Law of Banking, insurance and Negotiable Instruments

CHAPTER ONE

- WHAT IS BANK ?
- WHAT KINDS OF BANKS WE DO HAVE?
- WHAT ARE FUNCTIONS OF BANKS?

cntd

- Definition of the term Bank
- The term bank refers to an institution that deals in money and its substitutes and provides other financial services
- It is a business organization that perform the following activities
- ✓ It accept deposits (money, valuable things and documents)
- ✓ it lends money to others borrowers. (source of money is the deposit)
- ✓ It will buy and sell foreign exchange, and gold and silver bullions.
- ✓ It can issue commercial instruments and transferable securities having a future maturity date.
- Some banks also have the power to create money.
- Commercial bank vs Central Banks.

cntd

- The former deals with “receiving deposits” (borrowing money from individuals, firms and sometimes from government)
- With these resources and with the bank's own capital, the banker makes loans or extends credit and invests in securities
- The latter will lend money for government, Commercial banks, and for other financial institutions.
- This Bank is also responsible for formulating and implementing monetary and credit policies, usually in cooperation with the government.

cntd

- The difference between Banks and Financial intermediaries.
- Financial Intermediaries include; finance companies, savings banks, investment banks, trust companies, and home-loan banks.
- They sometimes called Banks, but they can not perform the banking functions described above.
- They rather use for channeling savings from private individuals into the hands of those who will use them, in the form of loans for building purposes or for the purchase of capital assets.
- They cannot create credit as the commercial bank do.

Cntd

- 1.2 The Development of Banking Systems
- When did Banking service started?
- Though Banking service have ancient origin, very little was known about it before 13th C.
- The functions of many early Banks were
- Changing and supplying foreign and domestic coins of the correct weight.
- acceptance of deposits. (for safekeeping or for purposes of transfer to another party)
- The service gradually grew up to credit transfer and issuing bank notes

1.2.2 The birth and development of Banking services in Ethiopia

- The first Bank called “Bank of Abyssinia” was established in 1950 based on the agreement signed between the Ethiopian Government and the National Bank of Egypt
- Its capital was 1 million shillings
- The agreement conferred the bank the power to perform only commercial activities like; selling shares, accepting deposits and effecting payments in cheques and to issue currency notes.
- The agreement prevented the establishment of any other bank in Ethiopia (monopoly right was given to the Bank of Abyssinia only).

cntd

- A year after it's establishment, this bank opened it's branches in Harar, Dire Dawa, Gore and Dembi- Dolo as well as an agency office in Gambela and a transit office in Djibouti.
- It's function was limited to serving foreigners residing in Ethiopia, and holding government accounts.
- it could not attract deposits from Ethiopian nationals due to unfamiliarity of banking services for Ethiopians during that time.
- Latter, Emperor Haile Sellassie, closed the Bank of Abysinia by paying compensation to its shareholders.

cntdchjhsdj

- In 1932, Emperor Haileselasie established an other bank called ‘Bank of Ethiopia”
- This bank was fully owned by Ethiopians.
- It had a capital of 750, 000 pound Sterling.
- The majority shareholders of the Bank of Ethiopia were the Emperor and the political elites of the time.
- The Bank was authorized to combine the functions of central banking (issuing currency notes and coins) and commercial banking
- It opened branches in Dire Dawa, Gore, Dessie, Debre Tabor and Harrar.

- During the Italian occupation, the operation of the Bank of Ethiopia was terminated.
- .after closing this bank, the itallians established their own banks called; Banco Di Roma, Banco Di Napoli and Banca Nazionale del Lavora.
- In 1945 the Agricultural Bank was established but was replaced by the Development Bank of Ethiopia in 1951, which changed in to the Agricultural and Industrial Development Bank in 1970.
- In 1963, the Imperial Savings and Home Ownership Public Association (ISHOPA) and the Investment Bank of Ethiopia were founded.

cntd

- But in 1965 the investment bank was renamed Ethiopian Development Corporation S.C.
- In 1965, the Savings and Mortgage Company of Ethiopia S.C. was also founded
- After the Ethiopia's liberation from Italy, a new bank called "the State Bank of Ethiopia" was established in 1943 with a capital of 1 million Maria Theresa Dollars.
- like its predecessor, this bank had combined the functions of central banking with those of commercial banking activities.
- It opened 21 branches, including one in Khartoum (the Sudan) and a transit office in Djibouti.

