**Chapter One**

**Introduction**

Learning Objectives: After studying this lesson, students will be able to:

* Define a bank;
* Describe the functions of commercial banks;
* Identify the organization /structure of banking;
* Define customers; and
* Explain the relationship between a banker and customer;
  1. **Definition, Function, Types and Organization of Banks**

**1.1.1Definition of Banking Business**

As Per Proclamation No.592/2008, Banking Business Proclamation **“**banking business” is defined as business that consists of the following activities:

1. Receiving funds from the public through means that the National Bank has declared to be an authorized manner of receiving funds;
2. using the funds referred in whole or in part, for the account and at the risk of the person undertaking banking business, for loans or investments in a manner acceptable by the National Bank;
3. the buying and selling of gold and silver bullion and foreign exchange;
4. the transfer of funds to other local and foreign persons on behalf of the banks themselves or their customers;
5. the discounting and negotiation of promissory notes, drafts, bills of exchange and other evidence of debt;
6. Any other activity recognized as customary banking business

**What is the meaning of Banker?**

A banker is a dealer in capital or more properly a dealer in money. It is an intermediate party between the borrower and the lender. It borrows from one party and lends to another.

Banking has been defined as “Accepting for the purpose of lending or investment of deposits of money from the public, repayable on demand or withdrawals by check, draft, and order.

**1.1.2 Characteristics of Banking Business**

1. Run for Profit

Banks operate with the objective of making profit. Their fee structure and interest is designed with the intention of making money for owners and shareholders. Banks make money by charging clients who use their services and borrow their funds.

1. Privately owned

Banks are owned by private individuals or collection of private individuals acting as shareholders.

1. Primarily interested in working with Businesses

Banks sometimes offer products and services to individuals but their primary interest is in working with businesses. Banking services offered to individuals are sometimes called as ‘retail banking’, because they are often small scale transactions. Business accounts tend to involve larger sums of money a nd the fees and profits that banks reap from them tend to be greater.

**Functions of Commercial Banks**

Commercial banks have to 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 banks perform a variety of functions. These can be broadly divided into two categories: (a) Primary functions and (b) Secondary functions.

***A. Primary Functions***

1. **Acceptance of Deposits:** Accepting deposits is the primary function of a commercial bank; mobilize savings of the household sector. Banks generally accept four types of deposits viz., (a) Current Deposits (b) Savings Deposits, (c) Fixed Deposits, and (d) special demand deposit account

2. **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 way of lending is by:

(a) *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 br. 30,000 in his current account in a bank but requires br. 60,000 to meet his expenses. He may approach his bank and borrow the additional amount of br. 30,000/-. The bank allows the customer to overdraw his account through cheques. The bank, however, charges interest only on the amount overdrawn from the account.

(b) ***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. The borrower is required to pay interest only on the amount of credit availed to him.

(c) ***Discounting Bills of Exchange****:* This is another type of lending which is very popular with the modern banks. 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 a very 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.

(d) ***Money at Call:***Bank also grants loans for a very short period, generally not exceeding 7 days to the borrowers. Such advances are repayable immediately at short notice hence; they are described as money at call or call money.

(e) ***Term Loans:***Banks give term loans to traders, industrialists and now to agriculturists also against some collateral securities. Term loans are so-called because their maturity period varies between 1 to 10 years. Term loans; as such provide intermediate or working capital funds to the borrowers.

(f) ***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. Such consumer credit is made in a lump sum and is repayable in installments in a short time.

3. **Creation of Credit:** A unique function of the bank is to create credit. Banks supply money to traders and manufacturers. They also create or manufacture money.

4. **Financing Internal and Foreign Trade:** The bank finances internal and foreign trade through discounting of exchange bills. Sometimes, the bank gives short-term loans to traders on the security of commercial papers. This discounting business greatly facilitates the movement of internal and external trade.

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 by issuing bank drafts, mail transfers or telegraphic transfers on nominal commission charges.

***B. Secondary Functions***

1. **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:

(a) *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.

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

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

(d) *Income-tax Consultancy:* Banks may also employ income tax experts to prepare income tax returns for their customers and to help them to get refund of income tax.

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

(a) *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.

(b) *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.

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

(d) *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.

(e) *Underwriting Securities:* Banks underwrite the shares and debentures issued by the Government, public or private companies.

