been substantial growth in income protection insurance (insurance that replaces earnings if individuals are unable to work) and critical illness insurance (that covers medical costs and/or income).

5.2.6. FOREIGN EXCHANGE SERVICES

These banks finance mostly to the foreign trade of a country. Their main function is to discount, accept and collect foreign bills of exchange. They also buy and self-foreign currencies and help businessmen to convert their money into any foreign currency they need.

CHAPTER 6

DEVELOPMENT BANK, INVESTMENT BANK and CO-OPERATIVE BANKING

6.1 DEVELOPMENT BANKING AND ITS FUNCTIONS

There is no precise definition of development bank; William diamond and Shirley bosky consider industrial finance and development corporations and '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.

6.1.1 Features of development bank

Following are the main characteristics features of a development bank:

i. It is a specialized financial institution.
ii. It provides medium and long-term finance to business units.
iii. Unlike commercial banks, it does not accept deposits from the public.
iv. It is not just a term – lending institution. It is a multi-purpose financial institution.
v. It is essentially a development – oriented bank. Its primary objective is to promote economic development by promoting investment and entrepreneurial activities in a developing economy. It encourages new and small entrepreneurs and seeks balanced regional growth.
vi. It provides financial assistance not only to the private sector but also to the public sector undertakings.
vii. It aims at promoting the saving and investment habit in the community.

viii. It does not compete with the normal channels of finance, i.e. finance already made available by the banks and other conventional financial institutions. Its major role is of a gap-filler, i.e. to fill up the deficiencies of the existing financial facilities.

ix. Its motive is to serve public interest rather than to make profit. It works in the general interest of the nation.

Discussing what all about development banks, let us see the brief history and objectives and duties of development bank of Ethiopia (DBE) with regard to its establishment under the Ethiopian law.

B) BRIEF HISTORY OF THE DEVELOPMENT BANK OF ETHIOPIA (DBE)

The agricultural and industrial development bank, which was established as a 100 percent state owned share company in November 1970, taking over the activities of the former development bank of Ethiopia and the Ethiopia investment corporation, was brought under the umbrella of the development bank of Ethiopia by proclamation no. 99 of 1976. It had six branches and a capital of Birr 100,000,000. – (One hundred million) fully paid up. It was and still is entirely owned by the state. It has been reorganized and re-established by proclamation no. 158 of March 1979 as a "Public Finance Agency" possessing judicial personality, with the following objectives.

1. To extend loans to specified agricultural and industrial sectors as well as to other sectors of the national economy in pursuit of the nation's economic and social objectives so as accelerate the economic development of the country, and
2. To attract funds from national or international sources whether private or public.
3. Moreover, inconformity with the directives of the supervising authority, the bank shall have the following powers and duties in order to fulfill its objectives:
   i. Extend medium and long-term loans to viable development projects in the agricultural and industrial sectors of the national economy;
   ii. Extend, short-term agricultural sectors of the national economy;
   iii. Grant credits to other sectors of the national economy;
   iv. Upon charging appropriate fees manage funds entrusted to it by entrusting agencies without being liable to the failure or non-repayment of such funds;
   v. Act as a guarantor to viable agricultural and industrial development projects;

vi. Make the necessary effort to ensure the application of appropriate technology and managerial techniques by all projects financing by the bank;
vii. Participate with development agencies in project identification and promotional activities to ensure the efficient use of financial resources;
viii. Take part in or provide support to any program, or organization, whose purpose is to provide services to expedite the flow of technical, managerial, and financial knowledge and innovation in support of which the bank shall, as appropriate, engage its own staff and consultants and co-operate with other institutions having similar responsibilities;
ix. Participate in equity investments;
x. Borrow money from within or outside Ethiopia;
xi. Draw, accept, discount, buy and sell bills of exchange, draft and promissory notes payable within or outside Ethiopia and deal in treasury bills and government bonds;
xii. Open and operate bank accounts with banks and banking correspondents in Ethiopia and abroad;
xiii. Purchase, hold, sell, lease, mortgage or pledge property in accordance with the law;
xiv. Sue and be sued;
xv. Enter into contract;

Engage in all other transactions and operations that are incidental to or necessary for.

INVESTMENT bank

• Investment banking firms act as underwriters or agents for companies issuing securities, and advise the company on the issuance and placement of its stock.

