**UNIT 1 : Banking Theory and Practice-an over view**

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2. **AIMS AND OBJECTIVES**

At the end of this Unit you are expected to

* describe the history of banking.
* identify the types of banks.
* define banking.
* identify the type of banking system appropriate to less developed countries like our’s.
* identify the purposes of different banks.

**1.1 INTRODUCTION**

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

**1.2 Historical background**

**1.2.1 World Banking History**

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

The merchants, goldsmiths and money lenders can be regarded as the ancestors of present day bankers. These people start the banking activity by accepting deposits from the depositors and pay whenever demanded. For the deposit they accepted they used to give written evidences.

Through time they see that the amount deposited is kept for a long period of time without being withdrawn. At the same time there were others who were looking for money to facilitate their trading activity. Hence these parties start to lend with an interest.

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

The bank of Venice, established in 1157, is supposed to be the first bank founded as a public enterprise. It was simply an office for the transfer of the public debt and originally it was not a bank in the modern sense. There were other banks emerged in the Italian cites perhaps a little before 1200AD. Some of these bankers were carrying out business on their own account. The activity was almost similar to the modern bankers. People used to settle their accounts with their creditors by giving a check or draft on the bank or through transfer order, if the creditor has an account in the same bank. These bankers also received deposits and lent money.

As early as 1349 the drapers of Barcelona carried on the business of banking. They were required to give sufficient security before their commence this business i.e. they were under regulation.

During 1401 a public bank was established in Barcelona. It was used to exchange money, receive deposits, and discount bills of exchange for both the citizens and for the foreigners.

During 1407 the Bank of Genoa was established in Italy. And in 1609 the Bank of Amsterdam was established to meet the needs of the merchants of the city. It accepts all kinds of specie on deposits. Deposits could be withdrawn on demand or transferred from the account of one person to another. The bank also adopted a plan by which a depositor received a kind of certificate entitling him to withdraw his deposit within six months. These written orders, in course of time, came to be used in the same manner as the modern check.

In England, banking had its origin with the London goldsmiths, money lenders, merchants and money exchangers - during the reign of queen Elizabeth-I. They accepted a seizure of large gold hoards in the 17th century during the reign of King Charles-I. They were scared to keep this sizable amount of gold with themselves. Hence they began to keep the gold at the “Exchequer” with the guarantee of the king. However they were suffered during the reign of King Charles-II, who imposed several restrictions on the business of goldsmiths was finally ruined when the King closed the “Exchequer” with out giving any compensation to the depositors. It is believed that many of these goldsmiths were converted into bankers and their activity is replaced with a large number of private bankers. Bank of England was established in 1694.

* + 1. **Development of Banking in Ethiopia**

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

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

The bank was purchased by the order of the Emperor from the foreign company and was chartered on 29th August 1931 as Bank of Ethiopia. During the Italian occupation branches of Banco di’Italia, Banco di’Roma, Banco di’Napali and Banco Nationale del Lavoro were established.

In 1941 Barclays Bank and Dominion colonial & overseas came to Ethiopia with the British troops and organized Banking services in Addis Ababa. They withdraw in 1943 with the British troop. The same year Banco di Indo China was established.

National and commercial Bank proclamation, August 1942 was entrusted to the state Bank of Ethiopia for; controlling the issue of currency holding the foreign reserves of the country and acting as a fiscal agent of the government. Since the economy was highly under –developed the monetary situation was quite confused and credit was practically non-existent.

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

The Banking activity was reorganized in Ethiopia in December 1963. It splits the functions of Central Banking and Commercial Banking activities, which until this time was carried out by the State Bank of Ethiopia.

Commercial bank of Ethiopia was incorporated as Share Company with the following activities and business purposes. (1).The carrying out of all types of banking business and operations. (2). Attracting public deposits of all kinds including savings and (3). Promoting the banking habit and facilitating transactions.

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

Mortgage Company of Ethiopia was established in July 1965 to make available financial means and credit facilities for the construction of commercial, industrial and residential buildings against mortgage of immoveable properties.

In the year 1974, with the change in the government, all private banks were nationalized and there were only three banks: Commercial Bank of Ethiopia Agricultural and Industrial Bank and Mortgage Bank of Ethiopia, were functioning.