**Types of Banks**

Broadly speaking, banks can be classified into commercial banks and central bank.

Commercial banks are those which provide banking services for profit. The central bank has the function of controlling commercial banks and various other economic activities. There are many types of commercial banks such as deposit banks, industrial banks, savings banks, agricultural banks, exchange banks, and miscellaneous banks.

1. **Deposit Banks:** The most important type of deposit banks is the commercial banks.

They have connection with the commercial class of people. These banks accept deposits from the public and lend them to needy parties. Since their deposits are for short period only, these banks extend loans only for a short period. Ordinarily these banks lend money for a period between 3 to 6 months. They do not like to lend money for long periods or to invest their funds in any way in long term securities.

2. **Industrial Banks:** Industries require a huge capital for a long period to buy machinery and equipment. Industrial banks help such industrialists. They provide long term loans to industries. Besides, they buy shares and debentures of companies, and enable them to have fixed capital. Sometimes, they even underwrite the debentures and shares of big industrial concerns. The important functions of industrial banks are:

1. They accept long term deposits.

2. They meet the credit requirements of industries by extending long term loans.

3. These banks advise the industrial firms regarding the sale and purchase of shares and debentures.

3. **Savings Banks:** These banks were specially established to encourage thrift among small savers and therefore, they were willing to accept small sums as deposits. They encourage savings of the poor and middle class people.

4. **Agricultural Banks:** These banks meet the credit requirements of the farmers through term loans, viz., short, medium and long term loans.

5. **Exchange Banks:** These banks finance mostly foreign trade of a country. They buy and sell foreign currency and thus help businessmen in their transactions.

**Organization/structure of Banks**

**Branch Banking:** is a system in which every commercial bank has a network of branches operating throughout the country. Every bank is a separate legal entity and has one board of directors and one group of shareholders.

**Merit of Branch Banking**

**1. Advantage of the large scale – operations:** Efficiency in administration, economy in working, effective central banking control, etc., are some of the important advantages of having branch banking system. The banking functions can be divided into a number of departments and placed under different individuals or groups of individuals. Bank officers can be given management and supervisory training at the training centers established for that specific purpose. Expert advice from the head office is always available to all the branches.

**2. Economy of reserves:** Every bank is supposed to keep certain of its total deposits as cash reserves in order to gain and retain the public confidence at large. But profitability is an opposing consideration. The greater the amount of cash with the banks, the lesser the profitability and the lesser the amount of cash with the banks, the greater the profitability. In branch banking, however, the existence of a large number of branches enables a bank to keep the reserves at as low level as possible so that the profit-earning capacity of the bank would not reduce.

**3. Proper distribution of capital:** Branch banking makes possible the movement of capital from one place to another through the branches of a bank. Because of such transfers of capital, there are certain advantages. Firstly, funds can be transferred from those places where they are abundant to those places where they are scarce. Secondly idle capital in one lace can be transferred to another place where it can be profitability invested. Fourthly, capital is put to the most productive use. Lastly, the profit-earning capacity of the bank is greatly increased.

**4. Uniform Rates of Interest:** In branch banking, there is better control and coordination of the central bank. Consequently interest rates can be uniform.

5. **Better Cash Management:** In branch banking there can be better cash management as cash easily be transferred from one branch to another. Therefore, there will be lesser need to keep the cash idle for meeting contingencies.

6. **Better Training Facilities to Employees:** Under branch banking the size of the bank is quite large. Therefore, such banks can afford to provide better training facilities to their employees.

**7. Effective Central Bank Control:** Under branch banking, the central bank has to deal only with a few big banks controlling a large number of branches

**8. Geographical spreading of risks:** When a bank has its branches at different localities, it can minimize its risks because the losses incurred in depressed areas can be offset by the profits earned in prosperous areas.

**9. Large financial resources:** The financial resources of branch banks are of greater magnitude. Hence, the requirement of large customers can be easily met; loans and advances can be made on more liberal terms; and they are capable of withstanding greater shocks. Thus the branch banking has a sound and strong financial stability.

