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UNIT ONE

INTRODUCTION TO MONEY MARKET

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Objectives

At the end of this unit the student will able to:

- define meaning and characteristics of Money
- understand evolution of Money
- identify classification of Money
- understand characteristics of Good Money
- analyze the difference of Money market Vs Capital market

1.2 Introduction

Money refers to anything that is generally accepted in payment for goods and services or in the payment of debts and is distinct from income and also wealth, the total collection of pieces of property that are a store of value. This unit will detail the discussion on the reasons why modern money system innovated, meaning of money, characteristics of money, money markets and capital markets, classification of money, and economic role of the money market.



1. Why the modern system of money innovated over the barter system?-----

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1.2 Meaning and Characteristics of Money

1.2.1 Meaning of Money

Money is anything that is generally accepted in payment for goods or services or in the repayment of debts. Currency, which Birr notes and coins of different denominations represent clearly fit the definition and are one type of money.

On the other hand, to define money merely as currency is much too narrow because checks are also accepted as payment for purchases and settlement of debts and hence, checking account deposits are also considered money as well.

An even broader definition of money is often needed because other items such as savings deposits can in effect function as money if they can be quickly and easily be converted into currency or checking account deposits. Income, which is a flow of earning per period of time, could be converted into fixed assets or bonds and shares or kept in the form of money or in the bank under demand or current account deposits.

Hence keep in mind that the money refers to anything that is generally accepted in payment for goods and services or in the payment of debts and is distinct from income and also wealth, the total collection of pieces of property that are a store of value. What do you understand from the word barter? Look its meaning in the dictionary.

The barter system

Man has never been able to make with his own hands all the things he needed and desired. Man even used either force or the device of theft to acquire goods, which he himself did not produce, but the use of such devices were not conducive to social order or settled way of life. Therefore, man thought of some other way to get the goods he could not produce, but essential for his life.

The advantage of trade or exchange was realized firstly by chance and later through some sort of planned action. Some men produced or acquired more of certain things than was necessary for their own use. A man having surplus of a given commodity say, fish and needing another commodity say, salt – would seek a person who required fish and has the surplus of salt and would consequently be willing to exchange salt for fish. This act of direct exchange of one commodity for another without the intervention of money was known as **barter**. The reasons why barter system of the transaction replaced by modern money system are:

1. Inconvenience of barter system

The main reason for the invention of money sprang from the inconvenience inherent in the barter system. Looking for a person who satisfies all the conditions of direct exchange was very difficult which discouraged surplus production through specialization. The following are the basic problems of the barter system.

2. Lack Double Coincidence of Wants

Direct exchange or bartering needed a double coincidence of the two parties involved in the exchange process. A man who possessed commodity 'A' to exchange for commodity 'B' has to look for a person who possesses commodity 'B' and in the mean time willing to exchange for commodity 'A'. Therefore, managing to match wants of two persons for every surplus product was found to be difficult and time consuming.

3. Lack of Common Measure of Value

Even when two parties involved in the direct exchange process coincided, the two commodities meant for exchange could be of unequal values rendering one of the parties to the exchange at a disadvantage. Hence, the ratio or the value proportion at which the two goods should be

exchanged is unanswered question. Therefore in the absence of common measure in terms of which the values of goods subject for exchange, it will be fixed in an arbitrary manner depending upon the intensities of the reciprocal demand as a result of which one of the parties stands to gain and the other party will be a loser.

4. Lack of Divisibility of Certain Articles

Some commodities such as horses or cows cannot be divided without losing its identity, but commodities like wheat can certainly be divided into as many parts as wanted without any difficulty. The disadvantage to one of the exchanging parties arises due to such problems of indivisibility of some goods also.

5. Difficulty to Store Wealth

Under the barter system, no proper arrangement existed for storing wealth for future use. This is because most of the goods lacked durability whereas others are too bulky and inconvenient in addition to lack of durability.

Since most of the goods lacked durability and deteriorated with time, society could not think of storing wealth for the future contingencies.

The existence of pure barter system was, perhaps, compatible with the existence of simple or primitive form of economy and life where society were content with too few and simple requirements of life.

Later on, as social organizations became more complex, as the advantage of division of labor became evident and as multiplicity of wants became accomplished facts through time, the inconvenience of the barter system became most pressing. A feeling that barter had outlived its existence and should be replaced by some other more convenient and more efficient method of exchange gained momentum, and the search for such method led to the invention of device known as money.

Money, with the definition of which you are already acquainted for, was first used as a unit of account or standard measure of value in terms of which all other goods or services were compared with. For example, when a goat of a given size and weight was adopted as money

value of everything else was then measured in terms of the standard goat and the term of exchange between any pair of goods could thus be easily determined.

The conversantly is now on the goat-standard and this symbolizes the birth of money. Money as a unit of account or standard of value has been established in order to do away with the difficulties of barter.

But the idea of adopting some commodities as standard of value in terms of which all other things to be assessed did not remove the difficulties of the barter.

The problem of bringing the two parties together remained, through the invention of money during early periods although some writers say goat, as a common denominator was a fundamental invention in economics as the wheel in mechanics, fire in science and vote in politics are.

1.2.2 Characteristics of efficient money

So far you have seen the gradual development of money. In this part you will study the characteristics that efficient money should have.

During the course of the evolution of money, certain attribution of characteristics came to be expected from the commodity acting as money or means of exchange. These characteristics of efficient money are given below.

a. Acceptability

- It should be generally accept by virtue of its intrinsic value
- Because of government decree
- Because of convention
- Because of convenience

b. Scarcity

- To be scarce its supply must remain in the borderline of its demand
- It should not be too scarce so as to limit trade
- There must be some controlling mechanism by the government put in place with a view to ensure progressively adequate supply of it

c. Reconcilability

- In order to avoid unfair practice of cheating it has to be recognizable by its size, color, texture etc.

d. Divisibility

- It must be capable of being divided into the smallest fraction or unit without the loss in its value.

e. Stability

The conditions of its supply and demand should remain stable so that its value (Purchasing Power) remain stable.

f. Homogeneity

Each and every unit should be exactly the same as every other unit. Otherwise, people would prefer to hold more valuable unit and would release the less valuable unit, thereby destabilizing its supply and demand conditions.

g. Portability

Each unit should have small weights compared to its value so that it could easily carried about as necessary.

h. Durability

It should not be a wasting asset, either physically or in terms of its value. No one wants to hold wasting or perishable asset. Most of the commodities used as money early days failed in durability criteria. Example, salt bar cannot be durable money because it is sensitive to changes in climate and its value also alter with the distance from the salt mining place.

1.3 Development and Evolution Of Money

1.3.1 Development of Money

Money we use now a day which consists largely of bank notes issued by government central banks and demand deposits operated with the help of cheques are only of recent development. They were not widely used until late in the eighteenth century.

The primitive money took forms of commodity money. The commodity chosen depended upon the location of the community concerned, climate of the region, culture and economic development of the community involved etc.

For example communities, which lived in the seashore, chose shells or fish hooks as money or medium of exchange. In places like Siberia it is said that skins and furs were used as money. In tropical regions elephant tusks were used as money.

In primitive agricultural communities domestic animals were the most obvious form of wealth and hence cattle were used as money. Elsewhere, Salt bar or iron bar were also used as money. However all of the commodities as money lacked standardization, store of value, easy handling, portability, divisibility etc.

As the society progressed the idea of money changed from non-metallic commodities to early metallic commodity, which also in no way were perfect in respect of size shape and weight etc. Of these metallic money, silver and gold played a major role for a long period of time because of the divisibility durability as well as scarcity. Gold and silver after having served as money approximately for over 150 years failed to cope up with rapidly increasing international trade starting 1930s onwards when production of gold and silver did not match with the demand for it both on account of huge increase in trade locally and foreign and ever increasing industrial use of it.

1.3.2 Evolution of Money

The evolution of money has passed through the following five stages depending upon the progress of human civilization at different times and places.

1. Animal Money

Animals were being used as a common medium of exchange in the primitive hunting stage.

2. Commodity Money

Various types of commodities have been used as money from the beginning of human civilization. The particular commodity chosen to serve as money depended upon various factors like; Location of the community, climatic environment of the region, cultural and economic standard of society, etc.

For example: * People living at the sea shore $\Rightarrow$ used shells and dried fish

* People of the cold region $\Rightarrow$ used skins and furs of animals

* African people $\Rightarrow$ used Ivory and tiger jaws.

However, the use of commodities as money had the following defects;

- i. Lack of uniformity and standardization make pricing difficult
- ii. Difficult to store and prevent loss of value in the case of perishable commodities
- iii. Uncertainty of supplies of such commodities
- iv. Lack of portability and hence were difficult to transfer from one place to another
- v. Indivisibility

3. Metallic Money

With the spread of civilization and trade relations by land and sea, metallic money took the place of commodity money. The metallic money which was the raw metal, was an inconvenient thing to accept, weigh, divide and assess in quality. Hence, metal was made into coins of predetermined weight, which was attributed to king Midas of Lydia – a Greek city-state in 700 Bc. The first type of metal used as money was gold.

But some ingenious persons started debasing (lowering value) the coins by clipping a thin slice off the edge of coins. This led to the minting of coins with a rough edge – check your coins in your pocket. As the price of gold began to rise, gold coins were melted in order to earn more by selling them as metal. This increases costs of melting to the government. Hence, government mix copper or silver or alloy or some other metal with gold so that their intrinsic value (its value as a commodity) might be less than their face value (their value as money).

Metallic money possesses the following defects:

- i. It was not possible to change its supply according to the requirements of the nation both for internal and external use.
- ii. Being heavy, it was not possible to carry large sums of money in the form of coins from one place to another.
- iii. It was unsafe to carry and could be easily lost or stolen.
- iv. It was very expensive, the use of coins led to their debasement and their melting and exchange at the melt, cost a lot to the government.

4. Paper Money

As the name represents paper money refers to money made of paper materials. The development of paper money started with goldsmiths who kept strong safes to store their gold. Because of the difficulties of commodity money stated above, merchants were hesitant to use commodity as a medium of exchange. Hence, they used to keep their metallic money with the goldsmith. The goldsmith in return offers a written paper stating the amount of metallic money kept with him by the merchant whose name is written on it. The merchant, then, use this written paper as a means of payment for his purchase or can withdraw the commodity money any time he or she wants by returning the paper.

At the early age this paper money was emerged as “token money” – which is a representative paper money – convertible to gold. In the later stages this “token money” become “Fiat money” i.e., inconvertible legal tender.

5. Credit Money

With the development of banking and credit creation activities, another form of convertible money developed in the form of money or bank money. This is referred as cheque system. Cheque is a credit instrument used to facilitate exchange but is not a real money. It is a form of money in a modern society. The greater the utilization of cheque in the exchange process in a given society, the modern\civilized that society is. Cheques are created with the creation of demand deposit accounts.

6. Near Money

Near money items are financial assets which are easily convertible into money. They are not money in real terms. But, they are financial assets used to facilitate exchange. They are: bills of exchange, treasury bills, bonds debentures, saving certificates, etc.

In short, anything and everything can serve and has served as money provided it is generally recognized and accepted as means of payment. But all things cannot serve as a good money. A good money should possess the attributes of general acceptability cognoscibility, portability, divisibility, durability, uniformity, adequacy and stability of value. (see the characteristics of good money).

1.4 Classification Of Money

Money can be classified based on the following different criterion.

From those criteria, monetary system or the physical characteristics of the materials of which money is made further classified as follows:

1.4.1 Metallic Money

Money made of any metal such as gold, silver, nickel, copper, etc is called metallic money. It has a given size, shape, weight and fineness whose value is certified by the state/government.

Metallic money can be further classified as:

i) Standard Money/Coins

This is money whose value as a commodity for non-monetary purpose is as great as its value as money. i.e., its intrinsic value is equal to its face value. In other words, its value as a commodity is equal to its value as money. Hence, it is also referred as full-bodied money.

ii) Token money/coins

As debasement of metallic money widespread, government start to include other inferior metals with gold coins and hence the value of the metal as money will be less than the value of the metal as a commodity. It is representative money whose intrinsic value of the metal is less than its face value.

iii) Subsidiary money/coins

These are metallic coins introduced to support the use of other metallic coins (token money or coins).

1.4.2 Paper Money

Paper money refers to notes of different denominations made of paper and issued by the central bank and/or the government of the country (state treasury). This can be classified into:

i) Representative paper money

It is in effect a circulating warehouse receipt for full-bodied coins or their equivalent in bullion. It is fully convertible into gold coins or bullion i.e., you can take the gold coins or bullion equivalent to the value of the paper money in exchange for it. For example, you have deposited three quintals teff in a certain warehouse and the owner of the warehouse gave you a receipt in

exchange for your property until you do not want the teff you have kept at the warehouse, you can keep the receipt with you. But if you want to get back your property, you have to return the receipt to the warehouse keeper. That is why it is referred as fully convertible money. It is also known as representative full-bodied money.

ii) Convertible paper money

This is paper money which can be converted in to gold coins or bullions. However, it does not have a 100 percent (100%) backing in the form of standard coins or bullion. Hence this paper money cannot be fully converted into gold coins or bullion i.e., the amount of gold kept at the issuer's possession (eg. National Bank in Ethiopia) is less than the value of paper money in the hands of the society. For example, in our example under (i) the warehouse receipt shows three quintals of teff and whenever he wants, he can get it back. But in this case, though, the receipt stated to be equivalent to three quintals of teff, the actual volume of teff that exists in the warehouse is less than three quintals. Therefore, if you want to return the receipt and get back three quintals of teff, you cannot get, as the volume of teff in the warehouse is less than three quintal.

iii) Inconvertible paper money

This is a paper money which does not have any backing of standard coins or bullion and is not convertible into them. Notes issued by Central Banks of all countries represent it. This money is also known as fiduciary money.

iv) Fiat Money

This is a paper money which circulates in a country on the authority of the government. It is created and issued by the state of the given country. It is not convertible by law and is legal tender money. Fiat money is representative or token money. Practically, there is no difference between fiat money and inconvertible paper money. This form of money exists only when the society accepts the government of the country. It will have value only when the government (National Bank) declares that paper has to be accepted as money. Otherwise, its value as commodity is very less than its value as money. Now you check your birr in your pocket and read what it says. It says “payable to the bearer on demand “or “LUS”< ”Ç=ŸđM IÓ ÁeÑÉÇM”. Therefore, it shows that it is accepted only by the enforcement of the law of the country.

v) Credit money

Credit money is created and transferred by commercial banks in the form of a cheque or draft. But a cheque or draft is not a legal tender money. No one is legally forced to accept cheques or drafts as a payment for goods sold or services rendered.

Paper money has certain advantages and disadvantages compared with the metallic money.

Advantages of Paper Money

- a) Paper money is economical. It is cheaper than any metal. Therefore, we can issue more paper money with least cost.
- b) Paper money economises the use of precious and scarce metals by serving as representative money.
- c) It is portable. It is very convenient to carry paper money from place to place
- d) It is easy to store. Paper money can be stored in small place.
- e) It is easier to count paper notes than metallic coins.
- f) Supply of paper money is easily adjustable as per the need of the economy.

Disadvantages of paper money

- a) There is the danger of over issue of notes as they can be easily printed.
- b) Paper money lacks general acceptability if the people lose confidence in the government for one reason or the other.
- c) Durability of paper money is much less than metallic money
- d) Paper money can circulate within the domestic economy only.

5.1 Acceptability Criterion (The nature of the issuer)

On the basis of acceptability criterion, money is classified into two as legal tender money and non-legal tender money.

i) Legal Tender Money

It is that which the state and the people accept as the means of payment and in discharge of debts. It is accepted compulsorily by the people. It becomes money only when the state declares it to be accepted as money. For example, all notes and coins issued by the government and the Central Bank are legal tender money. Our birr notes and coins are legal tenders of the country.

1.5 Money Markets and Capital Markets

1.5.1 Money Markets

The money market is a market for short-term instruments that are close substitutes for money. The short-term instruments are highly liquid, easily marketable, with little chance of loss or low default risk and low cost of executing transactions. It provides for the quick and dependable transfer of short-term debt instruments maturing in one year or less, which are used to finance the needs of consumers, business agriculture and the government.

Money markets are markets in which commercial banks and other businesses adjust their liquidity position by borrowing, lending or investing for short periods of time. In the money market, businesses, governments, and, sometimes, individuals borrow or lend funds for short periods of time – usually 1 to 120 days commercial paper, repurchase agreements, federal funds, promissory notes, treasury bills, certificates of deposits, bill of exchange call and notice money and banker's acceptances also are important money market instruments.

The money markets are also distinct from other financial market in that they are wholesale markets because of the large transactions involved. Money market transactions are called open market transactions because of their impersonal and competitive nature. There are no established customer relationships.

A. Economic Role of the money market

The most important economic function of the money market is to provide an efficient means for economic units to adjust their liquidity positions. Money markets help governments, businesses, and individuals to manage their liquidity by temporarily bridging the gap between cash receipts and cash expenditures. If a firm is temporarily short of cash, it can borrow in the money market; or if it has temporary excess cash, it can invest in short-term money market instruments. In doing so a money market performs a number of functions in an economy.

- It provides funds
- It helps to use surplus funds
- It eliminates the need to borrow from banks
- It helps government to borrow money at a lower interest rate

- It helps the implementation of the monetary policies of the central bank
- It facilitates the financial mobility from one sector to the other
- It promotes liquidity and safety of financial institutions
- It brings equilibrium between demand and supply of funds
- It economizes the use of cash.

B. Institutions of the Money Market

The various financial institutions which deal in short-term loans in the money market are:

1. **The Central Bank:** It does not itself enter into direct transactions. But control the money market through variations in the bank rate and open market operation. It acts as a guardian of the money market.
2. **Commercial Banks:** They deal in short-term loans which they lend to business and trade. They discount bills of exchange and treasury bills. They lend against promissory notes and through advances and overdrafts.
3. **Non-bank Financial Intermediaries:** This includes savings and loans associations, mutual funds and credit unions. They deal in short term lending and advances.
4. **Discount Houses and Bill Brokers:** Discount houses' primary function is to discount bills on behalf of others. Bull brokers or dealers act as an intermediary between borrowers and lenders by discounting bills of exchange at a nominal commission. Dealers buy securities for their own position and sell from their security inventories, when a trade takes place. Dealers and brokers specialize in one or more money market instruments and they remain to be the main part of the money market.
5. **Acceptance Houses:** They act as agents between exporters and importers and lender and borrower traders. They accept bills drawn on merchants whose financial standing is not known in order to make the bills negotiable.

C. Sub Markets of the Money Market

The money market is a network of markets that are grouped together because they deal in financial instruments that have a similar function in the economy and are to some degree substitutes from the point of view of holders. However, these markets use different credit instruments. As the money market consists of varied types of institutions dealing in different types of instruments, it operates through a number of sub-markets.

1. **The call loan market:** It is a market for marginal funds, for temporarily unemployed or unemployable funds. For instance, commercial banks advance loans to bill brokers and dealers in stock exchange so as to use the fund to discount or purchase bills or stocks for a short period of time, one night, a week or not more than 14 days. The same thing is true that central banks advance loans to commercial banks for a short period. The central bank applies a rate called “call rate”, which is usually less than the normal rate but sometimes it may be even greater than the normal rate.
2. **The bill market:** It is the short period loan market. In this market Commercial banks, discount houses and brokers lend to businesspersons. The commercial banks discount bills of exchange, lend against promissory notes, or through advances or overdrafts to the businessperson and lend government through treasury bills.
The discount houses and bill brokers lend to businesspersons by discounting their bills of exchange before they mature.
3. **The collateral loan market:** the commercial banks lend the discount houses and bill brokers against collateral bonds, stocks; securities, etc. The commercial banks borrow from big/large/ banks and the central bank on the basis of collateral securities.
4. **The acceptance market:** The merchant bankers accept bills drawn on domestic and foreign traders whose financial standing is not known commercial banks have started the acceptance business.

D. Characteristics of the Money Market

Money markets may be developed and undeveloped markets. Their characteristics can be presented as follows.

i. Characteristics of an Undeveloped Money Market

The main characteristics of such a market are:

1. **There is Personal Touch:** The lender and borrower are known each other and decision made in this market are not rational and objective.
2. **There is flexibility in loans:** The amount of the loan depends upon the nature of security or the borrowers good will with the moneylender.
3. **Multiplicity of Lending Activities:** Money lending activity is combined with other economic activities i.e., money lending is not the only activity of the moneylender.

4. **Varied Interest Rates are Applied:** The rate depends on the need of the borrower, the amount of the loan, the time for which it is required and the nature of security.
5. **Defective Accounting System:** The accounts of the moneylenders are not liable to checking by any higher authority.
6. **Absence of link with the developed Market:** There is no established channel to create a link between the developed and undeveloped markets. The undeveloped money market consists of the moneylenders, the indigenous bankers, traders, merchants, landlords, brokers, etc.

ii. Characteristics of a Developed Money Market

The main characteristics of such a market are:

1. It is a well-developed market and consists of the central bank, the commercial bank, bill brokers, discount houses, acceptance houses, etc.
2. The central bank controls, regulates and guides the entire money market
3. It consists of a number of specialized sub markets dealing in various types of credit instruments such as the call loan market, the bill market, the treasury bill market, the collateral loan market, the acceptance market and the foreign exchange market.
4. It has a large number of near money assets of various types such as: bills of exchange, promissory notes, treasury bills, securities, bonds, etc.
5. It has an integrated interest rate structure. The change in the bank rate leads to proportional changes in the interest rate prevailing in the sub-markets.
6. It has an adequate financial resources form both within and outside the country.
7. It provides easy and cheap remittance facilities for transferring funds from one market to the other.
8. It is highly influenced by such factors as restrictions on international transactions, crisis, boom, depression, war, political instability, etc.

1.5.2 The Capital Market

The capital market is a market which deals in long-term loans. It functions through the stock exchange market. A stock exchange market is a market which facilitates buying and selling of shares, stocks, bonds, securities and debentures for both new and old ones.

It supplies industry with fixed and working capital and finances medium-term and long-term borrowings of the central, state and local governments. It deals in ordinary stocks, shares and debentures of corporations and bonds and securities of governments. The funds which flow in to the capital market come from individuals who have savings to invest, the merchant banks, the commercial banks, and non bank financial intermediaries, such as insurance companies, finance houses, unit trusts, investment trusts, venture capital, leasing finance, mutual funds, building societies, and underwriting companies.

Importance or Functions of Capital Market

The capital market helps in capital formation and economic growth of the country. The functions/importance are discussed as follows:

1. *It acts as an important link between savers and investors*

The savers are called the “surplus units” and they are lenders of funds. Whereas the investors are called the “deficit units” and they are borrowers of funds. Hence, the capital market is the transmission mechanism between surplus units and deficit units. It is a conduit through which surplus units lend their surplus funds to the deficit units. Surplus units buy securities with their surplus funds and deficit units sell securities to raise funds they need. This fund flow may be directly or indirectly.

2. *It gives incentives to savers and investors*

Savers or surplus spending units will be rewarded in a form of interest, if they deposit their money in a bank and buy interest bearing financial assets or in a form of dividend, if they buy shares and stocks, for their postponement of present consumption. This leads to capital formation which is used by investors or deficit spending units. Investors or DSUs will be also rewarded in a form of profit from their investment activity. By doing so, it diverts resources from wasteful and unproductive channels to productive investments.

3. *It brings stability in the value of stocks and securities*

It does so by providing capital to the needy at reasonable interest rates and helps in minimizing speculative activities.

4. *It encourages economic growth*

The various institutions which operates in the capital market give quantitative and qualitative direction to the flow of funds and bring rational allocation of resources. They do so by converting financial assets in to productive physical assets. Business firms invest in the projects offering the highest rates of return and that households invest in direct or indirect financial claims offering the highest yields for given levels of risk.

