CHAPTER-THREE

AN OVERVIEW OF BANKS AND THEIR FUNCTION

Introduction

A bank is a financial institution and a financial intermediary that accepts deposits and channels those deposits into lending activities, either directly by loaning or indirectly through capital markets.

A bank may be defined as an institution that accepts deposits, makes loans, pays checks, and provides financial services. A bank is a financial intermediary for the safeguarding, transferring, exchanging, or lending of money. A primary role of banks is connecting those with funds, such as investors and depositors, to those seeking funds, such as individuals or businesses needing loans. A bank is the connection between customers that have capital deficits and customers with capital surpluses.

Banks distribute the medium of exchange. Banking is a business. Banks sell their services to earn money, and they must market and manage those services in a competitive field. Banks are financial intermediaries that safeguard, transfer, exchange, and lend money and like other businesses that must earn a profit to survive. Understanding this fundamental idea helps you to understand how banking systems work, and helps you understand many modern trends in banking and finance.

The services banks offer to customers have to do almost entirely with handling money or finances for other people. Banks are critical to our economy. The primary function of banks is to put their account holders' money to use by lending it out to others who are in need of the same.

Definition of Banking and banker

There are numerous definitions of the words ‘Banking’ and ‘Banker’.

According to Dr. H.C.Hart, “a banker or bank is a person or company carrying on the business of receiving moneys, and collecting drafts, for customers subject to the obligation of honoring checks drawn upon them from time to time by the customers to the extent of the amounts available on their current accounts”.

The above definition tells the features of an institution to be called as a bank or banker. They are: -

(i) **Receiving money and collecting drafts** – this means accepting the money on current accounts and collecting the checks and drafts on behalf of the customer.

(ii) The **obligation of honoring checks** drawn upon them, making payment across the counter on demand by the customer to the extent of money available at the credit of customer's account.

Duties of a Banker

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

(I) Obligation to honour the checks.

(II) Obligation to maintain secrecy of accounts.

I. Obligation to Honour the Checks:

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

"The drawee of a check having sufficient funds of the drawer in his hands properly applicable to the payment of such check, must pay the check. When duly required to do so and in default of such payment must compensate the drawer for any loss or damage caused by such default."

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

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

Sufficient funds means, the funds at least equal to the amount of the check presented. Generally checks sent for collection by the customer are not treated as cash in hands of the banker until the same are realized. Further, the credit balances in other accounts of the customer at other branches need not be taken into account in computing sufficiency of funds for his purpose.

The funds in the hands of the drawee banker must be equal to or more than the amount of the check presented for payment. The banker is directed by the drawer to pay a specified sum of money to the payee, and if such sum is not in the hands of the banker at the time of presentation of the check, the banker is under no obligation to make part payment of the check. If the payee of the check makes a deposit in the account of the drawer to make in such deficiency and then presents the check for payment, the banker will be insisted in making such payment.

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

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

3. The banker must be duly required to pay:

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

II. Obligation to Maintain Secrecy of Accounts

The banker is under an obligation to take utmost care in keeping secrecy about the accounts of his customer. If the facts about customer's account are made known to others the customer's reputation may suffer and he may incur losses also.

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

i) When the law requires such disclosure to be made.

ii) When the practices and usages among the banker permit such disclosure.

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

Disclosure permitted as per law:

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

Disclosure Permitted by the Banker's Practices and Usages:

With express or implied consent of the customer:

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

Disclosure in Public Interest:

If a customer holds an illegal account, which is against the interest of the nation, the banker should disclose the account to proper authorities.

Disclosure in the Interest of the Banks:

The banker in his own interest can disclose the account of the customer. If the customer fails to clear the debt, the banker will approach the guarantor and the guarantor can ask for the disclosure of the borrower's account, which the banker does and he is insisted in doing so. Thus the banker is justified in providing the details about the customer's account.

Rights of a Banker

Banker is having the following rights:

I. Right of general lien

II. Right of set- off

III. Right of appropriation

IV. Right to charge interest, incidental charges, etc.

V. Right under garnishee order

I. Right of General Lien:

Lien means the right of creditor to retain the goods and services owned by the debtor until the debt due from him is repaid. Here the creditor has the right to retain and not to sell. Lien may be either General lien or Particular lien.

A. Particular Lien:

A particular lien can be refers to a particular property which is retained by the lender or creditor against the specific or particular loan. This lien is enjoyed by the persons who have spent their labor on such properties and have not recovered their labor charges or service charges from the debtors. This applies in case of craftsmen, transport operators, various service organizations or individuals, etc. For e.g. a tailor had the right to retain the clothes made by him for his customers until his tailoring charges are paid by the customer. Another illustration, AtoAlmu is transport operator can retain the property sent for transshipment till such time the customer pays his transport charges.

B. General Lien:

A general lien is applicable in respect of all amounts due from the debtor for the creditor. The right of general lien is given to the banker.

Exception to the right of general lien: -

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

1. **Safe custody of valuables: -**

A customer deposits his valuables such as securities, documents, ornaments etc. with the bank. He entrusts them to the banker as a bailee or transferee in order to ensure the safety from theft fire etc., thus the banker cannot exercise his right of general lien over such valuables.

