# CHAPTER ONE

## 1. OVERVIEW OF BANKS AND THEIR FUNCTIONS

### 1.1 INTRODUCTION

This Unit is designed to introduce you with the meaning of a bank. The chapter also identifies the types of banks as central bank, commercial banks, development banks, investment banks, cooperative banks and specialised banks.

### 1.2. Definition of Bank/Banker

A Bank/banker is a financial institution which accepts, for the purpose of lending or investment, deposits of money from the public, repayable on demand or otherwise and can be withdrawn by check, draft, or order or otherwise.

Therefore, a banking company is defined as any company which transacts the business of banking which means accepting deposits of money from the public for the purpose of lending or investment, repayable on demand or otherwise, and withdrawn by check, draft, or otherwise."

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

For an institution to be considered as a banking institution, the following conditions must be fulfilled

A. A banking company must perform both accepting deposits and lending or investing of money. If the purpose of accepting of deposits is not to lend or invest, the business will not be called as a banking business.
B. The banker accepts deposits of money and not of anything else.
C. The definition also specifies the time and mode of withdrawal of the deposits. The deposited money should be repayable to the depositor on demand made by the depositor or according to the agreement reached between the two parties.
D. The act also specifies that the withdrawal should be effected through an order, check, and drafts or otherwise.

### 1.3. TYPES OF BANKING

There are various types of banks which operate in our country to meet the financial requirements of different categories of people engaged in

agriculture, business, profession, etc. On the basis of functions, the banking institutions may be divided into the following types:

### 1. Central Bank

A bank which is entrusted with the functions of guiding and regulating the banking system of a country is known as its Central bank. There are usually hundreds of banks in a country. There should be some agency to regulate and supervise their proper functioning. This duty is discharged by the central bank. Such a bank does not deal with the general public. That means Central banks are operated for the public welfare and not for maximum profit. It acts essentially as Government's banker; maintain deposit accounts of all other banks and advances money to other banks, when needed. The Central Bank provides guidance to other banks whenever they face any problem. It is therefore known as the banker's bank. The Central Bank maintains record of Government revenue and expenditure under various heads. It also advises the Government on monetary and credit policies and decides on the interest rates for bank deposits and bank loans. In addition, foreign exchange rates are also determined by the central bank. Another important function of the Central Bank is the issuance of currency notes, regulating their circulation in the country by different methods. No other bank than the Central Bank can issue currency. An example of central bank is: National bank of Ethiopia.

### 2. Commercial (Retail) Banks

Commercial Banks are banking institutions that accept deposits and grant short-term loans and advances to their customers. In addition to giving short-term loans, commercial banks also give medium-term and long-term loan to business enterprises. Now-a-days some of the commercial banks are also providing housing loan on a long-term basis to individuals.

**Types of Commercial banks**: Commercial banks are of three types i.e., Public sector banks, Private sector banks and foreign banks.

(i) **Public Sector Banks:** These are banks where majority stake is held by the Government. An example of public sector bank is: Commercial bank of Ethiopia.

(ii) **Private Sectors Banks:** In case of private sector banks majority of share capital of the bank is held by private individuals. These banks are registered as companies with limited liability. For example: Awash international bank, Oromia international bank, Abyssiniya bank, Birhan international bank etc.

(iii) **Foreign Banks**: These banks are registered and have their headquarters in a foreign country but operate their branches in our country.

Banks often open a foreign branch to provide more services to their multinational corporation customers. However, operating a foreign branch bank may be considerably complicated because of the dual banking regulations that the foreign branch needs to follow.

For example, suppose that Bank of America opens a foreign branch bank in Canada. The branch would be legally obligated to follow both Canadian and American banking regulations

**3. Development Banks**

Development banks are those which have been set up mainly to provide infrastructure facilities for the industrial and agricultural growth of the country. Development banks are specialized financial institutions. They provide medium and long-term finance to the industrial and agricultural sector. They provide finance to both private and public sector. Development banks are multipurpose financial institutions. They do term lending, investment in securities and other activities. They even promote saving and investment habit in the public.

A development bank is a 'bank' established for the purpose of 'financing development'**.** A traditional definition of a development bank is one which is a national or regional financial institution designed to provide medium-and long-term capital for productive investment, often accompanied by technical assistance, in less-developed areas. Development banks fill a gap left by undeveloped capital markets and the reluctance of commercial banks to offer long-term financing.

Business often requires **medium** and **long-term** capital for purchase of machinery and equipment, for using latest technology, or for expansion and modernization. Such financial assistance is provided by Development Banks. Development bank of Ethiopia is an example.

Development banking therefore can also be defined as a form of financial intermediation that provides financing to high priority

investment projects in a developing economy. In short, a development bank is a development-oriented bank."

The Development Bank of Ethiopia is established with the purpose of providing long-term loans to agricultural and industrial undertakings, which are considered crucial in the development of the economy. It was intended to serve as the major financer for the various co-operatives and government owned farms and factories. Now it also provides long-term loans to private investors who are engaged in agricultural and manufacturing activities

**4. Investment bank**

An investment bank is a financial intermediary that specializes primarily in selling securities and underwriting the issuance of new equity shares to raise capital funds.

They were called investment banks because they didn't have money to lend, like commercial banks and merchant banks; they created and sold securities to investors on behalf of issuers. In many cases, investment bankers became financial advisors to companies.

Investment banking is a bank that helps individuals or organisations in raising long term fund through underwriting and issuing of securities (stocks and bonds or other financial instruments) and provides financial consultancy services to them. They act as intermediaries between security issuers and investors and help new firms to go public.

These financial instruments are issued normally for already established institutions or for governments or public entities.

The primary services of an investment bank include:

(a) Raised capital for large corporations and government by acting as underwriters for corporate and government securities (acting as an intermediary between a securities issuer and the investing public) and

(b) For a fee, arranged assists companies' with mergers and acquisitions. (Facilitating mergers and other corporate reorganizations) and acting as a broker or financial adviser for institutional clients.

**5. Co-operative Banks**

People who come together to jointly serve their common interest often form a co-operative society. When a co-operative society engages itself in banking business it is called a Co-operative Bank. Example: Co-operative bank of Oromia.

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 service.

The mission of cooperative banks is to promote the economic interests and the social and economic benefits of their members–customers–employees, within a not-for-profit framework. That means 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. Therefore it works on the principle of maximum profit for the shareholders. They provide short term and medium term loans to their members. Generally they provide services such as savings and loans to non-members as well as to members.

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, 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.

6. **Specialised Banks** – These banks specialize in providing financial assistance to a particular sector. Know the specialized banks as those banks that specialize in financing certain economic sectors, and most important types of specialized banks For example, Export-Import (EXIM) Bank, industrial Development bank, (IDB) agricultural and Rural Development bank (ARDB) etc.

   Often focus on the achievement of economic and social development, nor is it a key profit target (which does not have to accept demand deposits of the main aspects of its activities), so they are owned by the state in most cases.

   1. **Export-Import Bank**: This Bank specializes in providing financial assistance to the import and export sector. The services of Exim Bank are Limited only to export and import sector. EXIM Bank provides all the required support to exporters and importers.
   2. **Industries Development Bank:** Industries require a huge capital for a long period to buy machinery and equipment. IDB specializes in providing financial assistance to industries. They provide loans on easy terms to industries. Generally, Industrial banks are those banks

which provide medium term and long term finance to industries for the purchase of land, machinery etc.

3. **Agricultural and Rural Development Bank**: Agriculture has its own problems and hence there are separate banks to finance it. ARDB specializes in providing financial support to the agricultural sector in the rural areas. Agricultural banks are those banks which meet the credit requirements of the farmers through term loans, viz., short, medium and long term loans.

# CHAPTER TWO

# 2. CENTRAL BANKING

## 2.1. INTRODUCTION

A central bank is a ‘top institution’ in the banking structure of a country. It supervises controls and regulates the activities of commercial banks and acts as a banker to them. It also acts as a banker, agent and adviser to the

government in all financial and monetary matters. A central bank is also the custodian of the foreign balances of the country and is responsible to maintain the rate of exchange fixed by the government and manages exchange control. The most important function of a central bank is to regulate the volume of currency and credit in a country. It will be no exaggeration to say that a modern central bank is the central playful to the monetary and fiscal framework in almost all the countries developed or developing in the world. In developing economies, the central bank has also to perform certain promotional and developmental functions to accelerate the pace of economic growth.

## 2.2. FUNCTIONS OF CENTRAL BANK

The functions of the central bank differ from country to country in accordance with the prevailing economic situation. But there are certain functions which are commonly performed by the central bank in all countries.

**1. To issue paper money and coins:** Central bank now-a-days has the monopoly of note-issue in every country. The currency notes printed and issued by the central bank are declared unlimited legal tender throughout the country.

Central bank has been given exclusive monopoly of note-issue in order to secure control over **volume of currency and credit**. It will also avoid the possibility of over-issue by individual banks.

The central banks, thus, regulate the currency of country and the total money-supply in the economy. The central bank has to keep gold, silver or other securities against the notes issued. The system of note-issue differs from country to country.

It may be noted that NBE (National bank of Ethiopia) issues all currency notes in Ethiopia. Remember, the central government of a country is usually authorised to borrow money from the central bank.

When the central government expenditure exceeds government revenue and the government is unable to reduce its expenditure, then it borrows from the central bank. This is done by selling security bills to central bank which creates new currency notes for the purpose. This is called

**monetisation of budget deficit or deficit financing**. The government spends new currency and puts it into circulation to meet its expenditure.

**2**. **Custodian (protection) of foreign currency reserves and gold:** It has been mentioned above that a central bank is the custodian of foreign exchange reserves and country's gold. That means the central bank holds all foreign exchange reserves-key currencies such as U.S. dollars, British pounds and other prominent currencies, gold, silver, bullion, and other such reserves-in its custody.

These reserves are required as a 'cushion' in the event of a balance of payments deficit. They would be used to help finance the deficit. In the case of a balance of payments surplus the central bank would add to the reserves. Thus reserves fall during balance of payments deficit and rise during surplus. The central bank also administers government regulations as regards supply of and demand for foreign exchange and arranges loans (possibly from the IMF) to supplement the reserves.

**3. Exchange control:** Another duty of a central bank is to see that the external value of currency is maintained. The central bank has the duty of keeping external value of the country's currency through various measures. It keeps a close watch on external value of its currency and undertakes exchange management control. For instance, in Ethiopia, the National bank of Ethiopia takes steps to ensure external value of a birr. It adopts suitable measures to attain this object. Under exchange control system, every citizen of Ethiopia has to deposit with the NBE all foreign currency or exchange that he receives. And whatever foreign exchange he might need has to be secured from the National bank by making an application in the prescribed form.

This right of the central bank enables it to exercise a reasonable control over foreign exchange, for example, to maintain the countries international liquidity position at a safe margin and to maintain the external value of the country's currency in terms of key foreign currencies.

**4, Banker, Agent and Adviser to the Government:** Central banks everywhere perform the functions of banker, agent and adviser to the government.

**As a banker to the government**, the central bank of the country keeps the banking accounts of the government both of the Centre and of the States performs the same functions as a commercial bank ordinarily does for its customers. Providing the government with short term loans and advances is an important banking service rendered by the central bank. This enables

the government to meet its current financial obligations in anticipation of its revenue.

**As an agent to the government,** the central bank also delegated with the management of public debt and the issue of new loans and treasury bills on behalf of the government. Similarity, central bank accepts receipts and makes payment on behalf of the governments.

**As an advisor** central bank advises the government on monetary and economic matters For example, releases another important service. The role of the central bank as an advisor to the state is gifted with much significance because of the essential status which it enjoys in the monetary map of the country. It is in a position to judge the general financial situation of the country and to render appropriate financial advice.

**5**. **Banker to Commercial Banks:** Broadly speaking, the central bank acts as the banker's bank in two different capacities: (a) It acts as the custodian of the cash reserves of the commercial banks (b) It acts as the lender of the last resort/option. We shall now discuss these two functions one by one.