• An investment bank is a financial institution that assists corporations and governments in raising capital by underwriting and acting as the agent in the issuance of securities. An investment bank also assists companies involved in mergers and acquisitions, derivatives, etc

Investment banking is a very vast area in the field of banking and finance. Investment banking includes a wide variety of activities, including underwriting, selling, and trading securities, providing financial advisory services, and managing assets

Investment banks cater to a diverse group of stakeholders, companies, governments, non-profit institutions, and individuals and help them raise funds on the capital market. Investment banking is a specific division of banking related to the creation of capital for other companies. There are a number of investment banks that also provide highly professional services in assisting their clients with industrial know-how on various parameters. An investment bank is like a middleman between investor and issuer and helps their client to raise money through debt and equity offering. Investment banks do not hold retail deposits and their liabilities are mainly securities and short-term wholesale financing.

The main role of investment banks is to help companies and governments raise funds in the capital market either through the issue of stock (otherwise referred to as equity or shares) or debt (bonds).

Their main business relates to issuing new debt and equity that they arrange on behalf of clients as well as providing corporate advisory services on mergers and acquisitions (M&As) and other types of corporate restructuring.

Typically their activities cover the following areas:

- underwriting of securities issues (guaranteeing a price that the new equity or bond issue will sell for);
- financial advisory specially on Mergers &Acquisitions
- Serve as agent of clients or trading and investing in securities on behalf of the bank or for clients
- Intermediary between issuer and investor.

This activity can include trading and investments in a wide range of financial instruments including bonds, equities and derivatives products;

- Provides Asset management service Like

– managing wholesale investments (such as pension funds for corporate clients) as well as

- providing investment advisory services to wealthy individuals (private banking) and institutions;

- Other securities services – brokerage, financing services and securities lending.

COOPERATIVE BANKING AND ITS FUNCTIONS

What is cooperative Bank?

It is a bank that holds deposits, makes loans and provides other financial services to cooperatives and member-owned organizations. It also known as Banks for Cooperatives.

According to the International **Co-operative Alliance Statement** of co-operative identity, a co-operative 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. Co-operatives are based on the values of self-help, self-responsibility, democracy, equality, equity and solidarity. In the tradition of their founders, co-operative members believe in the ethical values of honesty, openness, social responsibility and caring for

A **co-operative bank** is a financial entity which belongs to its members, who are at the same time the owners and the customers of their bank. Co-operative banks are often created by persons belonging to the same local or professional community or sharing a common interest. Co-operative banks generally provide their members with a wide range of banking and financial services (loans, deposits, banking accounts...).

Co-operative banks differ from stockholder banks by their organization, their goals, their values and their governance. In most countries, they are supervised and controlled by banking authorities and have to respect prudential banking regulations, which put them at a level playing field with stockholder banks. Depending on countries, this control and supervision can be implemented directly by state entities or delegated to a co-operative federation or central body.

Co-operative banks are deeply rooted inside local areas and communities. They are involved in local development and contribute to the sustainable development of their communities, as their members and management board usually belong to the communities in which they exercise their activities by increasing banking access in areas or markets where other banks are less present

- Provided financial assistance mainly to Economical weaker section of the society such as SMEs, farmers in rural areas, middle or low income households in urban areas

- Co-operative banks reduce banking exclusion and foster the economic ability of millions of people. They play an influential role on the economic growth in the countries in which they work in and increase the efficiency of the international financial system. Their specific form of enterprise, relying on the above-mentioned principles of organization, has proven successful both in developed and developing countries. The primary objective of cooperative bank is to maximize the welfare of its member community by helping them to meet their various needs and aspirations Even if their organizational rules can vary according to their respective national legislations, co-operative banks share common features:

- **Customer's owned entities**: in a co-operative bank, the needs of the customers meet the needs of the owners, as co-operative bank members are both. As a consequence, the first aim of a co-operative bank is not to maximize profit but to provide the best possible products and services to its members. Some co-operative banks only operate with their members but most of them also admit non-member clients to benefit from their banking and financial services.
- **Democratic member control**: co-operative banks are owned and controlled by their members, who democratically elect the board of directors. Members usually have equal voting rights, according to the co-operative principle of "one person, one vote".
- **Profit allocation**: in a co-operative bank, a significant part of the yearly profit, benefits or surplus is usually allocated to constitute reserves. A part of this profit can also be distributed to the co-operative members, with legal or statutory limitations in most cases. Profit is usually allocated to members either through a patronage dividend, which is related to the use of the cooperative's products and services by each member, or through an interest or a dividend, which is related to the number of shares subscribed by each member.