2. Documents deposited for special purpose: -

If a customer sends any document with the specific instruction for utilizing its proceeds for any specific purpose, the right of general lien does not exist. Similarly if a customer hands over some shares to the banker with some instruction to sell them at certain price, and the same are lying unsold with the banker, here also the banker cannot exercise the right of lien. However, if the security comes into the possession of the banker in the ordinary course of business, he can exercise his right of general lien.

3. Securities left with the bank negligently: -

The banker does not possess the right of lien on the documents or valuables left in his possession by the customer by mistake or by negligence.

4. Securities held in trust: -

The banker cannot exercise his right of general lien over the securities deposited by the customer us a trustee in respect of his personal loan.

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

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

(2) Right of Set-Off:

A banker possesses the right of set-off which enables him to combine two accounts in the name of the same customer and to adjust the debit balance in one of with the credit balance in the other. For Example, Mr. Zelalem has taken an overdraft from his bank (Awash Bank) to the extent of Br.10000 and he has a balance of Br.5000 in his saving account. Hence the banker can combine both of these accounts and claim the remaining amount of Br.5000 only. This right of set-off can be exercised by the banker after a notice is served on the customer intimating the decision of the banker of set-off.

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

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

Here the account with the banker must not only be in the same name but also in the same right. "The same right" means that the capacity of the account holder in both the accounts must be the same. Thus the funds belonging to someone else, but standing in the same name of the account holder, should not be made available for satisfy his personal debts. (E.g.) The personal account of the trustee cannot be set-off with the trust account money.

(***2) The right can be exercised in respect of debts due and not in respect of future debts***. For e.g., a banker can set-off a credit balance in the account of an customer towards the payment of a bill which is already due, but in respect of a bill which will mature in future.

(3) The amount of debts must be certain: -

It is essential that the amount of debts due from both the parties to each other must be certain. If liability of anyone of them is not determined exactly, the right of set-off cannot be exercised. For e.g., if Mr. Zelalem is a guarantor for a loan of Br.100,000 given by a bank to Mr. Hungaew, his liability as guarantor will arise only after Mr.Hungaew delays in making payment. The banker cannot set-off the credit balance of the guarantor till his liability as a guarantor is determined.

For this purpose the banker must first demand payment from his debtor. If the debtor defaults in making payment of his debt, only then the liability of the guarantor arises and the banker can exercise his right of set-off against the credit balance in the account of the guarantor.

(4) The right may be exercised in the absence of an agreement to the contrary. If these is an agreement express or implied, the banker cannot exercise the right.

(5) The banker can exercise the right for the purpose of exercising this ***right of all the branches of a bank constitute one entity and the bank can combine two or more accounts in the name of the same customer at more than one branch.***

(6) ***The banker has the right to exercise this right before his garnishee order is made effective.*** In case a banker receiving a garnishee order in respect of the funds belonging for his customer, he has the right first to exercise his right of set-off & thereafter to surrender only the remainder amount to the judgment creditor.

(3) Right of Appropriation:

In course of his business a banker receives payments from his customer. If the customer has more than one account or has taken more than one loan from the banker, the question of appropriation of the money subsequently deposited by him naturally arises.

(4) Right to Charge Interest and Incidental Charge

Normally the banker has no right to charge interest on loans sanctioned; however there has been a universal custom to make such charge. To strengthen this implicit right, it is usual for the banker now to have an express agreement to the effect. Likewise the banker has an implied authority to recover from the customer "incidental charges" in respect of current accounts. Some of the current accounts may mean more of botheration and expense to the banker than what he would be earning by maintaining them. The practice of charging commission on such accounts has become so general. The interest and commission may be paid in cash, or else debited to the customer's account.

(5)Right under garnishee order:-

The obligation of a banker to honor his customer's cheques is extinguished on receipt of an order of the court, known as the garnishee order. The term 'garnishee' is derived from Latin word 'garnire' it means to warn.

This order warns the holder of money of judgment debtor not to make any payment out of it till the court directs. Garnishee order is issued by the court at the request of the judgment creditor. For example, W/t Slam is contractor and obtains a loan from Ato Sabir. W/t Slam fails to pay the money toAtoSabir as per the stipulation. AtoSabir files a suit in the court of law for dues. AtoSabir also knows that money is due to W/t Slam from a bank. He can request the court to issue an order directing the banker not to make any payment to W/t Slam.

Types of Banks

Based on the nature of the banking business Banks can be classified in to seven. such as:

A. Central Banks

In terms of banks, the central bank is the head honcho. Central banks manage the money supply in a single country or a series of nations. They supervise commercial banks, set interest rates and control the flow of currency.

Central banks also implement a government's monetary policy goals, whether that involves combating deflation or keeping prices from fluctuating. If necessary, they can lend money in rough economic times to keep the monetary system from collapsing. In the Unites States, the Federal Reserve System is the central bank.