**(a) It acts as the custodian of the cash reserves of commercial banks:** Commercial banks keep part of their cash balances as deposits with the central bank of a country known as **centralization of 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. They draw during busy seasons and pay back during slack seasons. Part of these balances is used for clearing purposes. Other member banks look to it for guidance, help and direction in time of need.

There are many advantages when all banks keep part of their cash reserves with the central bank of the country. In the first place, centralized cash reserves will enable commercial banks to meet crises and emergencies. Secondly, it enables the central bank to provide additional funds to those banking institutions which are in temporary difficulties. Lastly, it enables the central bank to influence and control the credit creation of commercial banks by making the cash reserves of the latter more or less.

**(b) Lender of the last resort/option:** Whenever banks are **short of funds**, they can take loans from the central bank. As the banker's bank, the central bank can never refuse to accommodate commercial banks. When commercial banks have exhausted all resources to supplement their funds

at times of liquidity crisis, they approach central bank as a last resort/option. As lender of last resort, central bank guarantees solvency and provides financial accommodation to commercial banks:

(i) By rediscounting (selling) their eligible securities ( bills of exchange, and such other eligible papers) and
(ii) By providing loans against their securities. This saves banks from possible failure and banking system from a possible breakdown. On the other hand, central bank, by providing temporary financial accommodation, saves the financial structure of the country from collapse.

In the case of any eventuality the central bank acts as the lender of the last resort to the various commercial banks. The central bank is a source of great strength to the banking system,

**6. Controller of Credit and Money Supply:** Probably the most important of all the functions performed by a central bank is that of controlling the credit operations of commercial banks. Commercial banks create lot of credit which sometimes results in inflation. In modern times, bank credit has become the most important source of money in the country, transferring coins and currency notes to a minor position. Moreover, it is possible, for commercial banks to expand credit and thus increase Inflationary pressure or contract credit and thus contribute to a deflationary situation.

The expansion or contraction of currency and credit may be said to be the most important causes of business fluctuations. The need for credit control is obvious. It mainly arises from the fact that money and credit play an important role in determining the level of incomes, output and employment.

It is, thus, of great importance that there should be some authority which will control the credit creation by commercial banks. As controller of credit, the central bank attempts to influence and control the volume of bank credit and also to stabilize business conditions in the country.

Thus, the control which the central bank exercises over commercial banks as regards their deposits, is called controller of credit

**7. Promoter of Economic Development:** In developing economies the central bank has to play a very important part in the economic development

of the country. Its monetary policy is carried out with the object of serving as an instrument of planned economic development with stability. The central bank performs the function of developing long-term financial institutions, also known as **development banks,** to make available adequate investible funds for the development of **agriculture, industry, foreign trade,** and **other sectors of the economy**. In addition, the central bank may also undertake miscellaneous functions such as providing assistance to farmers through co-operative societies by subscribing to their share capital, promoting finance corporations with a view to providing loans to large-scale and small-scale industries. In short, a central bank is an institution which always works in the best economic interests of the nation as a whole. In view of all these functions, as discussed above, it follows that a modern central bank is much more than a Bank of Issue.

**8. Clearing House function:** Central bank also acts as a clearing house for the settlement of accounts of commercial banks. A clearing house is an organisation where mutual claims of banks on one another are offset, and a settlement is made by the payment of the difference. Central bank being a bankers' bank keeps the cash balances of commercial banks and as such it becomes easier for the member banks to adjust or settle their claims against one another through the central bank.

Suppose there are two banks, they draw cheques on each other. Suppose bank A has due to it Rs. 3,000 from bank B and has to pay Rs. 4,000 to B. At the clearing house, mutual claims are offset and bank A pays the balance of Rs. 1,000 to B and the account is settled. Clearing house function of the central bank leads to a good deal of economy in the use of cash and much of labour and inconvenience are avoided.

**9. Collection and Publication of Data:** It has also been entrusted with the task of collection and compilation of statistical information relating to banking and other financial sectors of the economy.

# CHAPTER THREE

# 3. COMMERCIAL BANKING

## 3.1. INTRODUCTION

Commercial Banks are banking institutions that accept deposits and grant short-term loans and advances to their customers. In addition to giving short-term loans, commercial banks also give medium-term and long-term loan to business enterprises. Now-a-days some of the commercial banks are also providing housing loan on a long-term basis to individuals. Commercial banks are of three types i.e., Public sector banks, Private sector banks and foreign banks.

## 3.2 Meaning

Commercial 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. 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 loans out of the funds received as deposits to needy people. It thus, functions as a mobilise 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. FUNCTION OF COMMERCIAL BANKS OR MODERN 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. It is difficult to discuss all functions here. However, some basic functions performed by the banks are discussed as follows.

The functions of commercial banks are of two types. (A) Primary functions; and (B) Secondary functions. Let us discuss in details about these functions.

**(i) Primary functions:**

The primary functions of a commercial bank include: a) Accepting deposits; and b) Granting loans and advances.

**a) Accepting deposits**

The most important activity of a commercial bank is to mobilise deposits from the public. People who have surplus income and savings find it convenient to deposit the amounts with banks. Depending upon the nature of deposits, funds deposited with bank also earn interest. Thus, deposits with the bank grow along with the interest earned. If the rate of interest is higher, public are motivated to deposit more funds with the bank. There is also safety of funds deposited with the bank.

**b) Grant of loans and advances**

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 second important function of a commercial bank is to grant loans and advances. Such loans and advances are given to members of the public and to the business community at a higher rate of interest than allowed by banks on various deposit accounts. The rate of interest charged on loans and advances varies according to the purpose and period of loan and also the mode of repayment. The various types of loans granted by the bank are:

1. Term Loans
2. Advances
   a. Cash credit
   b. Overdraft facility
   c. Discounting of bills of exchange

**1) Term Loans:** They are loans granted for a specific period of time. The time period may be short-term, medium and long-term loans. Short-term loan is usually a loan granted up to one year, and medium term 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, agricultural, consumer, educational medical, etc.

The borrower may be given the entire amount in lump sum or in instalments. Loans are generally granted against the security of certain assets. A loan is normally repaid in instalments. However, it may also be repaid in lump sum.

**2) Advances**

An advance is a credit facility provided by the bank to its customers. It differs from loan in the sense that loans may be granted for longer period, but advances are normally granted for a short period of time. Further the purpose of granting advances is to meet the day-to-day requirements of business. The rate of interest charged on advances varies from bank to bank. Interest is charged only on the amount withdrawn and not on the sanctioned amount.

**Types of Advances**:

Banks grant short-term financial assistance by way of cash credit, overdraft and bill discounting. Let us learn about these.

**a) Cash Credit:**

Under this account, the bank gives loans to the borrowers against certain security. That means this loan is granted against collateral. 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 amount of credit availed to him. That means a certain amount of money is granted for a customer and 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. 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. Cash Credit is granted as per terms and conditions agreed with the customers.

**b) Overdraft :**

Overdraft is also a credit facility granted by bank 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. A customer who has a current account with the bank is allowed to withdraw more than the amount of credit balance in his account. 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 business man 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.

**c) Discounting of Bills:**

This is another type of lending which is very popular with the modern banks. 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.

The holder of a bill can get it discounted by the bank, when he is in need of money. 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 party gets the funds without waiting for the date of maturity of the bills. In case any bill is dishonoured on the due date, the bank can recover the amount from the customer.

**ii) Secondary functions:**

In addition to the primary functions of accepting deposits and lending money, banks perform a number of other functions, which are called secondary functions. These are as follows:

**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. **Acting guarantee**: bank stands guarantee on behalf of its customers, for making payment for purchase of goods, machinery, vehicles etc.

C. Agency service: A bank acts as an agent of its customers in collecting and paying cheques, bills of exchange, dividends etc. it also buys and sells shares and debentures. Further it pays subscription, insurance premium, rent, electric and water bills and other similar charges on behalf of the clients.

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. **Providing consumer loans:** bank provides consumer finance for individuals by way of loans on easy terms for purchase of consumer durables like televisions, refrigerators, etc.

F. **Providing educational loan**: Bank provides Educational loans to students at reasonable rate of interest for higher studies, especially for professional courses.
G. Providing customers with facilities of foreign exchange dealings.
H. Transferring money from one account to another; and from one branch to another branch of the bank through cheque, pay order, demand draft.

## 3.4. CREDIT CREATION

An important function performed by the commercial banks is the creation of credit. 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 and expand the money supply. Banks supply money to traders and manufacturers. When a bank advances a loan to its customer, it does not pay cash but opens an account in the borrower's name and credits the amount of loan to this account. . He can withdraw the amount whenever he wants by a cheque. 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. In this case, bank has created a deposit without receiving cash. That is, banks are said to have created credit.

**Basis of Credit Creation**

The basis of credit money is the bank deposits. The bank deposits are of two kinds.

(1) Primary deposits, and
(2) Derivative deposits.

1. **Primary Deposits:** Primary deposits arise or formed when cash or cheque is deposited by customers. When a person deposits money or cheque, the bank will credit his account. The customer is free to withdraw the amount whenever he wants by cheques. These deposits are called "**primary deposits"** or **"cash deposits**." It is out of these primary deposits that the bank makes loans and advances to its customers.

The initiative is taken by the customers themselves. In this case, the role of the bank is passive. So these deposits are also called **"passive deposits**." These deposits simply convert currency money into deposit money. They do not create money. They do not make any net addition to the stock of money. In other words, there is no increase in the supply of money.

**2**. **Derivative Deposits:** Bank deposits also arise when a loan is granted or when a bank discounts a bill or purchase government securities. Deposits which arise on account of granting loan or purchase of assets by a bank are

called “**derivative deposits.”** Since the bank play an active role in the creation of such deposits, they are also known as “**active deposits.”** When the banker sanctions a loan to a customer, a deposit account is opened in the name of the customer and the sum is credited to his account. The bank does not pay him cash. The customer is free to withdraw the amount whenever he wants by cheques. Thus the banker lends money in the form of deposit credit. The creation of a derivative deposit does result in a net increase in the total supply of money in the economy.

Granting a loan is not the only method of creating deposit or credit. Deposits also arise when a bank discounts a bill or purchase government securities. When the bank buys government securities, it does not pay the purchase price at once in cash. It simply credits the account of the government with the purchase price. The government is free to withdraw the amount whenever it wants by cheque. Similarly, when a bank purchase a bill of exchange or discounts a bill of exchange, the proceeds of the bill of exchange is credited to the account of the seller and promises to pay the amount whenever he wants. Thus asset acquired by a bank creates an equivalent bank deposit. It is perfectly correct to state that “bank loans create deposits.” The derivate deposits are regarded as bank money or credit. Thus **the power of commercial banks to expands deposits through loans, advances and investments are known as “credit creation.”**
Thus, credit creation implies increase of bank deposits. Credit creation maybe defined as “the expansion of bank deposits through the process of more loans and advances and investments.”

**Limitation on Credit Creation**
The commercial banks do not have unlimited power of credit creation. Their power to create credit is limited by the following factors:

**1. Amount of Cash:** The power to create credit depends on the cash received by banks. If banks receive more cash, they can create more credit. If they receive less cash they can create less credit. Cash supply is controlled by the central bank of the country.

**2**. **Cash Reserve Ratio:** All deposits cannot be used for credit creation. Banks must keep certain percentage of deposits in cash as reserve. The

volume of bank credit depends also on the cash reserve ratio the banks have to keep. If the cash reserve ratio is increased, the volume of credit that the banks can create will fall. If the cash reserve ratio is lowered, the bank credit will increase. The Central Bank has the power to prescribe and change the cash reserve ratio to be kept by the commercial banks. Thus the central bank can change the volume of credit by changing the cash reserve ratio.

**3**. **Banking Habits of the People:** The loan advanced to a customer should again come back into banks as primary deposit. Then only there can be multiple expansions. This will happen only when the banking habit among the people is well developed. They should keep their money in the banks as deposits and use cheques for the settlement of transactions.

