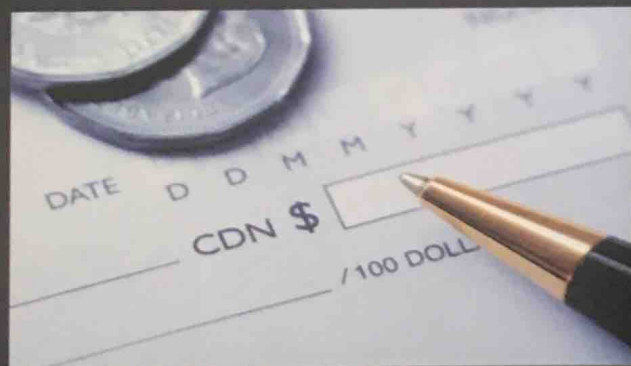


**NEW
PAPER
PATTERN**

MODERN BANKING

FOR XII COMMERCE



MOHAMMED AMIN KHALID
MBA (IBA)

**NEW
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MODERN BANKING

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MOHAMMED AMIN KHALID
MBA (IBA)

Erstwhile Controller of Examinations
Board of Intermediate Education, Karachi

SYLLABUS - 2007

PRINCIPLES OF COMMERCE (BANKING)

PAPER - II

1. INTRODUCTION

Origin and development of Banking, Definition of Bank.

2. KINDS OF BANK

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3. COMMERCIAL BANKS

i) Scheduled and non-scheduled Banks.
ii) Functions, Importance and services performed by a modern commercial Bank.

4. KINDS OF BANK ACCOUNT

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iv) PLS v) Operation of above accounts (Practical Demonstration)

5. CREDIT INSTRUMENTS**Cheques:**

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Bill of Exchange:

Definition, Inland and foreign Bill, Parties in a Bill of Exchange, Discounting and Dishonour of Bills of Exchange.

- Promissory Note.
- Letter of Credit
- Pay Order
- Bank Draft
- Credit Card.
- Endorsement: Concept, Types of Endorsement.

6. BANK ADVANCES

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PREAMBLE

It will be extremely appreciated by teachers and students that the Board Intermediate Education, Karachi has introduced a new syllabus of Banking devised for intermediate students effective from 2007 – 2008. This book has been designed completely in accordance with the new syllabus.

Modern banking and monetary systems have turned into an essential pillar of the present economic system. Whether it is market economy or controlled one, if the banking system is excluded the economic system will collapse. Production, trade, import, export, issuance of currency, credit transactions or whatever business activity all are dependent on banking. The importance of banking can be assessed from the existence of International Monetary Fund, World Bank and International Finance Corporation which control the world banking and economic system. In fact, the IMF is assuming the status of world central bank.

In Pakistan the importance of banking has been well-recognized and the banking sector, since the inception of State Bank of Pakistan in 1948, has been faring extremely well. The Institute of Business Administration is offering MBA in banking and Pakistan Banking Council offers course for bankers that lead to their career in banking. Having studied this book under any course program you too can go a long way in adopting a banking career.

This book on banking has been made different in that it gives you latest data on national and international financial institutions including World Bank, IMF, PICIC, ICP, IDBP, NIT and ADBP. It also entails sufficient information on SDR. In addition, some misconceptions have been removed. For instance, when bill of exchange is dishonoured noting and protesting are registered. The protest used here does not mean an objection as suggested in many books. It is rather an affirmation of the claim by the Notary Public. For the first time in a textbook on banking specimens of noting and protesting are being included here. Likewise judicious utilization, one of the principles of employing bank funds, is misunderstood as legal utilization although it refers to prudent utilization. These concepts have been clarified in this book.

To make this book more useful some additional topics, that a banking student must know, have been added. Special Drawing Rights (SDR), a new international currency ; credit management; Federal Funds Purchased; and Euro dollars, have been discussed briefly. Latest balance sheets and profit and loss accounts of the State Bank of Pakistan along with its organization chart has been added.

Every topic discussed in the book is in simple language in optimum size enabling students to prepare well for their exams.

I am thankful to my son, Mr. Ahmed Waheed Khalid who rendered his untiring and devoted services in the completion of this book. Composing, proofreading, publishing and production of this book go to his credit.

I invite students, teachers, and other readers to send their comments and suggestions to improve the book.