1.5.3 Distinction Between Money And Capital Markets

The money market differs from the capital market on several grounds.

1. The money market deals in short-term funds, whereas, the capital market deals in long-term funds.
2. The money market uses short-term instruments, such as promissory notes, bills of exchange, treasury bills, certificates of deposits, commercial papers, etc. whereas; the capital market uses long-term securities such as shares, debentures, bonds of industrial concerns and bonds and securities of the government.
3. Institutions operating in the two markets differ. In the money market: the central bank, commercial banks, non-bank financial intermediaries and bill brokers operate. In the capital market, stock exchange, mutual funds, insurance companies, leasing companies, investment banks, investment trust, etc, operate.

1.5.4 Interrelation between money and capital markets

These markets are closely interrelated because most corporations and financial institutions are active in both. Their interrelation is discussed as follows:

1. Lenders may choose to direct their funds to either or both markets depending on the availability of funds, the rates of return and their investment policies.
2. Borrowers may obtain their funds from either or both markets according to their requirements.
3. Some corporations and financial institutions serve both markets by buying and selling short-term and long-term securities.

4. All long-term securities become short-term instruments at the time of maturity. So some capital markets instruments also become money market instruments.
5. Funds flow back and forth between the two markets whenever the treasury finances maturing bills with treasury securities or whenever a bank lends the proceeds of a maturing loan to a firm on a short-term basis.
6. Yields in the money market are related to those of the capital market. As the long-term interest rates fall, the short-term interest rate will fall. However, money market interest rates are more sensitive than are long-term interest rates in the capital market.

👉 1.6 Post Test Progress Checking Questions

No.	Questions	Yes	No
1	Did you identify the reasons why modern money system innovated?		
2	Did you understand the role of money marketing?		

3. Discuss the classification of money based on the criterion of materials it made. -----

 -----,

What are the relationship of money and capital market?-----

 -----,

1.7 Summary

Money is anything that is generally accepted in payment for goods or services or in the repayment of debts and also money merely as currency is much too narrow because checks are also accepted as payment for purchases and settlement of debts and hence, checking account deposits are also considered money as well. The direct exchange of one commodity for another without the intervention of money was known as **barter**.

The reasons why barter system of the transaction replaced by modern money system are: inconvenience of barter system, lack double coincidence of wants, lack of common measure of value, lack of divisibility of certain articles, and difficulty to store wealth.

Efficient of Money Characterized by its: *Acceptability, Scarcity, Reconcilability, Divisibility, Stability, Homogeneity, Portability and Durability*

Depending upon the progress of human civilization at different times and places. evolution of money has passed through *Animal Money, Commodity Money, Metallic Money, Paper Money, Credit Money, Near Money* stages.

Paper money refers to notes of different denominations made of paper and issued by the central bank and/or the government of the country (state treasury). This can be classified into: *Representative paper money, Convertible paper money, Inconvertible paper money, Fiat Money* and *Credit money*.

The money market is a market for short-term instruments that are close substitutes for money.

The short-term instruments are highly liquid, easily marketable, with little chance of loss or low default risk and low cost of executing transactions

The capital market is a market which deals in long-term loans. It functions through the stock exchange market

UNIT TWO

FUNCTION AND STRUCTURE OF MONEY

Contents

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Objective

At the end of this Unit you are expected to:

- understand money as a value or account
- identify money as a medium of exchange
- distinguish classification of money
- understand functions of money

2.1 INTRODUCTION

Money serves as a unit of measurement and a medium of exchange by decomposing the single old transaction of barter into two separate. Thus by functioning as a unit in terms of which all future payments are expressed, money also serves as a unit of account or standard of deferred payment. All the payments are made and general purchasing power is held with the actual money. Money also performs a number of primary, secondary, contingent and other functions to remove the difficulties of barter.



1. What are the functions of money? Could you note down some of them?-----

-----.

2. What are the four essential functions, which have removed the difficulties of barter?---

-----.

2.2 Money as a Unit of Value or Account

This function of money serves as a unit of measurement in terms of which the values of all goods and services are measured and expressed. The existence of a common unit of account is indispensable for the emergence of an orderly pricing system, which is essential both for rational economic calculation and choice by the individual, and for transmitting economic information between parties to exchange of goods and services. By using money different goods and services values of which not otherwise are not comparable are made comparable.

The prices of different goods and services stated in terms of money enable the individual to decide on what he should specialize as a seller and in what proportions he should buy and combine different goods and services as a buyer. Producers also depend on money to provide them the lines of communications. They look on money prices of goods and services to furnish them with vital information on the bases of which they make production decisions, which maximize their profits.

2.3 Money as a Medium of Exchange

The introduction of money as a medium of exchange by decomposing the single transaction of barter into two separate transactions of sale and purchase, eliminates the need for double coincidence of wants. Money will not be required as a means of payment unless we want to sell at one time and place and buy at another.

Each person accepts money as the means of payment because he is confident that others will accept it in payment from him. A country's legal system also enforces the acceptance of national currency in discharge of all payments. A social convention-giving general acceptability to money

as a means of payment could also be established if some important members of the group say, business community unilaterally accepts in payment a certain form of money of which cheques are good example.

2.3.1 Money as a Standard of Deferred Payments

In a modern economy, a large volume of transaction relate to future contractual payments, which are stated in terms of money unit. Thus by functioning as a unit in terms of which all future payments are expressed, money also serves as a unit of account or standard of deferred payment. Banks make available huge amounts of loans and advances to businessmen and consumers as well. Such loans are settled in the future time in terms of money. Business as well as personal loans from banks would have been impossible had there not been for the service of money to settle such loans in long future times. This function of money is best fulfilled only if purchasing power or value of money remains reasonably stable.

2.3.2 Money as a Store of Value

Money as a medium of exchange has made it possible for people to sell at one place and time and to buy at quite another place and time. It is however, not possible to do so unless it is possible to store the means of payment. Means of payment or purchasing power during the time interval between the sale of one commodity and the purchase of another is kept in the money form.

Money although being no income-bearing asset is preferred to be held because of its liquidity advantage or future use of purchasing goods and services in the distance future by using money as a store of wealth in the form of purchasing power.

In a summary money does perform functions of knowing inter-commodity values, the unit of account, acts as a medium of exchange to enable transactions to take place, enables purchasing power over goods and services and facilitates credit sales by being an instrument of payments in the future.

2.4 Classification of Money

The actual money, which is the money of a country circulates and is current in the market. It is used as a medium of exchange for goods and services of that country. All the payments are made and general purchasing power is held with the actual money. Paper notes issued by the banks and coins minted for monetary uses are all under different denominations are examples of money.

However, debts, prices contracts and general purchasing powers are expressed and accounts are maintained in term of money. Money of account is the description or title and actual money is the thing, which answers this description. The description may remain the same (the unit of money) while the actual money might have changed. Money is classified differently of which the important classification include the following.

2.4.1 Commodity Money and Representative Money

Actual money or money proper is further subdivided into commodity money which is also known as full-bodied money and representative.

Commodity money is that money which is composed of non-metallic and metallic commodities, which possess intrinsic value in addition to their monetary value or face value.

Commodity which possesses intrinsic value acts as both a medium of exchange and store of value gold and silver store value because they can be kept for a long time period during which time they do not lose their market value as commodity.

On the other hand bank notes, which have monetary value, do not store value because they cannot be sold as commodity in the market. Such bank notes are known as representative money. Representative money is further divided into **convertible** and **inconvertible** into gold on demand at a per determined fixed rate where as inconvertible bank notes, as we see them today, are not actually so redeemable.

2.4.2 Legal Tender Money and Optional Money

Legal tender money is that money by means of which any payment can be made and the payees are legally bound to accept unconditionally while:

- i) executing exchange of various goods and services
- ii) settling debts resulting from previous contractual obligations.

Legal tender money may be made unlimited or limited legal tender. Example coin in so far as bulk purchases are concerned have limited legal tender whereas say a note of Birr 100 may not be a legal tender to settle Birr 0.50 for shoe shine.

Optional money consists of vast amounts of monetary circulation, which while not legal tender is generally accepted, in discharge of debts and all other payments.

The acceptability or refusal to accept non-legal tender or optional money such as cheques, promissory notes, bills of exchange etc. has no backing of legal obligation. Therefore, acceptances of these instruments of payment receive them on account of confidence and credibility of the parties, which offer them.

2.4.3 Coinage

Kinds of coinage:

A. Free and Limited Coinage

Coinage is said to be free if the public is allowed to offer gold bullion for being minted into coins. But when minting coins is done by only the government it is known as limited coinage.

B. Gratuitous and Non-Gratuitous Coinage

If no fee is charged by the government for manufacturing coins, it is called gratuitous. Governments apply such system of coinage when they want to keep the intrinsic and face value of the coins the same. On the other hand, if government charges fee to manufacture or mint the coins it is said non-gratuitous coinage.

C. Debasement Coinage

This is a system where there is difference between the standard value of the metal fixed by law as money and actual value or intrinsic value of the metal contained in it. By the way, by intrinsic value we mean that the value of the money metal if sold as commodity rather than used as purchasing power.

This system was practiced frequently by governments to secure revenue or prevent the exportation of the coins.

D. Standard Coinage

These are coins where their face values and intrinsic values are equal. For example, gold and silver usually have intrinsic value or commodity value, where as paper money has no intrinsic value. It is unlimited legal tender and is subject to free coinage by banks since its face value and intrinsic values are the same, it is also called as **full-bodied coinage**.

E. Token Coinage

A token coin is one whose face value is greater than its intrinsic value. It is also known as subsidiary money as such has limited legal tender and is subject to limited coinage. Token coins

are called fiat coins or money since their value depends not on their intrinsic value, but on the order of the state. The advantage of this types of coins is that they are cheaper to produce and put into circulation than full bodied coins hence there are less chances of being method purpose for ornamental as is the case with gold and silver.

2.5 Characteristics or Qualities of Money

Money has the following characteristics or qualities

a) General Acceptability

For anything to be money, it should be acceptable by every body as a means of payment in exchange of goods sold or services rendered. Gold and silver are considered as good money materials because they have alternative uses and are generally accepted. Paper notes are accepted as money when they are issued by the central bank and /or the government and are legal tender. Cheques and bills of exchange are not generally accepted. Hence, they are the least form of money in terms of general acceptability.

b) Durability

Anything to be a good money, it should be storable and last long without losing its value over a period of time. Gold, silver, alloy, etc are best forms of money. Paper money which includes currency notes and credit money are next. However, animal and perishable commodities are not good money materials in terms of durability.

c) Portability

The material used as money should be easily carried and transferred from one place to another. It should contain large value in small bulk. In this regard gold and silver money possess high quality but there is transporting risk. Paper is considered as a better material and is used in the form of notes. Hence, bank money or credit money is the most portable money.

d) Cognosability

The material with which money is made should be easily recognized by sight or touch. It should be distinguishable by sight or touch from other types of money. Coins and currency notes of different denominations in different designs and sizes meet this quality of good money.

e) Homogeneity

The material with which money is made should be of the same quality. All forms of money should be same, material, Weight, size and colors. For instance all coins of one denomination

must be of the same metal, weight, shape and size. Similarly all paper notes of one denomination must have the same quality of paper, design and size. This is the reason why the blind in your village can identify each coin and paper notes.

f) *Divisibility*

The money material should be capable of being divided into smaller parts without losing value. This will facilitate transaction and exchange to the smallest unit. Gold, silver and other such materials possess this quality and paper when notes of small and large denominations are issued. *The larger denomination can be divided into smaller units notes.*

g) *Stability of value*

Money to serve as a store of value and as a common denominator of value, it should be stable in its own value. If its value fluctuates its function as a store of value and measure of value will be jeopardized. Gold and silver possess this quality because they are neither available in abundance nor very scarce. Paper money is preferred to Gold and silver because it is cheap and easily available. Its value is kept stable by keeping control over its issue. As the value of paper money increases unnecessarily, government increases its supply and decreases its supply as its value declines below what is expected to be.

2.6 Functions of Money

Money performs a number of primary, secondary, contingent and other functions which not only remove the difficulties of barter but also oils the wheels of trade and industry in the present day world.

2.6.1 Primary Functions

The primary functions of money can be classified into two: Medium of exchange and unit of value. They will be discussed as follows

a) Money as a medium of exchange

Money serving as a medium of exchange removes the need for double coincidence of wants and the inconveniences and difficulties associated with barter. Then, money serving as a medium of exchange separate transactions of sale and purchase, in time and place. You can sale what you have today and may buy what you need in a future time. You may sale your product at some place and may buy from other place. Besides, it affords the freedom of choice, you can buy any thing that maximizes your utility and allocate what you have in proportion with the utility that you can get from the products. By doing so, money facilitates exchange and trade.

Moreover, money removes the clumsiness, inconvenience and inefficiency of barter. And because, exchange is simple every one start to produce the most that he can which leads to the creation of division of labor and specialization. Division of labor also intensifies market competition which leads to the efficient allocation of resources.

b) Money as a unit of account

Alternatively, this function is known as unit of account, standard of value, common measure of value and common denominator of value. Since one would have to use a standard to measure the length or height of any object, it is only sensible that one particular standard should be accepted as the standard. Money is the standard for measuring value just as the yard or meter is the standard for measuring length. Money acts as a means of calculating the relative prices of goods and services.

The use of money as a standard of value eliminates the necessity of quoting the price of apples in terms of different other goods like the barter system. Money as a unit of value also facilitates accounting. “Assets, liabilities, income, and expenses of all kinds can be stated in terms of common monetary units to be added or subtracted.”

Money as a unit of account helps in calculations of economic importance such as costs, revenues, profitability and gross national product. It also helps to reward different factors of production according to their contribution to the economic development.

2.6.2 Secondary Functions

Money performs three secondary functions: as a standard of differed payments, as a store of value and as a transfer of value. They can be discussed as follows.

a) Money as a Standard of Differed Payments

Debt taking was easy even in the barter system, but not repayment. Specially when there are perishable articles. However, money simplifies both taking and paying debts, through this function, money links the present values with those of the future and it offers the following benefits:

- credit transactions are simplified
- contracts of goods supply in future with an agreed payment of money become possible
- borrowing is facilitated by consumers, business persons and firms
- the buying the selling of shares, debentures of securities become simple

There is, however, a danger of changes in the value of money overtime which harms or benefits the creditors and debtors. For example, if the value of money increases through time i.e., price of goods decreases, the creditor will receive money that can buy more goods and services than the time of credit. However, the borrower losses as he pays money that buys many goods and services at the time of repayment. Therefore, so as to prevent this problem a price index is applied so as to measure the change in price and to make the necessary adjustment.

b) Money as a Store of Value

The good chosen as money is always something which can be kept for long periods without deterioration or wastage. It is a form in which wealth can be kept intact from one year to the next. Money is a bridge from the present to the future. It is, therefore, essential that the money commodity should always be one which can be easily and safely stored. However, this could be defined as the functions of assets. Assets can serve as a store of value. Ordinarily they yield an

income in the form of interest, profits, rent or usefulness. But they have certain disadvantages as a store of value.

- i) They sometimes involve storage costs
- ii) They may depreciate in terms of money
- iii) They are illiquid in varying degrees and hence
 - They are not generally acceptable as money
 - It may be possible to convert them into money quickly only by suffering a loss of value.

Therefore, commodities are not the best tools as a store of value

c) Money as a Transfer of value

Since money is a generally acceptable means of payment and acts as a store of value, it keeps on transferring values from person to person, place to place and generation to generation.

2.6.3 Contingent Functions

According to Professor David Kinley contingent or incidental functions are the following and they are discussed as follows.

a) Money as a means of maintaining liquidity

Money is the most liquid of all liquid assets. Though, individuals and firms may hold wealth in infinitely varied forms, all are liquid forms of wealth which can be converted into money, and vice-versa.

b) Money as a basis of the credit system

Business transactions are either in cash or on credit. Credit economies the use of money. But money is at the back of all credit. With the absence of money, credit is impossible. If a country (commercial banks) have huge cash/money, they will create a huge credit and vice versa.

c) Money as an equalizer of marginal utilities and productivities

Marginal utilities refers to a concept which deals with the additional utility earned per unit of consumption. Hence, the main aim of a consumer is to maximize his satisfaction by spending a given sum of money on various goods which he wants to purchase.

Marginal productivity also refers to a concept which deals with the additional productivity achieved per unit of input. The main aim of the producer is to maximize his profits by allocating his resources in to the most productive resources.

Marginal utility and marginal productivity can be defined in terms of money i.e., marginal utilities refers to price of goods and marginal productivity refers to cost of goods, and prices and costs are expressed in money terms

d) As a Measure of National Income

National Income refers to an income generated by a given country at a given time period. This is achieved when the various goods and services produced in a country are assessed in money terms.

e) As a means of distribution of National Income

Rewards of factors of production in the form of wages, rent, interest and profit are determined and paid in terms of money. It is possible and simple to measure the contribution of each factor to the national development and rewarding it with money.

2.6.4 Other functions

Money in addition to the above stated primary, secondary and contingent functions, have other functions, too. They are:

a) Helpful in making decisions

Money is a means of store of value and the consumer meets his daily requirements on the basis of money held by him. Any purchase or action decisions made by individuals, firms and the state depends on the amount of money possessed by him/her.

b) Money as a basis of adjustment

Money is used to make adjustments between money market and capital market, in foreign exchange and international payments of various types.

2.7 Significance or Role of Money

Money is of vital importance to an economy due to its roles: Static and dynamic roles. Its static role emerges from its static or traditional functions and in its dynamic role, money plays an important part in the life of every citizen and in the economic system as a whole.

2.7.1 Static Roles of Money

In its static role, the importance of money lies in removing the difficulties of barter in the following ways:

a) By serving as a medium of exchange:

Money removes the need for double coincidence of wants, the inconveniences and difficulties associated with barter. Besides, it breaks up the single transactions of barter into separate transactions of sales and purchases in time and place.

b) By acting as a unit of account:

Money becomes a common measure of value. It eliminates the necessity of quoting the price of one item with many other items. Money is the standard of measuring value and value expressed in money is price.

c) By acting as a standard of deferred payments:

Money eliminates the difficulties associated with taking loans and making repayments that exist during the barter system. Money has simplified both taking and repayment of loans because money is the unit of account and its value is durable. The future value of money given/loaned today can be determined at time of loan and hence repayment is expected to be made accordingly. Money also overcomes the difficulty of indivisibility of commodities.

d) By acting as a store of value:

Money removes the problem of storing of commodities under barter. Because, it is made from a material that can be stored/kept for long periods without deterioration or wastage.

e) As a portable material:

Money removes the problem of transferring purchasing power from place to place. It can be transferred simply through draft, bill of exchange, cheques, etc.

2.7.2 Dynamic Role of Money

In its dynamic role, money plays an important part in the daily life of a person whether he/she is a consumer, a producer, a businessperson, an academician, a politician or an administrator. Besides, it influences the economy in a number of ways. This can be discussed below.

a) To the consumer

The consumer/person receives his income in the form of money. With this money in his hand, he can get any commodity and services he likes in whatever quantities he needs, and at any time he requires. Money acts as an equalizer of marginal utilities for the consumer. It helps in equalizing the marginal utilities of goods. Money enables a consumer to make a rational distribution of his income on various commodities of his choice.

b) To the producer

The producer keeps his account of the values of inputs and outputs in money. The raw materials purchased, the wages paid to workers, the capital borrowed, the rent paid, the expenses on advertisements, etc, is with money. Hence, money helps the producer to equalize the marginal productivity of the different inputs. He/she can rationally allocate his wealth to the different inputs according to their contribution to the attainment of organizational objectives.

Sale of products in money terms are his sale proceeds. The difference between the two gives him profit. Thus, money is used as a measure of performance of the producer.

c) To division of labor and specialization

Money helps the capitalist to pay wages to a large number of workers engaged in specialized jobs on the basis of division of labour. Each worker is paid money wages in accordance with the nature of work done by him. And every worker can get everything he/she wants and able to buy with this money.

Therefore, money helps in the growth of industries. All inputs are purchased and all output is sold in exchange for money. Money facilitates division of labor and hence specialization. Specialization also helps to increase productivity which in turn facilitates growth of an industry.

That is why professor Pigou said, “In the modern world industry is closely infolded in a garment of money.”

d) As the basis of credit

The entire modern business in a modern society is based on credit and credit is based on money. All monetary transactions consists of cheques, drafts, bills of exchange, etc. They are credit instruments which are not in a true sense money. But easily convertible into money. Banks issue such credit instruments and create credit.

e) As a means of capital formation

Consumers and producers earn their rewards in money form. They allocate this reward in to different things. They may buy what ever they want in their life and as it is already discussed above this allocation is rational. Hence, from their income they may put aside some money in form of savings. This savings will be deposited in a bank and the bank lend this money to business persons to invest in machineries, equipments and raw materials. This makes capital mobile and leads to capital formation and economic growth.

f) As an index of economic growth

The various indicators of economic growth are: National Income, per capita income, economic welfare, etc. These are calculated and measured in money terms. Changes in the value of money or prices also reflect the status of an economy. Fall in the value of money or rise in prices means that the economy is not progressing in real terms. Continuous rise in the value of money or fall in prices reflects retardation of the economy. Somewhat stable prices imply a growing economy.

g) In the distribution and calculation of income

The rewards to the various factors of production in a modern economy are paid in money. Workers get wages, capitalists get interest, landlords get rent, entrepreneurs get profit, etc in money forms.

h) In National and international trade

The use of money as a medium of exchange, as a store of value and as a transfer of value has made it possible to sell commodities not only within the country but also internationally. There are banks, financial institutions, stock exchanges, produce exchanges, international financial institutions, etc which operate on the basis of the money economy and the help in both national and international trade.

Trade relations among different countries have led to international cooperation. As a result developed countries help undeveloped countries by giving them loans and technical assistance. This is possible because the value of aid in foreign currency and the repayment are made /measured in money.

i) In solving the central problems of an economy

The central problem of an economy is to determine what to produce for whom to produce, how to produce and in what quantities. These are solved by money because on the basis of its functions money facilitates the flow of goods and services among consumers, producers and the government. The amount of money possessed by the different categories of the society helps to determine the above stated problems.

j) To the government

Government carries out many functions using money. Money facilitates buying of the government, collection of taxes, fines, fees and prices of services rendered by the government to the people. It simplifies the floating and management of public debt and government expenditure on development and non-developmental activities. It also simplifies the functions of the government.

Money helps in achieving these goals of economic policy through its various instruments. It also helps government in improving the standard of living of the people by removing poverty, inequalities, unemployment and achieving growth with stability.

k) To the society

The superstructure of credit is built in the society on the basis of money. It simplifies consumption, production, exchange and distribution of goods and services. It promotes national unity-when people use the same currency in every corner of the country. It acts as a lubricant for the social life of the people, and oils the wheels of material progress. Money is at the back of social prestige and political power. Thus money is the pivot round which the whole science of economics clusters.



1. What are the dynamic roles of money in cooperative organization? -----

2. What it mean that the money solves the central problems of economy? -----

3. Discuss the characteristics of money? -----

2.8 Summary

Functions of money serves as a unit of measurement and medium of exchange by decomposing the single transaction of barter into two separate transaction of sale and purchase. It also perform a numbers of primary, secondary contingent and other functions, which contribute economic growth of one country though serving the consumers, producers, government, etc.

Money is also classified into commodity, representative, legal tender, and optional money which is characterized by its general acceptability, durability, portability, cognosability, homogeneity, divisibility, and stability of value.

