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Banking Law

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MEANING OF BANKING

Banking includes a wide variety of financial institutions that store the money of individuals, businesses and other entities. Banks provide financial services that help people save, manage and invest their money.

DEFINITION - BANKING "Banking is the business of accepting for the purpose of lending or investment, of deposits of money from the public repayable on demand or otherwise and withdrawable by cheque, draft, and order or otherwise." Indian Banking Regulation Act, 1949. The term "bank" can refer to many different types of financial institutions — including bank and trust companies, savings and loan associations, credit unions or any other type of institution that accepts deposits.

BANKER AND CUSTOMER RELATIONSHIP General Relationship Debtor and creditor relationship: When the banker accepts deposits from the customer then the bank becomes the debtor and the customer is the creditor. If a customer takes loans from a bank, then the customer becomes a debtor and the banks becomes a creditor. Pledger and Pledgee relationship: when customer pledges (promises) certain assets or security with the bank in order to get a loan. In this case, the customer becomes the Pledger, and the bank becomes the Pledgee.

Relationship of Trustee and Beneficiary: -

A trustee holds property for the beneficiary, and the profit earned from this property belongs to the beneficiary. If the customer deposits securities or valuables with the banker for safe custody, the banker becomes a trustee of his customer. The customer is the beneficiary so the ownership remains with the customer.

Relationship of Bailor and Bailee: The relationship between banker and customer can be that of Bailor and Bailee. A bailment is a contract for delivering goods by one party to another to be held in trust for a specific period and returned when the purpose is ended. Bailor is the party that delivers property to another. Bailee is the party to whom the property is delivered. So, when a customer gives a sealed box to the bank for safekeeping, the customer became the bailor, and the bank became the bailee.

Relationship of Advisor and Client:-

When a customer invests in securities, the banker acts as an advisor. The advice can be given officially or unofficially. While giving advice the banker has to take maximum care and caution. Here, the banker is an Advisor, and the customer is a Client.

Relationship of Agent and Principal:- The banker acts as an agent of the customer (principal) by providing the following agency services: Buying and selling securities on his behalf, Collection of cheques, dividends, bills or promissory notes on his behalf.

LAW OF BANKING

A bank must always have cash balances on hand in order to pay its depositors upon demand or when the amounts credited to them become due. It must also keep a proportion of its assets in forms that can readily be converted into cash. Only in this way can confidence in the banking system be maintained. Provided it honors its promises (e.g., to provide cash in exchange for deposit balances), a bank can create credit for use by its customers by issuing additional notes or by making new loans, which in their turn become new deposits. The amount of credit it extends may considerably exceed the sums available to it in cash. However, a bank is able to do this only as long as the public believes the bank can and will honor its obligations, which are then accepted at face value and circulate as money. So long as they remain outstanding, these promises or obligations constitute claims against that bank and can be transferred by means of checks or other negotiable instruments from one party to another. These are the essentials of deposit banking as practiced throughout the world today, with the partial exception of socialist type institutions.

The Development of Banking Systems:

General Overview

Development of Banking: General Overview

Banking is of ancient origin, though little is known about it prior to the 13th century. Many of the early ―banks‖ dealt primarily in coin and bullion, much of their business being money changing and the supplying of foreign and domestic coin of the correct weight and fineness. Another important early group of banking institutions was the merchant bankers, who dealt both in goods and in bills of exchange, providing for the remittance of money and payment of accounts at a distance but without shipping actual coin. Their business arose from the fact that many of these merchants traded internationally and held assets at different points along trade routes. For a certain consideration, a merchant stood prepared to accept instructions to pay money to a named party through one of his agents elsewhere; the amount of the bill of exchange would be debited by his agent to the account of the merchant banker, who would also hope to make an additional profit from exchanging one currency against another. Because there was a possibility of loss, any profit or gain was not subject to the medieval ban on usury. There were, moreover, techniques for concealing a loan by making foreign exchange available at a distance but deferring payment for it so that the interest charged could be camouflaged as a fluctuation in the exchange rate.