EXERCISES

MULTIPLE CHOICES

1. which of the following Account permits the collection and payment of interest

A, current account

B, Islamic Sharia law

C, saving account

D, all of the above

2. ____is an agreement with the bank by which a current account holder is allowed to withdraw over and above the amount in his account.

A. Term loan

B. Cash credit

C. Overdraft

D, none of the above

3. Commercial bank is a financial institution dealing in money means

A. it accepts deposits of money from the public to keep them in its custody
B. it accept valuable for safety custody
C. it create credit by making advance out of the fund received as deposit
D. all

4. Which one of the following is not the primary function of commercial banks?

A. Acceptance of deposits
B. Advancing loans
C. Remittance of funds
D. None

5. What kind of deposit that commercial bank accepts

A. current deposit
B. fixed deposit

C. saving deposit

D. All

6. Which one of the following is/are the way of advancing loan?

A. Overdraft Facilities

B. Cash Credit

C. Discounting Bills of Exchange

D. Term Loans:

7. Which one of the following is/ are not part of banks asset account

A. cash

B. loan and advance

C. fixed asset

D. deposit

E. capital stock

F. D&E

8. A banks liability account excludes

A. Deposits

B. Bills Discounted

C. Bills Payable

D. Bills for Collection

E. B&C

F. C&D

9. The main rights and duties of a banker towards the customer include

A. To honor a customer's check

B. Standing orders

C. To charge interest and commission

D. Secrecy of the customer's account

E. All except 'C'

F. All

10. True statement about the Feature of the current account is

A. The amount deposited in these accounts is repayable on demand without any restriction

B. Most of the banks charge incidental charges on such account

C. It is non-interest bearing account to the public

D. all

11. an advantage customer derives from Savings deposit accounts is

A. Money can be withdrawn concurrently

B. Enhances business transaction

C. Enables to depositors to get loans

D. Strengthens the credit system

12. Which of the following are(is) not role of banking

A. Create goods and services

B. Lending money for consumers only

C. facilitates business transactions

D. All of the above

13. How many parties may have participate in Letter of credit

A. 4 parties

B. 3 parties

C. 5 parties

D. 2 parties

14. Which one of the following is not a criterion to be customer of a bank?

A. A bank account must be opened in his name by making necessary deposit of money.

B. The dealing between the banker and the customer must be of the nature of banking

C. The customer must depositing valuables for safe custody

D. all

E. E .all except C

15. _____________is a financial entity which belongs to its members, who are at the same time the owners and the customers of their bank

A. Cooperative bank.

B. Central bank.

C. Commercial bank.

16. Primary banking functions of the commercial banks exclude

A. Remittance of funds

B. Agency Services

C. Creation of credit

D. Promote cheques facilities

E. All

17. When customer pledges (promises) certain assets or security with the bank in order to get loan what type of relationship exist between the customer and bank respectively.

A. Pledger and Pledgee

B. Pledgee and Pledger

C. All

D. None

18. ____________is the delivery of goods in trust.

A. A bailment
B. Bailer
C. Bailee
D. B and C

19. Which one of the following is /are the commonfeature co-operative banks.

A. Profit allocation
B. Democratic member control
C. Customer's owned entities
D. All

Ato Abebe wants to import goods on credit from an Italian exporter known as **Malana**. Now Mr. **Malana** prefers the credit to be guaranteed by a known bank in Ethiopia. Here Commercial Bank of Ethiopia, who is the banker to Ato Abebe, 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 bank will advise Mr. **Malana** to deliver goods according to the agreement with Ato Abebe. 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. **Malana** 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.
Based on the above paragraph Answer questions 19 &20

20. Commercial bank of Ethiopia is__________

A. Issuing bank
B. Advisory bank
C. Customer
D. Payee bank

21. Mr. **Malana** and Abebe ______________and_________respectively

A. Seller or beneficiary and Buyer or customer
B. Buyer or customer and Seller or beneficiary
C. Both are seller

D. None of the above

22. Which one of the following is/are the way of advancing loan?

A. OVERDRAFT Facilities

B. Cash Credit

C. Discounting Bills of Exchange

B. Term Loan

23. Which one of the following is/are not the main right of customers on bank?

A. Customer who has deposited money can draw check on his account up to the extent of his credit balance or according to overdrawing limit sanctioned by the bank.