UNIT THREE

EVOLUTION OF BANKING

Contents

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3.9 References

Objectives

The aim of banking was originated to perform safe keeping and saving functions. At the end of this chapter the student will able to;

- identify Historical Background of Banking
- define and describe functions and meaning of Commercial Banks
- understand the Role of Commercial Banks in Economic Development
- identify Nature and Function of Central Bank/National Bank
- analyze differences between Central Bank and Commercial Bank
- understand the role of Central Bank in A Developing Economy

3.1 Introduction

The evaluation of banking can be traced back to the around 2000 BC by Babylonians. From this time onwards many countries of the world institutionalized banking activities to meet the need of the community. In the beginning the bank has suffered major setbacks. It had to pass through difficulty for years together because it was operating in barter system; the money economy was not yet operating. The banking concept was unknown to public, the merchant community was a small group, even the king and the government treasury preferred to hoard rather than to deposit in banks. The history of banking in our country can be traced back to 1905 with the establishment of Abyssinia bank and the same to other countries, the development bank also passed through difficulty in acceptance and using the services it provide by and to different bodies. This unit will discuss in detail historical background of banking, meaning and functions of Commercial Banks, the role of Commercial Banks in Economic Development, meaning, nature and function of Central Bank/National Bank, differences between Central Bank and Commercial Bank and role of Central Bank in A Developing Economy



1. What are the functions of commercial bank? -----

2. What are the differences between commercial and central bank?-----

3.2 Historical Background Of Banking

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

In England, banking had its origin with the London goldsmiths who in the 17th century began to accept deposits from merchants and others for safe keeping of money and other valuables. Bank of England was established in 1694 after the goldsmiths as safe keepers were ruined in the 1640's by the then ruler Charles II.

The bank of Venice, established in 1157, is supposed to be the first bank founded as a public enterprise. It was simply an office for the transfer of the public debt and originally it was not a bank in the modern sense. There were other banks emerged in the Italian cities perhaps a little before AD 1200. Some of these bankers were carrying out business on their own account. The activity was almost similar to the modern bankers. People used to settle their accounts with their

creditors by giving a check or draft on the bank or through transfer order if the creditor has an account in the same bank. These bankers were also received deposits and lent money.

As early as 1349 the drapers of Barcelona carried on the business of banking. They were required to give sufficient security before they commence this business i.e., they were under regulation. During 1401 a public bank was established in Barcelona. It was used to exchange money, receive deposits, and discount bills of exchange for both the citizens and for the foreigners.

During 1407 the bank of Genoa (in Italy) was established. In 1609 the bank of Amsterdam was established to meet the needs of the merchants of the city. It accepts all kinds of specie on deposits. Deposits could be withdrawn on demand or transferred from the account of one person to another. The bank also adopted a plan by which a depositor received a kind of certificate entitling him to withdraw his deposit within six months. These written orders, course of time, came to be used modern check. This time onwards many countries of the word institutionalized banking activities in their respective countries. Many types of banks were established to meet the needs of the community.

3.3 Commercial Banks

Commercial banks are one form of banks that any country can have. They perform all kinds of banking business. They generally finance trade and commerce. They usually accept short-term deposits and advance short-term loans to the businessperson and traders and avoid medium term and long term loans.

3.3.1 Functions of Commercial Banks

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

A. Accepting deposits

The bank accepts deposits from those who can save but cannot profitably utilize this saving themselves. People consider it more rational to deposit their savings in a bank because by doing

so they, on the one hand, earn interest and on the other, avoid the danger of theft. Banks provide alternative deposit accounts, that permits depositors to chose based on their respective objectives. Some of these accounts are: Time deposits, savings deposit accounts, and chaking accounts.

B. Advancing loans

The purpose of accepting deposit is to mobilize funds to be used for advancement of loans. The bank, after keeping certain cash reserves, lend their deposits to the needy borrowers. Before advancing loans, the bank must satisfy themselves about the credit worthiness of the borrowers. The bank can grant different types of loans such as: call loans, cash credit, term loans, overdraft facilities and discounting loans.

C. Agency services

In addition to the main functions of the bank stated above, banks perform many agency and general utility functions. The bank offers the following agency services.

- i) Collection and payment of credit instruments
- ii) Execution of standing customer orders
- ii) Purchasing and sale of securities on behalf of customers
- iii) Collection of dividends on shares on behalf of his customer
- iv) Income tax consultancy
- v) Acting as trustee and executor
- vi) Acting as representative and correspondent
- vii) Remittance of funds

The bank can also provides the following general service functions to customers

- i) Traveler's cheques
- ii) Safe custody of valuables and securities
- ii) Letters of credit facilities

3.3.2 The Role of Commercial Banks in Economic Development

Commercial banks play important roles in bringing economic development in a give country. Some of the roles of commercial banks shall be discussed as follows:

a) Mobilizing savings for capital formation

Commercial banks provide facilities to customers to save their surplus income (Income-consumption expenditure). Those who save their money in a bank gets interest income, or

can easily effect payment with convinency. This situation helps capital formation in the country. Capital formation also helps to encourage investment, employment, production, etc

b) Financing Industry

Commercial banks finance industries by providing loans to buy raw materials machineries, etc., through different loan mechanisms.

c) Financing Trade

d) Financing Agriculture

e) Financing consumers to acquire durable goods

f) Financing service rendering enterprises

g) Co-operate with the central bank to implement monetary policy.

3.4 Meaning, Definition And Development Of Central Banking

3.4.1 Meaning of Central banking

Central banking is the apex of banking system. It plays an active role in implementing government's economic policy in the country.

According to Will Rogers, Central Bank is one of the three great inventions in the human development, with fire and wheel. It may not be accepted by others even if the importance is known for certainty by all.

Today, central bank is the *central arch* of the *monetary and fiscal framework* in every country of the world and its activities are essential for the proper functioning of the economy and indispensable for the fiscal operations for the government.

Central banking is mostly a recent development being essentially a product of the *nineteenth century*. The following cases can be considered here:

- Riksbank of Sweden – established in 1668
- Bank of England – established in 1694 – serve as a central bank in 1844
- Bank of France – established in 1800

- Reichs bank of Germany – established in 1876
- Bank of Netherlands – established in 1814 – on the ruins of old bank of Amsterdam
- National bank of Austria – established in 1817 – reorganized as the bank of Austria-Hungary in 1877
- The bank of Norway – established in 1817
- The national bank of Denmark - established in 1818
- The national bank of Belgium - established in 1850
- The bank of Spain - established in 1856
- The bank of Russia - established in 1860
- The bank of Japan - established in 1882
- The bank of Italy - established in 1893
- The Swiss national bank - established in 1907
- National bank of Ethiopia - established in 1942 – National & Commercial Bank proclamation, August 1942
- The Federal Reserve system in America - established in 1913
- The bank of Canada - established in 1934

In the nineteenth century Central Banks of many other countries were established. They were empowered to issue notes with special principles and powers. They became bankers and advisers of their respective governments

In 1920, The International Financial Conference held at Brussels resolved that “All those countries which had not yet established a central bank should proceed to do so as soon as possible, not only with a view to facilitating the restoration and maintenance of stability in their monetary and banking systems but also in the interest of world cooperation.”

Hence, a number of Central Banks were added to the list of central banks in the world and there is no independent country without a central bank.

The central banks of these countries establish an effective relationship with IMF matters relating to foreign exchange.

3.4.2 Definition of Central Bank

A Central Bank may be defined as that central monetary institution which is charged with performing the duties of bankers' bank, fiscal agent for the government and managing the monetary system of the country.

Economists have defined central bank differently, emphasizing its one function or the other.

- Vera Smith – The primary definition of central banking is a banking system in which a single bank has either complete or a residuary monopoly of note issue.
- Show – The Central Bank is a bank which controls credit.
- Haultrey – Central Bank is a bank which controls credit.
- Statutes of the bank for international settlements – A Central Bank is the bank in any country to which has been entrusted the duty of regulating the volume of currency and credit in the country.
- Kisch and Elkin – A Central Bank is a bank whose essential duty is to maintain stability of the monetary standard.

3.4.3 Functions of a Central Bank

According to De Kock, and as accepted by the majority of economists the functions of a Central Bank are:

A. Bank of Issue/Regulator of Currency

The central bank is the monopoly of bank note issue. Notes issued by it circulate as legal tender money. The reasons for granting the exclusive monopoly of note issue to the central bank are:

- a) for credit control purpose
- b) to impart the notes a distinctive prestige i.e., it brings stability in the monetary system and creates confidence among the public.
- c) to ensure uniformity in the notes issued which helps in facilitating exchange and trade within the country.
- d) to make it easy for the state to supervise and control the irregularities and malpractices committed by the central bank in issuing notes.
- e) to restrict or expand the supply of cash according to the requirements of the economy.
- f) to control the banking system by being the ultimate source of cash.

B. Government Banker, Fiscal Agent and Advisor

- a) As banker to the government the Central Bank keeps deposits of the Federal and regional governments makes payments on behalf of governments, but it does not pay interest on government deposit's. It buys and sells foreign currencies on behalf of the government and keeps the stock of gold of the government. Thus it is the custodian of government money and wealth.
- b) As a fiscal agent, the central bank makes short-term loans to the government for a period not exceeding 90 days, floats loans, pays interest on them, and finally repays them on behalf of the government.
- c) As advisor, the central bank advises the government on such economic and money matters as controlling inflation or deflation, devaluation or revaluation of the currency, deficit financing and balance of payments, etc

C. Custodian of commercial banks cash reserves

Commercial banks are required by law to keep a certain percentage of the time and demand deposits as a reserve at the Central Bank. The purpose of keeping reserves at the central banks are:

- a) For transfer of funds between commercial banks through the clearinghouse.
- b) As a source of great strength to the banking system of the country.
- c) As the basis of a large and more elastic credit structure than if the same amount were scattered among the individual banks.
- d) Centralized cash reserves can be utilized fully and most effectively during periods of seasonal strains and in financial crises or emergencies.
- e) By varying these cash reserves the central bank can control the credit creation by commercial banks.
- f) The central bank can provide additional funds on a temporary and short term basis to commercial banks to overcome their financial difficulties.

D. Custody and Management of Foreign Exchange Reserves

This function derived from its functions as the bank of issue and the custodian of member banks' cash reserves.

It is an official reservoir of gold and foreign currencies. It buys and sells foreign currencies at international prices. It sells gold to the monetary authorities of other countries. It fixes the exchange rates of the domestic currency in terms of foreign currencies and tries to bring stability in foreign exchange rates. It manages exchange control operations by supplying foreign currencies to importers and persons visiting foreign countries on business, studies, etc. In keeping with the rules laid down by the government.

E. Lender of the Last Resort

In its capacity of lender of the last resort, the central bank meets directly or indirectly all reasonable demands for financial accommodation from the commercial banks, discount houses, and other credit institutions subject to certain terms and conditions which constitute its discount rate policy. Today this function is regarded as the sine qua non of central banking

F. Bank of Central Clearance, Settlement and Transfer

As a bankers' bank, the central bank acts as a clearing house for transfer and settlement of mutual claims of commercial banks. Since commercial banks keep their surplus cash reserves in deposits with the central bank it is far easier to clear and settle claims between them by making transfer entries in their accounts maintained with the central bank.

This function of the central bank is sometimes granted by law where as some other times by customary functions of banks. It saves time and creates convenience plus test at any time the degree of liquidity of banks.

G. Controller of Credit

The most important function of the central bank is to control the credit creation power of commercial banks in order to control inflationary and deflationary pressures within the economy.

For this purpose, it adopts quantitative and qualitative methods. Quantitative methods aim at controlling the cost and quantity of credit by adopting bank rate policy, open market operations and variations in reserve ratio of commercial bank.

3.4.4 Role of Central Bank in a Developing Economy

The central bank in a developing economy performs both traditional and non-traditional functions. The traditional functions are the monopoly of note issue, banker to the

government, banker's bank, lender of the last resort, controller of credit and maintaining stable exchange rate.

It aims at the promotion and maintenance of a rising level of production, employment, and real income in the country. It is given a wider power to promote the growth of economies in underdeveloped countries. They, therefore, perform the following functions towards this end.

1. Creation and expansion of financial institutions
2. Proper adjustment between demand for and supply of money
3. Creating a suitable interest rate policy
4. Debt management
5. Credit control
6. Open market operations

3.5 Difference between Central Bank and Commercial Bank

A central bank is basically different from a commercial bank in the following ways:

1. The Central Bank is the apex institution of the monetary and banking structure of the country. The commercial bank is one of the organs of the money market.
2. The Central Bank is a non-profit institution which implements the economic policies of the government. But the commercial bank is a profit-making institution.
3. The Central Bank is owned by the government, whereas the commercial bank is owned by shareholders.
4. The Central Bank is a banker to the government and does not engage itself in ordinary banking activities. The commercial bank is a banker to the general public.
5. The Central Bank has the monopoly of note issue, while the commercial bank can issue only cheques. The notes are legal tender. But the cheques have the nature of near-money.
6. The Central Bank is the banker's bank. As such, it grants accommodation to commercial banks in the form of rediscount facilities, keeps their cash reserves, and clears their balances
7. The Central Bank controls credit in accordance with the needs of business and economy. The Commercial Bank creates credit to meet the requirements of business.

8. Every country has only one Central Bank with its offices at important centers of the country. On the other hand, there are many Commercial Banks with hundreds of branches within and outside the country.
9. The Central Bank is the custodian of the foreign currency reserves of the country while the Commercial Bank is the dealer of foreign currencies.
10. The chief executive of the central bank is designated as “Governor” whereas the chief executive of a Commercial Bank is called “chairman” or “president” or “managing director”.
11. The Central Bank helps the expansion of Commercial Banks whereas Commercial Bank facilitates the expansion of industries by underwriting shares and debentures and by meeting financial requirements.

3.6 Evolution of Banking in Ethiopia

3.6.1 Origin of Banks in Ethiopia

Banking is relatively new concept in Ethiopia. The history of banking can be traced back to 1905 with the establishment of Abyssinia bank on 15th February 1906 in the premises of Ras Mekonnen, the present University campus of Addis Ababa. In the beginning the bank has suffered major setbacks. It had to pass through difficulty for years together because it was operating in barter system; the money economy was not yet operating. The banking concept was unknown to public, the merchant community was a small group, even the king and the government treasury preferred to hoard rather than to deposit in banks. The bank was not able to earn profits for a period of eight years, its reported profits for the year 1914 and then its 1919 and 1920. By the end of 1924 it started earning substantial and steady profits.

The reasons for poor performance was basically the economy was not money economy there were three types of exchanges in operations. Among them barter system was at the local level. For transactions that involved important commodities, crude media of exchange were used such as bars of salt (traditionally called amole), bullets, country shells and other related items silver coins called Maria, Theresa, Thalers were used for significant transactions such as land, firearms etc. In addition to this societies like the Harari. Amorite and the coastal trading communities

used their own coins or used coins imposed from neighboring countries like the Indian rupee. It is evident that the overall economy was in primitive stage.

In fact, the last quarter of the century witnessed an increase in foreign trade and modernization, as a result of the policy of the then ruler of the country. Emperor Menilik II. The idea came up as early as 1890 for discussion to start a bank in the country on foreign capital or as an affiliation of a foreign bank. In view of other factors, somehow the matter has been pending for a period and the leaders in 1903 have decided to invite the British government to support the idea of Ethiopian government plans to establish a bank. After two years the national bank of Egypt, an affiliate of the Bank of England, which was given monopoly position in banking with regard to other foreign banking companies and other privileges. It was to set up a bank in Ethiopia to be called the Bank of Abyssinia.

The bank of Abyssinia's headquarter in a new building was inaugurated on 1st January, 1910 and expansion of branches took place in Harar 1906, DireDawa 1908, and Gore 1912. They never had Ethiopian qualified staff until their liquidation in 1931.

The liquidation of Bank of Abyssinia.

The liquidation of bank of Abyssinia took place in 1931 in order to give the way for the establishment of first national bank of Ethiopia called the Bank of Ethiopia in August 1931. Even this was formed with the support of bank itself and National Bank of Egypt. The bank of Ethiopia was given all the powers and responsibilities of a central bank. Because it was a national bank. Modernization of currency was given more priority. Paper notes were used a year after.

The remarkable progress of the bank was made when the country was invaded by the Fascist Italy in 1935 and left in 1941 leaving the bank in a complete vacuum.

However, the Italian period saw the introduction of Italian banks and insurance companies in the country. The money economy was further expanded in the five year of rule. Banking and insurance also witnessed considerable expansion. All this is due to the large investment that the fascist government made in the infrastructure.

Building and huge amount of money was spent in the country.

In view of the above, the Imperial regime which was between 1941 to 1974 had to start from the scratch and the banking industry undergone dynamic growth. The exercise of establishing central bank and designing currency notes as well as formulating a monetary reforms were few sensitive issues having direct impact on the sovereignty of the country. Emperor Haile Selassie along with his economic departments, leaders of the state had to move very carefully. Finally, they manoeuvred the British in such a way that without their knowledge a State Bank of Ethiopia was set up in 1942, and designed a new currency pegged to the dollar.

The years following the liberation of the country Fascist Italians rule were devoted to the rehabilitations of the economy. This can be observed by the steady expansion of the modern sector of the economy and a steady growth of the money economy that was the reverse of the last decline of barter.

In 1945, Agricultural Bank was established to help the rehabilitation of the agricultural sector. Four years later the same was changed as agricultural and commercial bank. On the recommendation and assistance at the predecessor of the world bank (the IBRD), the bank was further converted in 1951 into the development bank of Ethiopia.

In the year 1963, it was felt in view of the increased operations of State Bank of Ethiopia to restricte to make it more effective. It was split into the National Bank of Ethiopia and Commercial Bank of Ethiopia dividing the responsibilities between the two banks.

Parallel development took place in the insurance sector and financial sector specially in banking sector. By the time revolution broke out there were four commercial banks in operations mainly Commercial Bank of Ethiopia, (wholly government owned) Addis Ababa Bank (a private bank) Banco di Roma and Banco di Napoli. In 1975 the provisional Military Administrative Council (Derg Government) nationalized privately owned financial institutions including three commercial banks and thirteen insurance companies and two non-banking financial intermediaries. While National Bank of Ethiopia was retained as a separate institution, all other commercial banks were merged with the commercial bank through an act.

In the recent past several changes took place in banking sector. Many private banks entered into fray and competing with government banks. At present there are six private banks are in

operations they are Dashen Bank, United Bank, Abyssinia Bank, Wegagen Bank, Awash Bank and Nebe Bank.

3.6.2 Types of Banks in Ethiopia

With the passage of time, several types of banks have come into existence performing different specialized functions. Based upon the function performed by them, banks may be classified into different types.

i. Commercial Banks

They are joint stock banks, which accept different kinds of deposits from the public and grant short-term loans. Their main aim is to provide security of funds to the depositors and make profits for their shareholders. As their deposits are mainly for short periods, they cannot lend money for long periods. They mainly finance business and trade for short periods to meet their day-to-day transactions. They may provide finance in the form of each credits or overdrafts or loans. They also provide fiancé by discounting bills of exchange.

ii. Industrial Banks

The banks are also called investment banks. They provide long-term finance to industries ranging over a few decades. They finance long-term projects and development plans. They receive long-term deposits from the public. They may also raise funds by the issue of shares and debentures. They specialize in and undertake industrial finance. They may purchase the new issue of shares, debentures and securities of new enterprises. They may also provide underwriting facilities. Unlike commercial banks, these industrial banks do not exist in all countries. In some countries, commercial banks under the mixed banking system are undertaking both commercial banking and industrial banking functions. They meet the long-term capital requirements of industrial concerns. They also promote new industrial units. They provide not only financial assistance but also technical and managerial guidance for efficient working of industries. In the developed world, especially in Germany and America, these banks are assuming increasing importance.

iii. Agricultural Banks

The commercial and Industrial Banks are not able to meet the financial requirements of agriculture. Agriculture requires both short term and long-term finance. Short period loans are provided by Cooperative banks while long-term loans are provided by land mortgage banks. Farmers require short-term finance to buy seeds, fertilizers, implements, etc. They require long term finance to make permanent improvement on their land like digging wells or purchasing farm machinery and equipment of a permanent nature. They provide long-term loans against the security of land. As the loans are given mainly for development purpose, these banks are called as "Land Development Banks". These banks may borrow from Government. They may also raise capital by issuing bonds and debentures. They have become prominent in Ethiopia and other countries like Germany and Japan.

iv. Co-operative Banks

The banks are formed to supply credit to members on easy terms. They do not aim at profit in their operations. They attract deposits from the farmers and promote thrift by offering slightly higher rates of interest than commercial banks. They provide credit facilities to needy farmers and small-scale industrial units.

v. Exchange Banks

They specialize in financing the import and export trade of the country. They purchase bills from exporters and sell them to importers. Exchange banks discount these bills of exchange to promote foreign trade. They open many branches in different countries and settle the foreign exchange transactions between traders of different countries. They may also undertake the usual banking operations. They provide remittance facilities and trade information to their clients. In recent years, commercial banks have also entered this field by opening their branches in foreign countries.

vi. Savings Banks

These banks collect small and scattered savings of the low and middle-income group people. These banks aim at promoting thrift among the low-income people who otherwise would have spent the money for unproductive purposes. These banks receive small amounts of deposits and withdrawals are restricted. Banks offer minimum interest on these deposits.

vii. Central Banks

The central bank controls the entire banking system in the country. It operates the currency and credit system in the country. It acts as an agent and adviser to the government and works in the best interest of the nation without any profit motive in its operations.

viii. Indigenous Banks

These form part of unorganized money market. They lend money for short periods and charge very high rates of interest. They lend money to small traders, farmers, businessmen, etc... against securities. The National Bank of Ethiopia defined an indigenous banker or bank as an individual or private firm receiving deposits and dealing in hundies or lending money. They maintain vernacular system of accounts and do not maintain any audited accounts.

3.5.3 Short Summary of banking development and other financial institutions in Ethiopia

The agreement that was reached in 1905 between Emperor Minilik II and Mr. Ma Gillivray, representative of the British owned National Bank of Egypt marked the introduction of modern banking in Ethiopia.

Following the agreement, the first bank called Bank of Abyssinia was inaugurated in Feb. 16, 1906 by the Emperor. –Liquidated 1931.

1915: Formation of other types of Banks like Bank di'Italia, Bank d'Roma.

1931: The Bank of Abyssinia was purchased by the GoE in 1931 shortly after Emperor Haile Selassie came to power and renamed as Bank of Ethiopia. –Liquidated 1936.

1936: Italian Invasion-Expansion of Modern Cooperatives in the country.

1943: State Bank of Ethiopia established. –Liquidated 31st Dec. 1963.

1943: Establishment of Ministry of Agriculture (MoA)

Various programmes launched such as

CADU, WADU, EPID, ARDU, CPP, MPP

1941: Barclays Bank came to Ethiopia with British troops and organized banking services in Addis Ababa until its withdrawal in 1943.

1945: Agricultural Bank that provides loans for the agricultural and other relevant projects established.

1949: Agricultural Bank replaced by the Investment Bank of Ethiopia.

1951: Investment Bank of Ethiopia replaced by the Development Bank of Ethiopia.

1951: Imperial Insurance Company was established.

1960: Decree Number 44/1960, which is known as “The Farm Workers” Decree was issued. Ministry of National Community Development was charged to promote and carry out the registration of Cooperatives.

1962: The Imperial Savings and Home Ownership public Association (ISHOPA) which specialized in providing loans for the construction of residential houses and to individuals under the guarantee of their savings.

1963: Addis Ababa Bank S.C. –In the same year Monetary and Banking Proclamation Number 206/1963 came into force.

1964: National Bank of Ethiopia with more power and duties started its operation

1964: Commercial Bank of Ethiopia took over the commercial banking activities of the former State Bank of Ethiopia.

1964: Addis Ababa Bank S.C-The first privately owned bank was established on Ethiopians initiative and started operation.

1964: Establishment of SACCOs in Ethiopia (1957: ERA; 1964: Ethiopian Airlines)

1965: The Saving and Mortgage Corporation of Ethiopia whose aims and duties were to accept savings and trust deposits account and provide loans for the construction, repair and

improvement of residential houses, commercial and industrial buildings and carry out all activities related to mortgage operations.