**Demerits of Branch Banking**

1. **Lack of Initiative:** The branches of the bank under this system suffer from a complete lack of initiative on important banking problems confronting them. No branch of the bank can take decision on important problems without consulting the head office. Consequently, the branches of the bank find themselves unable to carry on banking activities in accordance with the requirements of the local situation.
2. **Unnecessary Competition:** under branch banking system, the branches of different banks get concentrated at certain places, particularly in big towns and cities. This gives rise to unnecessary and unhealthy competition among them. The branches of the competing banks try to tempt customers by offering extra inducements and facilities to them. This naturally increases the banking expenditure.
3. **Expensiveness:** Branch banking system is much more expensive than the unit banking system. When a bank opens a number of branches at different places, then there arises the problem of co- coordinating their activities with others. This necessitates the employment of expensive staff by the bank.
4. **Funds of a region use elsewhere:** Funds of one region or locality may be used in other regions or localities.
5. **Supervisory problems:** In branch banking, there are many supervisory problems in matters of managing and controlling the far-flung branches of the bank. In the branch offices, there is an ever-present danger of mismanagement.

**Unit banking**

It refers to a single bank which renders services and operates without any branches anywhere. This kind of banking system is common in the USA. Previously, Zemen Bank can be taken as an example in Ethiopia.

***Advantages of Unit Banking***

1. **Efficient Management:** One of the most important advantages of unit banking system is that it can be managed efficiently because of its size and work. Co-ordination and control becomes effective. There is no communication gap between the persons making decisions and those executing such decisions.

2. **Better Service:** Unit banks can render efficient service to their customers. Their area of operation being limited, they can concentrate well on that limited area and provide best possible service. Moreover, they can take care of all banking requirements of a particular area.

3. **Close Customer-banker Relations:** Since the area of operation is limited the customers can have direct contact.

4. **No Risks of Fraud:** Due to small size of the bank, there is stricter and closer control of management. Therefore, the employees will not be able to commit fraud.

5. **Closure of Inefficient Banks:** Inefficient banks will be automatically closed as they would not be able to satisfy their customers by providing efficient service.

6. **Local Development:** Unit banking is localized banking. The unit bank has the specialized knowledge of the local problems and serves the requirement of the local people in a better manner than branch banking. The funds of the locality are utilized for the local development and are not transferred to other areas.

***Disadvantages of Unit Banking***

1. **No Economies of Large Scale:** Since the size of a unit bank is small, it cannot reap the advantages of large scale viz., division of labor and specialization.

2. **Lack of Uniformity in Interest Rates:** In unit banking system there will be large number of banks in operation. There will be lack of control and therefore their rates of interest would differ widely from place to place. Moreover, transfer of funds will be difficult and costly.

3. **Lack of Control:** Since the number of unit banks is very large, their co-ordination and control would become very difficult.

4. **Risks of Bank’s Failure:** Unit banks are more exposed to closure risks. Bigger unit can compensate their losses at some branches against profits at the others. This is not possible in case of smaller banks. Hence, they have to face closure sooner or later.

5. **Limited Resources:** Under unit banking system the size of bank is small. Consequently its resources are also limited. Hence, they cannot meet the requirements of large scale industries.

6. **Unhealthy Competition:** A number of unit banks come into existence at an important business centre. In order to attract customers they indulge in unhealthy competition.

# **Group Banking**

Group Banking is the system in which two or more independently incorporated banks are brought under the control of a holding company. The holding company may or may not be a banking company. Under group banking, the individual banks may be unit banks, or banks operating branches or a combination of the two.

Participating banks retain their own boards of directors which are responsible to the supervising and regulatory authority and depositors for the proper operation of the bank. That is, each bank in the group has got a separate entity. This system has developed in United States in 1900. It was popular and extensively developed in 1920's.

**Chain Banking**

Chain banking is a situation in which three or more banks that are independently chartered are controlled by a small group of people. The mechanisms used to establish this type of arrangement normally involve securing enough stock between the individuals to have a controlling interest in each of the bank corporations involved. The arrangement can also be managed with the establishment of interlocking directorates or boards of directors that effectively create a network between the banks without the need for some type of central holding company.

**Correspondent Banking**

Correspondent banking refers to a financial institution that conducts business transactions on behalf of another financial institution. It takes up roles like accepting deposits and gathering information on behalf of another financial institution. Correspondent banks are mostly used in foreign countries and they act as agents of the original bank.