Mohammed Amin Khalid

Chapter 1

ORIGIN OF BANKING

Origin

Definition

Examination Questions

CHAPTER 1

BANKING

Evolution/ Origin of Banking

Mankind has always been seeking security and protection. This need has led him to scientific and technological development on one hand, and banking development on the other. In modern times the banking has become so necessary that if it is excluded from any economic system the whole business and economic world will collapse like house of cards.

Man has always found himself in the pursuit of safety and convenience. If we dig into the history we will come to know that his persistent effort to achieve these two targets brought him blessings in the form of not only evolution and later revolution in science and technology but also in the banking field. Today banking has assumed that high importance, you just withdraw and exclude it the whole economic and financial structure will collapse.

In the days gone by when man started saving money he felt himself unsecured. First he buried his savings underground. But this practice did not last long for its shortcomings. Consequently, he resorted to deposit his savings with the strong and robust persons for safekeeping who hired armed guards on wages. These trustees charged fee from depositors to earn livelihood and finance the expenditure on armed guards.

This practice turned into widely accepted business, which gave rise to the idea to lend the deposited money. Thus the innovator trustees earned income from two ends, from depositors and from borrowers. The reinforced business, in turn, attracted severe competition that led the idea to dropping the receiving of the fee from depositors. The new scheme proved a blessing in disguise because it, then, attracted even more business and brought the trustee new dimensions of profit, and thus modern banking started. In this banking development the services of three groups of persons cannot be ignored:

1. Money lenders

2. Merchants
3. Gold smiths

The Bank of Venice is perhaps the first ever regular bank in the banking history and was established in 1157 followed by these banks as under:

- Bank of Barcelona in 1401
- Bank of Genoa (Italy) in 1407
- Bank of Amsterdam in 1609

Banking History of England

During the era of King Charles James II (1660-1685), the Whigs, a political group in Great Britain identified with industrialists. Non conformists and reforming interests, which later become Liberal Party under Gladstone, established a finance company that carried out banking business. The King Charles, compelled by economic distress, seized its all assets including gold and silver. Consequently, the group established another bank named, Bank of England in 1694 to financially help bail out King Charles III (1689-1702).

Later, it became the central bank of England, and in 1946 it was nationalized. The bank has played tremendous role in the development of the modern banking.

In mid-twenties a great many banks were formed in the U.K. which were merged into four big banks, popularly called Big Four. They are:

- Lloyd Bank
- Barclays Bank
- Midland Bank
- National Bank
- National Westminster Bank

In addition to the Big Four, the U.K. had smaller banks.
 Royal Bank of Scotland
 National Giro Bank
 Trustee Savings Bank

Banking History of the USA

In the U.S. in 1791 Alexander Hamilton founded Bank of United States that was wound up in 1811. The bank was revived in 1816 only for 20 years.

According to a survey, there were fifteen thousand commercial banks working in the US, of which around ten thousand were state banks functioning under their respective state laws. In America, provinces are called states. The remaining five thousand banks were working under the federal government law, and are referred to as national banks.

Banking History of India

The first bank in the Indo-Pak subcontinent came into existence in 1809. Its name was Bank of Bengal. It was followed by a bank in Madras in 1840, and one in Bombay in 1863. Imperial Bank was formed in 1921. In 1935 Reserve Bank of India was established as a central bank. Habib Bank in Bombay in 1941 and Muslim Commercial Bank in Calcutta in 1947 were founded.

Banking History of Pakistan

In Pakistan, banking sector was created with the setting up of the Habib Bank in 1947 which was shifted to Karachi from Bombay, and Muslim Commercial Bank in 1948 from Calcutta to Chittagong. After partition of the subcontinent Reserve Bank of India assumed the responsibility of performing central banking functions in Pakistan. Subsequently, the functions were taken over by the State Bank of Pakistan which was organized in July, 1948. Its one of the main feats was the rescue of the Bank of Bhawalpur which had gone on the brink of bankruptcy. The salvage by the State Bank wrote a glittering history of banking stability in Pakistan.

In July, 1974 all commercial banks were nationalized, and in August, 1991 their privatization started. In the late 80s private sector banking was allowed.

Definitions

According to **KINLEY**:

“An establishment which makes to individuals such advances of money, or other means of payment, as may be required and safely made and to which individuals entrust money or the means of payment when not required for use by them”.

Dr. Herbert L. Hart defines bank as:

"A banker is one who in the ordinary course of business honors cheques drawn upon him by persons for whom he receives money on current account."

Hartley Withers defines it as:

"A manufacturer of credit and a machine for facilitating exchanges".