1965: Investment Bank of Ethiopia replaced by Ethiopian Investment Corporation Share Company

1966: Cooperative Societies Proclamation No. 241/1966- Cooperatives were registered by the Ministry of Community Development and Social Affairs.

1970: Proclamation No.55/1970 established the Agricultural and Industrial Development Bank Share Company by taking over the asset and liability of the former Development Bank and Investment Corporation of Ethiopia.

1970: A National SACCO Promotion Committee known as the Ethiopian Thrift and Credit Cooperatives Development Committee was organized.

1974: “Declaration of Socialism”

1975: The Savings and Mortgage Corporation S. C and Imperial Saving and Home Ownership Public Association were also merged to form the Housing and Saving Bank (Proclamation No.60/1975).

1975: All insurance companies operating were nationalized and a single unit called Ethiopian Insurance Corporation became the sole operator.

1975: Cooperative Societies Proclamation No. 71/1975 was issued. It was a proclamation to provide for nationalization of rural land and provides direction for the formation of PAs, PCs, and SCs.

1976: Proclamation No.99/1976 brought into existence the Agricultural and Industrial Bank (AIB) was brought under the umbrella of the NBE.

1978: NBE was established SACCOs as per Proclamation No. 138/1978 until cooperative societies proclamation No. 147/1998.

1979: AIB reestablished by proclamation No. 158/1979 and named Agricultural and Industrial Development Bank (AIDB).

1990: “ Mixed Economy” –Bad Day for Ethiopian Cooperatives

1991: “ EPRDF”

1994: Financial Sector Reform

Monetary and Banking Proclamation No.83/1994

Licensing and Supervision of Banking Business No.84/1994

Agricultural Cooperative Societies Proclamation No. 85/1994

CBE-re-established and re-organized

Construction and Business Bank- (ex-Housing and Saving Bank)

DBE-(ex-AIDB)

1995: Private Bank....

1996: A Cooperative Desk was established in the Office of the Prime Minister together with RCPBs, ZCPD and WCPD.

1998: Cooperative Societies Proclamation No. 147/1998 was issued.

2002: Federal Cooperative Commission- Proclamation No. 274/2002

2003: Draft Cooperative Policy

2004: Cooperative Bank of Oromiya registered as Cooperative bank based on Licensing and Supervision of Banking Business No.84/1994 article 304

2005: Since March 2005 Cooperative Bank of Oromiya under operation.

2006-2012:---?

? What are the banks established since 2006 to 2012? Please describe the banks with the time of establishment? -----



1. Which bank play in implementing government`s economic policy in the county?-----

2. Discuss historical development of bank and other financial institutions in Ethiopia? ----

3. In Ethiopia based on their function performed, banks are divided in how many? And describe them? -----

s/n	Test questions	Yes	No
1	Did you understand the reasons why banks were originated?		
2	Did you identify the functions of central bank and commercial bank?		
3	Are you sure to discuss the differences between central and commercial banks		

3.7 Summary

The origin of banking can be traced back to around 2000 BC by Babylonians who was performing the safe keeping and saving functions in its oldest form. In ancient Greece and Rome, the practice of safe keeping of gold's and coin at temples and granting loans for public and private purpose on interest was prevalent

Commercial banks are one form of banks that any country can have. They perform all kinds of banking business. Some of them;

A. Accepting deposits

B. Advancing loans

C. Agency services

Commercial banks play important roles in bringing economic development in a give country.

Some of the roles of commercial banks are:

Mobilizing savings for capital formation

- Financing Industry
- Financing Trade
- Financing Agriculture
- Financing consumers to acquire durable goods
- Financing service rendering enterprises
- Co-operate with the central bank to implement monetary policy

Central bank is the *central arch* of the *monetary and fiscal framework* in every country of the world and its activities are essential for the proper functioning of the economy and indispensable for the fiscal operations for the government.

According to De Kock, and as accepted by the majority of economists the functions of a Central Bank are:

- Bank of Issue/Regulator of Currency
- Government Banker, Fiscal Agent and Advisor
- Custodian of commercial banks cash reserves
- Custody and Management of Foreign Exchange Reserves
- Lender of the Last Resort
- Bank of Central Clearance, Settlement and Transfer
- Controller of Credit

The history of banking can be traced back to 1905 with the establishment of Abyssinia bank

With the passage of time, several types of banks have come into existence performing different specialized functions. Based upon the function performed by them, banks may be classified into Commercial Banks, Industrial Banks, Agricultural Banks, Co-operative Banks, Exchange Banks, Savings Banks, Central Banks, Indigenous Banks types.

3.8 Answers

In module everything in the question has been discussed in detail, please refer it.

UNIT FOUR

NEGOTIABLE INSTRUMENT

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 - 4.5.1 Holder
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- 4.6 Endorsement
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- 4.7 Payment of Cheques
- 4.8 Post test question
- 4.9 Summary

4.12 Answers to question

Objectives

After completing this Unit the student will develop the knowledge to define, discuss, elaborate, identify and describe: Meaning, Concepts, Presumption, Alterations, Presentment and Dishonor, kinds, Maturity of Negotiable Instruments and Negotiation and Bills of Exchange.

4.1 INTRODUCTION

A negotiable instrument is one which is by a legally recognized custom of trade or law, transferable by delivery or by endorsement, in such circumstance that, the holder of it for the time being may sue on it in his own name. One of the important characteristics of a negotiable instrument is that it is freely transferable from one person to another. Delivery of the instrument is an essential formality to complete negotiation whether the instrument is payable to bearer or to order. The property in the instrument does not pass unless it is delivered to the desired person.

Therefore, in this unit we will discuss about the meaning of negotiable instruments, their characteristics, conditions and presumptions about issuance of negotiable instruments. There after we will discuss about types of negotiable instruments, their respective characteristics, parties to these instruments, their similarities and differences. Finally, we will discuss about the basic concepts of negotiable instruments such as; holder and holder in due course, endorsement, crossing, payment in due course, precautions to be taken in payment of these instruments, collections of cheques, and legal protections given to a collecting bank.

4.2 MEANING OF NEGOTIABLE INSTRUMENTS AND NEGOTIATION

4.2.1 Meaning of Negotiable Instruments

A negotiable instrument is one which is by a legally recognized custom of trade or law, transferable by delivery, or by endorsement and delivery, in such circumstance that, the holder of it for the time being may sue on it in his own name and the property in it passes, free from equities, to a bona fide transferee for value, notwithstanding any defect in the title of the transferor.

A negotiable instrument is that piece of paper which when transferred by delivery or by endorsement and delivery passes to the transferee a good title irrespective of the title of the transferor provided the transferee is a bona fide holder for value and does not have knowledge of any defect in the title of the transferor. Thus mere transferability of the instrument by delivery or by endorsement and delivery is not sufficient to make it negotiable. In addition to this, it must give the transferee the right of action in his own name and without defenses, which could have been set up against the transferor.

4.2.2 Meaning of Negotiation

Negotiation means the transfer of the right, title and interest of the holder of a negotiable instrument, so as to give the transferee good title, if he be a holder in due course, even though the transferor has a bad or defective title, except in the case of forgery of the holder's signature if the instrument is payable to order, or in the case of an instrument is void or except in the case of an instrument completed and transferred after it is stolen and which was not at all delivered by the maker or drawer to anybody.

One of the important characteristics of a negotiable instrument is that it is freely transferable from one person to another. The ownership of a negotiable instrument can be transferred in any of the two ways:

Modes of Negotiation

Negotiation may take place in either of the two ways: By delivery and by endorsement and delivery.

a) Negotiation by delivery

Negotiable instruments payable to bearer are negotiable by mere delivery. There is no need of endorsement in such cases. By delivery, we meant that, the transfer of the physical possession of the instrument. An instrument is said to be bearer instrument, if the instrument is expressed to be payable to bearer and if it is endorsed in blank as follows:

- i). Pay to A or bearer
- ii). Pay to the bearer
- iii). If the last endorsement bear only the endorser's name

Transfer by delivery of a bearer instrument is a sale of the instrument just like a sale of the goods and the transferee becomes the holder of the instrument. A person who steals or finds a bearer instrument is not the holder because it has not been delivered to him. Thus, delivery is essential to make the transferee the holder of the instrument.

For example;

- o Ato Alemayehu, the holder of a negotiable instrument payable to bearer, delivers it to Ato Megersa's agent to keep for Ato Megersa
- o Ato Hogos and Ato Zeberga have an account at Dashen Bank. Ato Hogos, the holder of a negotiable instrument payable to bearer directs Dashen Bank to transfer the instrument to Ato Zeberga's account. The banker (Dashen Bank) does so, and accordingly now possessed the instrument as Ato zeberg's agent.

In both cases, the instruments are negotiated and Ato Megersa and Ato Zeberga becomes the holder of the instrument.

b) By endorsement and delivery

A negotiable instrument payable to order is negotiable by the holder through endorsement and delivery. Thus, in case of on order instrument, the holder must first endorse it and then deliver it to the endorsee. Endorsement can be done by signing his name by the endorser on the back of the instrument. Mere endorsement does not account to negotiation of the instrument payable to order, it must be delivered to the endorsee to make him the holder. An instrument is said to be an order instrument, if the instrument is expressed to be payable to a particular person: the payee or endorsee, and if the instrument does not contain words prohibiting transfer or indicating an intention that it shall not be transferable: -

- For example: - i) Pay to A
ii). Pay to A or order
iii). Pay to the order of A

The payee mentioned in the instrument is the rightful person to make the first endorsement. After this, any party who has become the holder of the instrument can make endorsement. Such a holder may be even the drawer or maker of the instrument and if this happens, the drawer or maker of the instrument can endorse it in his capacity as the holder.

Delivery of the instrument is an essential formality to complete negotiation whether the instrument is payable to bearer or to order. The property in the instrument does not pass unless it is delivered to the desired person i.e. to the bearer, incase of bearer instrument, and to the endorsee, in case of an order instrument. For example, If Ato Suleman endorse (write his name on the instrument) an instrument for the benefit of Ato Gemechis but deceased before delivery, the instrument is not said to be negotiated and Ato Gemechis, the endorsee, in the instrument, has no right to claim the amount in the instrument. Delivery of a negotiable instrument may take place in any of the following three ways:-

- ❖ **Actual Delivery:** - This exists when the change of physical possession of the instrument takes place from one person to another
- ❖ **Constructive Delivery:** - This takes place without change of actual physical possession of the instrument. A person is said to have constructive possession of the instrument when it is in the actual possession of his agent, clerk, or servant on his behalf.
For example, Ato Amare holds a bill on his won account subsequently endorses it in favor of Ato Migbaru and holds it as to Ato Migbaru's agent. This is a case of constructive delivery.
- ❖ **Conditional Delivery:** - where a negotiable instrument is delivered continually, property in the instrument does not pass until the condition is fulfilled. In case of conditional delivery, if the holder transfers the instrument to some body else and does not fulfill the condition attached to delivery, plea of conditional delivery will be available only against the person who takes it with the notice of the condition and not against the holder in due course.

4.3 Certain Concepts Related With Negotiable Instruments

4.3.1 Presumption of Negotiable Instruments

Negotiable instruments are written contracts entered between and among parties. However it is different from other forms of contracts in certain characteristics. The following are some of the characteristics of Negotiable Instruments, which distinguish them from other forms of written contracts.

i) **Transferability.** The basic feature of a negotiable instrument is that it is easily transferable from person to another person and the ownership of property in the instrument can be transferred by mere delivery, if the instrument is bearer instrument, and by endorsement and delivery, if the instrument is an order instrument. No formalities are necessary in transferring the right in a negotiable instrument.

ii) **Good Title of the Transferee**

The person who takes a negotiable instrument in good faith and for value gets it free from all defects and thus is entitled to recover the amount of money mentioned in the instrument. The transferee of a negotiable instrument is known as a “holder in due course”. His title is not affected by any defect of title on the part of the transferor or of any of the previous holders of the instrument (see other privileges of a holder in due course under its section.)

iii) **Right of Action:-**

The holder of a negotiable instrument who is also the holder in due course gets the right to sue upon the instrument in his own name and without making the transferor a part to the suit.

iv) **Presumption as to consideration:-**

It is presumed that consideration has been given for the negotiable instrument. Besides, there are other presumptions, which will be discussed later.

V) **No need to give notice of transfer to the party liable to pay.**

It is not necessary to give to the party, liable on the instrument, notice of its transfer to ensure that he makes payment only to the transferee.

4.3.2 Presumption as to Negotiable Instruments

The following legal presumptions are made in respect of a negotiable instrument until the contrary is proved.

- i) **Consideration:** -Every negotiable instrument was made or drawn for consideration and that every such instrument, when it has been accepted, endorsed, negotiated or transferred; was accepted, endorsed, negotiated or transferred for consideration. Consideration means payment given as reward.
- ii) **As to date.** The date that a negotiable instrument bears is presumed to be the date it was made or drawn, though, the issuance date and the date written on the instrument may be different. The instrument may be post dated or ante dated.
- iii) **As to time of acceptance:** -. Every accepted instrument (a bill of exchange) must be accepted within a reasonable time after it is being made and before its maturity.
- iv) **As to time of transfer:** -Every transfer of a negotiable instrument is made before its maturity. An instrument transferred after maturity does not grant the holder of it a better title.
- v) **As to order of endorsement:** - The endorsements appearing up on a negotiable instrument are made in the order in which they appear. Their liability also falls in the order that it appears.
- vi) **As to stamp.** Negotiable instruments are assumed to be properly stamped as they are issued.
- vii) **Holder as a holder in due course:** - The holder of a negotiable instrument is a holder in due course; provided that, the instrument has been obtained from its lawful owner, or from any person in lawful custody, by means of an offence or fraud, or has been obtained from the maker or acceptor by means of an offence or fraud or for unlawful consideration, the burden of proving that the holder is a holder in due course lies upon him.
- viii) **In a suit upon a dishonored instrument,** the court shall on proof of the protest, presume that it was dishonored until this fact is disproved.

4.3.3 Alterations of Negotiable Instrument

Normally, a written contract cannot be unilaterally altered. If a contract in writing has been executed, it can only be altered by a voluntary act by both parties as evidenced by their signatures to the alterations. This rule applies equally to Negotiable Instruments. In the case of

Negotiable Instruments, alterations may be divided into the following three categories: Material Alterations, Immaterial Alterations, and Unilaterally Allowed Alteration

1. Material Alteration

It is an alteration, which makes significant variations in the rights and liabilities of the parties. The parties who have not agreed to such an alteration are absolved from liability on the instrument. Therefore, material alterations cannot be made by one party without the consent of the other party. These material alterations include:

- a) Alteration of the date of the instrument
- b) Alteration of the sum payable
- c) Alteration in the time of payment
- d) Alteration of the place of payment
- e) Alteration of the rate of interest
- f) Alteration of the name of the parties
- g) Addition or omission of a new or an existing parties to or from the instrument
- h) Tearing an instrument in a material part

2. Immaterial Alterations

It is an alteration, which does not have a significant effect on the position of the parties. Any party without the consent of the other party may make it. It includes:-

- a) Alterations made before the issue of the instrument
- b) Alteration made to carry out the common intention of the parties to the instrument
- c) Alteration made for correction of a mistake in date or of a clerical error like: Crossing a “t”, dotting an “i”, correcting spelling errors.
- d) Alteration made with the consent of all the parties
- e) Alteration which have resulted from an accident, e.g. mutilation by washing and ironing of a garment
- f) Correcting other obvious error in the body of the instrument

3. Unilaterally Allowed Alteration

There are certain alterations to an instrument, which are allowed to be made by one party without the consent of the other party. These include;

- a. Crossing uncrossed instrument
- b. Conversion of a blank endorsement in to endorsement in full and vice versa
- c. Filling a blanks in inchoate instruments
- d. Altering a general crossing to a special crossing

Presumption of Negotiable Instruments

An instrument to be a negotiable instrument, it should fulfill the following conditions

- a. The transferee should be a holder in due course
- b. The instrument should not be completed after stolen.
- c. The instrument should be delivered by the maker or drawer to any body
- d. Signature should not be forged in case of order instrument
- e. The title of the transferor may be bad or defective.

4.3.4 Presentment and Dishonor of Negotiable Instruments

4.3.4.1. Presentment of Negotiable Instruments

Presentment of a negotiable instrument means placing the instrument before the drawee or maker for any of the following purposes:

- i) Presentment for acceptance
- ii) Presentment for sight
- iii) Presentment for payment

i). Presentment for Acceptance

Acceptance is defined as the signification by the drawee of his assent to the order of the drawer. After acceptance, the drawee is known as the acceptor. It is only a bill of exchange, which may have to be presented for acceptance. Presentment of a bill is not necessary for acceptance in all the cases. Bill of Exchange payable on demand or at sight or on a certain date need not be presented by the holder for acceptance; however, presentment of a bill for acceptance is desirable in order to:

- a. Obtain additional security of the acceptor's name on the bill

- b. Obtain an immediate right of recourse against the drawer and the other parties in case the bill is dishonored by non-acceptance.

Presentment for acceptance of a bill is, however, necessary in the following cases:

- a. When a bill is payable at a given time after acceptance or sight, presentment for acceptance is necessary to fix the maturity of the instrument
- b. When a bill expressly stipulates that it shall be presented for acceptance; it must be presented for acceptance before it is presented for payment.

The essentials of a valid acceptance are:

- a) Acceptance must be in writing and must appear on the bill
- b) Acceptance must be signed by the drawee or his duly authorized agent
- c) The bill must be delivered to the holder

Types of acceptances

The acceptor is the drawee or any person who has signed his assent up on the bill and delivered it to the holder or has given notice of his so doing to the holder. He can be only the drawee or a person named as drawee in case of need or an acceptor for honor or an agent to the drawee. Acceptance may be general or qualified.

a. General Acceptance.

When the drawee of a bill accepts the order of the drawer to pay the amount in full without any condition or limitation, acceptance is said to be general or absolute. It is affected when the drawee signs his name on the bill with the word “accepted.” thereby signifying his assent to the bill. No addition must be made on the instrument.

b. Qualified Acceptance.

In case of qualified acceptance, the drawee accepts the bill subject to certain qualifications or conditions. Acceptance is qualified in various ways i.e. as to time, place, event, amount, drawee, etc. may be added to the acceptance.

ii) Presentment for sight

The Negotiable Instrument Act sec. 63 deals with the necessity to presentment for sight of promissory note payable at certain period, after sight. A promissory note, payable at a certain period, after sight, must be presented to the maker for sight by a person entitled to demand payment, within a reasonable time after it is made and in business hours on a business day. If the

holder fails to present in such case, no party in the instrument is liable to the person making such default.

iii) Presentment for payment

According to sec.64 of the negotiable instrument act, promissory notes, bill of exchange and cheques must be presented for payment to the maker, acceptor or drawee respectively, by or on behalf of the holder. In case of the death of these parties, presentment should be made to his legal representative or assignee. It can be presented for payment either by the holder or his authorized agent or in case of his death or insolvency, by his legal representative or official assignee. If the holder fails to present, the other parties to the instrument are not liable to the holder.

Rules Regarding Presentment for payment

The following rules are applicable as to presentment of a negotiable instrument for payment.

Presentment for payment must be made during the usual hours, of business. In case of a banker, presentment must be made within banking hours.

- ❖ A promissory note or a bill of exchange which is payable at a specified period after date or sight must be presented for payment at maturity.
- ❖ A promissory note, bill of exchange, or a cheque made, drawn or accepted payable at a "specified place and not elsewhere" must be presented for payment at that place in order to charge any party. In case the holder fails to present the bill at the specified place, all parties will be discharged from their liability,
- ❖ A promissory note or a bill of exchange made, drawn or accepted payable at a specified place must be presented for payment at that place in order to charge the maker or drawer. Failure to present will discharge all the prior parties, drawer and endorsers but not the acceptor.
- ❖ If no specific place is mentioned in the bill or the note, it must be presented for payment at the place of business, or at the usual residence of the drawee (acceptor) or the maker, as the case may be. If the latter has no known place of business or fixed residence, such presentment may be made to him in person wherever he can found.
- ❖ A negotiable instrument payable on demand must be presented for payment within a reasonable time after it is received by the holder.
- ❖ Presentment for payment may be made to:-
 - a) the duly authorized agent of the drawee, maker or acceptor
 - b) his legal representative in case of his death

c) his assignee, if he has been declared insolvent

- ❖ A presentment through the post office by means of a registered letter is sufficient, if authorized by agreement or usage.

Delay in presentment may be excused if the delay is caused by circumstances beyond the control of the holder and not imputable to his default, misconduct or negligence. When the cause of delay ceases to operate, presentment must be made within a reasonable time.

Presentment for payment is excused when:

There is intentional prevention of presentment: - When the holder of a negotiable instrument lost the same, he has to report to the maker and the maker is required to give a copy of the original instrument. But, when a bill of exchange is lost and a duplicate is not supplied, presentment is not necessary, as it is considered the existence of an intentional prevention of presentment.

Place of Business Closed: - When the instrument is payable at the maker, acceptor and drawees place of business and that is closed during normal business hours, no presentment is necessary.

Payer absents from place of payment. When the instrument is payable at a specified place on the due date but there is no person authorized to refuse or make payment at that place.

Payer is not found after due search. When the instrument is not payable at any specified place and the person liable to make payment is not found after making reasonable search.

Waiver of presentment. This is when the parties to the negotiable instrument have undertaken to pay the instrument in spite of its non-presentment for payment. Presentment for payment in this case is waived either expressly or impliedly.

When the drawer could not suffer damage for non-payment, any holder can make the drawee liable without presentment, e.g. where the drawer draws the bill on himself or when the drawee is a fictitious person.

4.3.4.2 Dishonor of Negotiable Instrument

A bill of exchange is said to be dishonored when either it is not accepted by the drawee or payment is requested by the drawee or acceptor. A promissory note or a cheque is said to be dishonored when the maker of the note or the drawee banker refuses payment. Thus negotiable instrument may be dishonored either by non-payment or non-acceptance.

a. Dishonor by non-acceptance

Only a bill of exchange can be dishonored by non-acceptance. It shall be dishonored by non-acceptance in the following cases:-

1. The drawee has refused to accept the bill when it is presented to him for acceptance or he does not accept the bill within 48 hours from the time of presentment for acceptance.
2. When acceptance of bill is not given in those cases where presentment for acceptance is excused.
3. When the drawee is incompetent to contract
4. When the drawee gives a qualified acceptance (if the holder wishes to consider as accepted, it can be treated as accepted).

In these cases an immediate right of recourse against the drawee and endorser accrues to the holder without waiting until the maturity date.

b. Dishonor by Non-payment

All types of negotiable instruments may be dishonored by non-payment in the following cases: -

1. If the maker of the promissory note, acceptor of the bill or drawee of the cheque refuses to pay or
2. When payment is excused and the bill is overdue unpaid.
3. When they cannot be obtained at maturity day.

When a bill is dishonored by non-payment, an immediate right of recourse against the drawer and the endorser accrues to the holder. Notice of dishonor should be given on the dishonor of a negotiable instrument.

Notice should be given by the holder or some party thereto who remains liable on the instrument. The agent of any such party may also give notice. A notice by a stranger is invalid. When the

holder has given the notice to any of the parties liable on the instrument and the party has in turn given due notice of dishonor to all other prior parties, the holder can treat it as notice given by him.

No notice is necessary to the maker of a note or acceptor of a bill of exchange or drawee of a cheque as they are the principal debtors and they themselves have dishonored the note or the bill. Notice must be given to other parties to whom the holder wants to make liable. Notice of dishonor must be given as follows.

- When there are two or more persons jointly liable as drawees or endorsers, notice to any one of them is taken as notice to all.
- In case of death of a person, notice may be given to his legal representative.
- In case of his insolvency, it may be given to the official Assigner or receiver.