Correspondent banks are used by domestic banks in order to service transactions originating in foreign countries, and act as a domestic bank's agent abroad. This is done because the domestic bank may have limited access to foreign financial markets, and cannot service its client accounts without opening up a branch in another country.

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| ***Activity1.1***  *Why banks need to operate unit bank without having branches in general and take the case of Zemen Bank in Ethiopia in particular? How the correspondent banking operates in Commercial Bank of Ethiopia. Take assignment and make a report in class or in lab.* |

* 1. **Definition of 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.

* 1. **Relationship between a Banker and Customer**

The relationship between the banker 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

**1.3.1. General Relationship**

**Debtor and Creditor:**

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). The position is reversed if the customer is advanced loan then the banker becomes creditor and the customer is debtor.

**1.3.2. Special Relationship**

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.

1. **Bailer and Bailment relationship**

A bailment is the delivery of goods in trust. A bank may accept the valuables of his customer such as jewillary, 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.

1. **Pawner and Pawnee:**

When a customer Pledge goods and documents as security for an advance he then become Pawner (Pledger) and the bank becomes the Pawnee (pledgee). The pledged goods are to be returned intact to the pawner after the debt is repaid by him.

1. **Mortgager and Mortgagee relationship**

Mortgage is the transfer of an interest in specific immovable property for the purpose of securing the payment of money advanced or to be advanced by way of loan. When a customer pledges a specific immovable property with the bank as security for advance, the customer becomes mortgager and banker is the mortgagee.

1. **Bank as a trustee**

The bank can act as a trustee for his customer. When the banker accepts securities and other valuables for safe custody is called that it is acting as trustee. In such cases the customer continues to be the owner of the valuables deposited with the bank. The bank also acts as executor, attorney and guarantor for his customer.

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| ***Activity 1.2***  *Are all the banker-customer relationships operational in public and private commercial banks in Ethiopia? Take time for discussion.* |

**1.4. Rights and Obligations of the Banker and the Customer**

**1.4.1. 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 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.

**1.4.2 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 responsible to honor the check of the customers provided the check is:

* Properly drawn
* The customer has balance to his credit
* There is no legal ban or restriction attaching to the customer’s funds.

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

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.

4. Garnishee order (order of the court)

It is the duty of the banker to abide by the order of the court (garnishee order) and attached the funds of the customer to the creditors who has obtained the order in his favor.

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.
2. Right to charge interest, commission etc: It is the right of the banker to charge interest commission etc according to the rates for the services the banker has rendered to the customer as agent, trustee etc.
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.

Summary

A banker is a dealer in capital or more properly a dealer in money. It is an intermediate party between the borrower and the lender. Commercial banks have to perform a variety of functions which are common to both developed and developing countries. Banks can be organized as branch banking, unit banking, group banking, chain banking and correspondent banking. The relationship between the banker and customer generally be categorized as general and special relationship. In their relationship the banker and the customer have both rights and obligations which are required by law.

***Review Questions***

*CHOICE QUESTIONS:*

*1. Garnishee Order is issued by:*

*A) Income Tax Authorities B) Court C) Bank D) none*

*2. All of the followings are agency services provided by the bank, except*

1. *Underwriting securities C) collection and payment of credit instruments*

*B) Collection of dividends on shares D) purchase and sale of securities*

*3. \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ refers to a financial institution that conducts business transactions on behalf of other financial institution*

1. *Group banking C) correspondent banking*
2. *Chain banking D) Branch banking*

*4. If the customer requests the banker to keep his valuables in safe vaults, the relationship created is that of;*

1. *Debtor-creditor C) trustee- beneficiary*
2. *Agent –principal D) there is no relationship created*

*DISCUSSION QUESTIONS:*

1. *Discuss the main difference between primary and secondary functions of a bank.*

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1. *Describe at least three important functions of industrial banks.*

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1. *List and explain the obligations that bankers and customers have.*

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***Self check table for students assessment***

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| ***No.*** | ***Do students grasp objectives/competencies*** | ***Yes*** | ***No.*** |
| *1* | *Define a bank* |  |  |
| *2* | *Describe the functions of commercial banks* |  |  |
| *3* | *Identify the organization /structure of banking* |  |  |
| *4* | *Define customers and* |  |  |
| *5* | *Explain the relationship between a banker and customer* |  |  |