B. .A customer has the right to receive statement of accounts from the bank.

C. A customer has a right to sue and demand compensation if the bank fails to maintain the secrecy of his account.

D. The instruments of credit should be presented by the customer with in due time from their dates of issue.

24. Which one of the following is not true about the advantages of the note issue by central bank.

A. People have more confidence in the currency issued by the central bank.

B. It brings uniformity in the currency system of the country.

C. Monetary management of the paper currency becomes difficult.

D. none.

25. **__________**is the process of controlling the supply of money

A. monitory instrument

B. monitory policy

C. fiscal policy

D. A&B

25. Which one of the following is the objective of monetary policy?

A. price stability C. high employment

B. economic growth D. all

27. _________is 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

A. commercial bank

B. central bank

C. development bank

D. all

28. A type of bank situated in the exporter's country which guarantees the credit on the request of the issuing Bank refers to:

A. Paying Bank
B. Confirming Bank
C. Negotiating Bank
D. Issuing
E. None of the above

TRUE OR FALSE QUESTIONS

1. The agriculture bank provides Short-term credit to purchase land, to make permanent improvements on land.

2. The main documentary instrument in foreign trade is the letter of credit (LC).

3. Islamic Sharia law permits the collection and payment of interest.

4. Money cannot be transferred from one place to another through bank transfers.

5. Clearing house keeps the central bank fully informed about the liquidity position of the commercial banks.

6. Safe deposit box vault are made available by the bank only to fixed deposit holder.

7. Liabilities are those items on account of which the bank is claim on others.

3. Profit and Loss Account reported under balance sheet represents liability on the bank.

8. Current deposits cannot be withdrawn before the expiry of the period for which they are deposited or without giving a prior notice.

9. Term Loans are loans granted for a fixed period of time

10. A bank has the right to retain the property belonging to the customer until the debt due from him has been paid.

11. Co-operative banks are often created by persons belonging to the different local

12. co-operative banks are owned and controlled by their members, who democratically elect the board of directors
13. Fixed deposit can be withdrawn before the expiry of the period for which they are deposited or without giving a prior notice.
14. In letter of credit The customer may be the debtor or the one who buy on credit
15. Retained earnings is portion of the bank's profit that is paid out to shareholders as dividends
16. The banks allow overdraft facilities to the Savings deposit account holders
17. The instruments of credit should be presented by the customer with in due time from their dates of issue.
18. The special relationship between bank and a customer is that of a debtor and a creditor.

The rate of interest on fixed deposits is higher than that allowed on savings deposit account

DISCUSSION QUESTIONS

1. Describe briefly the various ways of acceptance of deposits by Banks.
2. List the main functions of bank
3. List the main functions of a central bank
4. What is the difference between Bank and Banking?
5. Classify of bank based on different criteria
6. Explain the difference between central bank and commercial bank
7. What is the difference between commercial bank and commercial bank?
8. What do you mean by discounting of bills by bank?

ASSIGNMENTS

Based on the questions given prepare report about the titles below from No 1 to No 6

1. **Central bank**

♦What is central bank?

♦ what is the main Objective

♦What are the main functions of central Bank of Ethiopia?

♦Who are the owners and customers?

2. **Commercial bank**

♦What is Commercial Banks?

♦What is main objective

♦ who are the owners and customers of the bank?

♦What are the main functions of Commercial Banks of Ethiopia?

3. **Development bank**

♦What is Development bank?

♦ what is the main objective?

♦Who are the owners and customers?

♦what are the main functions of Development bank of Ethiopia?

4. **Cooperative bank**

♦What is cooperative bank?

♦What is the mail objective of cooperative bank ?

♦what are the functions of cooperative and its practice in Ethiopia?

♦ Who are the owners and customers ?

5. **Investment bank**

♦What is investment bank

♦What are the main objectives of investment bank?

♦What is function of investment bank and its practice in Ethiopia

♦Who are the owners and customers?

6. Foreign bank

♦What is foreign bank?

♦ What is its function?

♦What is its main objective?

♦ is there foreign bank in Ethiopia? If so explain it