The Birth and Development of Banking Services in Ethiopia

It was in 1905 that the first bank, the ―Bank of Abyssinia‖, was established based on the agreement signed between the Ethiopian Government and the National Bank of Egypt, which was owned by the British. Its capital was 1 million shillings. According to the agreement, the bank was allowed to engage in commercial banking (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, thus giving monopoly right to the Bank of Abyssinia. The Bank, which started operation a year after its establishment agreement was signed, opened branches in Harar, Dire Dawa, Gore and Dembi- Dolo as well as an agency office in Gambela and a transit office in Djibouti. Apart from serving foreigners residing in Ethiopia, and holding government accounts, it could not attract deposits from Ethiopian nationals who were not familiar with banking services. The Ethiopian Government, under Emperor Haile Sellassie, closed the Bank of Abysinia, paid compensation to its shareholders and established the Bank of Ethiopia which was fully owned by Ethiopians, with a capital of pound Sterling 750,000. The Bank started operation in 1932. 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. The Bank of Ethiopia opened branches in Dire Dawa, Gore, Dessie, Debre Tabor and Harrar. With the Italian occupation (1936-1941), the operation of the

Bank of Ethiopia came to a halt, but a number of Italian financial institutions were working in the country. These were Banco Di Roma, Banco Di Napoli and Banca Nazionale del Lavora. It should also be mentioned that Barclays Bank had opened a branch and operated in Ethiopia during 194243. In 1946 Banque Del Indochine was opened and functioned until 1963. 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. The later was renamed Ethiopian Development Corporation S.C. in 1965. In the same year, the Savings and Mortgage Company of Ethiopia S.C. was also founded. With the departure of the Italians and the restoration of Emperor Haile Selassie‘s government the State Bank of Ethiopia was established in 1943 with a capital of 1 million Maria Theresa Dollars by a charter published as General Notice No. 18/1993 (E.C). The Bank which, like its predecessor, combined the functions of central banking with those of commercial banking opened 21 branches, including one in Khartoum (the Sudan) and a transit office in Djibouti. In 1963, the State Bank of Ethiopia split into 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. The new banks started operation in 1964. The first privately owned company in banking business was the Addis Ababa Bank S.C., established in 1964. 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. The Bank carried our typical commercial banking business. Banco Di Roma and Banco Di Napoli also continued to operate. Thus, until the end of 1974, there were state owned, foreign owned and Ethiopian owned banks in Ethiopia. The banks were established for different purposes: central banking, commercial banking, development banking and investment banking. Such diversification of functions, lack of widespread banking habit among the wider population, the uneven and thinly spread branch network, and the asymmetrical capacity of banks, made the issue of completion among banks almost irrelevant. Thus, 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. 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. Several private companies were formed during the early 1990s, one of which is Oda

S.C. which conceived the idea of establishing a private bank and private insurance company in anticipation of a law which will open up the financial sector to private investors.

Economic Significance of Banks

The existence of a strong and effective banking system is very important for the economic development of a country. Banks through acceptance of deposit of money from persons who do not need it at the present and lending it to persons who want it for investment, serve as financial intermediaries thereby providing ideal source of fund for investment that is crucial in increasing production, exports, creation of jobs and foreign exchange earnings of the country. Similarly bank lending to customers who need the money for consummation, purchase of various goods and services, construction of houses, and education increases demand for those goods and services, thereby encouraging producers and service providers to expand their undertakings and increase production. Expansion and increase in production requires employment of additional workers, thereby creating new jobs, encourage producers and suppliers of raw materials to increase their production and supply.

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. 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 /i.e. the interest banks pay on money deposited on saving and other accounts / 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 them to rent collection /potential investors may decide 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, creation of employment opportunities, increase in exports and foreign exchange earnings of the country. 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.

National Bank

Central Banks: General Overview It refers to an institution, such as the Bank of England, the U.S. Federal Reserve System, the Bank of France, or the Bank of Japan, that is entrusted with the power of regulating the size of a nation‘s money supply, the availability and cost of credit, and the foreign-exchange value of its currency. Regulation of the availability and cost of credit may be nonselective or may be designed to influence the distribution of credit among competing uses. The principal objectives of a modern central bank in carrying out these functions are to maintain monetary and credit conditions conducive to a high level of employment and production, a reasonably stable level of domestic prices, and an adequate level of international reserves. Central banks also have other important functions, of a less-general nature. These typically include acting as 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, and, in the case of central banks of the major industrial nations, participating in cooperative international currency arrangements designed to help stabilize or regulate the foreign-exchange rates of the participating countries.

The National Bank of Ethiopia

The National Bank of Ethiopia was created by order No 30/1963 and 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 financial system and such other credit and exchange conditions as are conducive to the balanced growth of the economy of Ethiopia. / Art 6/ The bank will have the following powers and duties that will help it to achieve its purpose, /Art 7/ - 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).