cntd

- In 1963, the State Bank of Ethiopia split into two (the National Bank of Ethiopia and the Commercial Bank of Ethiopia) S.C. with the purpose of segregating the functions of central banking from those of commercial banking.
- In 1964, the first private bank was established in Ethiopia called “Addis Ababa Bank S.C”
- In this bank
  - 51% of the shares of the bank were owned by Ethiopian shareholders
  - 9% by foreigners living in Ethiopia and
  - 40% by the National and Grindlays Bank of London

cntd

- Banco Di Roma and Banco Di Napoli also continued to operate until 1974.
- Thus, until the end of 1974, there were state owned, foreign owned and Ethiopian owned banks in Ethiopia.
- Following the 1974 Revolution, on January 1, 1975 all private banks and 13 insurance companies were nationalized and owned by the government.
- The three private banks, Banco Di Roman, Banco Di Napoli and the Addis Ababa Bank S.C. were merged to form “Addis Bank.”
- in 1980, this bank was again merged with the Commercial Bank of Ethiopia

cntd

- In 1976, the Ethiopian Investment and Savings S.C. was merged with the Ethiopian government Saving and Mortgage Company to form the Housing and Savings Bank
- The Agricultural and Industrial Development Bank continued under the same name until 1994 when it was renamed as the Development Bank of Ethiopia.
- Therfore, from 1975 to 1994 there were four state owned banks and one state owned insurance company, i.e., the National Bank of Ethiopia (The Central Bank), the Commercial Bank of Ethiopia, the Housing and Savings Bank, the Development Bank of Ethiopia and the Ethiopian Insurance Corporation.
-

cntd

- After the overthrow of the Dergue regime by the EPRDF, the Transitional Government of Ethiopia was established and the New Economic Policy for the period of transition was issued.
- This new economic policy replaced centrally planned economic system with a market-oriented system and ushered in the private sector
- during the early 1990s, Several private companies were formed and the financial sector was opened for private investors.

1.3 Economic Significance of Banks

- Banks serve as financial intermediaries and provide source of fund for investment that is crucial in increasing production, exports, creation of jobs and foreign exchange earnings of the country.
- banks also use to increase the demand for goods and services by lending money for consumers of those goods and services.
- This again will encourage producers and service providers to expand their undertakings and increase production
- Banks also play a positive role in encouraging savings by providing an incentive to save through payment of interest on deposits/savings and providing safety and security.
- Saving is also an important source of future investment and the improvement of the living standards of the society.

cntd

- The power of the national bank in fixing interest rates is particularly crucial in both investment and saving
- If the rate of interest fixed by the bank on deposits is attractive, it will encourage people to save their money rather than spend it
- However, such interest should not discourage people from investment and productive activities and turn to deposit their money and collect interest
- If the rate of interest charged by banks on money given on loan to borrowers is lower, it may encourage potential borrowers and investors to borrow and invest, thereby contributing their part in the expansion and increase of production of goods and services.

cntd

- The existence of a network of banks covering all parts of a country facilities business transactions in the country by making payments easier, safer and cheaper
- Payment through banks also avoids the risk of loss or theft of money.
- other benefits of banks----------

1.4 Types of Banks

1.4.1 Central or National Banks

- The history of central banks dated back to 1668 with the establishment of bank of Sweden.
- Central banks are operated for the public welfare and not for maximum profit

Functions of central banks

- Use as a fiscal agent of the government
- supervising the operations of the commercial banking system,
- clearing checks,
- administering exchange-control systems,
- serving as correspondents for foreign central banks and official international financial institutions,

1.4.2 The National Bank of Ethiopia

- The National Bank of Ethiopia was created by order No 30/1963
- Later, it was reconstituted by the Monetary and Banking Proclamation No 83/1994 as an autonomous organ, which is engaged in the provision of regular banking services to the government and other banks and insurance companies'
- The main purpose of the bank is to forester monetary stability of financial system and such other credit and exchange conditions as are conducive to the balanced growth of the economy of Ethiopia. Art 6

cntd

- Based on Article 7, The bank will have the following powers and duties
- Mint coin, print and issue legal tender currency.
- Regulate the supply and availability of money and fix the minimum and maximum rates of interest that banks and other financial institutions may charge for different types of loans, advances and other credits and pay on various classes of deposits. (Art 7 and Art 30).
- Implement exchange rate policy, allocate foreign exchange, manage and administer the international reserve fund of Ethiopia. This reserve fund consists of gold, silver, foreign exchange and securities, which are used to pay for imports into the country and pay foreign international debts and other commitments (Art 50).