Again, after the fall of dreg regime and with the free market economy many private banks were established. These are Bank of Abyssinia S.C., Awash International Bank S.C., Dashen Bank S.C., United Bank S.C., Wogagen Bank S.C., Nib International Bank S.C.

**1.3 The nature and classification of banks**

**Meaning of bank**

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

**1.4 FUNCTIONS of commercial banks or modern banks**

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

* + 1. **Accepting deposits**

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

1. Fixed deposit account
2. Current deposit account
3. Saving deposit account

##### i. Fixed deposit Accounts

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

**ii. Current deposit accounts**

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

**iii. Saving Deposit Accounts**

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

* + 1. **Advancing Loans**

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

1. Money at call
2. Cash credit
3. Overdraft facility
4. Discounting of bills of exchange
5. Term loan

##### A. Call loan

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

##### B. Cash Credit

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

##### C. Overdraft Facility

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

##### D. Discounting Bills

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

##### E. Term loans

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

* + 1. **Credit Creation**

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

* + 1. **Promoting Cheque System**

In the modern business transaction, cheques have become much more convenient method of settling debts than the use of cash. Through a cheque, the depositor directs the bankers to make payment to the payee. Cheque is the most developed credit instrument in the money market.

* + 1. **Agency Service**

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

1. Collection and payment of credit instruments like cheques, bills of exchange, promissory notes, etc
2. Execution of standing orders.

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

* + Insurance premiums
	+ Subscriptions on clubs and societies, and
	+ Similar payments of a regularly recurring nature
1. Purchasing and sale of securities

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

1. Collection of dividends on shares on behalf of his customer.
2. Income tax consultancy

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

1. Acting as trustee and executor.

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

1. Acting as representative and correspondent

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

1. Remittance of funds

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

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

1. Bank draft
2. Telegraphic transfers and
3. Mail transfer

**I. Bank draft**

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

**Essential features of a bank draft**

A bank draft possesses the following important features.

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

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

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

The remitter does not remain a party to the instrument.

**Difference between a cheque and a bank draft**

The Negotiable Instruments Act has taken that they are similar. However a bank draft is different from a cheque in several respects. The points of differences are:

1. A draft cannot be made payable to the bearer while a cheque can be so drawn.
2. A banker is under a legal obligation to pay the money of a draft. Its payment cannot be stopped except in cases where loss or theft of the draft has been reported.

While the drawer can easily get payment of ac stopped, if he so likes.

1. In case of a draft, the banker has a direct liability to pay. The remitter after he purchases the draft is not part of the instrument and the drawer is under obligation to transfer the fund to be paid by the drawee branch to the payee - whose name is in the draft.

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

**Stopping payment of the draft**

The banker even on receiving instructions from purchaser of the draft cannot stop the payment of the draft. This is for the simple reason that by issuing a bank draft, the banker takes upon himself a commitment in favor of a third party (i.e. the payee) to pay a certain amount of money.

**Loss of the draft**

A banker can stop payment of a draft in those cases where either the purchaser of the draft or the payee of the draft has reported about the draft being lost or stolen. The bank should take extreme caution and should immediately inform the drawee branch about the loss.

There can be two different situations

1. When the draft is lost before it is endorsed
2. When the draft is lost after it has been endorsed

##### *Loss of the draft before endorsement*

If the drawer branch is satisfied about the lose of the draft, the drawee branch should not pay such a draft, if it is presented for payment with any endorsement It should be returned with the remark

 Draft reported to be lost

Payee's endorsement requires verification

**II. Loss of draft after endorsement**

In this case there can be two situations

* 1. The payment of the draft may be requested at the counter of the bank (drawee) in such a case, the banker should satisfy it self about the identity of the claimant and the endorsement in his favors. If it is not satisfied, it should return the draft with the remark.

 Draft reported to be lost

Payee's endorsement requires verification

* 1. The payment of the draft may be required through a collecting banker. In such a case, also the drawee banker should follow all the above precautions.

**Issue of a duplicate draft**

In case a draft is reported lost and a duplicate draft is required to be issued, the banker should attend the following steps:

* 1. It should satisfy itself regarding genuineness of the party requesting issue of a duplicate draft.
	2. It should obtain the necessary confirmation of the drawee branch that the relevant draft is still outstanding with that branch.
	3. An indemnity bond should be obtained from the purchaser of the draft.
	4. While issuing a duplicate draft, the number of the draft originally issued should be incorporated boldly on the draft form.