**4**. **Nature of Business Conditions in the Economy:** Credit creation will depend upon the nature of business conditions. Credit creation will be large during a period of prosperity, while it will be smaller during a depression. During periods of prosperity, there will be more demand for loans and advances for investment purposes. Many people approach banks for loans and advances. Hence, the volume of bank credit will be high. During periods of business depression, the amount of loans and advances will be small because businessmen and industrialists may not come to borrow. Hence the volume of bank credit will be low.

**5. Complete Securities:** A bank creates credit in the process of acquiring complete and profitable assets, like bills, and government securities. If people cannot offer complete securities, a bank cannot create credit. Crowther says “a bank cannot create money out of thin air. It transmutes other forms of wealth into money.”

**6. Monetary Policy of the Central Bank:** The extent of credit creation will largely depend upon the monetary policy of the Central Bank of the country. The Central Bank has the power to influence the volume of money in circulation and through this it can influence the volume of credit created by the banks. The Central Bank has also certain powerful weapons, like the bank rate, open market operations with the help of which it can exercise control on the expansion and contraction of credit by the commercial bank. . This function has far-reaching effect on the working of the economy, especially on the business activity. Bank credit is the oil which lubricates the wheels of the business machine.

## 3.6. BALANCE SHEET OF BANKS:

Balance sheet of bank contains asset and liabilities. Assets are what others owe the bank, and what the bank owes others constitutes its liabilities. The business of a bank is reflected in its balance sheet and hence, it's financial position as well. The balance sheet is issued usually at the end of every financial year of the bank. The balance sheet of the bank comprises of two sides; the assets side and the liabilities side. It is usual to record liabilities on the left side and assets on the right side.

### 3.6.1. The Bank's assets

**Assets**: Assets are the claims of the bank on others.

**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 defence 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 defence to the bank.

**Bills Discounted:** The commercial banks invest in short term bills consisting of bills of exchange and treasury bills which are self-liquidating in character. 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.

**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. Like government bonds, other financial asset,

**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

**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.

### 3.6.2. The bank's Liabilities

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

The liabilities side includes several types of claims on the bank's assets. These claims consist of **deposits**; the bank's **borrowing** at central bank or other financial institutions, and the **claims of the bank's stockholders**. Thus, the liabilities side of bank's balance sheet represent sources from which bank obtained the funds. The bank obtains funds by borrowing and by issuing other liabilities such as deposits.

**Capital:**

Banks have to meet a minimum capital requirement.

Bank equity capital or primary capital is the stockholders' equity in the bank. It is represented on the balance sheet mainly by outstanding stock, profits, and retained earnings. In addition to equity capital, banks can account as part of their long-term funds which it has obtained by selling bonds and notes– sometimes called a secondary capital but that is a kind of borrowing (and a part of liabilities).

**Retained earnings:** Reserve fund is the accumulated undistributed profits of the bank. The bank maintains reserve fund to tide over any crisis. But, it belongs to the shareholders and hence a liability on the bank.

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**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 liability on the bank

# CHAPTER FOUR

# 4. BANK-CUSTOMER RELATIONSHIPS

## 4.1. INTRODUCTION

This chapter deals with the relationship that exists between the banker and customer. All the legal aspects associated with these two vital organs of the banking operations are discussed. The relationship between the customer and the banker is vital. The relationship starts right from the moment an account is opened and it comes to an end immediately on closure of the account. The relationship stands established as soon as the agreement or contract is entered into. The nature of the relationship depends upon the state of the customer's account.

**Definition of a Customer**

The term 'Customer' has not yet been statutorily defined. However, in general, the term 'Customer' means a person who has an account with the bank.

According to John Paget, "to constitute a customer there must be some recognizable course of dealing in the nature of regular banking business". Thus, according to the above view, a person does not become a customer simply by opening an account with the bank. He should be in the habit of dealing with the bank, i.e. there should be some measure of continuity in his dealings with the bank. This is popularly known as "Duration theory. Thus, in order to constitute as a customer, a person should satisfy two conditions:

A. He should have an account with the bank, whether fixed, savings or current.

B. The dealings should be of a banking nature. Dealings of banking nature have to be differentiated from other dealings, which are of a casual nature. For example, here money must be deposited in the customer's account and drawings should be made from this account and occasionally getting a check cashed and depositing valuables for safe custody.

### 4.2. The Banker-Customer Relationship

The relationship between the banker and the customer arises out of the contract entered in between them. This contract is created by mutual consent. A contract that exists between a bank and its customer is a loan contract. This is because if the customer's account is in credit, the bank owes him that money and vice versa, if the account is overdrawn. The relationship between the banker and the customer is vital. The relationship starts right from the moment an account is opened and it comes to an end immediately on closure of the account. This relationship is of two types: ***general and special relation ship***

### A. GENERAL RELATIONSHIP BETWEEN BANKER AND CUSTOMER

The general relationship between a banker and customer can be studied under three heads;

1) Debtor - Creditor relationship.
2) Trustee - Beneficiary relationship.
3) Agent - Principal relationship.

#### 1. Debtor - Creditor Relationship

On the opening of an account, the banker assumes the position of a debtor. The money deposited by the customer with the banker is in legal terms, lent by the customer to the banker, who makes use of the same according to his discretion. The creditor has the right to demand back his money from the banker, and the banker is under an obligation to repay the debt as and when he is required to do so etc.

A depositor remains a creditor of his banker so long as his account carries a credit balance. The relationship will be reversed as soon as the customer's account is over drawn.

Although the relationship between a banker and a customer is mainly that of a debtor and creditor, it differs from similar relationship of debtor and creditor of ordinary commercial debts in the following respects.

**The Creditor must demand payment:**

Demand for repayment is necessary. The creditor (customer) must demand a payment from debtor (banker). The banker is under no obligation to refund the customer's deposits unless demanded is made. In case of ordinary commercial debt, the debtor pays the amount on the specified date or earlier or whenever demanded by the creditor. But in case of a bank deposit, the debtor (banker) is not required to **repay** the amount on his own. It is essential that the creditor (depositor) must make a demand for the payment of the deposit in the proper manner. This difference is because a banker is not an ordinary debtor; it is termed as a privileged debtor.

**I. Proper Place and Time of Demand**

The demand by the creditor must be made at the proper place and in proper time. His demand for the repayment of the deposit must be made at the same branch of the bank, where the customer's account is maintained, otherwise, the banker is not bound to honour the checks.

It is also essential that the demand must be made during a working day of a bank i.e. not on a holiday or a day which is closed for public. And in addition, it must be presented during business hours i.e., it should not be presented either before or after the business hours.

**II. Demand must be made in Proper Form**

Demand for the refund of money deposited must be made through a check or an order. In other words, the demand should not be made **verbally** or through a **telephonic message**. A verbal or telephonic demand will not be taken as a proper demand.

**III. No time bar**. The deposits with a bank do not become time barred on the expiry of a certain time as in the case of other commercial debts. This is because of the reason that the amount does not become due unless it is demanded.

**2. <u>Trustee – Beneficiary Relationship</u>**

In certain circumstances, the banker may acts as a trustee also. A trustee holds money or assets and performs certain functions for the benefit of some other person called the beneficiary. For e.g. if the customer deposits

securities or other valuables with the banker for safe custody, the banker acts as a trustee of his customer.

The legal position of the banker, as a trustee, therefore differs from that of a debtor of his customer. The position of a banker as a trustee or as a debtor is determined according to the circumstances of each case. For e.g. in case of a check sent for collection, the banker acts as a trustee till the check is realized and credited to the customer's account and thereafter he will be the debtor for the same amount.

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.

**3. Agent –Principal Relationship**

Banker acts as the agent of the customer in those cases where it performs agency functions:- Such as; collection of cheque and bills of exchange on behalf his customer, purchasing and selling of securities on behalf of his customer, payment of insurance premium, rent electric and water bills, etc. Thus, the range of such agency functions has become much wider and the banks are now rendering large number of agency services.

To conclude, the general relationship exists when the account is opened by customer with bank. The relationship is that of debtor and creditor. When the bank acts as trustee or agent for the valuables, he will be establishing the general relationship.

**B. SPECIAL RELATIONSHIP BETWEEN BANKER AND CUSTOMER**

The special relationship between banker and customer takes the form of rights which the banker can exercise and the obligations/ duties which he owes to his customers.

**RIGHTS OF A BANKER**

The banks have been conferred by law special rights which are not available to an ordinary creditor, following are the rights enjoyed by the banker with regard to the customer's account:

1. Right of lien
2. Right of set-off
3. Right to charge interest, incidental charges
4. Right to appropriate payments
5. Right under Garnish order
6. Right to close an account

**1. <u>Right of lien</u>**

Lien means the right of a creditor to retain in his possession property (goods and securities) owned by the debtor or belonging to a debtor until he has discharged a debt due to him but not the right to sell. However, the right of a banker amounts to an implied pledge, which gives him a right to sell the goods in due course to realize his dues.

In case lien is exercised by a trader on his customer's goods, he has neither right to use the goods nor any right to sell them. All that he can do is to retain the goods until the obligations are cleared. Once the obligations are cleared by the customer, it is an obligation on the part of the trader to return back his goods immediately. There are two kinds of lien: ***general lien and particular lien***

**(a)** ***Particular Lien****:* A particular lien confers a right to retain the goods in respect of a particular debt involved in connection with a particular transaction. This lien is enjoyed by the persons who have spent their labour on such properties and have not yet recovered their labour charges or service charges from the debtors. For example, a tailor has the right to retain the cloths made by him for his customer until his tailoring charges are paid by the customer. So is the case with public carriers and the repair shops. Generally a particular lien is a specific lien, which confers a right to retain those goods for which the amount is to be paid.

**(b)** ***General Lien****:* A general lien confers a right to retain goods not only in respect of debts incurred in connection with a particular transaction but also in respect of any general balance arising out of the general dealing between the two parties. This right can be exercised only by persons such **as bankers, factors, brokers, attorneys of High Court** etc. The basic object of general lien is to have protection for the bank funds. The loans or

advances granted to customers can be recovered easily if the general lien is exercised by the bankers.

Banker's lien is a general lien in that bankers have general lien on all goods and securities deposited with them by a customer, It is applicable in respect of all amounts due from the debtor to the creditor..

***The right of general lien is available to the banker only with following conditions;***

A. The banker possesses the right of general lien on all the goods and securities entrusted to him in his capacity of a banker. E.g Bonds and coupons belonging to the customer deposited for collection. This right will arise only when the goods and securities have been left with him in order that he may deal with them in his capacity of a banker.

   Thus he cannot exercise his right of general lien if;

   - The goods and securities have been received by the banker as a trustee or an agent.

B. The right of lien can be exercised on goods and securities standing in the name of the borrower only and not jointly with other. That means a banker can exercise his right of general lien only on those goods, which are the property of the borrower. The banker can't exercise this right in case of goods held in joint- ownership or partnership of which borrower is one of the joint-owners or partners.

C. The banker can exercise his right of lien on any security given by the customer for the purpose of a covering loan**.** that means . A banker can exercise his right of lien on the securities remaining in his possession after the loan, for which they were lodged or wedged, is repaid by the customer and there exists no contract to the contrary

**Exceptions to the right of general lien**

The right of general lien cannot be exercised by the banker in the following circumstances.

**(a)** ***Safe custody of valuables:*** The banker cannot exercise his right of lien on valuables deposited by his customer for safekeeping. Because in such cases, the bank is the trustee of the goods deposited by the customer and so the banker must perform his duties in accordance with the terms of contract.

(**b)** ***Documents deposited for special purpose***: If a customer sends any document with the specific instruction for utilizing its proceeds for any

specific purpose, the right of general lien does not exist. E.g. when a customer sends a cheque or a bill of exchange with the clear instruction to utilize its proceeds for a specified purpose, the banker cannot exert his right of lien on the proceeds of such cheque or bill of exchange because a contract inconsistent with the right of general lien is presumed to exist. Similarly, if a customer hands over some shares to the banker with same instruction to sell them at certain price, and the some are lying unsold with the banker, here also the banker cannot exercise the right of lien because a contract inconsistent with the right of general lien is presumed to exist. However, if the security comes into the possession of the banker in the ordinary course of business, he can exercise his right of general lien.