According to *Crowther*:

"The present day banker has three ancestors: merchant, money-lender, and goldsmith. A modern bank is something of each of these".

Exercises

MULTIPLE CHOICE QUESTIONS (MCQs)

1. The first bank in the Indian sub-continent was
 - A. Bank of Bengal
 - B. Bank of India
 - C. Imperial Bank
 - D. National Bank
2. Initially banks were established for
 - A. Multiplying money
 - B. Spending
 - C. Security
 - D. Replacing barter system
3. Credit for banking development goes to
 - A. Money lender
 - B. Goldsmiths
 - C. Merchants
 - D. All of the above
4. A bank is the manufacturer of
 - A. Accounting system
 - B. Industries
 - C. Trade
 - D. Credit

5. The first bank established in Pakistan was
A. National Bank
B. State Bank
C. Habib Bank
D. Muslim Commercial Bank
6. State Bank of Pakistan came into being in
A. 1947
B. 1948
C. 1949
D. 1950
7. Banks were nationalized in Pakistan in
A. July, 1974
B. March, 1974
C. November, 1973
D. January, 1972
8. Bank's privatization process started in
A. 1980
B. 1985
C. 1995
D. 1991
9. In 1947 Pakistan's banking system was run by
A. State Bank of Pakistan
B. Reserve Bank of India
C. Habib Bank
D. Bank of England
10. In the banking history the first ever regular bank is
A. Bank of England
B. Bank of India
C. Bank of venice
D. Bank of Barcelona

ANSWER KEY

1	a	2	c	3	d	4	d	5	c
6	b	7	a	8	d	9	b	10	c

SHORT QUESTION

1. Define banking.
2. Give two definitions of a bank.
3. Briefly describe the origin of bank.

DESCRIPTIVE QUESTION

1. Describe the background and evaluation of banking.
2. Define a bank as given by various economists and bankers.

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Chapter 2

BANKING SYSTEM & KINDS

Kinds of Banks By Functions

Central Bank – Industrial Bank – Commercial Bank –
Exchange Bank – Agricultural Bank – Savings Bank –
Mortgage Bank.

Kinds of Banks By Ownership

Private Bank – Public Bank – Nationalized Bank –
Partnership Bank – Statutory Bank – Chartered Bank –
Cooperative Bank.

Administrative Organization / Department

Human Resources Department – Legal Department –
Public Relations Department – Security Department.

CHAPTER 2

BANKING SYSTEM AND KINDS

KINDS OF BANKS BY FUNCTIONS

Bank is an institution that deals in money. In general, it receives deposits and advance loans.

By functions banks can be classified into the following categories:

1. Commercial bank
2. Central bank
3. Industrial bank
4. Agricultural bank
5. Savings bank
6. Exchange bank
7. Mortgage bank

Commercial Bank

Commercial bank receives deposits and advance loans to promote business and commerce. Their important functions include making payment against cheques, advancing loans and overdrafts, issuing letters of credit, discounting bills of exchange, transferring of money (by TT, bank drafts, pay orders).

Businessmen and salaried persons are provided the facility of operating bank accounts. They settle their accounts by issuing cheques. The bank not only facilitates trade but also helps agriculturists to some extent. Those commercial banks who become the member of the central bank are known as scheduled banks. The following are the famous commercial banks in Pakistan:

United Bank, Habib Bank, Muslim Commercial Bank, National Bank of Pakistan, Allied Bank Limited. In addition, new commercial banks are coming up in the private sector.

Central Bank

It is the bank which is responsible for the financial and economic stability of the country. It offer services to the state and banking industry. As a banker to the state it monopolises the issue of currency notes, manages public debts and acts as a custodian of foreign

exchange and national reserves. As a banker to the scheduled banks it rediscounts their bills of exchange, clears their cheques drawn on each other, and regulates their activities. Every country has its own central bank.

Industrial Bank

Industrial banks offer valuable services for the development of industries in a country. They offer long-term loans, both in local and foreign currencies, to the industrialists. They prepare feasibility reports on new projects and expansion plans. They provide valuable consultations on the establishment of factories, their modernization and improvement. They are a part of development financial institutions (DFIs).

Agricultural Bank

The agricultural bank plays a vital role in the agriculture field. It provides loans to farmers, landlords, and feudal, to enable them to buy fertilizers, seeds, tractors. With such loans they also finance water and irrigation expenses. The loans are offered against the hypothecation (mortgage) of the land and its harvest or crop of a season.