Effect of the Omission to give notice

Omission to give notice of dishonor to parties entitled to such notice will discharge them from their liability. Therefore, holder must give notice to all the prior parties to enforce his right against them.

Mode of Giving Notice

Notice of dishonor may be given to a duly authorized agent of the person to whom it is required to be given or when he has died, to his legal representative, or where he has been declared an insolvent, to his assignee; may be oral or written; may, if written, be sent by post; and may be in any form; but it must inform the party to whom it is given either in express terms or by reasonable intendment, that the instrument has been dishonored and in what way, and that he will be held liable; and it must be given within a reasonable time after dishonor, at the place of business or, at the residence, in case such party has no place of business, of the party for whom it is intended.

Thus notice of dishonor may be oral or written. If written, it may be sent by post. If the notice is duly directed and sent by post and miscarries, such miscarriage does not render the notice invalid. Any party receiving notice of dishonor must, in order to render any prior party liable to him self, give notice of dishonor to such party within a reasonable time, unless such party has received.

4.3.5 Maturity of Negotiable Instruments

The maturity of a promissory note or a bill of exchange is the date at which it falls due. A bill or note payable at sight or on demand or a cheque becomes payable at once and so there is no question of these being matured.

Every promissory note or bill of exchange which is not expressed to be payable on demand, at sight or on presentment is presented at maturity, on the third day after the day on which it is expressed to be payable. These additional three days are called the days of grace.

Rules for the determination of the maturity date

- 1.If a negotiable instrument has been made payable after a stated number of months "after date" or after sight " or after a certain event" the period stated shall be held to terminate on the day of the month which corresponds with the day on which the instrument is dated, presented for acceptance or sight or the event happens.

4.4 Kinds of Negotiable Instruments

There are two broad categories of Negotiable Instruments. They are:

Negotiable Instruments by statute: The Negotiable Instruments Act states three instruments: cheque, bill of exchange and promissory note as Negotiable Instruments. These are, therefore, called negotiable instruments by statute.

Negotiable Instruments by custom:- The Transfer of property Act states that instruments may be negotiated by custom and their negotiability will be recognized by courts. Instruments falling in this category are: Bank draft, Notes, etc. However, it is nowhere stated that these are the only documents that are negotiable instruments. Other instruments may also be added to this list of negotiable instruments provided they fulfill the following two conditions.

- a) They are transferable by mere delivery or by endorsement and delivery; and
- b) The holder in due course can sue in his own name.

Therefore, every instrument which entitles a person to receive money and which possesses the characteristics of negotiability is a negotiable instrument. In other words, it can be said that a negotiable instrument is an ordinary chose-in-action clothed with the feature of negotiability.

4.4.1. Bills of Exchange

The Negotiable Instruments Act defines a bill of exchange as an instrument in writing containing unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of, certain person, or to the bearer of the instrument. Thus a bill of exchange is a written acknowledgment of debt, written by the creditor and accepted by the debtor.

a. Essential Characteristics

The essential characteristics of bill of exchange are:

1. It must be in writing
2. It must be signed by the drawer
3. The drawer, drawee and payee must be certain.
4. The sum payable must also be certain
5. It should be properly stamped
6. It must contain an express order to pay money and money alone

A mere request to pay on account, will not amount to an order. But an order expressed in courteous words or polite language will not be taken to be mere request.

Example: -

1. I shall be highly obliged if you make it convenient to pay Birr 100.00 to Alemu.
2. Ato Amare, please let the bearer have Birr 100.00 and place it to the debit of my account.
3. Please pay Birr 100.00 to the order of A.
4. Mr. A will oblige Mr. B by paying to the order of Mr. C.

The 1st and 2nd are not order to pay but only a request to pay. The 3rd and 4th are order to pay. Hence, the 1st and 2nd are not termed as a bill of exchange but the 3rd and 4th are bills of exchange.

7. The order must be unconditional

It should not be attached with uncertain future events. It must not order any act to be done in addition to the payment of money.

4.4.2. Promissory Notes

According to the Negotiable Instruments Act, a promissory note is an instrument in writing (not being a bank or a currency note) containing an unconditional undertaking signed by the maker, to pay a certain sum of money only to, or to the order of a certain person, or to the bearer of the instrument.

A promissory note is drawn and signed by the debtor (called the “maker”). Who promises to pay the creditor (called the “payee”), a certain sum of money. The note may be drawn in any form, but the words used must clearly bring out a promise to pay.

- A promissory note may be payable on demand or after the expiry of a fixed time after date or sight.

Differences between a bill of exchange and a promissory notes.

1. Number of parties

Bill of exchange: - There are three parties: drawer, drawee and payee. The drawer may also be the payee. In bill of exchange, drawer and payee and drawer and drawee can be one and the same person

Promissory note: -There are only two parties maker and payee. Maker cannot be payee

2. Promise and order

A bill contains an order to pay certain sum of money, whereas a promissory note contains a promise to pay a certain sum of money to the payee.

3. Acceptance

Bill payable after sight requires acceptance of the drawee before it is presented for payment while a promissory note does not.

4. Nature of Liability

The liability of the maker of a note is primary and absolute but that of a drawer of a bill of exchange is secondary and conditional. The drawer can be liable only on the default of the acceptor in payment of the money due and provided the fact of dishonor has been notified to him.

5. Maker's Position

The maker of a promissory note stands in an immediate relationship with a payee.

The maker in a promissory note being the originator of the note cannot make it conditional.

The drawer in a bill of exchange stands in immediate relationship with the acceptor and not the payee. The drawee (acceptor) in a bill of exchange can accept the bill conditionally because his contract is only supplementary. Being super imposed on that of the drawer.

6. Notice in the case of dishonor

Notice of dishonor must be submitted to all prior parties, in case of dishonor of a bill either by non-acceptance or non-payment.

In case of dishonor of a promissory note no notice is necessary to the maker as the maker is the one who dishonor it by non-payment.

7. Who may draw the instrument?

A creditor always draws a bill on the debtor. Promissory note is drawn by the debtor and given to the creditor.

8. **Bearer or order.** A bill can be drawn payable to bearer, provided it is not payable on demand. A promissory note cannot be made payable to bearer.

4.4.3 Cheque

According to the Negotiable Instruments Act., “A cheque is a bill of exchange drawn on a specified bank and not expressed to be payable otherwise than on demand.” It is unconditional order in writing, signed by the drawer requiring the banker to pay on demand a sum certain in money to, or to the order of a specified person or to the bearer.

- It is always drawn on a specified banker
- It is always payable on demand
- It is a bill of exchange.

Thus, all cheques are bill of exchange but all bills are not cheques.

A. Essentials /Characteristics of a cheque.

An instrument to be called a cheque must fulfill the following conditions

i. The instrument must be in writhing.

The instrument to be referred as a cheque, it must be in writhing. It can be written in different forms such as: printed characters, type written, pen or pencil or engraved characters. There is no legal restriction as to the form of writing. However, banks do not generally honor cheques drawn in pencil, unless confirmed by the drawer, because it is easy to make unauthorized alterations when a cheque is drawn in pencil.

ii. The instrument must contain an unconditional order.

The order to pay must be unconditional, that is, no condition should be attached to the payment of the cheque. If the banker is asked to do something else besides payment of money on the cheque, the order will be conditional order. Thus it will not be called a cheque. But if the condition is communicated only to the payee but not the banker, the order to pay may be regarded unconditional.

iii. The maker must sign the instrument

In order to be a valid cheque the instrument must contain the signature of the drawer. In the case of an illiterate person, his/her thumb impression is necessary. Pencil signatures are discouraged by banker, but legally permissible. Rubber stamp impression is not permitted generally.

iv. Drawn on a Specified Banker.

It should be drawn on a banker only. The name of the banker must be specified or stated. Fortunately, the name of the bank and the name of the specific branch where the account is maintained is printed on the face of the cheque.

v. The order must for a certain sum of money only.

The order must be for the payment of money only. The money means legal tender-currency. The amount must be certain or definite; when the cheque is drawn in any foreign currency and when it is payable with interest at a given rate up to the date of happening of a fixed future event, it is believed the amount is certain.

vi. Payee to be certain.

The person to whom the amount is to be paid must be certain. It may be made payable to a certain person or to his order or to the bearer. If not payable to barer;

-The payee must be named or otherwise indicated therein with reasonable certainty.

-The payee need not be a human being; it can be a legal person.

vii. Payable on demand.

The instrument must be payable to or to the order of a certain person or to his bearer on demand. Cheques are always made payable on demand at sight or at presentment.

B. Dating of cheques.

There are two ways of dating a cheque.

1. Ante-dated cheque.

It is one that bears a date earlier than the date of issue; It is a negotiable instrument and payable on demand.

2. Post –dated Cheque

It is one that bears a date later than the date of issue. It is a negotiable instrument but not an instrument payable on demand. A cheque is not invalid merely on the ground that it is antedated or post-dated, or that it bears a date on Sunday (holiday).

A bank is not bound to honor an undated cheque. It is an inchoate cheque. But it is still a valid cheque. Hence, the holder of such a cheque is authorized to fill in the date within a reasonable time.

The holder of a cheque must present it for payment within a reasonable time of its issue, and failure to do this will discharge the drawer to the extent of any damage he may suffer from the delay.

C. Crossing of cheques

In actual practice, there are two types of cheques. Namely open cheques and crossed cheques.

Open cheques: are those, which can be directly presented to the bank for payment over the counter and those which doesn't bear any crossing over their face. They may be either bearer cheque or an order cheque.

Crossed cheques: where a cheque bears across its face two parallel transverse lines, the cheque is said to be crossed. The lines are generally drawn on the top corner of the left hand side of the cheque though there is no hard and fast rule regarding this.

Crossing is a direction to the paying banker that the cheque should be paid only to a banker and if the banker is named in the crossing, only to the banker. Crossing prevents the paying banker from paying the value of the cheque at the counter. Whenever two parallel transverse lines appear on the cheque, the bank will not make payment to its holder at the counter of the bank. The payment of a crossed cheque can only be obtained through the bank of the holder. This ensures the safety of payment by means of cheques. Thus, crossing affords security and protection to the true owner of the cheque. The holder of the cheque is not allowed to cash it across the counter but he can deposit it in his account and can withdraw by his won cheque, there after.

Crossed cheques are negotiable by delivery, incase they are payable to bearer and by endorsement and delivery when they are payable to order. But when words “Not negotiable” are added to the crossing, the cheque is not negotiable, though transferable.

Advantages of Crossing

A crossed cheque offers the following advantages

- i) Crossing protects payment of cheques to the wrong full holder.
- ii) Crossing cautions the bank not to pay the amount of cheque at the counter. Payment of a crossed cheque must be collected through a bank. This reduces the risk of fraud.
- iii) If a cheque is crossed, it is easy to trace the person for whose benefit the payment was collected.

Bearer cheque:- In case of a bearer cheque, the liability of the paying bank is over, after making payment to the bearer of the cheque. If it is lost or stolen, the bank will not be responsible, if the payment is made to an unauthorized person or a thief. The bank cannot refuse to make the payment of a bearer cheque if it is in order and there is sufficient balance in the concerned account. If an instrument is issued originally expressed to be payable to bearer, it will always be treated as bearer and the bank will be discharged from liability by making payment across the counter to the bearer.

Order Cheque:- In case of an order cheque, the bank makes payment across its counter to the person or payee named in the cheque. The bank must ensure that payment is made only to the payee. In other words, the identity of the payee of the cheque must be verified before making the payment.

Since open cheques are not required to go through a bank before being presented to the drawee bank for payment, there are certain risks attached to such cheques. When an open cheque is lost or stolen, the finder or thief may get it encashed at the drawee bank. If the cheque is payable to order and the drawee bank makes payment in due course, it will be discharged from its liability. Thus, open cheques are liable to risks in the course of circulation. In order to avoid such risks and protect the holder of the cheque, crossing has been introduced.

Type of Crossing

The Negotiable Instruments Act provided two types of crossing: General crossing and Special crossing. In Addition the commercial usage adopted a third type of crossing: Restrictive Crossing.

General Crossing:- When a cheque bears across its face two transverse parallel lines with or without any words, such as “and company” or “and co”, “not negotiable” it is called generally crossed and the process is known as general crossing. These, two transverse lines across the face of the cheque are essential for general crossing.

A cheque bearing general crossing cannot be encashed at the counter of the bank. It must be presented for collection through the bank of the payee to the drawee bank. After collection, the collecting bank will credit the account of the customer with the amount of the cheque. The customer can then withdraw the amount.

The addition of the words “account payee” or “payee’s account” to the crossing increases the safety of the cheque. However, they cannot be strictly considered as addition to the crossing, the paying banker’s position remains practically the same and they are intended to warn the collecting banker that the amount should not be collected except for the benefit of the payee’s account. But the addition of the word “not negotiable” has significant legal effect.

Significance of general crossing

General crossing provides the following meaning:-

1. Cash will not be paid across the counter.
2. The cheque is deposited in the holder's account, if he has an account in that particular bank/ branch.
3. The cheque is instructed to be deposited in another bank/ branch, if he has no account in the collecting bank/ branch.
4. He can withdraw from his account through a cheque, if it is deposited in a correct account.
5. He can withdraw from his account through withdrawal slip, if it is deposited in saving account.
6. He can withdraw (collect) it through a person having an account in the same bank or any other bank.

 ō Specimen forms of general crossing

- i. And company
- ii. & Company
- iii. Not Negotiable
- iv. Not negotiable & com.

Special Crossing:- The Negotiable Instrument Act states that “where a cheque bears across its face an addition of the name of a banker, either with or without the word “not negotiable”, that addition shall be deemed a crossing and the cheque shall be deemed to be crossed specially and to be crossed to that holder,” Here, the name of the banker through whom the cheque can be collected appears on the face of the cheque.

A special crossing warns a paying banker that the amount should be paid only to the banker whose name mentioned in the crossing. The special crossing on the cheque is a direction to the paying banker to honor the cheque only when it is presented through the bank mentioned in the crossing and no other bank. The cheque crossed specially is safer than the generally crossed cheque. The banker to whom a cheque is crossed specially may appoint another banker as his agent for the collection of such cheque.

The specimen forms of special crossing are:-

1. Commercial Bank of Ethiopia
2. Not Negotiable, Dashen Bank
3. Account payee, AIB

Significance of Special Crossing

The paying banker should pay the amount only to the banker whose name is stated on the face of the cheque or to its agent for collection.

Restrictive Crossing:- Restrictive crossing is only a direction to the collecting banker that the proceeds of the cheque are to be credited only to the account of the payee named in the cheque. In case the collecting banker allows the proceeds to be credited to some other account, it may be held liable for wrongful conversion of funds. In restrictive crossing, the lines of crossing contain the words “Account payee only” or “Payee’s account only”. Restrictive crossing does not affect the negotiability of the cheque, if it is negotiable to its origin. Thus, the payee mentioned in the cheque is entitled to transfer the cheque to any one. But the transferability of such a cheque renders difficulty because the bank will not like to receive payment on behalf of any person other than the payee. The words “Account payee only” constitute a direction to the collecting banker that the proceeds of the cheque are to be credited to the account of the payee only.

Thus, in practice restrictive crossing hinders the negotiability of the cheque; such a crossing does not in any way affect the paying banker. It is not the duty of the paying banker to ascertain that the cheque is being collected on behalf of the person named as payee.

A cheque may be crossed either generally or specially with the words “not negotiable” on it. A person taking cheques crossed generally or specially, bearing in either case the words not negotiable, shall not have, and shall not be capable of giving a better title to the cheque than that which the person from whom he took it had.

“Not negotiable” crossing does not make the instrument “non-transferable”. But the person holding a crossed cheque bearing the words ‘not negotiable’ does not get better title than that of his transferor and he can not convey a better title to his own transferee. Thus “not negotiable” crossing takes away the negotiable value of the cheque because the person taking it will only get the rights of the transferor. He will not become the holder in due cause.

What is not crossing?

Two transverse lines on the face of the cheque are essential in case of general crossing, whereas the name of a bank on the face of the cheque is also a must for special crossing.

The following cases do not constitute crossing:

- i) A cheque bearing the words “not negotiable” or “account payee only” without two parallel lines or the name of any bank.
- ii) A cheque bearing single line across its face
- iii) A cheque bearing “X” mark on its face.

Persons Authorized to Cross a Cheque

A cheque can be crossed by any of the following parties:-

- i) **The drawer:** -The drawer of the cheque can make a general, special or restrictive crossing on cheque before issuing it.
- ii) **The Holder:** - He can cross a cheque delivered to him under the following condition:-
 - a) Where the cheque is uncrossed, the holder may cross it generally or specially.
 - b) Where a cheque is crossed generally, the holder may cross it specially.
 - c) Where a cheque is crossed generally or specially, the holder may add the word “not negotiable”.
- iii) **The banker:** -Where a cheque is crossed specially, the banker to whom it is crossed may again cross it specially to another banker as his agent for collection. A cheque can be crossed especially only once except where the second crossing is to a banker as agent for collection.

4.5. Holder, Holder in Due Course and Payment in Due Course

4.5.1 Holder

According to the Negotiable Instrument Act, "holder of a promissory note, bill of exchange or cheque means any person entitled in his own name to the possession of an instrument and to receive or recover the amount due thereon from the parties in the instrument. A person is called the holder of a negotiable instrument if the following conditions are satisfied.

1) He must be entitled to the Possession of the instrument in his own name and under a legal title.

A holder may be the payee or endorsee or the bearer. If the instrument is payable to the order: the payee, if the instrument is not negotiated and the endorsee, if the instrument is negotiated. If the instrument is payable to the bearer, the holder is the one who actually /physically possess the instrument. Actual possession is necessary if the instrument is payable to the bearer and it is not necessary if it is payable to the order- being either payee or endorsee is suffice. The holder must have the legal right to possess the instrument in his own name - It means that the title to the instrument is acquired lawfully and in a proper manner. But, if a person acquires a cheque or bill by theft, fraud, or forged endorsement or finds it laying somewhere, he does not acquire in his own name legal title thereto and hence, he cannot be called its holder.

2) He must be entitled to receive or recover the amount from the parties concerned in his own name.

A person can be entitled to receive or recover the amount in his own name if he is a payee or endorsee, in the instrument payable to the order and the bearer, in the instrument payable to the bearer. The holder is competent to require payment or recover the amount by filing a suit in his own name against other parties, to negotiate the instrument and to give a valid discharge. In case the instrument is lost or destroyed, its holder is the person who was entitled at the time of loss or destroys.

4.5.2 Holder in due course

According to the Negotiable Instrument Act, "Holder in due course means any person who, for consideration, became the possessor of a negotiable instrument, if payable to bearer, or the payee or endorsee if payable to order, before the amount mentioned in it became payable, and without having sufficient cause to believe that defect existed in the title of the person from whom he derived his title."

The essential qualifications of a holder in due course are summarized as follows:

1. He must be a holder for valuable consideration.
He must receive the instrument as a reward for some legal and genuine activity.
2. He must become a holder (possessor) of the instrument before the maturity date of the instrument

3. He must become holder of the negotiable instrument in good faith i.e. without having sufficient cause to believe that defect existed in the title of the person who transfers the instrument.
4. A holder in due course must take the Negotiable Instrument complete and regular on the face of it. Complete refers that all the necessary information is filled. Regular also refers that the endorsement, the form of the cheque, and other components of a cheque are in order.

If the contrary is proved, the person who becomes the possessor of the instrument cannot be a holder in due course.

4.5.3 Payment in Due Course

According to a Negotiable Instruments Act, "Payment in due course means payment in accordance with the apparent tenor of the instrument in good faith and without negligence to any person in possession thereof under circumstances which do not afford a reasonable ground for believing that he is not entitled to receive payment of the amount mentioned in the instrument." Payment should be made to the right person, and according the tenor of the instrument by the paying banker, the acceptor of the bill. Otherwise the latter shall be responsible for the beneficiary. Payment is an effective discharge only if it is "payment in due course".

The essential features of a payment in due course are:-

1. **The payment should be made in accordance with the apparent tenor of the instrument,** that is, according to the true intention of the parties as apparent from the document itself.

For example;

- If the cheque is postdated - It means pay only after the future stated date
- If the cheque is crossed - It is ordering the paying banker not to pay cash at the counter but to credit an account.

The payment should be made at or after maturity. A payment before maturity is not a payment according to the apparent tenor of the instrument and so, not a payment in due course. If an instrument is paid before maturity and is subsequently endorsed to a bone fide endorsee, it remains valid. When the instrument is payable on demand, its payment will not be effective discharge unless it is cancelled. A payment by the drawee or acceptor before maturity operates as

a purchase of the instrument, he may endorse the bill to any person and then all the parties to the instrument will remain liable.

2. The payment should be made in good faith and with out negligence. In good faith, means honestly and not fraudulently. The paying bank should effect payments to suspicious or doubtful payees or presenters after making proper inquiries from the drawer, otherwise, the paying bank will be liable. The banker should not make payment negligently. He should take all the necessary precaution and act as a reasonable person will act in a particular circumstance of a case. Therefore, he should ascertain that the cheque is complete, all alterations are duly confirmed and the endorsements are regular.

3. Payment must be made to the person in possession of the instrument in circumstances, which do not arouse suspicion about his title to possess the instrument and to receive payment. In other words, payment should be made to the rightful holder who can give a valid discharge. If the instrument is made payable to bearer, the rightful holder is the person who has received it by delivery. The maker or drawee while making the payment to the possessor of the instrument must see that there is nothing to show that he is not entitled to recover it. However, when the instrument is payable to a particular person or order and is not endorsed by him, payment to the possessor of such an instrument will not amount to payment in due course. Further, the payment must be made by the maker or drawee of the instrument or on his behalf.

Examples of payments, which are not, deemed payment in due course can be shown as follows;

1. A cheque bearing a special crossing in the name of Abyssinia Bank is paid when presented through Dashen Bank
2. The banker pays a cheque containing forged signature of the drawer.
3. A cheque dated 30th October 2002 is presented for payment on 20th of October 2002 and is paid on the same date.
4. A cheque having alterations in the name of a payee or the amount of the cheque (material alteration), not confirmed by the full signature of the drawer, is paid by the banker.
5. The drawer of a cheque countermands its payments, but the banker pays the cheque.
6. An agent or a prone of a company presents a cheque for big amount on behalf of the company, which is contrary to the past practice and the banker pays the cheque without any enquiry.

4.6 Endorsement

According to The Negotiable Instruments Act, "When the maker or holder of a negotiable instrument signs the same, otherwise than as a maker, for the purpose of negotiation, on the back or face of the instrument, usually on the back, or on a slip of paper annexed there to, or signs for the same purpose a stamped paper intended to be completed as negotiable instrument, he is said to have endorsed the same and is called the endorser." Endorsement means signing a negotiable instrument for the purpose of negotiation.

Negotiable instruments can be negotiated in two different ways

- a). By delivery only - if the instrument is payable to bearer. Here no need of endorsement
- b). By endorsement and delivery - if the instrument is payable to order i.e. before delivery the drawer or any holder signs the instrument for the purpose of negotiation.

The person who signs the instrument for the purpose of negotiation is called the "endorser" and the person in whose favor the instrument is transferred is called the "endorsee". The endorser may sign either on the face or on the back of the negotiable instrument. But the common usage is on the back of the instrument. If the space on the back of the instrument is not sufficient for additional endorsement, a piece of paper known as "allonge" may be attached with the instrument.

4.6.1 General Rules regarding the form of Endorsement

The appropriateness or otherwise of a particular form of endorsement depends upon the practice amongst the banker. However, in general, endorsement must be regular and valid in order to be effective. The following rules are followed in this regard.

1. Signature of the endorser: -The signature on the instrument for the purpose of endorsement must be that of the endorser or any other person who is duly authorized to endorse on his behalf. If a cheque is payable to two or more persons, both or all of them should sign in small letters, in their own handwriting. If endorser signs with block letters, it will not be considered as a regular endorsement.