(***c) Securities left with the bank negligently:*** The banker does not possess the right of lien on the documents or valuables left in his possession by the customer by mistake or by negligence.

**(d)** ***Securities held in trust:*** The banker cannot exercise his right of general lien over the securities deposited by the customer as a trustee in respect of his personal loan.

**(e)** The bankers' right of lien extends over goods and securities handed over to the banker. Money deposited in the bank and the credit balances in the accounts do not fall in the category of goods & securities. Therefore, the banker may exercise his right of set-off rather than the right of general lien.

**(f)** The banker cannot exercise his right of general lien over the securities given to him for securing a loan, before such loan is actually granted to him.

**2 Right of set-off**

A customer may maintain two or more accounts at one branch or at several branches of the same bank. This right enables the banker to combine the two accounts in the name of the same customer and to set to the debt, if there is no agreement to the contrary. The right of set off gives a special protection of the banker in case of a default by a customer whose one account is overdrawn and the other account has a credit balance. Thus, where a customer maintains two accounts in his name, and one of them shows a debit balance, the bank can set off the debit balance against the credit in the second account. A banker possesses the right of set-off, which enables him to combine two accounts in the name of the same customer and to adjust the debit balance in one with the credit balance in the other. For example, Mr. A has taken an overdraft from his banker to the extent of

Br.10, 000 and he has a balance of Br.5000 in his saving bank account. Hence, the banker can combine both of these accounts and claim the remaining amount of Br.5000 only. This right of set-off can be exercised by the banker after a notice is served on the customer intimating the decision of the banker of set-off.

**The right of set-off can be exercised subject to the fulfilment of the following conditions;**

1. ***The accounts must be in the same name and in the same right:***

Before combining the different accounts the customer, the banker should ensure that such accounts are in the same right and same name. The banker should be cautious in situations where accounts are in the same name but are in different rights or capacities. Here the account with the banker must not only be in the same name but also in the same right. "The ''**same right**" means that the capacity of the account holder in both the accounts must be the same. Thus the funds belonging to someone else, but standing in the same name of the account holder, should not be made available for satisfy his personal debts. Example If one account is in single name in personal capacity and other account is in joint name or in the capacity of a trustee, banker cannot combine these accounts. That means the personal account of the trustee cannot be set-off with the trust account money. Similarly, a personal account of a partner cannot be combined with the account in his capacity as a partner.

***2. The right can be exercised in respect of debts due and not in respect of future debts.***

The right to combine two or more accounts can be applied to existing debts due from the customer. It cannot be applied to future debts For example, a banker can set-off a credit balance in the account of a customer towards the payment of a bill which is already due, but not in respect of a bill which will mature in future.

***3. The amount of debts must be certain:***

It is essential that the amount of debts due from both the parties to each other must be certain. If liability of anyone of them is not determined exactly, the right of set-off cannot be exercised. For example, if Mr. A is a guarantor for a loan of Br.100, 000 given by a bank to Mr. B. Mr. A's

liability as guarantor will arise only after Mr. B delays in making payment. The banker cannot set-off the credit balance of the guarantor till his liability as a guarantor is determined. For this purpose, the banker must first demand payment from his debtor. If the debtor defaults in making payment of his debt, only then the liability of the guarantor arises and the banker can exercise his right of set-off against the credit balance in the account of the guarantor.

**4. The right may be exercised in the absence of an agreement to the contrary.**

The right of set -off is available to the banker without any agreement. But, if these are any agreement implied or expressed, which is contrary to such right, the banker cannot avail this right against the customer.

**5. For the purpose of exercising this right, all the branches of a bank constitute one** entity and the bank can combine two or more accounts in the name of the same customer at more than one branch.

**6. The banker has the right to exercise this right before his garnishee order is made effective**. Garnishee order is a court order given to the Banker to stop operation of an account. If a banker has received a garnishee order against his customer, the banker should exercise right of set-off before the garnishee order is made effective. If the banker does not exercise the right of set off and informs the court of the entire balance to the court, it will be difficult for the banker to realize the debts due from the customer.

**Automatic Right of Set-off**

In the following cases, a banker enjoys the right of Automatic set-off without giving notice

- On the death, or insanity of customer.
- On the insolvency of a partner.
- On receipt of Garnishee order
- On receiving the notice of second mortgage on the security on which the bank holds first charge.
- On the winding up of a company.

Thus, the right of set-off is a statutory right. But to exercise this right, it is the normal practice of the banker to obtain a letter of set-off from the customer.

## 3. Right to charge interest & commission

As a creditor, a banker has the implied right to charge interest on the loans granted to the customer. The rate of interest is nowadays levied as per the directions of Central Bank. The banker is also entitled to charge commission for services rendered to his customer.

## 4.Right to appropriate payments

A customer may owe several debts to a banker and make some payment to the banker, which is not sufficient to discharge all his debt. Then, the problem of appropriating this payment arises. As to which debt should be discharged first?

Right of appropriation is the right of a banker to appropriate the money paid by the customer to any of the loans including the time-barred debts. The banker can do so when the debtor has not asked the banker at the time of making the payment to cancel or reduce any one of the debts, irrespective of the order of the time when the debt is incurred. The implications regarding appropriation of payments made by the customer are as follows;

**Appropriation indicated by the debtor.**

If a customer has more than one debts due to the banker, he has the right to direct the banker to reduce or cancel any debt at the time of payment, For instance, if a customer has two account and one of them shows an overdraft, the customer may direct, at the time of payment, the banker to credit the same to any of the two accounts as per his instructions. Once the customer gives specific directions regarding appropriation, the banker has no right to alter them. It is his bounden duty to carry out the instructions of the customer. This right of appropriation is to be exercised by the customer at the time of making payment and not later.

**ii) Appropriation by Banker.**

In the absence of any instructions from a customer who owes money to the banker on a number of accounts, the banker has a right to appropriate the payment to any debt or account according to his discretion. But he should inform the customer about the appropriation.

**iii) When neither party appropriates.**

When neither the customer has given any instruction to the banker nor the banker has taken any action to appropriate the money, the payment must be appropriated to discharge the debts in chronological order (i.e. order of time) irrespective of the fact that some debts are time-barred. If the account is discontinued and new account is opened, the rule does not apply to the old account. In case both have not used their powers..

## 5. Right under garnishee order

Garnishee order is a court order given to the Banker to stop operation of an account of his customer. The term “Garnishee” is derived from the Latin word “garnire” which means “**to warn.** This order warns the holder of money of judgment debtor, not to make any payment out of it till the court directs.

It is an order issued by a competent court of law addressed to a banker instructing him to stop or withhold payment of money belonging to a particular person who has committed a default in satisfying the claim of his creditors. Therefore, whenever a bank receives such an order, the banker has to obey the order fully.

Let us take an example to clearly explain this procedure.
Mr X is a contractor and obtains a loan from Mr Y a money lender or banker. Mr X fails to pay the money to Mr Y as per the provision. Hence Mr Y files a suit in the court of law for payments. Mr Y also knows that the money is payable to Mr X from the agency (third party) with which he is doing his contract business. Now Mr Y can request the court to issue an order directing the Mr X’s agency not to make any payment to Mr X. If the court issues the order that becomes garnishee order, in this suit Mr X is a judgment debtor and Mr Y is a judgment creditor. The third party is garnishee.

Sheldon defines Garnishee order thus, “It is an order obtained by a judgment creditor attaching funds in the hands of a third party, who owes the judgment debtor money, warning the third party, not to release the money attached until directed by court to do so.”

Thus, garnishee order is a direction given by the court to a third party who is due to the judgment debtor not to make any payment till it gives a decision regarding the paid money. This order is issued at the request of the judgment creditor.

In the following circumstances the Garnishee order would not be applicable:

A. Where the account of the judgment debtor is a joint account holder with another person
B. Where the identity of the judgment debtor is doubtful
C. Where the account of the judgment debtor is held by him in the capacity of a trustee
D. Where the judgment debtor has previously made an official assignment of his balance in favour of a third party and the banker is informed about it in writing
E. Where the account of the judgment debtor reveals a debit balance.

## 6. Right to close an account

The phrase closing of an account is used to denote the termination of relationship between a banker and customer. The termination may be by the parties (banker & customer) at their option..

1. A banker may close the account of his customer which has been unsatisfactorily conducted by sending a written intimation to the customer. The followings are the common reasons which necessitate closing of an account by the banker:
   - ✓ Repeatedly issuing checks without adequate funds
   - ✓ Frequently countermanding payment of checks
   - ✓ Paying in checks that are not honoured
   - ✓ Failing to remit funds to cover bills with the bank for payment

However, the banker is bound to give reasonable notice to the customer, before closing the account.. He may state there in that he will not receive any further credits and may additionally request the customer to withdraw his balance. Else, he may inform that he will honour the checks only until the balance is exhausted. The banker must give the customer a sufficient notice before closing the account. If he closes the account without giving proper notice and he dishonour checks, he will be held liable for unjustifiable dishonour. Banker must give sufficient time before the account is closed. The length of the notice will depend on the circumstances of the case and nature of the business of the customer. When a customer does not comply with the request of the banker to close his account even after the expiry of a reasonable notice given to him, the banker can close the account by returning the entire balance due to him. He must ask his customer to return the unused cheques.

**In the following cases, a banker can close the account of a customer without giving notice:**

- When a customer dies, the banker must close the account of his customer on receiving a notice of death.
- On the insanity of customer or when a banker comes to the knowledge that a customer has become insane, he should close his account.
- A banker should not honour checks after receiving the garnishee order from the court

2. Similarly, a customer may close the account with the banker at any time he feels without assigning any reason, though the usual reasons could be that he:
   - ✓ Does not agree with the terms and conditions of the bank
   - ✓ Feels unhappy with the quality of services
   - ✓ Loses confidence on the bank. He may close the account merely by presenting a check for the balance in his favour however it is common to inform the banker of his intention and return unused checks with him

**DUTIES OF A BANKER**

The obligations of a banker can be studied under three categories:

I. Obligation to honour the checks.
II. Obligation to maintain secrecy of accounts.
III. Obligation to Receive Checks and Other Instruments for Collection

**I. <u>Obligation to Honour the Checks:</u>**

The deposits accepted by a banker are his liabilities repayable on demand. Therefore the banker is under a statutory obligation to honour his customer's checks in the usual course.

"The drawee of a check having sufficient funds of the drawer in his hands properly applicable to the payment of such check, must pay the check. That means the banker is bound to honour his customer's cheques if there is sufficient balance in his account. When duly required to do so and in default of such payment must compensate the drawer for any loss or damage caused by such default."

Thus according to the above, the banker is bound to honour his customer's checks provided the following conditions are fulfilled;

***a. There must be sufficient funds of the drawer in the hands of the drawee***

Sufficient funds means, the funds at least equal to the amount of the check presented. Generally checks sent for collection by the customer are not treated as cash in hands of the banker until the same are realized. Further, the credit balances in other accounts of the customer at other branches need not be taken into account in computing sufficiency of funds for his purpose. The funds in the hands of the drawee banker must be equal to or more than the amount of the check presented for payment. The banker is directed by the drawer to pay a specified sum of money to the payee, and if such sum is not in the hands of the banker at the time of presentation of the check, the banker is under no obligation to make part payment of the check.

***b. The funds must be properly applicable to the payment of the check:***

A customer might be having several bank accounts, but it is essential that the account on which a check is drawn must have sufficient finds. Similarly, a depositor having a debit balance in his current account cannot draw a check on the basis of his fixed deposit with the banker. If there is an agreement between the banker and the customer, where by the banker agrees to sanction an overdraft, the banker's obligation to honour the customer's checks is extended up to the amount of overdraft sanctioned by him.

***c. The banker must be duly required to pay:***

The banker is bound to honour the checks only when he is duly required to pay. This means that the check, complete in order must be presented before the banker at the proper time, ordinarily, a check will have validity for a period of six months. On the expiry of this period, the check is treated as stale and the banker can dishonour the check. Similarly a post-dated check is also dishonoured by the banker because the order of the drawer becomes effective only on the date given in the check.