**Cancellation Of Draft**

In case the purchaser of the draft makes a request to cancel the draft and refund him the amount of draft, the bank should do so after taking the following precautions.

1. It should satisfy itself that the draft has not been delivered to the payee.

Making, accepting and endorsement of a negotiable instrument is completed only when it is delivered to the person concerned (section 46 of the negotiable Instrument Act)

Delivery could be actual or constructive. It can be through delivery and endorsement & delivery. Or it can be transferred through post office.

1. In case the purchaser wants to get the draft cancelled after it has been delivered to the payee, he can do so only with the consent of the payee. The advice regarding cancellation of she draft should be sent to the drawee branch
2. The drawee branch should also make a suitable note regarding cancellation of the draft in its records.

ii. **Mail/Telex Transfers**

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

- The name of the beneficiary

 - His/her account number, if any

- The amount to be transferred, and

- The name of the branch where the account is maintained or the beneficiary can receive.

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

**1.4.6. General Utility Function**

1. **Traveler's cheques**

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

**The following are their essential features of travelers cheques:**

1. Traveler's cheques can be purchased by any one. He need not be a customer of the bank
2. A person may buy any number of traveler’s cheques. The equivalent amount of money must be deposited.
3. Each traveler’s cheque should be signed by the purchaser at place marked. "When counter signed below with this signature." Before the official who issues the cheques.
4. The purchaser in English script should sign the cheque
5. The travelers' cheques are issued in single name i.e. not in joint names or names or clubs, societies and companies etc.
6. The travelers' cheques are generally encashable only at the branches of the issuing bank or the branches of the other banks with which the issuing bank may have arrangement.
7. The purchaser of the traveler’s cheques has to sign the traveler’s cheques again at the time of encashing the traveler’s cheques at the place marked "counter-sign here in presence of person cashing"
8. There is no expiry period for the travelers' cheque. Unused cheques can be returned back to the issuing bank and the payment can be returned back to the issuing bank and the payment can be obtained for them.

**Loss of the travelers' cheques**

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

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

**B. Safe custody of valuable and securities**

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

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

 **I. Accepting of valuables for safe custody**

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

* 1. The safe custody facility should be extended only to the bank’s customers
	2. The safe custody facility should be confined only to:
		1. Securities such as government promissory notes, stock/share certificates, bonds, debentures, certificates, title deeds, wills and post office national savings certificate, etc…
		2. Envelopes and packets, which are properly sealed with customers’ distinctive seals, markings, etc. with instructions regarding delivery.
		3. Locked boxes with customers’ names painted on the top thereof or otherwise adequately identifiable.

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

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

**Liability of a Banker**

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

**a. Negligence by the banker**

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

**b. For conversion**

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

**c. Fraud by its own employees**

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

**II. Hiring of safe Deposit Vaults**

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

* 1. Any person can take or hire a safe deposit locker from the bank.
	2. The person taking a locker on rent has to fill in a proper lease document which contains the terms and conditions of hiring the locker.
	3. The bank maintains safe deposit vaults register in which all transactions relating to each of the rented out lockers are recorded on a separated page. A pass word or code word is chosen by the hirer.
	4. In case of a locker being hired in joint names, specific instructions should be obtained as to the mode of operation and access to the lockers from joint lessees.
	5. Two keys are used for opening the lockers, one of which is kept by the hirer in his possession, while the other remain with the banker i.e. the master key will remain with the banker.
	6. The bank does not know the contents of the locker.
	7. In the event of death of the hirer the contents of the locker should be redelivered to the legal representative of the deceased only after his producing a valid succession certificate from the court.
	8. No locker should be leased out to minors, blind and illiterate persons
	9. The manager or any other authorized person should examine the locker soon after its operation, in order to ensure that it has been properly locked by the visitors and that no articles are left behind him inadvertently.