2. Spelling: - The endorser should spell his name in the way his name appears on the instrument as its payee or endorsee. If his name is misspelt or his designation has been given incorrectly, he should sign the instrument in the same manner as given in the instrument. However, if he likes to do, he may put his proper signature thereafter; but in the same hand writing. For example, if Ato Asamere's name is mis spelt as a payee as "Asemare ", he should write his name in the endorsement as "Asemare / Asamere/".

3. No addition or Omission of initial of the name: - An initial of the name should neither be added nor omitted from the name of the payee or endorsee as given in the cheque. For example, a cheque payable to Habte Georgics should not be endorsed as H/Giorgis because it will be doubtful for the paying banker to ascertain who the true owner is i.e. whether H/Giorgis is Habte Giorgis or Haile Giorgis.

4. Prefixes and Suffixes to be excluded. The prefixes and suffixes to the name of the payee or endorsee need not be included in the endorsement. For example, the words "Ato" W/ro, W/t, Major, Dejazamach, Captain, M.D, etc” need not be included in the endorsement given by the endorser; otherwise, the endorsement will not be regular. However, an endorser may indicate his title or rank, etc after his signature. For example, Meles Zenawi (Prime Minister), Fanta Belay (Major General) etc.

5. Maker or Holder:-The endorsement must be made by the Maker or holder of the instrument. A stranger cannot endorse it.

6. Delivery:-Endorsement is completed only by delivery-actual or constructive. The endorser himself must make the delivery. If the delivery is conditional, the endorsement is not complete until the condition is fulfilled.

7. Special cases

1. Partnership firm

In case of a partnership firm, the name of the firm must be signed by a person (partner, manager etc) who is duly authorized to sign on behalf of the partnership firm. But if the two partners sign without showing that they are the partners in the firm, the endorsement will not be a regular one.

2. Agent: -

A person may duly authorize his/her agent to endorse the cheque on his/her behalf. The agent should, therefore, use the words 'for', for and on behalf of ', 'on behalf of ', 'pre-pro' etc in the endorsement. This indicates that he signs the instrument only on his agency authority.

4.6.2 Kinds of Endorsement

According to the Negotiable Instrument Act, the following forms of endorsement are presented. They are discussed as follows: -

1. Blank endorsement or General endorsement: An endorsement that bears only the name of the endorser is deemed as a blank endorsement. The name of the endorsee is not included in the endorsement and hence the instrument becomes payable to bearer even if it is originated as order

instrument. Then it can be negotiated by simple delivery and the holder is entitled to this payment.

2. Full Endorsement/ Special Endorsement

If the endorser, in addition to his name, writes the name of the endorsee or adds a direction to pay the amount mentioned in the instrument to or to the order of a specified person, the endorsement is full endorsement. A Blank endorsement can be converted in to full endorsement by writing the name of the endorsee on top of the name of the previous endorser. Then, the last endorser will be free from any liability that may arise. In such an endorsement, it is only the endorsee that can negotiate the instrument by endorsement. Thus, the instrument retains its order character.

3. Partial Endorsement

It is one, which purports to transfer to the endorsee a part only of the amount payable under the instrument. A partial endorsement does not operate as a negotiation of the bill. The law lays down that an endorsement must relate to the whole instrument. Thus, a partial endorsement is invalid.

For instance, if A, the payee of bill for Birr 10,000.00 endorses it in favor of B for Birr 5, 000.00 and C, for the remaining Br 5,000.00. Since the endorsement is partial, it is invalid and no right of action will arise. But when amount of the instrument has been partly paid, a note to that effect may be endorsed on the instrument, which may then be negotiated for the balance.

4. Restrictive Endorsement

A restrictive endorsement gives the endorsee the right to receive payment of the cheque and to sue any party thereto that his endorser could have sued, but gives him no power to transfer his right to an endorsee unless it expressly authorizes him to do so. Hence the instrument will be transferable but not negotiable. The endorser restricts further negotiation of the instrument, in express words and excludes the right to negotiate. Here, the endorsee acquires all the rights of the endorser except the right of negotiation. The endorsement must in express words restrict or exclude the right of the endorsee.

E.g. pay the contents to C only

Pay C for the account of B

The within must be credited to C, etc

5. Conditional Endorsement/ Qualified Endorsement

The liability of the endorser dependent on the happening of a contingent event or may make the right of the endorsee to receive payment in respect of the instrument dependent on the happening of such an event. Such conditions may be either conditions precedent or conditions subsequent. However, it does not restrict or prohibit the negotiability of the instrument as in the case of restrictive endorsement. The endorser gets the following rights under such endorsements.

a) **In the case of a condition subsequent**, the right of the endorsee is defeated on the fulfillment of the condition.

E. g. "Pay A or order unless before payment, it is countermanded."

The endorser may make his liability on the instrument conditional on the happening of a particular event. He will not be liable to the subsequent holder if the specified event does take place before payment. The endorsee in such a case can sue other parties to the instrument even after the particular event takes place.

b) **In case of a condition precedent**, the right to recover the amount does not pass on to the endorsee until the condition is fulfilled. The endorser may make the right of the endorsee of the instrument conditional on the happening of a particular event.

E.g. "Pay on his marrying X". The endorsee gets title only if he marries X. If the event does not take place or if he cannot marry x, the endorsee can not sue any of the parties.

However, such an endorsement is generally used, and it does not make the instrument non-transferable. A conditional endorsement may take place in any of the following ways.

i) Endorsement "Suns Recourse"

An endorser of a negotiable instrument may by express words in the endorsement, exclude his own liability in the instrument. For example, if 'A' endorses a cheque as follows.

- i. Pay to 'B' or order at his own risk
- ii. Pay to 'B' without recourse to me

'A' will not be liable to 'B' or any of the subsequent endorsees, if the bank dishonors the cheque subsequently. Subsequent endorsees will have the right to sue any prior party except such an endorser. But if an endorser who so excludes his liability after wards becomes the holder of the instrument (If there is negotiation back to 'A'), all intermediate endorsers are liable to him. For example, 'X' issue the instrument in favor of 'Y', then 'Y' endorses it to 'A', 'A' transfer it to

B's favor with 'sans recourse endorsement'. 'B' again endorses it to 'C', 'C' to 'D' and 'D' back to 'A'. Here all parties i.e. X, Y, B, C and D will be liable to the last holder; A.

ii) Facultative Endorsement

When the endorser waves some of his rights or increases his liabilities intentionally in the instrument, it is said to be facultative endorsement. For example, "pay Alemu or order, notice of dishonor waived", is a facultative endorsement. In this case, the endorser has waived notice of dishonor, but will remain liable for non-payment.

iii) 'Sans Fraise' Endorsement

The endorser does not want any expenses to be incurred on his account on the bill by the endorsee or subsequent holder of negotiable instrument.

iv) Liability dependent upon a contingency

When an endorser makes his liability dependent up on the happening of a specified event, which may or may not happen, the liability of the endorser will take place only on the happening of that event. For instance, an endorser may write, "pay A or order on his marriage" or "pay A or order on the arrival of goods safely". Here, the endorser will not be liable to make payment until the marriage takes place or the said goods arrived safely, as the case may be.

C. Effect of Endorsement

The endorsement of a negotiable instrument followed by delivery transfers to the endorsee the property therein with right to further negotiation; but the endorsement may, by express words, restrict or exclude such right, or may merely constitute the endorsee an agent to endorse the instrument or to receive its contents for the endorser, or for some other specified person.

4.7 Payment of Cheques

One of the stationary obligations of a banker towards his customer is to honor the cheques drawn by the latter on the former. The paying banker is responsible to his customer and is under a duty to make payments to the right person in accordance with the instructions of the drawer. If he honors the cheques carelessly and negligently in a manner inconsistent with the instructions of a drawer, he subjects himself to heavy liability. Not only shall he lose the money so paid, but he shall be liable to pay damages or compensation to his customer and also to the true owner of the cheque. The duty of a paying banker is of great responsibility and calls for great care, caution, prudence and presence of mind on his part.



S/N	Did you understand:	Yes	No
1	Meaning of Negotiable Instruments and Negotiation?		
2	Characteristics of Negotiable Instruments?		
3	Presumption of Negotiable Instruments?		
4	Presentment and Dishonor of Negotiable Instruments?		
5	Kinds of Negotiable Instruments?		
6	General Rules regarding the form of Endorsement?		
7	Payment in Due Course?		

Questions to Check Your Progress

1. What is meant by negotiable instrument? Explain its characteristics.

.....
.....

2. Discuss about the presumptions as to negotiable instruments.

.....

3. Discuss the similarities and difference between and among promissory notes, bills of exchange and cheque

.....

4. What is an endorsement? Explain and illustrate the different kinds of endorsements.

.....
.....

5. Explain the precautions, which the paying banker should take before making payment of a cheque.

.....
.....

6. When must a bank reject the payment of a cheque? Discuss.

.....
.....

7. What are the duties and responsibilities of a banker in the collection of a cheque? Explain.

.....
.....

4.8. Summary

Every document which entitles a person to a sum of money and which is transferable by delivery is a negotiable instrument. It is one the property in which is acquired by anyone who takes it bona fide and for value, notwithstanding any defect of title in the person from whom he took. It includes promissory notes, bills of exchange and cheques.

Easy transferability is one of the important characteristics of a negotiable instrument. An instrument may be transferred through; a) Assignment, and b) Negotiation.

Banks take different precautions in accepting negotiable instruments. They have to treat them in a right manner so as not to affect the benefits of parties in the instrument. One of the important modern services of banks to their customers is collection of cheques and as the collector of customer's cheques; they take either a holder in due course or an agent for collection position. The collecting banker should take the necessary precautions so as to get legal protection.

Answers to post test questions

- | | |
|------------------------------|------------------------|
| 1. Refer section 4.2 & 4.3.1 | 5. Refer section 4.4.3 |
| 2. Refer section 4.3.2 | 6. Refer section 4.4.3 |
| 3. Refer section 4.4 | 7. Refer section 4.4.3 |
| 4. Refer section 4.6 | |

UNIT FIVE

RURAL AND URBAN COOPRATIVE BANKS

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- 5.2 Cooperative banks and rural credit
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 - 5.2.2 Central Co-operative Banks (CCBs)
 - 5.2.3 State Co-operative Banks (SCBs)
- 5.3 Commercial banks and rural credit
- 5.4 Role of rural bank in rural credit

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5.6 History of cooperative bank in India and Canada

5.6.1 Cooperative Banking in India

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5.9.1 Types of Agricultural loans

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5.12.2 How the agricultural finance programs are made

5.12.3 Different types of financial assistance

5.1 Introduction

The Co-operative bank has a history of almost 100 years. The Co-operative banks are an important constituent of a Financial System, judging by the role assigned to them, the expectations they are supposed to fulfill, their number, and the number of offices they operate.

Their role in rural financing continues to be important even today, and their business in the urban areas also has increased phenomenally in recent years mainly due to the sharp increase in the number of primary co-operative banks. Co-operative banks finance rural areas under, farming, cattle, milk, hatchery, and personal finance. This unit detail discusses about cooperative banks and rural credit, role of cooperative bank and rural credit, different countries experiences of cooperative banks, cooperative bank models at different levels, and systems of loan in urban and rural.

5.2 Cooperative Banks And Rural Credit

5.2.1 Primary Agricultural Credit Societies (PACSS)

An agricultural credit society can be started with 10 or more persons normally belonging to a village or a group of villages. The value of each share is generally nominal so as to enable even the poorest farmer to become a member. The members have unlimited liability, that is each member is fully responsible for the entire loss of the society, in the event of failure. Loans are given for short periods, normally for the harvest season, for carrying on agricultural operation, and the rate of interest is fixed.

The primary agricultural credit society was expected to attract deposits from among the well –to-do members and non-members of the village and thus promote thrift and self-help. It should give loans and advances to needy members mainly out of these deposits.

5.2.2 Central Co-operative Banks (CCBs)

The central co-operative banks are located at the district headquarters or some prominent town of the district. These banks have a few private individuals also who provide both finance and management. The central co-operative banks have three sources of funds,

- Their own share capital and reserves
- Deposits from the public and
- Loans from the state co-operative banks

Their main function is to lend to primary credit society apart from that, central cooperative banks have been undertaking normal commercial banking business also, such as attracting deposits from the general public and lending to the needy against proper securities.

5.2.3 State Co-operative Banks (SCBs)

The state Co-operative Banks, finance, co-ordinate and control the working of the central Co-operative Banks in each state. They serve as the link between the Reserve bank and the general money market on the one side and the central co-operative and primary societies on the other. They obtain their funds mainly from the general public by way of deposits, loans and advances from the Reserve Bank and they are own share capital and reserves.

5.3 Commercial Banks and Rural Credit

The commercial banks at present provide short term crop loans account for nearly 45 to 47% of the total loans given and disbursed by the commercial banks. Term loans for varying periods are

given for purchasing pump sets, tractors and other agricultural machinery, for construction of wells and tube well, for development of fruit and garden crops, for leveling and development of land, for purchase of ploughs, animals, etc. commercial banks also extend loans for allied activities viz., for dairying, poultry, piggery, bee keeping, fisheries and others. These loans come to 15 to 16%.

Commercial Banks and Small Farmers

The commercial banks identifying the small farmers through Small Farmers Development Agencies (SFDA) set up in various districts and group them into various categories for credit support so as to enable them to become bible cultivators. As regard small cultivators near urban areas and irrigation facilities, commercial banks can help them to go in for vegetable cultivation or combine it with small poultry farming and maintaining of one or two milch cattle.

5.4 Role of Rural Bank In Rural Credit

Since it was set up in 1934, RBI has been taking keen interest in expanding credit to the rural sector. After NABARD was set up as the apex bank for agriculture and rural development, RBI has been taking a series of steps for providing timely and adequate credit through NABARD.

Scheduled commercial banks excluding foreign banks have been forced to supplement NABARDs efforts-through the stipulation that 40percent of net bank credit should go to the priority sector, out of which at least 18 percent of net bank credit should flow to agriculture. Besides, it is mandatory that any shortfall in fulfilling the 40 percent target or the 18 percent sub-target would have to go to the corpus Rural Infrastructure Development Fund(RIDF).RBI has also taken steps in recent years to strengthen institutional mechanisms such as recapitalisation of Regional Rural Banks (RRBs) and setting up of local area banks(LABs).

5.5 MARKETING OF MUTUAL FUND UNITS

With a view to expanding the scope of business of RRBs and considering that marketing of Mutual Fund (MF) units provides a profitable avenue for banks, it has been decided by RBI on 17th May 2006 to allow Regional Rural Banks (RRBs) to undertake marketing of units of Mutual Funds, as agents.

Accordingly, RRBs may, with approval of their Board of Directors, enter into agreements with Mutual Funds for marketing their units subject to the following terms and conditions:

- * The bank should only act as an agent of the customers, forwarding applications of the investors for purchase / sale of MF units to the Mutual Fund / Registrar Transfer Agents.
- * The purchase of MF units should be at the risk of customers and without the bank guaranteeing any assured return.
- * The bank should not acquire such units of Mutual Fund from the secondary market.
- * The bank should not buy back units of Mutual Funds from their customers.
- * The bank holding custody of MF units on behalf of their customers should ensure that its own investment and investments belonging to their customers are kept distinct from each other.
- * Retailing of units of Mutual Funds may be confined to some select branches of the bank to ensure better control.
- * The bank should comply with the extant KYC/ AML guidelines in respect of the applicants.
- * The RRBs should put in place adequate and effective control mechanisms in consultation with their sponsor banks. Example,

5.6 History of Cooperative Bank In India And Canada

5.6.1 Cooperative Banking in India

Credit cooperatives are the oldest and most numerous of all the types of cooperatives in India. The cooperative credit institutions in the country may be broadly classified into urban credit cooperatives and rural credit cooperatives. There are about 2090 urban credit cooperatives and these societies together constitute for about 10 percent of the aggregate banking business and therefore regarded as an important segment of the banking system. The urban credit cooperatives are also popularly known as Urban Cooperative Banks.

The rural credit cooperatives may be further divided into short-term credit cooperatives and long-term credit cooperatives. With regard to short-term credit cooperatives, at the grass-root level there are around 92,000 Primary Agricultural Credit Societies (PACS) dealing directly with the individual borrowers. At the central level (district level) District

Central Cooperative Banks (DCCB) function as a link between primary societies and State Cooperative Apex Banks (SCB). It may be mentioned that DCCB and SCB are the federal cooperatives and thus the objective is to serve the member cooperatives. As against three-tier structure of short-term credit cooperatives, the long-term cooperative credit structure has two tiers in many states with Primary Cooperative Agriculture and

Rural Development Banks (PCARDB) at the primary level and State Cooperative Agriculture and Rural Development Bank at the state level. However, some states in the country have unitary structure with state level cooperative operating with through their own branches and in one state an integrated structure prevails. The organizational structure of the credit cooperatives in India is illustrated in chart I. interestingly, under the Banking Regulation Act 1949, only State Cooperative Apex Banks, District Central

Cooperative Banks and select Urban Credit Cooperatives are qualified to be called as banks in the cooperative sector. In other words, only these banks are licensed to conduct full-fledged banking business.

A. Banking Sector Reforms and Urban Cooperative Banks in India

The reform measures as applicable to UCB sector may be classified into three broad categories. First, while recognizing the differences between commercial and urban cooperative banks, a majority of the prudential norms introduced for commercial banks are being extended to UCBs, albeit in a phased manner. Second, policy initiatives have been introduced (through Monetary & Credit Policies) to contain the systemic risk emanating from cooperative sector, in particular

from UCB sector. Lastly, duality/multiplicity of control has been recognized as an irritant to their effective regulation and supervision. Although, the focal point of the reforms has been prudential norms, steps are also being initiated to professionalize the management and manpower of UCBs. The influence of the reforms on the functioning as well as the cooperative character of UCBs is discussed below.

B. Supervision and Regulation:

At present in India, urban credit cooperatives/banks are subjected to duality of control, meaning that the administration related aspects are being supervised and regulated by State Government and the banking operations are supervised and regulated by the central bank of the country. This has, understandably resulted in overlapping jurisdiction of the state Government and the central bank of the country. Moreover, a clear-cut demarcation of the financial and administrative areas for regulation is almost impossible and even if it is possible it surely acts as an impediment in effective supervision. While the central bank of the country has the wherewithal under the Banking Regulation Act for dealing with crucial aspects of functioning of commercial banks, in the case of cooperative banks it requires the intervention of the Registrar of Cooperative Societies (state Government). Given the number of urban credit cooperatives/banks, the central bank of the country is not in a position to effectively supervising them. Thus, the duality of control not only affects the quality of supervision and regulations, but also the functioning of the urban cooperative banking sector. Needless to mention, under this regime of duality of control the urban cooperative banks may turn out to be neither cooperative nor commercial banks. There are some areas of concern, some of them may be good for research as well.

C. Urban Cooperative Bank in India

The term Urban Co-operative Banks (UCBs), though not formally defined, refers to primary cooperative banks located in urban and semi-urban areas. These banks, till 1996, were allowed to lend money only for non-agricultural purposes. This distinction does not hold today. These banks were traditionally centred around communities, localities work place groups. They essentially lent to small borrowers and businesses. Today, their scope of operations has widened considerably.

The origins of the urban cooperative banking movement in India can be traced to the close of nineteenth century when, inspired by the success of the experiments related to the cooperative movement in Britain and the cooperative credit movement in Germany such societies were set up in India. Cooperative societies are based on the principles of cooperation, - mutual help, democratic decision making and open membership. Cooperatives represented a new and alternative approach to organisation as against proprietary firms, partnership firms and joint stock companies which represent the dominant form of commercial organisation.

Under State Purview

The constitutional reforms which led to the passing of the Government of India Act in 1919 transferred the subject of “Cooperation” from Government of India to the Provincial Governments. The Government of Bombay passed the first State Cooperative Societies Act in 1925 “which not only gave the movement its size and shape but was a pace setter of cooperative activities and stressed the basic concept of thrift, self help and mutual aid.” Other States followed. This marked the beginning of the second phase in the history of Cooperative Credit Institutions.

There was the general realization that urban banks have an important role to play in economic construction. This was asserted by a host of committees. The Indian Central Banking Enquiry Committee (1931) felt that urban banks have a duty to help the small business and middle class people. The Mehta-Bhansali Committee (1939), recommended that those societies which had fulfilled the criteria of banking should be allowed to work as banks and recommended an Association for these banks. The Co-operative Planning Committee (1946) went on record to say that urban banks have been the best agencies for small people in whom Joint stock banks are not generally interested. The Rural Banking Enquiry Committee (1950), impressed by the low cost of establishment and operations recommended the establishment of such banks even in places smaller than taluka towns.

The first study of Urban Co-operative Banks was taken up by RBI in the year 1958-59. The Report published in 1961 acknowledged the widespread and financially sound framework of urban co-operative banks; emphasized the need to establish primary urban cooperative banks in new centers and suggested that State Governments lend active support to their development. In 1963, Varde Committee recommended that such banks should be organised at all Urban Centres with a population of 1 lakh or more and not by any single community or caste. The committee

introduced the concept of minimum capital requirement and the criteria of population for defining the urban centre where UCBs were incorporated.

Duality of Control

However, concerns regarding the professionalism of urban cooperative banks gave rise to the view that they should be better regulated. Large cooperative banks with paid-up share capital and reserves of Rs.1 lakh were brought under the purview of the Banking Regulation Act 1949 with effect from 1st March, 1966 and within the ambit of the Reserve Bank's supervision. This marked the beginning of an era of duality of control over these banks. Banking related functions (viz. licensing, area of operations, interest rates etc.) were to be governed by RBI and registration, management, audit and liquidation, etc. governed by State Governments as per the provisions of respective State Acts. In 1968, UCBS were extended the benefits of Deposit Insurance.

Towards the late 1960s there was much debate regarding the promotion of the small scale industries. UCBs came to be seen as important players in this context. The Working Group on Industrial Financing through Co-operative Banks, (1968 known as Damry Group) attempted to broaden the scope of activities of urban co-operative banks by recommending that these banks should finance the small and cottage industries. This was reiterated by the Banking Commission (1969).

The Madhavdas Committee (1979) evaluated the role played by urban co-operative banks in greater details and drew a roadmap for their future role recommending support from RBI and Government in the establishment of such banks in backward areas and prescribing viability standards.

The Hate Working Group (1981) desired better utilisation of banks' surplus funds and that the percentage of the Cash Reserve Ratio (CRR) & the Statutory Liquidity Ratio (SLR) of these banks should be brought at par with commercial banks, in a phased manner. While the Marathe Committee (1992) redefined the viability norms and ushered in the era of liberalization, the Madhava Rao Committee (1999) focused on consolidation, control of sickness, better professional standards in urban co-operative banks and sought to align the urban banking movement with commercial banks.

A feature of the urban banking movement has been its heterogeneous character and its uneven geographical spread with most banks concentrated in the states of Gujarat, Karnataka,

Maharashtra, and Tamil Nadu. While most banks are unit banks without any branch network, some of the large banks have established their presence in many states when at their behest multi-state banking was allowed in 1985. Some of these banks are also Authorised Dealers in Foreign Exchange

If technology is supposed to be the greater equalizer and rural financial markets are increasingly similar to urban/national markets, then it follows that rural community banks are jumping like mad onto the technology bandwagon. But they're not. Meantime, their larger brethren have used technology to extend their reach and, through the Internet, are knocking on the doors of even the most remote communities for deposit dollars and fee-based services. This paper reports the results of a survey of non metro banks in the North Central U.S., examining the Internet's impact on competition in their markets and the banks' use of the Internet to compete. The message to rural banks: Wake up! Historically, rural markets have been less competitive for the financial services industry, if simply because lower population density and higher transportation costs have discouraged infiltration. That's changed, of course. By lowering transaction costs and allowing complex human interaction independent of distance, the information revolution offers the possibility to enhance competition in rural areas.