cntd

- License, supervise and regulate banks, insurance companies and other financial institutions such as savings and credit associations/co-operatives and postal savings.
- Set limits on gold and foreign exchange assets that banks and other financial institutions, which are authorized to deal in foreign exchange, can hold in deposits (Art 39).
- Set limits on the net foreign exchange position and on the terms and the amount of external indebtedness of banks and other financial institutions.
- Make short and long term refinancing facilities available to banks and other financial institutions

cntd

- Accept deposits of any type from foreign sources.
- Act as banker, fiscal agent and financial advisor to the government/Art 24, 25/.
- Promote and encourage the dissemination of banking and insurance services throughout the country.
- Prepare periodic economic studies together with forecasts of the balance of payment, money supply, prices and other statistical indicators of the Ethiopian economy used for analysis and for the formulation and determination by the bank of monetary, savings and exchange policies.

1.4.3 Vision, Mission and Goals of the National Bank of Ethiopia

- The vision, mission and goals of the National Bank of Ethiopia emanated from the overall vision of the government which is

  - *"to see a country, wherein democracy and good governance are prevailed upon the mutual consent and involvement of its people, wherein social justice is reigned, and wherein poverty reduced and income of the citizens reach to a middle economic level".*

cntd

1. Vision of the Bank

- To be one of the strongest and most reputable central banks in Africa

2. Mission of the Bank

- To maintain price and exchange rate stability, to foster a sound financial system and undertake such other functions as are conducive to the economic growth of Ethiopia.
-

3. Values of the Bank

- **the national bank have core, individual and operational values**

_A)_ Core value

- Promoting financial and monetary discipline

_B)_ Individual Values

- Integrity
- Neatness and good appearance
- Punctuality
- Team work spirit

C) Operational Values

- Commitment to Excellence in Service
- Confidentiality
- Continuous Improvement
- Transparency
- Accountability

4. Strategic Goals

- **Goal 1**: Carry out extensive and sound institutional transformation tasks.
- **Goal 2**: Maintain price and exchange rate stability.
- **Goal 3**: Maintain adequate international reserves.
- **Goal 4**: Improve the soundness of the financial system.
- **Goal 5**: Play a decisive role in economic research and policy advice to the Government.
- **Goal 6**: Create an efficient Payment System.
- **Goal 7:** Improve the currency management of the Bank

1.4.2 Commercial Banks

- Commercial banks are banks with the power to make loans for consumers, private business enterprises, governments, and other non-business institutions as well.
- The modern commercial bank also offers a wide variety of additional services to its customers, including savings deposits, safe-deposit boxes, and trust services.
- The Commercial Bank of Ethiopia and all the privately owned banks in Ethiopia fall under this category as they are primarily engaged in receiving money on deposit and providing loans to the public.

1.4.3 Savings Banks

- A savings bank is a financial institution that gathers savings and that pay interest or dividends to savers.
- It channels the savings of individuals who wish to consume less than their incomes to borrowers who wish to spend more
- The savings deposit departments of commercial banks, mutual savings banks or trustee savings banks (banks without capital stock whose earnings accrue solely to the savers), savings and loan associations, credit unions, postal savings systems, and municipal savings banks serve this function.
- This type of specialized banking service is not yet introduced in Ethiopia

1.4.4. Investment Banks

- Investment bank is a firm that originates, underwrites, and distributes new security issues of corporations and government agencies
- The investment-banking house operates by purchasing all of the new security issue from a corporation at one price and selling the issue in smaller units to the investing public at a price sufficiently high to cover expenses of sale and leave a profit
- This type of bank is not introduced in Ethiopia.

1.4.5 Development Banks

- Such banks are established to provide medium and long-term capital for productive investment
- Development banks are supported and encouraged by the International Bank for Reconstruction and Development of countries economy.
- Some of The large regional development banks include the Inter-American Development Bank, established in 1959; the Asian Development Bank, which began operations in 1966; and the African Development Bank, established in 1964.
- the main purpose of development banks is to support and promote private investment

cntd

- Development banks may be publicly or privately owned and operated.
- For privately owned development banks, governments will frequently make substantial contributions to their capital
- The Development Bank of Ethiopia is established with the purpose of providing long-term loans to agricultural and industrial undertakings, which are considered crucial in the development of the economy
- It was intended to serve as the major financer for the various co-operatives and government owned farms and factories
- What is its current status???????

1.4.6 Islamic Banking

- Islamic banking refers to a system of banking activity that is consistent with the Islamic law (Sheria).
- It is guided by principles of Islamic economics that prohibit usury or interest.
- In addition to this, Islamic law also prohibits investing in businesses that are considered unlawful, or harem (such as businesses that sell alcohol or dork or business that produce media such as gossip columns or pornography which are contrary to Islamic values
- In Islamic community Riba is prohibited.
- Riba means, increase or excess.