B. Commercial Banks

Although there are some types of commercial banks that help everyday consumers, commercial banks tend to concentrate on supporting businesses. Both large corporations and small businesses can turn to commercial banks if they need to open a checking or savings account, borrow money, get access to credit or transfer funds to companies in foreign markets.

C. Retail Banks

When you picture a bank, a retail bank probably comes to mind. Retail banks offer members of the general public financial products and services such as bank accounts, loans, credit cards and insurance. In some cases, they can set up checking accounts and make loans for small-scale businesses as well.

Retail banks can be traditional, brick-and-mortar brands that customers can access in-person, online or through their mobile phones. Others only make their tools and accounts available online or through

D. Shadow Banks

The shadow banking system consists of financial groups that aren't bound by the same strict rules and regulations that other banks have to comply with. Much like the standard regulated banks, shadow banks deal with credit and different kinds of assets. But they get their funding by borrowing it, connecting with investors or making their own funds instead of using money issued by the central bank.

Money market funds and hedge funds are two kinds of shadow banks. More recently, they've been a source of controversy for quite a few people. Many folks blame the less-regulated shadow banking industry for playing a role in the mortgage crisis leading up to the Great Recession.

E. Investment Banks

Investment banks like Morgan Stanley and Goldman Sachs have many responsibilities. On one hand, they manage the trading of stocks, bonds and other securities between companies and investors. On the other hand, they might focus their energy on advising individuals and corporations who need financial guidance, reorganizing companies through mergers and acquisitions, managing investment portfolios or raising money for certain businesses and the federal government.

F. Cooperative Banks

Cooperatives can be either retail banks or commercial banks. What distinguishes them from other entities in the financial system is the fact that they're typically local or community-based associations whose members help determine how the business is operated. They're run democratically and they offer loans and banks accounts, among other things. They're popular in countries throughout the world and in the U.S. they usually take the form of credit unions

Functions of bank

A. Principal Functions

(i) Receipts of various types of deposits viz., fixed, current and savings deposits.

(ii) Granting of credit to customers with or without security, in any one of the following ways;

(a) By discounting bills and promissory notes

(b) By granting of loans, overdrafts and cash credits

(c) By lending money to the call market

(iii) Providing remittances of funds through demand drafts, transfers etc.,

(iv) Accepting and endorsing bills on behalf of customers and

(v) Issuing of bank notes, a function which is the exclusive privilege of the central bank in many of the countries in the world.

B. Subsidiary Functions

(i) Buying and selling of securities

(ii) Executing standing instructions of customers relating to periodical payments such as club subscription, LIC premiums, professional membership fee, etc.,

(iii) Collecting interest and dividend on securities

(iv) Payment of bills domiciled with the bankers

(v) Safe custody of valuables of customers

(vi) Acting as executors and trustees and

(vii) Issuing different types of letter of credit

Banking issues in 21stcentury

There's a powerful combination of pressures at work in the banking industry – some of which challenge the very core of banking business: information and delivery. Aside from the global political, economic and regulatory landscape, it is the emergence of digital technology that has been the major disruptor to business as usual and long term strategic planning.

Banking in the 21st century brings a whole new set of challenges and opportunities. Voracious consumer appetites for omni-channel transactions, high expectation around customer experience, and low levels of patience and brand loyalty have put most banks on the back foot. The vast majority are playing catch-up with their customers today, let alone anticipating the needs of future customers. In a recent report, Forrester research underscores that banks grasp the digital transformation imperative but it's the complex, inflexible and decades-old application landscape elements that make the current state of digital banking is less than perfect.

That's why we wanted to outline what we consider to be the four essentials every banking institution should consider when thinking about how they address 21st Century customer requirements.

- **The first is convenience.** Sounds simple enough but you'd be surprised how many banks think about what their systems are capable of doing as their starting point, rather than understanding what their customers actually want. Banking services need to work around the consumer's busy life – not the other way around. That means looking at what customers want to achieve from their perspective. Those that can't be flexible in adapting their services to suit consumer convenience, risk jeopardizing long term success and sacrificing market share. It is that serious.
- **The second consideration is relevance.** The goal posts of customer engagement moved several years ago. Communication must be personalized and relevant to the context of the customer. Consumers expect their banks to know them as individual customers, with awareness of their requirements and even anticipating their future requirements. This involves the need to switch to real-time banking with maximized self-service that's underpinned with personalized, tailored advice when needed.
- **The third essential is responsiveness.** This is probably one of the biggest hurdles banks face because they're typically working with disparate systems in a silo branch network. Many internal processes simply don't reflect current business need – which means they must change. But it's not just the systems that need to adapt. People must as well. There must be a consistency of message and service delivery, along with being empowered to do so. Employees need access to all of the latest and most relevant data if they are to respond accordingly. I think we'll see much tighter integration on this front moving forward as sales and customer service continue to converge.
- **The fourth and final essential is reliability.** In an increasingly fragmented industry sector (think disintermediation from the likes of Face book, Apple and PayPal chasing the mobile wallet share), banks simply cannot afford to have an unreliable reputation. Recent research from The Economist Intelligence Unit found that consumers expect the same quality of experience as big Internet companies provide. Reliability is at the very core of quality experience.