What are rural banks doing about it? A recent USDA report on rural credit markets noted: "The range of [rural] institutions involved is likely to be different, often narrower than that serving urban communities, and competition for rural loans is often not as keen as it is for urban loans." The structure of non metro financial service markets and the way in which they operate remain remarkably similar to the structure and processes in place half a century ago. But data suggests that rural America is not lagging behind more metropolitan areas in its adoption of PC and Internet use. Current market conditions suggest that the percentage of households and farmers "wired" and able to access financial services electronically is poised to grow rapidly.

Debt financing provided by these banks can be divided into two categories, based on the type of loan you are seeking: short term debt financing and long term debt financing.

Short Term financing is essentially to provide capital deficit businesses funds for a short-term period of no more than a year.

- **An Overdraft** is a short-term credit that is bounded to company's current bank account. It allows company to withdraw or spend more money than it has, up to an agreed limit, known as the "overdraft limit". Overdraft is designed to meet the liquidity needs and

balance irregular cash flow.

- **Working Capital Loan** (current capital loan) is a special purpose loan for short-term financing of additional needs in working capital.
- **Loan for agricultural enterprises** is provided for companies in cooperation with the Rural Development Foundation (RDF). Credit institutions are granting financing for primary producers in the agricultural sector and issuing loans on favourable conditions. The purpose of this loan is to support agricultural producers and other undertakings operating in rural areas to assure better access to financial resources that are needed for development of the economic activity.

Long Term financing is a form of financing that is provided for a period of more than a year. Long-term financing services are provided to those business entities that face a shortage of capital.

- **Investment loan** is a long term loan the purpose of which is financing new projects such as acquisition of fixed assets or building office-, warehouse- or production facilities. Financed period for investment loans varies depending on the credit institution but usually does not exceed 15 years.
- **Start-up loan** is meant for the companies that are just starting in business and often have no strong assets. Start-up loan enables an entrepreneur to manage the business- and loan-related risks, as in comparison with ordinary loans they have to take smaller risks with their own property.

a) What type and level of supervision and regulation is required for urban credit cooperatives? Is it possible to draw an outline of the supervisory framework?

b) Is existing supervisor/regulator (central bank of the country) appropriate for regulating and supervising the activities of urban credit cooperatives/banks?

c) Can we think of a separate agency (or even regulator) for urban credit cooperatives?

5.6.2 Cooperative Bank in Canada

New information technology, globalization and demographic changes are driving innovation and giving rise to new opportunities and demands in the Canadian financial services sector. The impacts of these changes on consumers and businesses continue to drive the evolution of the sector. Canadian financial institutions are always looking for

ways to achieve economies of scale and cost efficiencies in order to remain competitive. These issues are particularly difficult for credit unions, which face a greater challenge in pursuing strategies that have a national focus.

A group of credit unions put forward the idea of establishing cooperative banks in Canada to the Task Force on the Future of the Canadian Financial Services Sector. In the fall of 1998 a group of 12 credit unions took the concept one step further by proposing a Community Bank model and developing a business case to support the proposition.

In its report published in September 1998, the Task Force recommended legislative changes to allow for the establishment of cooperative banks, but did not make specific recommendations. The following winter and spring saw continued debate on the particulars of a Community Bank model (e.g. capital and regulatory issues), but support for the initiative eroded following the withdrawal of some of its proponents.

Given the various options proposed to date and the current lack of consensus on a preferred approach, the Government is initiating a consultation process to focus discussion and identify whether such a consensus can be reached. This consultation document is the start of that process, and the Government hopes to hear from stakeholders and individual Canadians on this important issue.

5.7 THE NEW POLICY FRAMEWORK

One of the fundamental principles underpinning the new framework is the need to foster greater competition in the domestic financial services sector while ensuring access to services at the community level. This principle is reflected in the measures the Government recently put in place to encourage the development of a stronger second tier of financial institutions, of which credit unions are a key component. The cooperative bank concept should be viewed against the background of these new measures.

Bill C-8 introduced changes to the Cooperative Credit Associations Act to provide the credit union system with enhanced structural flexibility, as well as expanded business and

investment powers. The legislative measures allow the system to migrate from a three-tier system to a two-tier system in order to streamline its operations and take advantage of a more national structure.

Under the new legislative framework, a federal association can apply to become a retail association at the national level in order to offer financial services directly to individuals outside the credit union system. This will provide credit unions with additional choices to structure their operations and allow them to create new channels to better serve current members and prospective clientele.

Finally, Bill C-8 instituted a number of changes for associations, in parallel with those that applied to other federal financial institutions, in the areas of enhanced permitted activities and investments. The fundamental principle of the new regime is that if a financial institution is permitted to engage in a particular activity in-house, it will also be permitted to engage in the activity through its subsidiaries.

A large portion of the regulations accompanying the legislation, which are critical to its application and the realization of the policy framework, are already in force. The remaining regulations will be finalized over the coming weeks and months.

- *Improving the cost structure of the credit union movement*

The cooperative bank concept was born out of the desire by some credit unions for a greater national presence and the resultant increased efficiencies, i.e. the need to offer products across provincial boundaries, common branding, the reduction of cost duplication, better capital allocation, the ability to raise capital, and the ability to introduce new products and services to better serve more sophisticated consumers. Any proposed model should address these challenges in its design.

- *Accommodating interprovincial and federal cooperation*

The federal government's involvement in the cooperative sector has an interprovincial dimension, as current legislation requires a federal association's membership to originate in two or more provinces. Any proposed cooperative bank model should respect the spirit of this jurisdictional division of responsibilities.

Credit unions fall under provincial jurisdiction while banks are federally regulated. Any cooperative bank model should address issues related to the migration between jurisdictions that

would result from a provincially regulated credit union converting to a federally regulated cooperative bank structure. As provincial legislation may be required to enable the conversions, any proposed model should also address issues of federal/provincial harmonization and collaboration in the establishment of the new regime.

- *Measuring and taking into account the impact on the safety and soundness of the credit union system*

The proposed model should address the potential impacts of jurisdictional migration on the safety and soundness of the credit union system, particularly liquidity.

- *Respecting cooperative principles*

Any cooperative bank model should clearly state its corporate governance practices in relation to cooperative principles, including the protection of member rights, the attributes of member shares and the prohibition of control.

- *Creating consensus among stakeholders*

The proposed model should present a workable solution that is broadly supported by interested parties - from credit unions and centrals to provincial and federal regulators to other financial institutions.

5.8 DESCRIPTION OF COOPERATIVE BANK MODELS

This section briefly describes three cooperative bank models: the "national" cooperative bank model, the "federated" cooperative bank model and the "individual" cooperative bank model. There are a large number of cooperative banks operating around the world, each with their own particularities. However, all of these banks are variations or adaptations of the models discussed below.

This section does not present an exhaustive list of possible bank models. It does not imply government support for the models discussed nor does it reach conclusions on the viability of any particular model in the Canadian context.

5.8.1 The National Cooperative Bank Model

Under this model, the federal government would prepare legislation to allow two or more credit unions to roll over their assets into a federal cooperative bank. In essence, they would become one integrated institution with a single identity or brand. The former offices of the credit unions would then become "branches" of the new cooperative bank.

In return for contributing their assets to the bank, the credit unions would become members of the bank and be allocated a number of shares proportionate to their contribution to the new bank's assets. However, each member credit union would get only one vote and would name one director to the bank's board.

The profits and losses would be allocated by the bank to the local credit union members according to their number of shares. The cooperative bank would be regulated as a single federal institution; as such, it would produce consolidated financial statements.

The cooperative bank would control the types of products and services provided within the branches. The local credit unions would continue to exist and their boards could continue to design a range of initiatives to respond to particular communities' needs (e.g. community involvement, local marketing) consistent with certain parameters set by the bank at the national level.

Finally, the name of the bank would be used across Canada; local credit unions could initially maintain their names while indicating their affiliation with the bank. However, the common brand would be prevalent and the identity of the former credit unions' brands should disappear with time.

In the longer term the cooperative bank could operate on a truly national scale.

5.8.2 The Federated Cooperative Bank Model

This model, inspired by the Rabobank in the Netherlands, envisages a situation whereby each credit union in the group would become a local cooperative bank and the cooperative banks together would own a central cooperative bank.

By becoming banks, the local credit unions would be allowed to serve the general public and would no longer be restricted to serving members. However, they would still be operated under cooperative principles. Members would be rewarded by benefits, such as better rates or lower charges than those applied to non-members. Multiple memberships in local cooperative banks would not be permitted.

In addition to getting a say in the policy of their own bank, members of local cooperative banks would elect the directors of the local bank's board. The general manager of the local bank would also get a seat on the board. Directors of the central cooperative bank would be elected among the directors of the local banks.

All the local cooperative banks would be members of the central cooperative bank. Each member would exercise its voting rights under the one member, one vote principle. The central cooperative bank would support and advise the individual member banks, for example in the areas of strategy, policy, marketing, product development and information technology. It would provide group coordination and common branding. The central cooperative bank would own subsidiaries for the benefit of the entire group, in order to offer a broad range of financial services to local cooperative banks' customers (e.g. securities dealers, asset management, mutual funds, investment banking).

The central cooperative bank would also function as the local cooperative banks' principal banker, balancing differences in liquidity between the individual banks and raising capital on the capital markets where necessary. It would also supervise the management and administration of the local banks.

The local cooperative banks would be linked through a system of cross-guarantees, as all of them would be jointly and severally liable for each other's commitments. As such, the group could essentially be regulated as a single entity.

Each credit union would have to ask to convert to a cooperative bank structure. It would remain independent and maintain its own identity, but would have to respect the directions and policies established by the group.

5.8.3 The Individual Cooperative Bank Model

According to this model, individual credit unions would convert to individual cooperative banks with their own identities, brands, products, etc.

The common shares of individual cooperative banks would be designated as membership shares, redeemable for a fixed value.

The individual cooperative banks would apply the one member, one vote principle. The members would elect the directors of the board and would have a voice at the annual meeting.

The cooperative banks could service persons other than their members, and these non-member users could be eligible for patronage returns (based on use of the bank's services) at a rate equal to or less than the rate at which the surplus is distributed to members.

The individual cooperative banks would be regulated as single federal institutions.

5.9 Types of Agricultural Loans

5.9.1 Types of Agricultural Loans

Agricultural loans are categorized as short-term, intermediate-term or long-term, depending on their maturity. Lenders often describe loans by the purpose or terms of the loan. For example **short-term** loans are often used for operating expenses. Loan maturity usually matches the length of the agricultural production cycle (e.g., 3 to 18 months), hence a short-term loan. However, this may be described as **line-of-credit** financing under a credit commitment, which specifies the amount and timing of the disbursements and payments of the loan. The line-of-credit may be a single disbursement due at a specified future date or a **revolving** line-of-credit in which the borrower may borrow and repay as needed during a specified time period, usually subject to a maximum borrowing level. On a **non-revolving** line-of-credit, a borrower is entitled to a specified amount of funds, and repayment does not allow the borrower to draw those funds again. A non-revolving line-of-credit is sometimes referred to as a draw note.

Intermediate-term loans are used to finance depreciable assets such as machinery, equipment, breeding livestock and improvements. In addition, intermediate-term loans are sometimes used to restructure a borrower's balance sheet to provide additional working capital. Lenders often describe them as capital, or **installment**, loans. Loans usually range from 18 months to 10 years.

Long-term loans are used to acquire, construct and develop land and buildings, and usually are amortized over periods longer than 10 years. Lenders may describe them as **real estate mortgages** because they are usually secured by real estate. Long-term loans are sometimes referred to as **contract financing**, in which case a seller provides financing directly to a buyer.

5.9.2 LOAN DOCUMENTS

Loan transactions typically include several documents for the borrower to sign, depending upon the type of loan. The **note** or **promissory note** is a document in which the borrower agrees to repay a loan at a stipulated interest rate within a specified period of time. The note may specify a

variable, fixed or adjustable rate, and whether line-of-credit financing is being used. A **loan agreement** is a written agreement between a lender and a borrower stipulating the terms and conditions associated with a financing transaction, and the expectations and rights of the parties involved. The loan agreement may indicate reporting requirements, possible sanctions for lack of borrower performance and any restrictions placed on a borrower.

A **security agreement** is a legal document signed by a borrower granting a security interest to a lender in specified personal property pledged as collateral to secure a loan. Essentially, a security agreement states what happens to the collateral if a borrower fails to perform as promised. A **financing statement** is a document filed by a lender with public official. The statement reports the security interest or lien on the borrower's non-real estate assets. The **mortgage** serves the same purpose in financing real estate.

5.10 Terms and Conditions of the Loans

As discussed earlier, a borrower needs to understand the note and loan agreement completely. This section outlines the primary loan terms and conditions included in most notes and loan agreements.

Disbursement of Funds

Disbursements for intermediate- and long-term loans are usually a single payment advanced at a specified time. Some short-term operating loans may be single disbursements, but the trend in

the lending industry is to establish lines-of-credit. This feature allows the borrower to reduce interest costs by using funds when needed and repaying funds as surplus cash is available.

Disbursement of funds on lines-of-credit is handled many ways. Many commercial banks allow the customer to phone or electronically submit a request for a specified amount to be deposited into the borrower's checking account. The borrower's loan balance is increased and funds are added to the borrower's account. Or, the lender may provide the borrower a book of drafts. A draft can be used instead of a check to pay bills. The borrower's loan balance increases when the draft clears the financial system and returns to the borrower's financial institution. Lenders usually restrict drafts to business-related expenses.

Payment Type

Payment type refers to the method of repayment. Payments on line-of-credit financing generally occur when the borrower has surplus funds. The lender usually establishes a payment schedule for intermediate- and long-term loans. A borrower should ask the lender to produce a copy of a payment schedule that specifies principal and interest payments over the life of the loan. The borrower can then compare payment patterns on different loans.

A borrower should be aware of any **demand clauses** in a note or loan agreement. A demand clause is a provision that allows the lender to demand payment at *any* time. Even though the demand provisions are seldom carried out, a borrower should be *comfortable* with paying the loan upon demand, especially in times of economic uncertainty.

There are three common payment types. One payment type for intermediate- or long-term loans is the **fixed payment method**. This method requires a fixed payment (interest plus principal), which repays a loan over a specified period of time at a specified interest rate. This repayment process is often referred to as equal amortization. Part of each payment is allocated to principal and part to interest, with successive payments retiring more and more principal.

Another way to calculate the payment on an intermediate- or long-term loan is **fixed principal payment** with interest due on the unpaid balance. The fixed principal amount is usually calculated by dividing the loan amount by the total number of payments. Under this method, the initial payments of principal and interest are the largest, and the ability to cash flow these payments must be considered. This method of payment requires less total interest over the life of the loan because more of the principal is repaid earlier in the loan.

Interest Rate

Since it is the visible “price tag” of a loan, the interest rate is often used to compare loans. Loans carry fixed, adjustable or variable interest rates. A **fixed** rate loan carries the same interest rate until the loan is paid off. A variable or adjustable rate loan has provisions to change the interest rate based on changes in market rates of interest, a specified index or other factors determined by a lender. Interest rates on **adjustable** rate loans or mortgages can *only* change at intervals specified in a note or loan agreement. For example, the interest rate on a five-year adjustable rate mortgage can change once every five years.

A **variable** rate loan may also designate intervals in which interest rates may change, but in some variable rate loans a change in the interest may be at the *discretion* of the lender. If a borrower has a variable or adjustable rate loan, he or she should know how often and how much the interest rate may change. The borrower should also be able to calculate how changes in interest rates affect the loan payment. A borrower should ask the lender to estimate the scheduled payment at various rates of interest. The borrower should be comfortable with the uncertainty involved with potential interest rate changes. If not, the borrower may request loan terms that reduce the interest rate risk.

If the interest rate on a variable or adjustable rate loan is linked to a specified index rate, a lender typically adds a margin above the index rate to determine the interest rate. For example, if the index rate is 9% and the margin is 2%, the interest rate on a variable rate or adjustable rate loan is 11%. If the index rate changes to 11% in the next adjustment period, the interest rate charged will be 13%.

Many characteristics of variable and adjustable rate loan differ among lenders. The interest rate index (if any), margin, length of adjustment period and caps (upper limits) are the major distinguishing features. These features may be negotiable.

Interest rate index: The variable or adjustable interest rate is sometimes linked to an interest rate index. Many lending institutions use their average cost of funds or another internal rate as the basis to price loans. Other common indices include 1-year Treasury securities rates, 90-day Treasury bills, prime rate charged at money center banks, federal funds rate and the London Interbank Offer Rate (LIBOR). Differences between the indices can be substantial. Federal funds rates and 90-day Treasury bill rates can change every day, while the prime rate changes less frequently. A borrower should ask the lender about historical patterns of the index rate. In

addition, if the lender is using the institution's internal rate, a borrower should ask how often the lender changes this rate.

Margin: The margin refers to the percentage points that the lender adds to the rate index to determine the rate charged to the borrower. The margin covers the costs of administering the loan, a risk premium, and a profit margin for the lender. The note or loan agreement will state if the margin is to remain constant over the maturity of the loan.

Length of adjustment period: The adjustment period is the length of time before the lender can change the borrower's interest rate. At the end of each adjustment period, the interest rate may be adjusted to reflect changes in the index (if an index is used). The note *may* allow for other terms of the loan to change at each adjustment period.

Caps: Rate caps may be associated with variable or adjustable rate loans. They limit how much the interest rate can change at each adjustment period. Many loans also have life-of-loan rate caps which limit interest rate movements over the entire life of the loan. Often a cap may be purchased as an optional feature of the loan.

A borrower should be aware of each of these factors affecting a variable or adjustable rate loan. Moreover, the combination of the factors and the resulting implications must be considered. For example, if a lender has a volatile interest rate index, a borrower should consider some type of cap. Lenders will negotiate on the different variable and adjustable rate features. For example, a lender may lengthen the adjustment period in exchange for a higher margin. A borrower should feel comfortable with the variable or adjustable rate features and be willing to discuss changes in a loan package.

5.11 Lending Policies and Procedures

Making loans is the principal economic function of banks. For most banks, loans account for half or more of their total assets and about half to two-thirds of their revenues.

Risk in banking tends to be concentrated in the loan portfolio. Uncollectable loans can cause serious financial problems for banks.

Types of Loans Made By Banks:

Bank loans can be grouped according to their purpose.

1. Real Estate Loans
2. Financial Institution Loans
3. Agricultural Loans
4. Commercial and Industrial Loans
5. Loans to Individuals
6. Miscellaneous Loans
7. Lease Financing Receivables

Factors Determining the Growth and Mix of Bank Loans:

- Characteristics of Market Area Served
- Size of the Bank
- Experience and Expertise of Management
- Written Loan Policy
- Expected Yield of Each Type of Loan
- Regulations

Regulation of Lending

- The loan portfolio of any bank is influenced by regulation. For example, in the USA, real estate loans cannot exceed the bank's capital, or 70% of its total time and savings deposits. Also, a loan to a single customer cannot exceed 15 % of banks capital.
- The quality of a bank's loan portfolio and the soundness of its Lending Policies are the areas bank examiners look at most closely when examining a bank. The possible examiner ratings are:
 - 1=strong performance
 - 2=satisfactory performance
 - 3=fair performance
 - 4=marginal performance
 - 5=unsatisfactory performance

Asset Quality

- Criticized Loans
- Scheduled Loans
- Adversely Classified

1. Substandard loans
2. Doubtful loans
3. Loss loans

Examiners compare the weighted averages of adversely classified loans with the bank's sum of loan loss reserves and equity capital.

$$(.20) \text{ Substandard loans} + (.50) \text{ Doubtful loans} + (1.0) \text{ Loss loans} = \text{grand total}$$

Bank's Written Loan Policy

- Goal Statement for the Bank's Loan Portfolio
- Specification of Lending Authority of Each Loan Officer and Committee
- Lines of Responsibility for Making Assignments and Reporting Information
- Operating Procedures for Reviewing, Evaluating and Making Loan Decisions
- Required Documentation for All Loans
- Lines of Authority for Maintaining and Reviewing Credit Files

Guidelines for Taking and Perfecting Collateral

- Policies and Procedures for setting loan interest rates and fees and the terms for repayment of loans
- Statement of Quality Standards
- Statement of Upper Limit for Total Loans
- Description of Principal Trade Area Where Loans Should Come From
- 12. Discussion of Preferred Procedure for Working Out Problem Loans

Steps in the Lending Process

- The customer fill out a loan application
- An interview with a loan officer usually follows right away
- If a business or mortgage loan is applied for, a site visit is usually made by an officer of the bank to assess the property
- The customer is asked to submit several crucial documents, such as financial statements

- The credit analysis division of the bank analyses the application and prepares a brief summary and recommendation
- Recommendation goes to the loan committee for approval
- If the loan is approved, the loan officer check on the property that is pledged as collateral in order to ensure that the bank has immediate access to the collateral if the loan agreement is defaulted. This is often referred to as perfecting the bank's claim to collateral.

Credit Analysis:

The division of the bank responsible for analyzing and making recommendations about loan applications is the credit department.

Is the Borrower Creditworthy?

This usually involves a detailed study of six aspects of the loan application: character, capacity, cash, Collateral, conditions, and control.

The Six Basic C's of Lending

- 1. Character**—Specific Purpose For Loan and Serious Intent to Repay Loan
- 2. Capacity**—Customer Has Legal Authority to Sign Binding Contract
- 3. Cash**—Does the Borrower Have the Ability to Generate Enough Cash to Repay the Loan
- 4. Collateral**—Does the Borrower Have Adequate Assets to Support the Loan
- 5. Conditions**—Must Look At the Industry and Changing Economic Conditions to Assess Ability to Repay
- 6. Control**—Does Loan Meet Written Loan Policy and How Would Changing Laws and Regulations Affect Loan

Common Types of Collateral

- Accounts Receivable
- Factoring
- Inventory
- Real Property
- Personal Property

- Personal Guarantees

Sources of Information About Loan Customers

- The bank relies principally on outside information to assess the character, financial position, and collateral of a loan customer.
- The bank may contact other lenders to determine their experience with this customer
- The local or regional credit bureau may be contacted to ascertain the customer's credit history

Parts of a Typical Loan Agreement

The loan is given with a written contract that has several parts.

1. The Note: It is signed by the borrower and it specifies the principal amount, interest rate, and the term of repayment.

2. Loan Commitment Agreement: This is done for large loans and home mortgage loans. Bank promises to make credit available to the borrower over a certain period.

3. Collateral: Bank loans may be either secured or unsecured.

4. Covenants: Most formal loan agreements contain restrictive covenants, which are usually one of two types:

- o affirmative, or
- o negative

Affirmative Covenants: Require the borrower to take certain actions, such as periodically filing financial statements with the bank, maintaining insurance coverage on the loan and on any collateral pledged, .

Negative Covenants: Restrict the borrower from doing certain things without the bank's approval, such as taking on new debt, acquiring additional fixed assets, participating mergers, and selling assets.

Parts of a Typical Loan Agreement (cont.)

5. Borrower Guaranties or Warranties: The borrower guarantees or warranties that the information supplied in the loan application is true and correct.

6. Events of Default: most loans contain a section listing events of default, specifying what actions or inactions by the borrower would represent a significant violation of the terms of the

loan agreement, and what actions the bank is legally take in order to secure its funds.

Loan Review (Loan Monitoring)

- After the loan is granted, the loan department must periodically review all loans until they reach maturity. Loan review helps bank management to spot problem loans quickly. This increase the chance to recover the loans and reduce the bank losses.

Warning Signs of Problem Loans

- Unusual or Unexpected Delays in Receiving Financial Statements
- Changes in Accounting Methods
- Restructuring Debt or Eliminating Dividend Payments or Changes in Credit Rating
- Adverse Changes in Price of Stock

Loan Workouts (cont.)