1.4.6.4 Principles of Islamic Banking

- 1. Any predetermined payment over and above the actual amount of principal for any is prohibited. Islam allows only one kind of loan and that is qard-el hassan (literally good loan), where the lender does not charge any interest or additional amount over the money lent.
- 2. The lender must share in the profits or losses arising out of the enterprise for which the money was lent for the business. Islam encourages Muslims to invest their money and to become partners in order to share profits and risk in the business instead of becoming creditors
- 3. Making money from money is not Islamically acceptable; money is only a medium of exchange, a way of defining the value of a thing it has no value in itself and should not be all owed to give rise to more money through fixed interest payments, simply by being put in a bank or lent to someone else

cntd

4. Gharar (uncertainty risk or speculation) is also prohibited; and any transaction entered into should be free from uncertainty risk and speculation. Contracting parties should have perfect knowledge of the counter values intended to be exchanged as a result of their transactions

5. Investments should only support practice or products that are not forbidden. Trade in alcohol, for example would not be financed by an Islamic bank, a real estate loan could not be made for the construction of a casino and the bank could not lend money to other banks at interest, even if it is profitable.

1.5 Banks and Banking Transactions in Ethiopia.

- The Ethiopian commercial code fails to define “Bank and Banking Transactions”
- Therefore, we have to refer to other laws to define and determine what banks and banking transactions are under the Ethiopian legal system.
- Art 2 (12) of the Monetary and Banking Proclamation No 83/1994 define banking business as in the following way. Banking business means “any operation involving receiving money on deposit, lending money, receiving commercial instruments on deposit, accepting, negotiating/ transferring, discounting commercial instruments and other evidences of debt, and buying and selling of gold and silver notes and foreign exchange”.

Banking business

- Similarly, Art 2 (2) of the Licensing and Supervision of Banking Business Proclamation No 84/1994 defines banking business as:
- "Any business involving acceptance of money on deposit, using such funds or deposits, in whole or in part, for loans or investments on the account of and at the risk of the person undertaking the business, purchasing, selling and deposit of negotiable instruments (shares, bonds and other securities/ and checks, bills and notes, and buying and selling of gold and silver bullions and foreign exchange)".

Bank

- On the other hand, the term bank is defined, under Art 2(1) and (4) of the same proclamation, as a share company whose capital is wholly owned by Ethiopian nationals and/or business organizations wholly owned by Ethiopian nationals and which is registered under Ethiopian laws and which has its head office in Ethiopia and licensed to undertake banking business by the national bank of Ethiopia.
- In addition to this, Art 4(2) of the same proclamation clearly prohibits foreign nationals and business organizations from undertaking banking business in Ethiopia.

1.6. Micro Finance Institutions and their role in Ethiopia.

- In Ethiopia micro finance institutions started very recently
- This institutions are established to serve the poor and rural community in Ethiopia.
- Since the issuance of Proclamation 40/1996, which provides the establishment of microfinance institutions, sixteen microfinance institutions (MFIs) have been legally registered by the National Bank of Ethiopia (NBE) and started delivering services
- Based on Proclamation No. 40/1996, micro finance institutions should be licensed and supervise by the national bank of Ethiopia.

Establishment requirements

- According to article 4 of the Proclamation, any institution that needs to engage in microfinance activity should fulfill the following:
- ✓ obtain license from the National Bank of Ethiopia;
- ✓ formed as a company governed by the commercial code of 1960 (a share company owned fully by Ethiopian nationals and having its head office in Ethiopia);
- ✓ deposit the minimum capital required, i.e., 200,000 Birr in a bank;
- ✓ the directors and other officers meet requirements set by the bank.

cntd

- Furthermore, as to the purpose and duty of micro finance institutions, Article 3 of the same proclamation provides:
  - accepting savings as well as demand and time deposits;
  - drawing and accepting drafts payable within Ethiopia;
  - borrowing money for its business purpose against the security of its assets or otherwise;
  - purchasing such income generating financial instruments as treasury bills;
  - acquiring, maintaining and transferring of any moveable and immovable property including premises for carrying out its business;

cntd

- Providing counseling services to its clients
- encouraging income generating projects for urban and rural micro-operators;
- rendering managerial, marketing, technical and administrative advice to borrowers and assisting them to obtain services in those fields;
- managing funds for micro financing business; and
- engaging in other activities customarily undertaken by micro financing institutions