**II. Obligation to Maintain Secrecy of Accounts**

In an ordinary debtor-creditor relationship, there is no obligation of secrecy. But in the case of banker, one of the implied terms of the contract is that he is obliged to keep the affairs of his customer secret.

The banker is under an obligation to take utmost care in keeping secrecy about the accounts of his customer. If the facts about customer's account

are made known to others the customer's reputation may suffer and he may incur losses also.

Thus, the banker is under an obligation not to disclose **deliberately** or **intentionally** any information regarding his customer's accounts to third party and also takes all necessary precautions and care to ensure that no such information lends out of the account books except under special circumstances such as:-.

a. When the law requires such disclosure to be made.
b. Were disclosure is made with the consent of the customer
c. Where there is a duty to the public to disclose
d. Where the interest of the banker requires disclosure

Thus, a banker will be justified in disclosing information about his customer account on reasonable and proper occasions only as stated above.

**A. Disclosure permitted as per law:** If the government departments such as Federal Inland Revenue Authority, police department, Customs, etc. are in need of information about bank balances maintained by a person who has a bank account, the banker is under obligation to provide information to them.

***B .With express or implied consent of the customer***: The banker will be justified in disclosing any information relating to his customer's account with the consent of the customer, which may be express or implied. **Express consent** exists in case the customer directs the banker in writing to institute the balance in his account to his agent. In certain circumstances, the **implied consent** of the customer permits the banker to disclose necessary information. For example if the banker sanctions a loan to a customer on the guarantee of a third person and the guarantor asks the banker certain questions relating to the customer's account. Here the bank is justified in disclosing the facts to the guarantor, as there is an implied consent of the customer.

***C. Disclosure in Public Interest:*** If a customer holds an illegal account, which is against the interest of the nation, the banker should disclose the account to proper authorities.

***D. Disclosure in the Interest of the Banks:*** The banker in his own interest can disclose the account of the customer. If the customer fails to clear the debt, the banker will approach the guarantor and the guarantor

can ask for the disclosure of the borrower's account, which the banker does and he is insisted in doing so. Thus the banker is justified in providing the details about the customer's account.

### III. Obligation to Receive Checks and Other Instruments for Collection

Basically, the business of banking, as it is known today, comprises acceptance of money on deposit account and payment of checks. It also includes collection of checks. It may rightly be contended that anyone who does not perform these essential services is not a banker. Whenever a banker is entrusted with the job of collection of checks, they must be collected as speedily as possible through the accepted channels. Failure to exercise proper care and employ the recognized direction for collection may make the bank liable for any loss which the customer may sustain.

# CHAPTER FIVE: BANK SERVICES

## 5.1. OPENNING AN ACCOUNT

### Types of Customer Accounts with a Banker

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
4. Recurring deposit account

**1. Fixed Deposit Account**

These deposits are also known as **time deposits** or **"time liabilities**. Fixed deposits are accepted by banks for a specified period of time (say one, two or five years).and repayable **only** on the expiry of that period. Thus, it is repayable on the expiry of a specified period, chosen by the depositor to suit his purpose. The money so deposited cannot be withdrawn **before** the **expiry** of the fixed period.

As the date of repayment of a fixed deposit is determined in advance, the banker need not keep more cash reserves against it and can utilize such amount more profitably. Therefore, the banker offers higher rate of interest on such deposits (The rate of interest on this account is higher than that on other accounts). Fixed deposits have grown its importance and popularity in Ethiopia during recent years. These deposits constitute more than half of the total bank deposits.

### Opening of a Fixed Deposit Account:

In order to open a fixed deposit account, the depositor has to fill in an application form wherein he mentions the amount of the deposit and the period for which deposit is to be made. He also gives his specimen signature. Then, a fixed deposit receipt (FDR) will be issued to the depositor, acknowledging the receipt of the sum of money deposited. The maturity date and the rate of interest applicable for the deposit will be mentioned in the FDR.

**Special characteristics of fixed deposits**:

**(a)** ***Suitability:*** Fixed deposits are usually chosen by **people who have surplus money** and do not require it for some time. These deposit accounts are also preferred by the bankers because fixed deposit funds can be utilized by them freely till the due date of the repayment.

**(b)** ***Rate of Interest:*** The rate of interest and other terms and conditions on which the banks accept fixed deposits are regulated by the National Bank of Ethiopia. The National Bank of Ethiopia revised the rates of interest on fixed deposits several times.

Banks can use fixed deposits for the purpose of lending or investments. So they pay higher rate of interest on fixed deposits. Though interest is payable at the stipulated rate, at the maturity of the fixed deposit, banks usually pay interest quarterly or half-yearly also at the request of the depositor.

The interest earned will be credited to his savings account. The depositor is required to present the receipt for the purpose of necessary entry regarding payment of interest on the backside of the FDR. Interest will be paid only if the deposit is for more than one year. If the maturity date of a fixed deposit falls on a holiday, interest has to be paid for that day also.

**(c)** ***Restrictions on Withdrawals****:* Withdrawal of interest or the principal amount through checks is not permitted. The depositor is not given a checks book. At the request of the customer, the banker may credit the amount of interest or the principal to his saving or current account from which he may withdraw the some through checks.

**(d)** ***Payment before Due Date****:* Banks also permit encashment of a fixed deposit even before the due date, if the depositor so desires. But the interest agreed upon on such deposit shall be reduced.

**(e)** ***Advances against Fixed Deposits:*** The banker may also grant a loan to the depositor on the security of the fixed deposit receipt.

f**) Interest on Overdue Deposits:** As per law, interest ceases to accrue on the overdue deposits, i.e. the deposits that are not withdrawn even after the maturity date. However, the banker can allow interest, if the fixed deposit is renewed from the date of its maturity till some date. In case of renewal, the bank issues a fresh receipt as per the direction of the customer.

### 2. Current Deposit Account

These deposits are kept by **businessmen** and **organizations** who receive and make large payments through banks. In Ethiopia individuals are not allowed to open current accounts. Current accounts are operated through

checks (checks are used to withdraw the amount). A Current Account is a **running** and **active** account which may be operated upon any number of times during a working day. These deposits can be withdrawal at any time. These means this account never becomes time barred, because no interest is paid for credit balance in this account. That means no interest is allowed on current deposits account, and in case, the customer is required to leave a minimum balance undrawn with the bank. There is no restriction with regard to the number and amount of withdrawal. However, as the banker is under an obligation to repay these deposits on demand, they are also called **demand deposit** or ***demand liabilities of a banker.*** Moreover, to meet such liability, the banker keeps sufficient cash reserves against these deposits. Here the bank undertakes the obligation of paying all checks drawn against it by the customer till it has adequate funds of the customer with it. The bank levies certain incidental charges on the customer for the services rendered by it.

**Special features of the current account are**

**a.** The primary purpose of a current account differs from the purpose of other deposit accounts, because a current account is meant for the convenience of his customer, who is relieved of the task of handling cash themselves. E.g Businessmen have to receive and make a large number of payments every day. It is difficult to handle cash. The check facility removes the difficulty.

**b.** The banker undertakes to make payments and to collect the bills, drafts, checks, etc any number of times in a day, thus lots of bank personnel involved in current account. Thus, the banks do not pay any interest on the credit balance in the current account.

**c.** A current account carries certain privileges, which are not given to another bank account holder; for e.g.;

- Third party checks and checks with endorsements can be deposited in the current account for collection of credit.
- Overdraft facilities are given in case of current accounts only.
- There is no limit on the amount or number of withdrawals at a time by one check.

**3. <u>Savings Deposit Account</u>**

Savings deposit account is meant for **small businessmen** and **individuals** who wish to save a little out of their current incomes to safeguard their future and also to earn some interest on their savings. Banks impose certain restrictions on the savings bank accounts. 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. 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. Thus, rate of interest offered on savings deposit account is less than fixed deposits account. The need of keeping cash reserves against such deposits is comparatively larger than fixed deposits.

**Popularity of Savings Accounts**

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

- ✓ A savings account can be opened with a little possible amount (it can be opened with as little as25 birr only). It helps the people of small means to save for their future.
- ✓ The balance lying in the savings bank earns some interest. The customer is benefitted 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 conveniently from the savings account

4. **Recurring Deposit Account**

The Recurring Deposit Account has gained wide popularity these days. Under this, the depositor is required to deposit a **fixed** amount of money **every** month for **specific** period of time. The period of recurring deposit varies from bank to bank. However, banks open such accounts for periods ranging from 1 to 10 years. After the completion of the specified period, the customer gets back all his deposits along with the cumulative interest accrued on them.

Rate of interest paid to recurring deposits are more than the savings deposit account. The accounts are transferable from one branch to another without charge. The depositor has to pay the instalments for each month, before the last working day of that month. Accumulated amount with interest will be payable after a month of the payment of the last instalment.

**Benefits of recurring deposit Accounts**

Recurring deposit account offers the following benefits to the public:

- It provides a good way to save in small amounts for use in the future, e.g., education of children, marriage of children, etc.
- People having low income may open a recurring deposit account with a commitment to deposit as low as Br.50 every month.
- The recurring deposit account can be opened for any period ranging from 1to 10 years.
- Standing instructions to transfer monthly instalments from the savings account of the depositor are carried out without any charge.
- Loan can be taken up to 90% of the deposits if the depositor needs money.

**General Procedures for Opening Current & Savings Deposit Account**

By opening an account with the banks the customers enters into an agreement with the banker, and thus this relationship impose several obligations on the banker. Therefore, a banker should be very careful in opening an account in the name of a customer. Thus he has to take the following safety measures.

### 1. Fill in the Prescribed Application Form

Banks provide separate application forms for opening savings and current accounts for individuals, partnership firms and companies. The applicant has to mention his name, occupation, full address, specimen signature and the name and signature of a referee (introducer).

The applicant must also undertake to comply with the bank's rules and regulation in force from time to time. It means that the rules prevalent at the time of opening of an account may be changed or modified by the banker and the customer shall accept such modified rules.

Three copies of the passport size photograph have to be submitted.

### 2. Introduction of the Applicant

In order to get identity of the applicant the banker may require him to be introduced by an existing customer or a well – known person of that area. Thus, the applicant may be introduced to the banker in three ways:

A. A respectable person, either a customer of the same branch or who is known to the staff of the branch- introduces him by signing on the application form with his full address.

B. The applicant may give the name of any respectable person of another bank as referee. The banker enquires about the **honesty, respectability** and **financial position** of the applicant from the said referee. If the referee sends no reply the banker should not open the account.
C. Banks are also accepting the **postal identification cards** or **identity cards** of armed forces, police, government departments or passports for opening deposit accounts without check facility.

### 3. Specimen Signature

The applicant has to give his specimen signature on a prescribed form. The signature is verified by the banker and the signature of the account-holder on the checks is compared with his specimen signature. If the signature differs, the banker can refuse to honour the checks. Thus, the specimen signature prevents the banker against forgery. However the banker should be careful in comparing the signatures of the customer.

### 4. Opening the Account:

Once the formalities are over, the bank opens an account in the name of the applicant. It is essential that the applicant deposit some amount at the time of opening an account. The banker then provides the customer with pay-in-slip book, check book and a passbook and customizes the customer to operate the account.

## 5.2. THE PAYING BANKER

The banker who is liable to pay the value of a check of a customer as per the contract, when the amount is due from him to the customer is called “Paying Banker” or “Drawee Bank”. The payment to be made by him has arisen due to the contractual obligation. He is also called drawee bank as the check is drawn on him.

The payment has to be made by the banker as per the legal obligation also. The drawee of a check, having sufficient funds of the drawer in his hands properly applicable to the payment of such a check, must pay the check, when duly required to do so, and in default of such payment, must compensate the drawer for any loss or damage caused by such default. According to this provision, the drawee of a check, *i.e.,* paying banker has a legal obligations to honour the demand of the drawer or customer. If he fails to pay the money held, he is liable for damages. Thus paying banker has certain obligations to discharge.