Commercial Banks

Commercial banks are banks with the power to make loans that, at least in part, eventually become new demand deposits. Because a commercial bank is required to hold only a fraction of its deposits as reserves, it can use some of the money on deposit to extend loans. When a borrower receives a loan, his checking account is credited with the amount of the loan; total demand deposits are thus increased until the loan is repaid. As a group, then, commercial banks are able to expand or contract the money supply by creating new demand deposits. The name commercial bank was first used to indicate that the loans extended were short-term loans to businesses, though loans later were extended to consumers, governments, and other nonbusiness institutions as well. In general, the assets of commercial banks tend to be liquid and carry less risk than the assets held by other financial intermediaries. 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.

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. The major responsibility for setting the public offering price rests on the investment bank because it is in close contact with the market, is familiar with current interest rates and yields, and is best able to judge the probable demand for the issue in question. In the underwriting and distribution of most security issues, a syndicate of investment banking firms is organized. If the amount of capital sought is large enough to prohibit one investment banking firm's undertaking the risk of purchasing the entire issue, the investment bank that initiates the issue with the corporation organizes a group of investment bankers to divide the liability for the purchase, with the originator acting as manager of the group. If the market coverage that can be obtained by the members of the syndicate is deemed insufficient, selected dealers are used to bring about a wider distribution. Securities are sold to the dealers at a reduction (known as a concession), which reimburses the dealer for his expenses and provides him with a profit if the distribution is performed skillfully. When new securities are to be issued, an investment firm having close contact with the corporation is likely

to be asked to originate the issue. This process often is called private negotiation. An alternative arrangement is competitive bidding, under which the corporation itself settles upon the terms of the issue to be offered and then invites all banking firms to submit bids. The issue will be sold to the highest bidder.

Development Banks

It refers to a national or regional financial institution designed to provide medium- and long-term capital for productive investment, often accompanied by technical assistance, in less-developed areas. The number of development banks has increased rapidly since the 1950s; they have been encouraged by the International Bank for Reconstruction and Development and its affiliates. 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. They may make loans for specific national or regional.

Central Banks

The reserves of the commercial banks, which are continually being redistributed through the facilities of the money market, are in fact mainly deposit balances that these commercial banks have on the books of the central bank or notes issued by the central bank, which the commercial banks keep in their own vaults. As the central bank acquires additional assets, it pays for them by crediting depositors' accounts or by issuing its own notes; thus the potential volume of commercial bank reserves is enlarged. With more reserves, the commercial banks can make additional loans or investments, paying for them by entering credits to depositors' accounts on their books. And in that way the money supply is increased. It may be reduced by reversing the sequence. The central bank can sell some of its marketable assets in the money market or in markets closely interrelated with the money market; payment will be made by drawing down some of the commercial bank reserve balances on its books; and with smaller reserves remaining, the commercial banks will have to sell or reduce some of their investments or their loans. That, in turn, results in shrinkage of the outstanding money supply. Central bank operations of this kind are called open-market operations.

Responsibilities of Central Banks

The principles of central banking grew up in response to the recurrent British financial crises of the 19th century and were later adopted in other countries. Modern market economies are subject to frequent fluctuations in output and employment. Although the causes of these fluctuations are various, there is general agreement that the ability of banks to create new money may exacerbate them. Although an individual bank may be cautious enough in maintaining its own liquidity position, the expansion or contraction of the money supply to which it contributes may be excessive. This raises the need for a disinterested outside authority able to view economic and financial developments objectively and to exert some measure of control over the activities of the banks. A central bank should also be capable of acting to offset forces originating outside the economy, although this is much more difficult.

Relations with Commercial Banks One source of economic instability is the supply of money. Even in relatively well-controlled banking systems, banks have sometimes expanded credit to such an extent that inflationary pressures developed. Such an overexpansion in bank lending would be followed almost inevitably by a period of undue caution in the making of loans. Frequently the turning point was associated with a financial crisis, and bank failures were not uncommon. Even today, failures occur from time to time. Such crises in the past often threatened the existence of financial institutions that were essentially sound, and the authorities sometimes intervened to prevent complete collapse. The willingness of a central bank to offer support to the commercial banks and other financial institutions in time of crisis was greatly encouraged by the gradual disappearance of weaker institutions and a general improvement in bank management. The dangers of excessive lending came to be more fully appreciated, and the banks also became more experienced in the evaluation of risks. In some cases, the central bank itself has gone out of its way to educate commercial banks in the canons of sound finance. In the United States, the Federal Reserve System examines the books of the commercial banks and carries on a range of frankly educational activities. In other countries, such as India and Pakistan, central banks have also set up departments to maintain a regular scrutiny of commercial bank operations.