Savings Bank

Its objective is to encourage savings of the common man. These small savings, if deposited with the bank, turn into a large amount which is channeled in the development of commerce and trade. The more the savings are mobilized the greater the prospects are for national investment. Savings banks offer interest or profit to their accountholders. Now savings banking is attached with commercial banks.

Exchange Bank

It deals in foreign exchange and is involved in foreign trade. It provides foreign exchange to importers. It buys and sells foreign exchange at open market rates which are generally different from the rates determined by the central bank. Now foreign exchange dealings are made by commercial banks and money changers.

Mortgage Bank

It is the bank that commands its capital through deposits and dealing in shares and bonds. It finances agricultural people. It is of three kinds.

Cooperative banks
Quasi cooperative bank
Commercial bank

First two are non-scheduled banks. However all commercial banks in Pakistan performing mortgage functions are scheduled banks.

Mortgage banks lend for purchasing and reclaiming land, and discharging old debts. They mortgage 50 percent of the land. The period of loan ranges between 15 and 30 years. These loans are provided to their members.

KINDS OF BANKS BY OWNERSHIP

The existing banking system provides for the following organizations under which a bank can be formed.

Private Bank	This is the bank which is formed as a private company which is run by a group of persons, relatives or friends not exceeding 50 in number. Such banks include merchant banks, discounting and accepting houses. Discounting and accepting refer to those of bills of exchange.
Public Bank	These banks are established under Companies Ordinance 1984 and enjoy public investment. Most of commercial banks are founded as public banks / public companies. Their minimum number of members is seven.
Nationalized Bank	These are the ones which originally acted as public company and later were taken up by the government. In Pakistan, in 1974, all major commercial banks in the private sector were nationalized. These banks' equity is 100 percent owned by the government.
Partnership Bank	This type of bank is established under a Partnership Act 1932. The capital is brought in by partners whose minimum number is 2 and maximum 10.
Statutory Bank	This category comes into existence under the statute of a legislative assembly. In Pakistan its examples include State Bank of Pakistan, IDBP, ADBP, PICIC.
Chartered Bank	A bank may be organized as a chartered bank which is formed by the order of the king or queen of a country. Bank of England is its example.
Cooperative Bank	Bank organized under cooperative societies act are called cooperative banks. They work on mutual cooperation of the members. The banks may be subdivided as follows:

1. Primary cooperative societies
2. Central cooperative banking union
3. Provincial cooperative banks

At present in Pakistan there are over 28,000 primary cooperative societies, 52 central cooperative banking unions, and four provincial cooperative banks one each established in all the four provinces.

ADMINISTRATIVE ORGANIZATION (DEPARTMENTS OF BANKS)

The following are the departments of chief importance of a bank.

Cash Department

This department is responsible for the receipt and payment of cash. It maintains all records and accounting to this regard. The department conducts audit of cash so as to check any misappropriation or embezzlement of it. It also determines as to how much till cash is required.

Accounts Department

It gathers and keeps the record of all accounting data obtained from the head office and branches of the bank. Audit is one of its functions that comes in its purview. All the accounting work in other departments is done under its supervision. The department prepares final accounts of the bank.

Human Resource Department

This department is responsible for hiring and firing and other personnel affairs. Training, orientation, placement, promotion, transfer, termination, retirement, salaries and wages, overtime, and recreation fall under the purview of the human resource department. It also deals with the affairs of the labor union.

Legal Department

The legal department of a bank is responsible for legal matters of the bank. Its functions include interpretation of the banking and government laws, and their enforcement. It deals with the court matters. It prepares legal suits against defaulters and acts as a respondent to any lawsuit filed against the bank.

Public Relations Department

It goes for making and maintaining good relations with the leaders of the business world, customers, politicians, and public opinion leaders. It is responsible for the good market image and goodwill of the bank.

**Security
Department**

This department is responsible for the security of the property of the bank. It provides security systems and sends armed guards to branches. It takes all such measures necessary for the safety of the assets of the bank.