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

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

**C. Letters of credit**

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

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

For example, Ato Zeberga wants to import goods on credit from an Italian exporter known as Maldini. Now Mr. Maldini may not be willing to sell his goods on credit to an Ethiopian importer, Ato Zeberga, he rather prefers the credit to be guaranteed by a known bank in Ethiopia. Here Commercial Bank of Ethiopia, who is the banker to Ato Zeberga, writes a letter to another banker in Italy, may be Bank of Italy, to pay the agreed sum of money in the transaction, when the goods are arrived to the buyer, which might be communicated as it is realized. Then, the Italian bank will advice Mr. Maldini to deliver goods according to the agreement with Ato Zeberga. As the arrival of the goods is reported to Bank of Italy through Commercial Bank of Ethiopia, Bank of Italy will pay the amount or credit Mr. Maldini’s account, if he has an account in the same bank, or may transfer to another bank where he has an account, if it is instructed to do so.

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

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

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

**D. Foreign exchange**

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

**E. Collection of statistics**

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

**F. Underwriting securities**

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

* 1. **Systems of Banking Organization**

Banks may be organized on different systems. The various types of banking organizations are the following: Branch banking, Unit banking, Group banking, Chain banking, Mixed banking, Holding banking.

**1.5.1 Based on the Structure**

On the basis of organization structure and scale of operations, banking systems can be divided into two categories. They are Branch Banking and Unit Banking systems.

## The Branch Banking System

Under branch banking organization a big bank as a single institution and under single ownership operates through a network of branches spread all over the country or outside the country. The Ethiopian banks use this system. All of these banks have their head office in Addis Ababa and a number of branches through out the country and outside (Commercial Bank in Djibouti). The same thing is true with British banking system.

**Advantage of Branch Banking System**

Branch banking system possesses the following advantages.

* 1. **Economies of large-scale operations:** It possesses huge financial resources and enjoys the benefits of large scale operations such as:

a. Highly trained and experienced staff can be appointed.

1. Division of labor is introduced in the banking operation
2. Funds are made available liberally and at chapter rates
3. Foreign exchange business is done economically
4. Large financial resources and wider geographical coverage increases public confidence in the banking system.
5. **Spreading of risk:** The bank operates at different regions. As such the needs of these regions may vary. At some regions the demand for loan may be high whereas, in other areas the demand for credit may be low. In addition, business in some regions may be developed and may be low in other regions. Therefore this banking system will achieve the following benefits.
* Geographical spreading and diversification of risks
* Risks could be offseted by different branches
* It makes possible to raise large finance to face any crises
1. **Economy in cash Reserves:** As it is known, all banks are required by law to maintain the minimum cash reserve. And here though the numbers of branches are many only the head office is required to maintain the cash reserve. However, if any branch faces scarcity of funds it can easily obtain from other branches through the head office. Therefore, branches are not expected to maintain huge amount of reserves with them.
2. **Diversification on deposits and assets:** Deposits are received from areas where savings are in plenty. Loans are extended in those areas where funds are scarce and interest rates are high. Therefore, it is possible to transfer fund from areas where plenty of funds exist to areas where there is scarcity of funds.
3. **Cheap Remittance Facilities**: As the bank covers wider areas it is easy and cheap to transfer funds from one place to another. It uses its own facilities and a number of transfers can be mad with a single transaction with out additional charges.
4. **Better Facilities to customers**: Because there are many branches in a given bank every branch will have small number of customers. Since there will be small number of customers per branch and the increased efficiency achieved through large-scale operations, customers get better and greater facilities.
5. **Effective control by the central bank**: Central bank is the controller of banks. If the number of banks are many Central Bank is required to control all these banks. But here there are few banks with many branches. Therefore, Central Bank is expected only to control these few Head offices and hence through them the branches.

**Disadvantages of Branch Banking System**

Branch banking system has the following disadvantages.

* 1. **Management problem:** There will be mismanagement of resources, unnecessary delay of action and red-tapism in the banking business. Because branches are many and they are far from the head office, in terms of both geography and hierarchy, there may be difficulties to control their every day actions.
	2. **Lack of initiative:** Managers cannot take independent decisions and have to wait for the clearance signal from the head office. This will discourage them to take their own decision.
	3. **Monopolistic tendencies:** A few big banks dominate and control the whole banking system of the country through their branches. This can lead to the concentration of resources in to a few hands.
	4. It creates regional imbalance: Funds flow from an area where investment is weak to an area where business prospers.
	5. There is an adverse linkage effect of inefficient branches: The over all performance of the bank is evaluated and those branches which have low performance will hide behind other successful branches.
	6. Other defects:
	7. Preferential treatment is given to the branches near the head office
	8. There may be unhealthy competition among the branches of different banks in big cities.