While making payment he should be careful. He cannot honour the check when sufficient funds are not available at the credit of the customer. If he pays by oversight he will be running the risk of making good this loss i.e., making payment without having sufficient funds. At the same time he will also run the risk when he dishonours check even when sufficient funds are available at the credit of the customer. He is liable for damages for this wrongful dishonour. Thus in both the cases he runs the risk. However, the customer should present the check at the branch where the amount is kept and should not raise any objection if the check is dishonoured at branches where the customer does not hold the account. But he is at liberty to open accounts in any number of branches and can draw checks, when he is having sufficient funds in each account.

## 5.3. COLLECTING BANKER

Collecting banker means the banker who collects the checks and bills on behalf of the customers. While collecting the checks of a customer, the banker may act in the capacity of either ***as a holder for value, or as an agent of the customer***

A collecting banker is holder for value if he gives the value of the check in any form to its customer before collecting the proceeds of the check deposited by the latter. He does not remain an agent of the customer, but becomes the owner of the check in his own right since he has paid value for it, and has acquired the ownership right in good faith. In such a situation, the banker is called ***holder for value*** and he is also ***the holder in due course***.

When a collecting banker acts as an agent of the customer, he credits the latter's account with the amount of the check after the proceeds of the check are actually collected from the drawee banker. The customer can draw the amount after his account is credited with the proceeds. In such a case, banker acts as an agent of his customer and does not get better title to the check than that of the customer. If the title of the customer is defective, the banker will run the risk of being liable to the true owner if it collects the check. If the check collected by the banker does not belong to his customer, the banker will be liable for 'conversion of money' or in other words, for illegally interfering with the rights of the true owner of the check.

### DUTIES AND RESPONSIBILITIES OF A COLLECTING BANKER

1. **Due Care and Diligence in the Collection of Checks:** The collecting banker is bound to show due care and diligence in the collection of checks presented to him. In case a check is entrusted with the banker for collection, he is expected to show it to the drawee banker within a reasonable time.
2. **Serving Notice of Dishonour:** When the check is dishonoured, the collecting banker is bound to give notice to his customer within a reasonable time. It may be noted here, when a check is returned for confirmation of endorsement, notice must be sent to his customer. If he fails to give such a notice, the collecting banker will be liable to the customer for any loss that the customer may have suffered on account of such failure
3. **Remittance of Proceeds to the Customer:** In case a collecting banker has realized the check, he should pay the proceeds to the customer as per his (customer's) direction. Generally, the amount is credited to the account of the customer on the customer's request in writing.
4. **Collection of Bills of Exchange:** There is no legal obligation for a banker to collect the bills of exchange for its customer. But, generally, bank gives such facility to its customers. In collection of bills, a banker should examine the title of the depositor
5. **Agent for Collection:** In case a check is drawn on a place where the banker is not a member of the 'clearing-house', he may employ another banker who is a member of the clearing-house for the purpose of collecting the check. In such a case the banker becomes a substituted agent.

## 4.4 LOANS AND ADVANCES

One of the primary functions of a bank is to grant loans. Whatever money the bank receives by way of deposits, it lends a major part of it to its customers by way of loans, advances, cash credit and overdraft. Interest received on such loans and advances is the major source of its income. The banks make a major contribution to the economic development of the country by granting loans to the industrial and agricultural sectors. The banks make loans and advances out of deposits, received from their customers. Most of these deposits are payable on demand. As such the bank owes a greater responsibility to the depositors. ..

### CLASSIFICATIONS OF LOANS AND ADVANCES

One of the main questions of Banks is advancing loans to customers in different ways for different purposes and for different time span. Hence

Bank Loans and advances can be classified into different categories using different criterion such as Nature, purpose, time or maturity, security and method of repayment.

### 1. ON THE BASIS OF NATURE

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

1. **Call/Notice Loans:** are types of loans that are granted for a customer for a period of from an overnight to a maximum of 14 days. It is used for temporary purposes and is granted without securities.
2. **Cash Credit:** it is an arrangement under which a borrower is allowed to borrow up to a certain limit against the security of tangible assets or guarantees. Thus, cash credit may be regrouped as a secured cash credit and a clean cash credit. Under secured cash credit, the customer is required to provide tangible assets as security to cover the amount borrowed from the bank. In case of clean cash credit, the customer provides the bank with a promissory note, which is signed by one or more security or securities.

   In case of a cash credit, the customer need not withdraw the entire amount as in case of a loan. He can withdraw from his cash credit account any amount within the limit specified as and when required. The customer has to pay the interest only on the amount actually utilized by him and not on the limit granted.

   The limit of cash credit is fixed by the bank very carefully after considering a number of factors such as production, sales, inventory levels, credit worthiness of the borrower etc. A cash credit is repayable on demand though in practice the limit is available for a stipulated period.

   When a bank grants cash credit to a customer, it fixes a ceiling or limit beyond which the customer cannot draw but within which he can draw any amount he likes. The customer need not withdraw the amount in one lump sum; he can withdraw according to his requirements.

3. **Overdrafts:** a person is said to be availing overdraft from a bank, when his account with the bank shows a debit balance. Under this arrangement, the bank allows its customer to overdraw his current account so that it shows a debit balance. Any business person can enter into this arrangement to tide over a temporary shortage of funds. The bank may take some tangible security of the borrower. The customer can draw his fund as and when he requires and repays it when it is convenient for him. The operation of overdraft is same as that of cash credit with the main difference that cash credit is a little long-period accommodation. The customer is charged interest on the amount actually overdrawn by him and not on the limit sanctioned. He will be charged no interest if he does not overdraw at all during a particular period.

   In practice, the arrangement for overdraft and cash credit is identical except that in the case of an overdraft the arrangement is in relation to a person's current account. Thus, the extension of overdraft facility presupposes the existence of a current account in the name of the borrower. The banker gains from good current accounts which maintain daily cash balances. The moment the customer begins to overdraw amounts; the banker will be deprived of this benefit. The funds of the banker will be in the hands of the customer.

   Overdrafts facilitates are granted for six months time with subject to renewal up on the agreement of both parties i.e., the banker and the customer. It is used to solve temporary financial deficit by the customer. Whereas, cash credit is granted for a long period of time and used to alleviate permanent financial problem of the customer.
4. **Purchase and Discounting of Bills of Exchange:** the bank provides the customers with the facility of purchasing and discounting their bills receivable. This is a method of financial accommodation offered by the banker to the customer. The bank permits the customer to discount his bills receivable and have the value of the bills credited to his account. The bank charges on the face value of the bills. It waits till the maturity of the bill and presents it on the due date to the drawee for payment. After collection, the proceeds of the bill are appropriated towards the loan and interest due by the customer. If the bill is dishonoured, the amount will be recovered from the customer.

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

A loan is different from a cash credit. Cash credit is of a continuing nature, i.e., money can be withdrawn or paid into the cash credit account and interest will be charged only on the actual credit. But in case of a loan, the interest is charged on the entire amount and a loan once repaid in full or in part cannot be drawn again. A borrower has to apply for a fresh loan if he needs funds. The second transaction will be totally distinct from the first one. Commercial Banks generally advance loans for short-terms and medium terms. Since the banks charge interest on the entire amount of loans, this way of raising funds is costlier to the customer as compared to cash credits and overdrafts..

2. **ON THE BASIS OF PURPOSE OF LOAN**:
   Banks loans can be classified according to the purpose for which it is borrowed in to the following groups:

1. **Commercial Loans:** they are types of loans granted for commercial purposes i.e., to facilitate transactions being made between different firms. They have a short-term life i.e., such loans are granted to fulfil short term financial problems of firms so they have short duration. They may be given to businesses so as to pay salaries, to buy raw materials, to pay expenses, or to buy commodities to be resold.
2. **Industrial Loans:** they are loans granted to industrialists for the purpose of constructing or buying industrial buildings and to buy other fixed assets. Therefore, they have a long-term life.
3. **Agricultural Loans:** they are types of loans to be granted to the agriculturalists. They may be given for the purpose of buying land, cultivating and developing the land, buying tractors, fertilizer, insecticide, selected seeds, etc. They have both short life and long life. Those loans granted to acquire land to cultivate and develop

the land and to buy tractors have long repayment life. Whereas loans granted for fertilizers, insecticides, selected seeds have short repayment life.

4. **Educational Loans:** they are granted to finance education expenses of a customer.
5. **Medical Loans:** they are granted to a customer in order to finance his medication expenses.
6. **Consumer loans:** loans given for the purchase of consumer durables (refrigerator, television etc)
7. **Mortgage loans:** loans given to construct buildings

### 3. ON THE BASIS OF MATURITY

Banks loans can be classified according to the maturity of the loan into *short-term, medium-term and long-term loans*.

a. **Short-term loans:** they are loans usually granted for a period of time up to and less than one year.
b. **Medium term loans:** they are loans usually granted for a period of time more than one year and up to 5 or 7 years.
c. **Long-term loans**: they are granted for a period of time above 7 years.

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

### 4. ON THE BASIS OF SECURITY:

On the basis of the availability of security, bank loans can be classified as secured *loan* or *unsecured loan*.

1.**Unsecured or Clean Loans/Advances** the loan, cash credit, overdraft allowed by a bank to a business person without any security of tangible assets is known as **unsecured or clean loans/Advances**. It is allowed to the customer against his personal security or promissory note. When the customer is a man of outstanding reputation and sound financial position, he may be granted a loan or allowed on overdraft by the bank on personal security. Such an advance is known as clean or unsecured advance and is granted against the promissory note of the borrower. Generally unsecured loans are based on mere exclusively on borrower’s

integrity and financial condition, expected future income and past record of repayment.

**2. Secured Advances/Loans**: by secured loan/advances we mean those loans/advances which are granted against some tangible securities apart from the promissory note of the borrower. Secured loan or advance means a loan or advance made on the security of assets, the market value of which is at any time equal to or more than the amount of such loan or advance. The securities against advances are also known as **"collaterals".** Collateral means additional and securities offered by the borrower and called collaterals because they are offered in addition to the personal security of the borrower. Collateral for secured loans may consist of a variety of assets such as real state, warehouse receipts, goods, stock exchange securities, etc. The basic requirement of such assets is marketability. The main reason for requesting a loan to be secured is that to reduce the banks risks of loss in the event the borrower is unwilling or unable to repay the loan at maturity.

Security is required on loans/ advances for several reasons. One of the common reasons is probably the borrower's financial weaknesses. Such weaknesses may be indicated by several factors, including heavy obligation to creditors, poor management, and insufficient income. Borrowers in this financial condition can strength their credit by pledging certain assets.

### 5. ON THE BASIS OF METHOD OF REPAYMENT:

Bank loans may be repaid in one lump sum or instalment basis. ***Lump sum loans*** are usually referred as straight loans, which mean that the contract calls for repayment of the entire principal on maturity date. However, interest payment might be due at various intervals or when the loan matures.

***Instalment loans*** require periodic payments of principal, usually of equal amounts. Payment may be monthly, quarterly, semi-annually, and annually. Instalment lending recognizes the principle of **amortization,** whereby the principal amount is amortized over the life of the contract. In this manner repayment do not become a great burden on the borrower as if the total loan were due at one time.

**Interest rates for different loans**:

Interest rates differ from loan to loan. In the following paragraphs, interest rates for different types of loans have been discussed.

**1. Business loan:**

Interest rates on business loans are lowest, because of their relatively short maturity. Business loans for current production usually have a maturity of less than one year and are secured by highly marketable products. Because of those characteristics, they are among liquid assets made by commercial banks.

**2. Farm loans:**

Farm loan interest rates are higher because of their greater risk and smaller size. Farming is a risky one as a result of weather, diseases and over supply. Farm loans have long maturity comparing to business loans. Normally, maturity period of farm loans will be 6 months to one year, even sometimes more than one year if the loan is for some long term investments.

**3. Consumer loan:**

Interest rates on consumer loans are higher than most of the other bank loans because of their smaller size and high risk involved. In consumer loans, the costs are greater per unit of loan. For example, if a consumer loan officer gives 20 loans of Br. 30000 each in one day, the business loan officer may give a single loan with amount of Br. 600000. Thus, banks avoid such types of loans, because the repayment capacity of the borrower may be affected by unemployment, sickness, accident, or some other unforeseen circumstances. Thus, the interest rate will be high for such type of loan.