- Estimate Resources Available to Collect the Troubled Loan
- Conduct Tax and Litigation Search
- Evaluate Quality and Competence of Current Management
- Consider All Reasonable Alternatives

5.12 Agricultural Finance

Agriculture is a very important part of economy and contributes greatly to the gross domestic product of a country. In developing countries, where about 25% of GDP is derived from the agricultural sector, agriculture plays a very important role . Even the governments of various countries are quite aware of this fact and this is the reason why different types of agricultural policies are made at different levels .

5.12.1 Need for Agricultural Finance

There are many needs of agricultural sector for the fulfillment of which finance is required. Most of these needs pertain to farmers. Finance is required for the purchase of different types of agricultural implements, for the purchase of high quality seeds, for making marketing

arrangements, for storing etc It is very important to understand that apart from the agricultural activities, finance is also provided to different types of allied agricultural activities like apiculture, horticulture etc .

5.12.2 How the Agricultural Finance Programs are made?

In each country, there is a separate department at the federal level that takes care of all the agricultural development activities in the nation. This department makes all the policies of regarding agriculture finance. For ensuring that all the financial programs are executed in the proper manner, several government agencies have been made. These agencies not only helps farmer in providing different types of financial assistance but also in timely providing of finance. While formulating policies and providing finance to agricultural sector, the government takes into consideration all the types of farmers, whether small farm holder or big farm holders. Financial institutions like banks owned by government and other *agricultural finance* centers are required to open their branches in the rural sector so that agriculture finance is easily passed on to the farmers . Even there are specialized branches that provide agricultural loans only.

All the *agricultural finance programs* aim at fulfilling certain objectives.

Alternatively, it can be said that all the agricultural finance programs have to achieve some objectives. First objective is the development of local sources for agriculture. For the development of agricultural sector, it is required that there are developed local sources regarding manures, seeds, and irrigation implements, so that these can easily be procured by farmers. Next objective is the proper utilization of manpower in the rural areas. In case of intensive farming, there is more requirement of manpower and the agricultural finance programs must aim at the utilization of same.

There are many sources of getting *agricultural finance*. These sources vary from one country. For example, in United States, there are many agencies that work under USDA or United States Department of Finance and provide various types of agricultural finance programs. In developing countries like India, there are Co-operatives, commercial banks, moneylenders, and various state agencies etc that participate in providing the agricultural finance.

In the present times, in many countries, nodal agencies have been appointed which have been given the role of supervision of agricultural finance being made in the area. All the *agricultural*

finance-disbursing agencies are given certain targets and these agencies have to provide report on loans and finance made to farmers on fortnightly or monthly basis.

5.12.3 Different types of financial assistance

Agricultural finance can be classified into short-term finance, medium term finance and the long-term finance. The demarcation of each of these varies from one country to another. Generally, loans up to 12-15 months are categorized into short-term finance. Loans from 15-60 months are categorized into medium term finance and all the loans that are given for more than 5 years are put under long-term finance. Short-term agricultural finance is given for fulfilling temporary needs like buying of seeds, fertilizers, for meeting expenses of laborers etc. The short-term finance is given up to harvesting only. Medium term agricultural finance is provided for relatively bigger purposes like buying improved agricultural implements, livestock, for sinking of well etc. The long-term agricultural finance is provided for the purchase of heavy implements like tractors, making land improvements, buying land for increase in farm holding size etc. Apart from the above, agricultural finance is also provided in the form of cash credit, where the farmer can withdraw up to a certain limit and can deposit money also.

The exact type of agricultural finance differs from one country to another. In United States, there is a farm service agency under USDA, also called as FSA, which runs different types of agricultural finance programs for the farmers. Apart from credit facilities that are meant for farm development, this agency also provide financial assistance for the destruction occurred due to natural disasters. The agency provides various types of agricultural credit programs to different types of agricultural enterprises, which include nursery, orchard, vegetable, aquaculture, livestock rearing etc.

Under the finance assistance program, direct loans up to \$200000 are provided by the agency, whereas loans up to \$899000 are provided by means of different types of private institutions. There are also commodity loan programs that are given for the development of storage spaces etc relating to corn, wheat, barley, oilseeds, milk, cotton, sugar etc. For the rehabilitation of all the farmers that are affected by natural disasters etc, there is a Disaster and emergency payment assistance program in which the farmers are rehabilitated on the basis of cost sharing . The agency also runs a special program called as CRP or the Conservation Reserve Program, a type of agricultural finance program, in which the farmers are provided finance for the substitution of crops by vegetative covers on the land area that are very prone to the erosion .

Similarly, there is ECP or the Emergency Conservation Program in which the farmers and ranchers are assisted for the cleaning of land and growing of crops after the land has been destroyed by a natural disaster. Under the EQUIP or the Environment Quality Incentive Program, farmers are given incentive for taking part in different types of conservation activities and other works like improvement in quantity and quality of available water, grazing land conservation, etc . In this type of program, the assistance is sometimes provided up to 75% of cost of practice.

UNIT SIX

NEW FINANCIAL SERVICE AND INOVATIVE BANKING

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- 6.0 Objective
- 6.1 Introduction
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Objective

- Merchant banking
- Leasing finance
- Hire purchase

- Installment finance
- Credit cards

6.1 Introduction

6.2 Merchant Bank

Merchant bank is a traditional term for an Investment Bank. It can also be used to describe the private equity activities of banking. This article is about the history of banking as developed by merchants, from the Middle Ages onwards.

History

Merchant banks, now so called, are in fact the original "banks". These were invented in the middle Ages by Italian grain merchants. As the Lombardy merchants and bankers grew in stature based on the strength of the Lombard plains cereal crops, many displaced Jews fleeing Spanish persecution were attracted to the trade. They brought with them ancient practices from the middle and Far East silk routes. Originally intended for the finance of long trading journeys, these methods were now utilized to finance the production of grain.

The Jews could not hold land in Italy, so they entered the great trading piazzas and halls of Lombardy, alongside the local traders, and set up their benches to trade in crops. They had one great advantage over the locals. Christians were strictly forbidden the sin of usury. The Jewish newcomers, on the other hand, could lend to farmers against crops in the field, a high-risk loan at what would have been considered usurious rates by the Church, but did not bind the Jews. In this way they could secure the grain sale rights against the eventual harvest. They then began to advance against the delivery of grain shipped to distant ports. In both cases they made their profit from the present discount against the future price. This two-handed trade was time consuming and soon there arose a class of merchants, who were trading grain debt instead of grain. It was a short step from financing trade on their own behalf to settling trades for others, and then to holding deposits for settlement of "billete" or notes written by the people who were still

brokering the actual grain. And so the merchant's "benches" (bank is a corruption of the Italian for bench, as in a counter) in the great grain markets became centers for holding money against a bill (billette, a note, a letter of formal exchange, later a bill of exchange, later still, a cheque). These deposited funds were intended to be held for the settlement of grain trades, but often were used for the bench's own trades in the meantime. The term bankrupt is a corruption of the Italian banca rotta, or broken bench, which is what, happened when someone lost his traders' deposits. Being "broke" has the same connotation.

Modern practices

the definition of merchant banking has changed greatly since the days of the Rothschild's. The great merchant banking families dealt in everything from underwriting bonds to originating foreign loans. Bullion trading and bond issuing were some of the specialties of the Rothschild family. The modern merchant banks, however, tend to advise corporations and wealthy individuals on how to use their money. The advice varies from counsel on Mergers and acquisitions to recommendation on the type of credit needed. The job of generating loans and initiating other complex financial transactions has been taken over by investment banks and private equity firms.

Today there are many different classes of merchant banks. One of the most common forms is primarily utilized in America. This type initiates loans and then sells them to investors. Even though these companies call themselves "Merchant banks," they have few if any of the characteristics of former Merchant banks.

American merchant banks offer many of the following services:

1. Consulting advice on going public and international business.
2. Advice and help in taking your company public. If they are unwilling to supply Investment Banking bridge loans, they have a low cost strategy for taking your company public.
3. The do PIPE (Private Investment in Public Equities) financings.
4. They can advise or help with a company's M&A strategy.
5. They are essential advisors for companies seeking to become multinational corporations.
6. They offer pragmatic general business advice for real world situations.

In providing advice and assistance, merchant bankers must possess a complete understanding of all facets of capital markets. This includes every type of debt and equity financing both domestically and internationally. Merchant bankers cognizant of capital costs, seek optimum

sources of capital. It is fundamental to acknowledge that interest rates are not the only standard relating to capital costs. Restrictions on funding availability, repayment terms, and operating effectiveness often outweigh what might appear to be inexpensive capital. Too frequently capital costs compel a growing business to take undesirable actions. Some action might be necessary - or advantageous - but in the long run - inordinate capital costs can be detrimental. The traditional merchant banker understands capital limitations and is able to structure transactions which are beneficial to all parties - not just the capital source. A knowledgeable merchant banker knows how to substitute one kind of capital for another - sometimes utilizing internal sources by way of either asset or corporate repositioning or equity creation. Above all, a merchant banker fully comprehends the "risk" versus "return" element necessary to complete the capital procurement process.

6.3 Hire Purchase

Hire purchase (HP) is a common way of paying for major items, such as, cars, furniture and computers. But like any credit deal, you need to think carefully before committing yourself. This information will help you decide if HP is the right choice for you.

What are hire purchase and conditional sale?

With other forms of credit, such as a loan or credit card, the goods you buy belong to you straight away. When you use HP:

- You don't legally own the goods until you've paid back all the money you owe. This means that you cannot modify or sell them without the lender's permission
- Your contract is with a finance company (not the retailer) who will own the goods until the final payment is made
- The finance company can take the goods back if you don't keep up your repayments
- You will be liable for any damage caused to the goods during the contract period.

Under a hire purchase (HP) agreement, you pay an initial deposit followed by monthly payments (a portion of the money you borrowed plus interest) over an agreed period.

At the end of this period, you have the option of owning the goods outright, although your lender may require you to pay a fee (check because this could be high).

Conditional sale (CS) agreements are similar to HP; you will own the goods once all your installments have been paid. There will be no extra fee to pay at the end.

- Merchant Banking is an activity that includes corporate finance activities, such as advice on complex financings, merger and acquisition advice (international or domestic), and at times direct equity investments in corporations by the banks. Merchant banks are private financial institution. Their primary sources of income are PIPE financings and international trade. Their secondary income sources are consulting, Mergers & Acquisitions help and financial market speculation. Because they do not invest against collateral, they take far greater risks than traditional banks. Because they are private, do not take money from the public and are international in scope, they are not regulated. Anyone considering dealing with any merchant bank should investigate the bank and its managers before seeking their help.

6.4 Finance Lease

Finance leasing is a method of providing finance. In legal form a finance lease is just another lease - the legal ownership of the asset lies with the lessor. However the economic ownership of the asset - the risks and rewards of ownership - lies with the lessee. In substance the finance lessee buys the asset with a loan from the finance lesser.

The special character of a finance lease lies in the way the rentals are calculated. In economic substance a finance lease is a loan of money with the asset as security. It is an arrangement under which one person (the lessor) provides the money to buy an asset which is used by another (the lessee) in return for an interest charge. The lessor has security because it owns the asset. The terms of the leasing arrangements aim to give the lessor a banker's interest turn and no more or less - however good or bad the asset proves to be.

History of finance leasing

Large-scale finance leasing in the United Kingdom gained a substantial boost during the period of high first year allowances beginning about 1970 and ending, for most types of asset, in 1984. This investment incentive through the tax system, coupled on occasion with economic recession, meant that capital intensive businesses often found themselves tax exhausted and unable to benefit from the first year and other 'incentive' allowances due on their investment in fixed assets. Stock relief later accentuated the effects of first year allowances. At the same time financial businesses like banks did not enjoy these reliefs. Finance leasing offered a means for the surplus first year allowances to be transferred away from businesses without current taxable profits to banks and others able to use them. In the process the

users of the equipment obtained a significant part of the benefit of the tax allowances they could not use directly. This was achieved by leasing rates which reflected, often explicitly, the fact that the lessors could use the first year allowances. Companies trading as finance lessors could also surrender their tax losses under the group relief rules to fellow group members with trading profits, typically banking profits, which would otherwise have been exposed to tax.

Finance lease is a lease that is primarily a method of raising finance to pay for assets, rather than a genuine rental. The latter is an operating lease.

The key difference between a finance lease and an operating lease is whether the lessor (the legal owner who rents out the assets) or lessee (who uses the asset) takes on the risks of ownership of the leased assets. The classification of a lease (as an operating or finance lease) also affects how it is reported in the accounts.

The UK, like many other countries, has tax rules that attempt to control the use of finance leases to reduce tax (reduced compared to what would have been paid if an asset had been financed in a different way).

From an accounting point of view the classification of leases as finance leases is very important. With a finance lease assets must be shown on the [balance sheet](#) of the lessee, with the amounts due on the lease also shown on the balance sheet as liabilities. This is intended to prevent the use of lease finance to keep the lease liabilities [off-balance sheet](#).

6.5 Installment Finance

Installments Finance is being used for a number of reasons, like education, investment, business, cars and houses. Of all the reasons mentioned above, house loans are the most popular. Money for other expenses can be arranged easily, but organizing money to purchase a house is not an easy task. This can put a big hole in your monthly budget. This situation has to be tackled with care else you tend to lose all your life time savings. Installment Finance is an interest only loan. This can be used to purchase a property. The concept is simple; the buyer needs to pay only the interest for the loan taken for a stipulated period of time. The term period can depend upon the buyer and the lender. It can be divided into three, five, seven or even ten years for a single loan amount. Once the term ends the buyer can transform the loan into an amortized loan or can pay the principle amount.

Many borrowers opt for terms finance because of the flexibility factor involved. You can pay the interest for the current month and pay interest and part of principle for the following month. This convenience is not available in mortgage loan option. Term loans are the best means of procuring finance for a home. Terms finance is a good idea if you learn how the loan works. Right financial advice can help you realize your dream. People are using this option to buy property as they need to concentrate on the interest right now. Before opting for this loan it is important to check for the interest rates. Do some shopping for interest only loans and compare with various lenders before making a decision. Not all lenders will offer the same interest rates, check and select the one with lower rate of interest. Most of the other loan payments also go only for interest during the first few years. Also check if the rate of interest is fixed, else you may tend to pay more interest in the future. Once the term period is over you can pay the principle and finish the deal or even liquidate the house and clear the loan as per your convenience. Always keep in mind that the principle accumulates when you prefer to pay interest first. The value of the loan remains the same as the interest only is cleared periodically. Even though the term period can vary according to the wish of both the parties, it is best to arrange for the principle amount during this period in order to avoid inconvenience in the future.

6.6 Credit and Debit Cards

For consumers, the difference between a "debit card" and a "credit card" is that the debit card deducts the balance from a deposit account, like a checking account, whereas the credit card allows the consumer to spend money on [credit](#) to the issuing bank. In other words, a debit card uses the money you have and a credit card uses the money you don't have. "Debit cards" which are linked directly to a checking account are sometimes dual-purpose, so that they can be used as a credit card, and can be charged by merchants using the traditional credit networks. A merchant will ask for "credit or debit?" if the card is a combined credit + debit card. If the payee chooses "credit", the credit balance will be debited the amount of the purchase which is then withdrawn at a later date; if the payee chooses "debit", the bank account balance will be debited the amount of the purchase and the money will be withdrawn from the bank account immediately.

The "debit" networks usually require that a [personal identification number](#) (PIN) be supplied. The "credit" networks typically require that purchases be made in person and often allow cards to be charged with only a signature, and/or picture ID. However, most merchant agreements in the United States forbid picture ID as a requirement to use a Credit Card.

6.6.1 Types of debit card

Debit card

An example of the front of a typical debit card:

1. Issuing bank logo
2. [EMV chip](#)
3. [Hologram](#)
4. [Card number](#)
5. Card brand logo
6. Expiration date
7. Cardholder's name

An example of the reverse side of a typical debit card:

1. [Magnetic stripe](#)
2. [Signature](#) strip
3. [Card Security Code](#)

There are currently three ways that debit card transactions are processed: **online debit** (also known as **PIN debit**), **offline debit** (also known as **signature debit**) and **Electronic Purse Card**.

Although many debit cards are of the Visa or [MasterCard](#) brand, there are many other types of debit card, each accepted only within a particular country or region, for example [Switch](#) (now: Maestro) and [Solo](#) in the [United Kingdom](#), [Interac](#) in [Canada](#), [Carte Bleue](#) in [France](#), [Laser](#) in [Ireland](#), "EC electronic cash" (formerly [Eurocheque](#)) in [Germany](#) and [EFTPOS](#) cards in Australia and New Zealand. The need for [cross-border compatibility](#) and the advent of the [euro](#) recently led to many of these card networks (such as [Switzerland's](#) "EC direkt", [Austria's](#)

"BankomatKasse" and [Switch](#) in the [United Kingdom](#)) being re-branded with the internationally recognised [Maestro](#) logo, which is part of the [MasterCard](#) brand. Some debit cards are dual branded with the logo of the (former) national card as well as [Maestro](#) (e.g. EC cards in Germany, Laser cards in Ireland, Switch and Solo in the UK, Pinpas cards in the Netherlands, Bancontact cards in Belgium, etc.). The use of a debit card system allows operators to package their product more effectively while monitoring customer spending. An example of one of these systems is ECS by [Embed International](#).

Online Debit Card

Online debit cards require electronic authorization of every transaction and the debits are reflected in the user's account immediately. The transaction may be additionally secured with the [personal identification number](#) (PIN) [authentication](#) system and some online cards require such authentication for every transaction, essentially becoming enhanced automatic teller machine ([ATM](#)) cards. One difficulty in using online debit cards is the necessity of an electronic authorization device at the [point of sale](#) (POS) and sometimes also a separate [PINpad](#) to enter the PIN, although this is becoming commonplace for all card transactions in many countries. Overall, the online debit card is generally viewed as superior to the offline debit card because of its more secure authentication system and live status, which alleviates problems with processing [lag](#) on transactions that may have been forgotten or not authorized by the owner of the card. Banks in some countries, such as [Canada](#) and [Brazil](#), only issue online debit cards(santu)

Offline Debit Card

Offline debit cards have the [logos](#) of major credit cards (e.g. Visa or [MasterCard](#)) or major debit cards (e.g. [Maestro](#) in the [United Kingdom](#) and other countries, but not the [United States](#)) and are used at the [point of sale](#) like a credit card (with payer's signature). This type of debit card may be subject to a daily limit, and/or a maximum limit equal to the current/checking account balance from which it draws funds. Transactions conducted with offline debit cards require 2–3 days to be reflected on users' account balances. In some countries and with some banks and merchant service organizations, a "credit" or offline debit transaction is without cost to the purchaser beyond the face value of the transaction, while a small fee may be charged for a "debit" or online debit transaction (although it is often absorbed by the retailer). Other differences are that online debit purchasers may opt to withdraw cash in addition to the amount of the debit purchase (if the

merchant supports that functionality); also, from the merchant's standpoint, the merchant pays lower fees on online debit transaction as compared to "credit" (offline) debit transaction

Prepaid Debit Card

Prepaid debit cards, also called reloadable debit cards or reloadable prepaid cards, are often used for recurring payments. The payer loads funds to the cardholder's card account. Particularly for US-based companies with a large number of payment recipients abroad, prepaid debit cards allow the delivery of international payments without the delays and fees associated with international checks and bank transfers. Web-based services such as stock photography websites outsourced services, and affiliate networks (have all started offering prepaid debit cards for their contributors/freelancers/vendors)

Electronic Purse Card

Smart-card-based electronic purse systems (in which value is stored on the card chip, not in an externally recorded account, so that machines accepting the card need no network connectivity) are in use throughout Europe since the mid-1990s, most notably in Germany (Geldkarte), Austria (Quick), Belgium. In Austria and Germany, all current bank cards now include electronic purses.

Advantages and Disadvantages

Debit and check cards, as they have become widespread, have revealed numerous advantages and disadvantages to the consumer and retailer alike. Advantages are as follows (most of them applying only to some countries, but the countries to which they apply are unspecified):

- A consumer who is not credit worthy and may find it difficult or impossible to obtain a credit card can more easily obtain a debit card, allowing him/her to make plastic transactions.
- Use of a debit card is limited to the existing funds in the account to which it is linked (except cases of offline payments), thereby preventing the consumer from racking up debt as a result of its use, or being charged interest, [late fees](#), or fees exclusive to credit cards.
- For most transactions, a check card can be used to avoid check writing altogether. Check cards debit funds from the user's account on the spot, thereby finalizing the transaction at the time of purchase, and bypassing the requirement to pay a credit card bill at a later date, or to write an insecure check containing the account holder's personal information.

- Like credit cards, debit cards are accepted by merchants with less identification and scrutiny than personal checks, thereby making transactions quicker and less intrusive. Unlike personal checks, merchants generally do not believe that a payment via a debit card may be later dishonored.
- Unlike a credit card, which charges higher fees and interest rates when a cash advance is obtained, a debit card may be used to obtain cash from an ATM or a PIN-based transaction at no extra charge, other than a foreign ATM fee.

The Debit card has many disadvantages as opposed to cash or credit:

- Some banks are now charging over-limit fees or non-sufficient funds fees based upon pre-authorizations, and even attempted but refused transactions by the merchant (some of which may not even be known by the client).
- Many merchants mistakenly believe that amounts owed can be "taken" from a customer's account after a debit card (or number) has been presented, without agreement as to date, payee name, amount and currency, thus causing penalty fees for overdrafts, over-the-limit, amounts not available causing further rejections or overdrafts, and rejected transactions by some banks.
- In some countries debit cards offer lower levels of security protection than credit cards. Theft of the users PIN using skimming devices can be accomplished much easier with a PIN input than with a signature-based credit transaction. However, theft of users' PIN codes using skimming devices can be equally easily accomplished with a debit transaction PIN input, as with a credit translation PIN input, and theft using a signature-based credit transaction is equally easy as theft using a signature-based debit transaction.
- In many places, laws protect the consumer from fraud a lot less than with a credit card. While the holder of a credit card is legally responsible for only a minimal amount of a fraudulent transaction made with a credit card, which is often waived by the bank, the consumer may be held liable for hundreds of dollars, or even the entire value of fraudulent debit transactions. The consumer also has a much shorter time (usually just two days) to report such fraud to the bank in order to be eligible for such a waiver with a debit card, whereas with a credit card, this time may be up to 60 days. A thief who

obtains or clones a debit card along with its PIN may be able to clean out the consumer's bank account, and the consumer will have no recourse.

6.7 E-Banking

E-banking is defined as the automated delivery of new and traditional banking products and services directly to customers through electronic, interactive communication channels. E-banking includes the systems that enable financial institution customers, individuals or businesses, to access accounts, transact business, or obtain information on financial products and services through a public or private network, including the Internet. Customers access e-banking services using an intelligent electronic device, such as a personal computer (PC), personal digital assistant (PDA), automated teller machine (ATM), kiosk, or Touch Tone telephone. While the risks and controls are similar for the various e-banking access channels, this booklet focuses specifically on Internet-based services due to the Internet's widely accessible public network. Accordingly, this booklet begins with a discussion of the two primary types of Internet websites: informational and transactional.

E-Banking Components

E-banking systems can vary significantly in their configuration depending on a number of factors. Financial institutions should choose their e-banking system configuration, including outsourcing relationships, based on four factors:

- ◆ Strategic objectives for e-banking;
- ◆ Scope, scale, and complexity of equipment, systems, and activities;
- ◆ Technology expertise; and
- ◆ Security and internal control requirements.

Financial institutions may choose to support their e-banking services internally. Alternatively, financial institutions can outsource any aspect of their e-banking systems to third parties. The following entities could provide or host (i.e., allow applications to reside on their servers) e-banking-related services for financial institutions.