## The Unit Banking System

An individual bank operates through a single office or few branches within a strictly limited area. The size and area of operation are much smaller as compared to those of the branch banking system. They can be supported by correspondent banking system. The reason of its development is the fear of emergency of monopoly in banking business. This is true with the United States banking system.

**Advantages of Unit banking system**

1. **Local development:** It is localized banking. It will have a specialized knowledge on the local problems and serves the requirements. It also uses funds that it receives in form of deposit accounts to the development of the region.
2. **Promotes Regional Balances:** There is no transfer of resources from rural and backward areas to the big industrial commercial centers.
3. **Easy of management:** There are fewer chances of fraud and irregularities in the financial management.
4. No Monopolistic Tendencies
5. No inefficient branch, otherwise due to branch banking operations.
6. Initiative in banking business because decisions are made at the branch level.

**Disadvantage of Unit banking**

1. No distribution of risks – inability to face crisis
2. No banking development in backward areas because all unit banks would prefer already developed areas or regions.
3. **Lack of specialization:** Because of their small size they are not able to introduce, and get advantages of dividing of labor and specialization. They cannot employ highly trained and specialized staff.
4. **Costly Remittance of Funds:** It has to depend upon the correspondent banks for transfer of funds, which is very expensive.
5. **Local pressures:** Local pressures and interferences generally disrupt their normal functioning.
6. **Undesirable competition:** Different management independently run smaller banks. This results in undesirable competition among different unit banks.

**Conclusion:** Although both banking systems have their relative merits and demerits, the merits of the Branch banking system outweigh those of the latter. It is especially suitable for the underdeveloped countries.

**1.5.2 Based on Ownership**

On the basis of ownership banks can be classified as: Group banking and chain banking.

**A. Group banking**

It is a system whereby the affairs of two or more banks are directly controlled by a holding company. The holding company may or may not be a banking company.

**Advantages of Group banking**

Each member bank retains its separates entity and maintains its board of directors. It enjoys the benefits of centralized administration. There is grater liquidity and mobility of resources. There is economy of advertisement expenditure. There is a common purchasing agency, which leads to economy in purchases. Services of experts can be made available to the member banks to manage their business efficiently.

Common standardized accounting system improves the working of the member banks. Large-scale banking operations allow superior credit facility.

**Disadvantage of Group banking**

Group banking system possesses the following disadvantages.

* 1. Effective supervision is not possible
	2. Control is less direct
	3. The management of the holding company adversely affects efficiency of the member banks.
	4. The failure of the bank has its adverse effect on other member banks.

The common purchasing agencies often indulge in corruptive practices.

**B. Chain Banking**

The common management of two or more banks may be by single or a group of persons through stock ownership or otherwise.

The advantage and disadvantages of chain banking system are more or less similar to those of group banking system.

**1.5.3 Based on Activity Classification**

Based on activity Banking systems can be classified as: Investing Banking and mixed Banking

**A. Investing Banking**

They invest or help investment of funds in the shares or bonds of joint stock companies. They act as an intermediary between Business Corporation and investors. They can be classified;

1. Originators: -They bring out new issues of securities
2. Underwriters: - they act as agents on commission basis, they underwrite the issue of securities
3. Retailers: - They purchase entire issue of new securities of companies or government institutions and re- issue them for public subscription at a higher price. They have to use their assets for longer investments and risky ventures.

**B. Mixed Banking**

This is that system of banking under which the commercial banks make both short-term as well as long-term loans to commerce and industry. It is the combination or mix of investment banking and commercial banking. Commercial banks mainly involve in short term working capital with loans maturing in less then one year where as investments banks engage in long-term loan running for several years.

**Advantages of mixed Banking**

Mixed banking system possesses the following advantages.

1. The industrial units will have the advantage of receiving an expert guidance on various financial issues from their banker.
2. It helps banks to invest in the industrial development of the country.
3. Banks can acquire a thorough knowledge of the working of the industrial system of the country.