**4. Real estate loans**:

Interest rate on real estate loans is influenced by maturity of loan and loan to value ratio. If the maturity of the loan is longer, then the interest rate will be high. If the loan to value ratio is high, the interest rate of the given loan will be high.

**Illustration:**

Assume there are two applicants (X & Y) for a loan. Both the applicants demand the same amount (i.e. Br. 100,000), but provides collaterals which have different values. Mr. X provides collaterals

which values Br.120, 000 and Mr.Y provides collaterals, which values Br.180, 000.

Loan-to- Value ratio of Mr. X: = $\frac{\text{Amount of Loan}}{\text{Value of security}} = \frac{100,000}{120,000} = 0.83$

Loan-to- Value ratio of Mr. Y: = $\frac{\text{Amount of Loan}}{\text{Value of security}} = \frac{100,000}{180,000} = 0.55$

Therefore, the interest rate would be higher for Mr. X and the rate of interest would be less for Mr. Y.

**DETERMINING CREDITWORTHINESS**

The banker, before granting loans to customers should take certain considerations. These considerations are related to the borrower and the project (the borrower's business).

Banks do not grant loans to anyone who demands credit. Not all applicants are genuine. There are people who apply for loan from the bank either without having a well studied project, or without having the required skill to manage the business or with some purpose other than stated in the application. Therefore, a banker before granting loans to applicants, he has to evaluate and select the right applicant that can properly utilize the loan amount and who can make more value /surplus/ on the project.

A banker has to be very careful while granting loans. There is a greater risk in unsecured loans.

Even in the case of secured loans, the banker should carefully examine the creditworthiness of the borrower. The following factors should be kept in mind while determining the creditworthiness of the borrower:

1. **Character:** The concept of character means not only the willingness to repay the debts, but also a strong desire to settle all obligations within the terms of the contract. A person of good character usually possesses attributes such as honesty, integrity, credit-worthiness, capacity to repay, sense of responsibility, good habits and reputation. Here we can raise a number of questions that helps us to weigh the behaviour of the applicant. For example, is the customer dependable?

Is the customer willing to repay the loan according to the contract? Is he willing to use the fund advanced for the right purpose that he applied for? Etc. If he possesses these qualities he bears a good character and can be considered creditworthy for the loan. But, character is difficult to evaluate. The past record of a borrower in meeting his obligation is usually weighted heavily evaluating his character for credit purposes.

2. **Ability to run the business**: the ability of the borrower to manage his business is a vital consideration made in advancing a loan. In order to measure his capacity to manage his business, we can see his educational level and type and his experience as an entrepreneur or as an employee.

   If the borrower is fully capable of running the enterprise and has necessary skill and experience, his chances of success are high. As such there is little or no risk in granting loans.
3. **Adequate Capital**: here we measure the financial soundness of the customer. If a customer covers majority of the project cost, it is believed that, he will be highly committed to the success of the business/project. The bank can measure not only his contribution to the project, but also his alternative sources of capital to repay the loan in the event of adverse circumstances?

   An entrepreneur should have an adequate capital of his own. If his capital is inadequate there are greater chances of failure of his business. As such, the banker will not be able to recover his loan in such a situation
4. **Collateral**: The purpose of advancing loan is to enable the customer to undertake his business in a better standard and achieve a better value to himself – profit and to enable him to repay the loan within the agreed time period. However, things do not go always right as being expected to be. The business may get bankruptcy and the loans remain unpaid. Therefore, so as to secure the repayment of the loan the banker requires customers to provide adequate collateral/security for the loan. If the loan is not repaid as agreed up on the bank can sell/auction the property and use the proceeds to cover the unpaid balance. It must be noted, however, that the purpose of the collateral for the banker is not to disband the owner with outright sale.
5. **Profitability/Viability of the project:** the profitability or viability of the business must be determined. It is wise to invest in projects that attract positive net inflow than those with negative net-inflow. Therefore, before the bank permit loan to a customer, first the

viability of the project must be studied. The projects viability can be measured through project appraisal or feasibility study. The banker should carefully examine the project report to determine its viability and soundness. If the project is sound and viable the banker will be able to recover his debt. On the other hand, if the project is unsound the project will fail. The banker will not be able to recover his loan.

**SOURCES OF CREDIT INFORMATION**

A banker needs credit information about a customer, his enterprise, industry etc., in order to assess his creditworthiness. He should cross check the information collected by him from different sources. In our country there are no specialized agencies which can provide the necessary information. In western countries there are specialized agencies which supply credit information. Therefore, the banks have to make their own arrangement for collecting credit information. Credit information can be collected from the following sources:

1. **Interview with the loan applicant**: Through interview the lending officer learns the purpose of the loan and whether the loan request meets the various requirements set by the loan policy of the bank. From the interview, the lending officer can also get some idea as to the applicant's honest and ability and also ensures the adequacy of security. Information about history and growth of business, the efficiency of key personnel, nature of products and services, sources of raw materials and plans for the future can be obtained.

**2. Bank's own record**; A bank may maintain a central file of all its depositors and borrowers from which credit information can be obtained. For example, it show the payment record on previous loans, the current credit balance in checking and savings accounts, whether the applicant has a habit of overdrawing his account, etc. even if the applicant has been solicited by the bank's marketing department.

**3. External sources of credit:** There are different organizations that collect information about a single firm or the industry as a whole regarding its strengths, demand for the product, liquidity, net worth, etc. thus, the loan officer can purchase information from such organizations.

**4. Financial statements:** Financial statements are required, especially if the amount involved is relatively high. Proper evaluation of information contained in financial statements is of great importance in the credit analysis process.

## 5.4. LETTER OF CREDIT

**Introduction:** As the world's economy expanded, international trade started. In the beginning, there were serious problems of fraud, mismanagement and malpractices. Importers were unwilling to make payment to the exporters in other countries unless the desired goods reached them. Similarly exporters were unwilling to ship the goods unless the payments reached them. In order to solve this, letter of credit was devised.

Modern banks facilitate trade and commerce by rendering valuable services to the business community. Apart from providing appropriate mechanism for making payments arising out of trade transactions, the banks gear the machinery of commerce, especially in case of international commerce, by acting as a useful link between the buyer and the seller, who are often too far away from and too unfamiliar with each other. Opening or issuing letters of credit is one of the important services provided by the banks for these purposes. The foundation of the banking business is the confidence reposed in the banking institutions by the people in general and the mercantile community in particular. The standing, reputation and goodwill earned by a banking institution enables it to issue instruments, known as Letters of Credit, in favour of traders and banks to meet the needs of their customers. In fact, a letter of credit carries a promise or an undertaking by the issuing banker which is valued and honoured on a global basis.

Due to the nature of international dealings, including factors such as distance, differing laws in each country, and difficulty in knowing each party personally, the use of letters of credit has become a very important aspect of international trade.

In actual practice, a Letter of Credit means "a document issued by a banker authorizing the banker to whom it is addressed to honour the bills of the person named therein to the extent of certain amount."

**Definition:** A letter of credit is a commitment issued by a bank to another bank (especially one in a different country) on behalf of one of its customers to guarantee a payment that must be made to a third party as the result of an import/export transaction. In other words, the issuing bank will guarantee the payment to the exporter.

**What Does Letter of Credit Mean?** Letters of credit are financial instruments used by companies to facilitate import/export transactions. These letters are documents issued by the importer's bank (issuing bank) to

guarantee the payment of the goods being imported. The letter is issued and sent to the exporter's bank (accepting bank) to constitute an obligation to pay for the goods as long as a set of pre-established conditions are met. These conditions are usually in the form of documents to be presented such as commercial invoices, tax forms, certificates of origin, among others. The payment must be released by the issuing bank in full on the previously agreed date, if all these conditions are met.

**PARTIES TO LETTER OF CREDIT**

From the above definition of Letter of Credit, it is clear that there are following parties to a Letter of Credit

1. **Applicant:** The party who requests the letter of credit. This is the person or organization that will pay the beneficiary. The applicant is often (but not always) an importer or buyer who uses the letter of credit to make a purchase.
2. **Beneficiary:** The party who receives payment. This is usually a seller or exporter who has requested that the applicant use a letter of credit (because the beneficiary wants more security).
3. **Issuing bank:** The bank that creates or issues the letter of credit at the applicant's request. It is typically a bank where the applicant already does business (in the applicant's home country, where the applicant has an account or a line of credit).
4. **Negotiating bank:** The bank that works with the beneficiary. This bank is often located in the beneficiary's home country, and it may be a bank where the beneficiary is already a customer. The beneficiary submits documents to the negotiating bank, and the negotiating bank acts as a link between the beneficiary and the other banks involved. It is the bank which negotiates the Bills or Drafts under the Letter of Credit.
5. **Confirming bank:** A bank that "guarantees" payment to the beneficiary as long as the requirements in the letter of credit are satisfied. The issuing bank already guarantees payment, but the beneficiary may prefer a guarantee from a bank in her/his home country (with which she/he is more familiar). It is the bank the seller insists that the credit must be confirmed by it. This may be the same bank as the negotiating bank.
6. **Advising bank:** It is the correspondent bank situated in the same place as that of the seller which advises the credit to the beneficiary. Advising bank is the bank that receives the letter of credit from the issuing bank and notifies the beneficiary that the letter is available.

This bank is also known as the **notifying bank**, and may be the same bank as the negotiating bank and the confirming bank.

7. **The Paying Bank:** Paying bank is a bank in the exporter's country on which the bill or draft is drawn. When issuing bank has no branch in exporter's country then it requests any other bank of the exporter's country to complete the letter of credit operations. Such bank is called the **negotiating** bank or **paying** bank. It can be the confirming bank, the issuing bank or the notifying bank.
8. **Intermediary:** A company that connects buyers and sellers, and which sometimes uses letters of credit to facilitate transactions. Intermediaries often use back-to-back letters of credit (or transferable letters of credit).
9. **Freight forwarder:** A company that assists with international shipping. Freight forwarders often provide the documents exporters need to provide in order to get paid.
10. **Shipper:** the Company that transports goods from place to place.
11. **Legal counsel:** A firm that advises applicants and beneficiaries on how to use letters of credit. It's essential to get help from an expert who is familiar with these transactions.

**TYPES OF LETTERS OF CREDIT**

The Letter of Credit can be divided into two broad categories:

I. Travellers' Letter of Credit.
II. Commercial Letter of Credit

**I. Travellers' Letter of Credit**

Such types of Letters of Credit are issued by the banks for the convenience of the travellers. The travellers are saved from the risk of travelling with heavy cash with them. The facility of such Letters of Credit can be available both for travelling **in** and **outside** the country. The characteristics of such Letters of Credit are as under:

- A Travellers' Letter of Credit is issued by a bank on its own branch/ branches or correspondent bank/banks situated anywhere in the world.
- It contains a request by the issuing bank to make payment up to the amount to the person named therein.
- The issuing banker may issue a Letter of Identification to the holder of the Letter of Credit. The signature of the holder must be attested therein.

**Types of Travellers' Letter of Credit**:

The Travellers' Letter of Credit can be divided into the following forms:

1. **Travellers Check:** It is issued and drawn by a bank upon its own branch or another bank. It is a request by the issuing bank to the paying bank to pay a specified amount to the holder. It also contains the specimen signature of the holder for the purpose of identification.

2. **Circular Letter of Credit:** It is addressed to more than one banker. Details of the amount paid by the various bankers are entered in the Performa, printed on the back of the letter of credit. The holder is to deposit the required amount for which he wants a letter of credit with the issuing bank. The issuing bank charges its commission for the service.
In case of a circular letter of credit, the banker issues an identification slip which bears the signature of the holder attested by the issuing banker. In a travellers check these signatures are on the traveller's check itself.

3. **Circular Checks:** These are like travellers checks. However, these are not of specified denominations. The maximum amount payable is indicated on the circular check. No separate identification slip or letter is issued along with it. The holder's signatures are on the circular checks like those on the traveller's checks.
4. **Guarantee Letter of Credit:** In case of other letters of credit the holder has to pay in advance the required amount of the credit to the banker who issues letter of credit. In case of guarantee letter of credit, the holder is not required to deposit any amount in advance; he/she is only required to give guarantee of the amount required.