The Central Bank and the National Economy 1.6.2.1 Relations with Other Countries Since no modern economy is self-contained, central banks must give considerable attention to trading and financial relationships with other countries. If goods are bought abroad, there is a demand for foreign currency to pay for them.

Alternatively, if goods are sold abroad, foreign currency is acquired that the seller ordinarily wishes to convert into the home currency. These two sets of transactions usually pass through the banking system, but there is no necessary reason why, over the short period, they should balance. Sometimes there is a surplus of purchases and sometimes a surplus of sales. Short-period disequilibrium is not likely to matter very much, but it is rather important that there be a tendency to balance over a longer period, since it is difficult for a country to continue indefinitely as a permanent borrower or to continue building up a command over goods and services that it does not exercise

Banks and Banking Transactions in Ethiopia Book IV Title III of the Commercial Code of Ethiopia which deals with banking transactions fails to provide a definition of a bank and banking transactions though the latter may be gathered from the various sections governing the various types of transactions undertaken by banks. Therefore, we have to refer to other laws to define and determine what banks and banking transactions are under the Ethiopian legal system.

According to Art 2 (12) of the Monetary and Banking Proclamation No 83/1994, 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. 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).

Role of Micro Finance Institutions According to the preamble of Proclamation No. 40/1996, the monetary and banking laws in force do not provide for micro financing institutions catering for the credit needs of peasant farmers and others engaged in small scale production and service activities. So it has become necessary to legislate on the licensing and supervision of the business of micro financing institutions. So the development of microfinance in Ethiopia should be viewed as (a) an identification of considerable levels of unrealized demand and potential market growth for

financial services and (b) a shift by the NGO sector and government from relief assistance to sustainable development which intersects at the point of institutionalization of microfinance provision (Fiona, 1999). Although the development of microfinance institutions in Ethiopia started very recently, the industry has shown a remarkable growth in terms of outreach particularly in number of clients. 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, and two more applications by new MFIs are currently being processed.

The Regulatory Framework for the Microfinance Industry and Micro and Small Enterprises

The delivery of efficient and effective microfinance services to the poor required conducive macroeconomic policies and the establishment and enforcement of legal and regulatory frameworks of a country. An effective financial system provides the foundation for a successful poverty alleviation program. However, regulations in the microfinance industry do not only mean government regulations; it also involves self-regulations and code of conducts introduced by networks or associations.

According to article 4 of the Proclamation, any institution that needs to engage in microfinance activity should fulfill the following

i. obtain license from the National Bank of Ethiopia; ii. 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); iii. deposit the minimum capital required, i.e., 200,000 Birr in a bank; iv. the directors and other officers meet requirements set by the bank. Furthermore, as to the purpose and duty of macro finance institutions, article 3 of the same proclamation provides: 1. the purpose of micro financing institutions is granting credit, in cash or in kind, the maximum amount of which shall be determined by the bank. 2. subject to conditions set under this Proclamation, a micro finance institution may carry out some or all of the following activities: a. accepting savings as well as demand and time deposits; drawing and accepting drafts payable within Ethiopia; c. borrowing money for its business purpose against the security of its assets or otherwise; d. purchasing such income generating financial instruments as treasury bills; e. acquiring,

maintaining and transferring of any moveable and immovable property including premises for carrying out its business; f. providing counseling services to its clients; g. encouraging income generating projects for urban and rural microoperators; h. rendering managerial, marketing, technical and administrative advice to borrowers and assisting them to obtain services in those fields;

To realize the above pruposes and duties, the National Bank of Ethiopia has also issued 12 directives, which have been consistent with Proclamation No. 40/1996. These included setting a loan ceiling of 5,000 Birr and loan duration of one year. The interest rate has been waived and MFIs are now free to set their own interest rates ceiling. There is also a requirement for reregistration once an MFI mobilizes deposits greater than one million Birr. The regulatory framework has affected the welfare-oriented NGOs in Ethiopia which focus on welfare programs by providing free or subsidized micro-credit services. They tend to provide credit services at very low interest rate (below market interest rate) focusing on the poorest of the poor (based on humanitarian reasons) rather than on sound credit management principles. As a result, many of the NGOs, providing micro-credit services in Ethiopia, are in a transition from highly subsidized credit programs to a finance based system. Although the initial reactions of the NGOs in Ethiopia to the implementation of the regulatory framework (Proclamation No. 40/96) were negative, they have now realized that the regulatory framework has institutionalized and unified microfinance services in the country.