**Disadvantage of mixed Banking**

Mixed banking system has the following disadvantages**.**

1. It constitutes serious threat to the stability of the banks. Because the bank’s liability is short term, usually in a form of demand deposits withdrawable on demand, but the loans are granted for long-term purposes. This leads to scarcity of liquid cash, as customers demand to withdraw from their deposit accounts.
2. It is not a safe practice to lock up the bank’s resources in long-term investment. The types of loans granted by such banks are long term and in the long term the possibility of loss is high due to many factors such as; credit risk, interest rate risk and liquidity risk. These types of risks are discussed thoroughly in chapter four.

**1.6 Classifications of Banks**

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

**1.6.1 Based on Their Functions**

* 1. **Commercial Banks**:-They perform all kinds of banking business They generally finance trade and commerce. They usually accept short-term deposits and advance short-term loans to the businesspersons and traders and avoid medium- term and long term loans.
	2. **Industrial Banks**: - Also known as investment banks, They mainly meet the medium-term and long-term financial needs of the industries. The main functions are;
* Accept long-term deposits.
* Grant long-term loans to the industrialists to enable them to purchase land, construct factory building, purchase heavy machinery, etc.
* Help selling or even underwrite the debenture and share of industrial firms.
* Provide information regarding the general economic position of the economy.
	1. **Agricultural Banks: -** They are banks that finance agriculture. Agricultural credit needs are different from those of industry and trade. The agriculturists require:
	2. **Exchange Banks:** -They deal in foreign exchange and specialize in financing foreign trade. They facilitate international payment through the sale and purchase of bills of exchange.
* Short –term credit to buy seeds, fertilizers, and other inputs
* Long-term credit to purchase land, to make permanent improvements on land, to purchase agricultural machinery and equipment, etc.
	1. **Savings Banks**: - The main purpose is to promote saving habits among the general public and mobilize their small savings.
	2. **Central Bank**:-It is the apex institution, which controls, regulates and supervises the monitory and credit system of the country. Functions of the central bank are:
* It has the monopoly of note issue.
* It acts as the banker, agent and financial advisor to the state.
* It is the custodian of member bank’s reserves.
* It is the custodian of nation’s reserves of international currency.
* It serves as the lender of the last resort.
* It functions as the bank of central clearance, settlement, and transfer.
* It acts as the controller of credit.
	1. **World Bank**: - It refers to an institution that provides financial assistance to the member countries of the world. After the worldwide depression and World War II, two international institutions were founded in 1944. International Monitory Fund (IMF) to provide short term loans to overcome the balance of payments difficulties.
		1. International Bank of Reconstruction and Development (IBRD) or World Bank organized to achieve the following two objectives.
* Reconstructing the war-damage economies, and
* Developing the less developed economies.
	+ 1. **Based on Ownership**

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

* + - * 1. **Public Sector Banks**:-These are owned and controlled by the government.
				2. **Private sector Banks**:-These are owned and controlled by the private individuals or corporations and not by the government or co-operative societies.
				3. **Cooperative banks**:- They are operated on the cooperative e lines.

**1.6.3 Based on Domicile**

On the basis of domicile the banks are divided into two

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

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

**Check Your Progress Exercise**

1. Define a bank.

**……………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………….**

1. Summarize the evolution of banking.

**……………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………….**

1. Which banking systems more appropriate to less developed countries like ours? Why? Discuss.

**……………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………….**

1. Identify the functions of a bank.

**……………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………….**

1. Which of the stated type of accounts are the most important ones for a customer? Why? Discuss.

**……………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………….**

1. Which are suitable for the banker? Why? Discuss.

**……………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………….**

**1.7 Summery**

A Bank is an institution that involves is accepting deposits, advancing loans, create credits, offer foreign exchange services, create credit money-cheques offers agency services, and the like. It is organized on the joint company basis so as to increase the returns of shareholders in a form of dividend. A bank went through different stages of developments before it reaches to the present day development.

A modern bank raises funds using different methods such as; collecting paid up capital from share holders, accepting deposits in a form of current accounts, time deposits and saving deposits. A bank can be organized on different basis such as; branch banking, unit banking, group banking, chain banking, investment banking, and mixed banking systems.

* 1. **Answer to** **Check your progress questions**

1. Refer Section 1.3

1. Refer Section 1.2
2. Refer Section 1.6
3. Refer Section 1.4
4. Refer Section 1.4
5. Refer Section 1.4