5. **Bank Draft or Demand Draft:** A bank draft or a demand draft is a bill of exchange drawn by one bank on its own branch or any other bank. The essential features of a bank draft are:

- ✓ It is always drawn by a bank upon its own branch or another bank.
- ✓ It is always payable on demand and it cannot be made payable to bearer.

**II. Commercial Letter of Credit**

Such letters of credit are issued to facilitate trade and commerce particularly the international trade. An exporter is reluctant to send goods to the importer because he wants to minimize the risk for the payment. Similarly, the importer is also reluctant to send the payment in advance to the exporter. He is afraid that the exporter may not send the goods even after receiving payment in advance. The bank comes to the rescue (help) of both the parties. The documents of goods are sent through the bank with the instructions that the bank should deliver the documents viz., Bill of Lading or Freight Bill to the importer against payment or acceptance of the bill. The importer can get the

delivery of the goods by surrendering the bill of lading to the shipping company and the exporter will get the payment from the bank.
However, in the above case a risk is involved. The importer may not pay or accept the bill. The exporter will have to spend unnecessary money in getting the goods back. Such risks can be avoided if a letter of credit is opened by the importer.

A letter of credit issued by the importer's bank guarantees the exporter that the bank will pay or accept the bill accompanying the documents sent through the bank. The letter of credit specifies what goods have to be dispatched and also the date by which the goods must be dispatched. The exporter should strictly comply with the terms and conditions of the letter of credit. In case he fails to do so, the bank issuing the letter of credit will not liable to pay or accept the bill drawn by the exporter.

**Example**

- ✓ A manufacturer receives an order from a new customer overseas. The manufacturer has no way of knowing if this customer can (or will) pay for the goods after producing and shipping the products.
- ✓ To manage risk, the seller uses an agreement that requires the buyer to pay with a letter of credit as soon as shipment is made.
- ✓ To move forward, the buyer needs to apply for a letter of credit at a bank in their home country. The buyer may need to have funds on hand at that bank or get approval for financing from the bank.
- ✓ The bank will only release funds to the seller after the seller proves that the shipment happened. To do so, the seller typically provides documents showing how goods were shipped (with details like the exact dates, destination, and contents). In some ways, the buyer also enjoys protection under a letter of credit: Buyers might prefer to pay a bank with a big legal department rather than send the money directly to an unknown seller.
- ✓ If the buyer is concerned about a dishonest seller, there are additional options available for the buyer's protection. For example, somebody can inspect the shipment before the payment is released.

**Types of Letters of Commercial Credit**

1. **Documentary Letter of Credit:** When a clause is inserted in the letter of credit that the document of title to goods viz., bill of lading, insurance policy, invoice etc., must be attached to the bill of exchange drawn under the letter of credit. It is called a documentary letter of credit.

2. **Clean Letter of Credit:** If no such clause (as in documentary letter of credit) is inserted in the letter of credit, it is called a clean letter of credit. The documents of title in that case are sent directly to the importer.

3. **Fixed Letter of Credit:** If the banker specifies in the letter of credit the amount of the bill to be drawn within the time fixed, it is called a fixed letter of credit. Such a letter remains valid until the specified amount is utilized within the specified time.

4. **Revolving Letter of Credit:** In case of revolving letter of credit, the banker specifies the total amount up to which the bills drawn may remain outstanding at a time. For example, X opens a letter of credit with City Bank for a total sum of $1000 valid for a period of 3 months. The beneficiary (exporter) can draw bills under the letter of credit with the condition that the value of such outstanding bills should not exceed $1000at any given time.

The main advantage of revolving credit is that the beneficiary may draw a bill for an amount higher, than the one specified in the letter of credit. Again there is no need of renewal again and again. However, it is complicated. It is difficult to ascertain how much amount is outstanding at a particular time.

5. **Revocable Letter of Credit:** Unless specified otherwise, a letter of credit will be deemed revocable. In case of revocable letter of credit, the issuing banker resumes the right to cancel or modify the credit at any time without notice. Therefore, such a letter of credit is hardly of any use. However, in the above case modification or cancellation will become effective only on receipt of the notice by the negotiating banker.
6. **Irrevocable Letter of Credit:** Such a letter cannot be modified or cancelled without the consent of the applicant and the beneficiary. The issuing banker will be liable in case of irrevocable letter of credit if the exporter strictly complies with the terms and conditions of the letter of credit.

7. **Confirmed Letter of Credit:** When the banker issuing the letter of credit requests the advising bank in the exporter’s country to signify his confirmation to an irrevocable letter of credit and the advising bank accepts the request, it is called irrevocable and confirmed letter of credit. The advising banker is called confirming banker. He cannot cancel or modify his undertaking without the consent of the parties concerned.

8. **Unconfirmed Letter of Credit:** In case the issuing banker does not ask the advising banker to confirm the letter of credit, it remains unconfirmed letter of credit.

9. **Transferable Letter of Credit:** Where the goods are exported through middle men, the exporter may ask the importer to open a transferable letter of credit. Under a transferable letter of credit, the beneficiary will be able to transfer his right to draw a bill to a third party.

10. **Non-transferable Letter of Credit:** Every letter of credit unless stated otherwise is non-transferable. Hence the beneficiary cannot transfer such a letter of credit to a third party.

11. **Back to Back Letter of Credit:** A beneficiary of a non-transferable letter of credit may request the bank to open a new letter of credit in favour of some third party on the security of letter of credit issued in his favour, it is called a back to back letter of credit.

12. **Red Clause Letter of Credit:** If the exporter wants financial assistance in advance against his export for purchase of materials, packing etc., he can ask the importer to arrange a "Packing Credit". This packing credit is made available through the letter of credit by inserting a clause in red ink. Such a clause is called Red Clause. The negotiating banker can advance specified money to the exporter. Such accommodation is of temporary nature and is adjusted at the time of final payment.

In general, these are different types of letter of credit. You can see that from exporter point of view, the best form of letter of credit is confirmed, irrevocable letter of credit. This is because the interest of exporters is best saved in this form of credit.

**OPENING A LETTER OF CREDIT**

A banker runs great risks in opening a letter of credit. Therefore, to protect his interest he must be very careful. He should take the following steps while opening a letter of credit:

1. **Application for Opening a Letter of Credit:** The applicant is required to fill an application form giving the necessary details which includes

A. Amount and nature of credit required-documentary or clean, revocable etc.,
B. Goods to be imported along with prices, nature of invoice and other terms,
C. Shipping details and other documents like Bill of lading, Invoice, Insurance policy etc.,
D. The details about the bill like the amount, name of the drawee, mode of delivery of documents.
E. Other operating instructions.

It will be accompanied with an undertaking by the applicant that he will pay the bill drawn under the letter of credit.

2. **Scrutiny of the Application:** The banker should carefully examine the application and check that all the necessary information has been given by the applicant. He should particularly see that the applicant has signed the undertaking.

3. **Taking Security:** After the banker has examined the application and is satisfied that the necessary information has been submitted, he should ask for necessary security from the applicant in the form of cash and valuables.
4. **Fixing Margin:** The banker should fix the margin to be maintained. This margin is fixed keeping in view the creditworthiness and standing of the applicant.
5. **Effective Insurance:** The banker should ask the applicant to take appropriate insurance policy to cover the risks involved. The policy should be taken in joint names of the applicant and the importer.

**Precautions Taken by the Bank**

While opening a Letter of Credit, the banker should take the following precautions:

A. **Creditworthiness of the Party:** Before opening a Letter of Credit, the banker should examine the honesty, integrity and creditworthiness of the importer. The banker should also see the financial position of the importer in the market.
B. **Validity of the Period:** When the bank receives an application from the importer, it should examine carefully whether the period of import licence is valid or not. In case the period of import license is not valid under law, the banker should reject the application immediately.
C. **Terms of Letter of Credit:** The terms and conditions of Letter of Credit must be satisfactory. If the negotiating bank fails to satisfy itself with respect to the terms of Letter of credit.

**ADVANTAGES OF LETTER OF CREDIT**

Letter of Credit has numerous advantages for importer and exporter and for banks. Those are explaining below:

**Advantages to Bankers:**

**1. Source of Income:** First of all the Letter of Credit is a source of income for the bank. The bank charges commission for the operation of Letter of Credit. This commission constitutes bank earnings.

**2. Increase Balances:** The depositing of Letter of Credit Margin by numerous importers increases the bank's deposits.

**3. New Relations:** By providing Letter of Credit operation the banks come across new businessmen and parties. This helps in capturing new customers.

**4**. During Letter of Credit operation the banks has to maintain contact with different foreign banks. If the bank provides its services efficiently other foreign banks will take goods impression of it and banks reputation will improve.

**Advantages to the Exporter**

A. **Guarantee of Payment:** In case of foreign trade there is a greater risk as the exporter and importer do not know each other. Moreover, there are other risks as well. With the opening of the letter of credit the exporter is assured of the payment.
B. **No Risk of Dishonour of Bill:** Under the letter of credit the bill drawn on the importer is accepted by the negotiating banker. Therefore, there is no risk of its being dishonoured.
C. **No Risk of Exchange Restrictions:** The issuing banker examines carefully the restrictions imposed by the importing country before opening letter of credit. The exporter is saved of the worry and risks of foreign exchange restrictions.
D. **Availability of Advance under Packing Credit Facility:** An exporter can get advance financial assistance under packing credit to finance purchase of raw materials and its conversion into finished products and other expenses.
E. **No Risk of Loss Due to Fluctuation in Exchange Rates:** Under letter of credit the exporter is assured payment in the local currency. Therefore, he does not run the risk of fluctuation in foreign rates.

**Advantages to the Importer**

A. **It Facilitates Import:** It is very difficult to import goods as the exporter does not know the importer. The issuing banker guarantees the payment to the exporter and he readily agrees to export the goods. In the absence of letter of credit the exporter may be reluctant to export goods.
B. **No Risk in Import:** The risks involved in importing goods directly, is reduced. Under the letter of credit the importer is assured that the bill will be paid or accepted only when documents are received by the negotiating banker.

C. **Assurance of Compliance of Foreign Exchange Rules:** The issuing banker opens the letter of credit only when it is satisfied that all the requirements of foreign exchange rules of the country of importer have been properly complied with.

D. **Facility of Advance Payment Without any Risk:** Sometimes an exporter insists for advance payment to buy raw material and meet other costs. In such a case the importer can make advance payment by opening 'Red Clause Packing Credit' letter of credit. The negotiating banker will make advance payment, which will be adjusted while making final payment. Thus the importer is saved of the risks involved, in making advance payment for imports.

**Summary**

A letter of credit is just a guarantee given by one bank to a third party i.e., exporter. The guarantee ensured that he will receive payments of his goods provided he performs certain obligations. It also ensures to the importer that payment to the exporter will only be made when goods have been received.

Letter of credit can be broadly classified as Travellers' Letter of Credit and Commercial Letter of Credit. The travellers' Letters of Credit are issued by the banks for the convenience of the travellers where as the commercial letter of credit are issued to facilitate trade and commerce particularly the international trade in simple terms.

First of all the Letter of Credit is a source of income for the bank. The bank charges commission for the operation of Letter of Credit. This commission constitutes bank earnings. Due to the opening of Letter of Credit, the importer's credit standing increases and he/she is in a better position to conduct his business.

***Review Questions***

1. Define the letter of credit
2. Describe the types of commercial letter of credit
3. Who are the parties to letter of credit?
4. What are the procedures/steps in opening LC?
5. List the advantages of LC to the banker as well as to the importer.

**Group assignment**

**1.** WRITE A SHORT NOTE ON BANKING ISSUES IN 21ST CENTURY

2. DEFINE DEVELOPMENT BANKING AND LIST AND EXPLAIN THEIR FUNCTIONS
3. DEFINE INVESTMENT BANKING AND LIST AND EXPLAIN THEIR FUNCTIONS
4. DEFINE COOPERATIVE BANKING AND LIST AND EXPLAIN THEIR FUNCTIONS