Exercises

MULTIPLE CHOICE QUESTIONS (MCQs)

1. The bank that deals in receiving deposits and advancing loans is referred to as
 - A. Central bank
 - B. Mortgage bank
 - C. Commercial bank
 - D. Exchange bank
2. Financial and economic stability of accounting is the responsibility of
 - A. Commercial bank
 - B. Industrial bank
 - C. Exchange bank
 - D. Central bank
3. Statutory banks are established by
 - A. State
 - B. The king or the queen
 - C. A private group of persons
 - D. Public
4. State Bank of Pakistan is a
 - A. Chartered bank
 - B. Statutory bank
 - C. Cooperative bank
 - D. Public bank
5. Scheduled banks are referred to as
 - A. Commercial banks
 - B. Those that follow schedule of time set by the central bank
 - C. Central banks
 - D. Members of the central bank
6. Habib Bank is a
 - A. Scheduled bank

- B. Central bank
 - C. Commercial bank
 - D. Industrial bank
 - E. A & C
7. Banks can be established under
- A. Cooperative Societies Act
 - B. Companies Ordinance
 - C. Partnership Act
 - D. Legislative assembly
 - E. All of the above.
8. Farmers, landlords, and, fudels are financed b y
- A. Agricultural banks
 - B. Commercial banks
 - C. Central banks
 - D. Industrial banks
9. Administrative organization of a bank refers to
- A. Cash department
 - B. Board of directors
 - C. Chairman of the bank
 - D. Departmentation
10. Bank's important departments include
- A. Cash department
 - B. Security department
 - C. Accounts department
 - D. All of the above
 - E. A & C

ANSWER KEY

1	c	2	d	3	a	4	b	5	d
6	e	7	e	8	a	9	d	10	d

SHORT QUESTION

1. Define a commercial bank.
2. What is a central bank?
3. Distinguish between an industrial bank and an agricultural bank.
4. What is a savings bank?
5. What is a mortgage bank?
6. Define exchange bank.
7. What is a private bank?
8. What do you mean by public bank?
9. Explain the concept of nationalized bank.
10. What is a statutory bank?
11. Give three differences of a public bank and partnership bank.
12. What is a chartered bank?
13. Can Pakistan establish a chartered bank, Explain briefly?
14. What do you mean by administrative organization of a bank?
15. Explain any two departments of a bank.
16. Explain the following departments of a bank.
 - a. Accounts department.
 - b. Cash department.
17. What is the duty of a security department of a bank?
18. How does a bank's legal department work?
19. What are the kinds of a cooperative bank?

DESCRIPTIVE QUESTION

1. Discuss the kinds of banks by functions.
2. What do you know of the banks by ownership?
3. Elucidate the administrative organization of a commercial bank.
4. Write notes on the following:
 - a. Cash department of a bank
 - b. Commercial bank
 - c. Partnership bank
 - d. Central bank

Chapter 3

COMMERCIAL BANKS

Definition

Functions

Primary Functions:

Receiving Deposits – Advancing Loans

Secondary Functions:

Accepting & Discounting B/E – Transfer of Money – Creation of Credit Money – Underwriting Shares – Issuing L/C – Lockers-Agency Services.

How Credit is Created

Chart of Functions

CHAPTER 3

COMMERCIAL BANKS

Definition

Commercial banks are ones that receive deposits and advance loans and play an important role in the creation of credit money.

They help businessmen promote their business. They work for traders, manufacturers, wholesales, retailers, importers, and exporters. The bank's main functions are receiving deposits and advancing loans.

KINDS OF COMMERCIAL BANK

Commercial banks are divided into two types:

1. Scheduled banks
2. Non scheduled banks

Scheduled Banks

These are the banks which are the members of the central bank. They are referred to as scheduled banks since their names appear in the schedule, list, or register of the central bank.

Once they become the scheduled bank they enjoy the following facilities and services from the central bank.

1. Rediscounting of the bill of exchange
2. Clearing house
3. Lender of last resort
4. Advisory services

However, such banks have to discharge certain liabilities to the central bank.

1. Maintaining cash reserve at the central bank as a mandatory requirement.
2. Following credit control policy of the central bank.

Because of their being member of the central bank, the scheduled commercial banks enjoy a strong market and financial goodwill which attracts huge amount of deposits from industrialists, traders, and the

public at large. They also borrow from these banks with confidence and at better conditions than non-scheduled banks.

Not only local commercial banks, but also foreign banks are required to become the scheduled banks to be able to work in that country.

Non-Scheduled Banks Non-scheduled banks are not the members of the central bank, and hence they cannot get all those facilities and services that are allowed to scheduled banks from the central bank. They also do not enjoy the public confidence. In practice, such banks do not exist.

FUNCTIONS OF COMMERCIAL BANKS

Functions of commercial banks can be divided in to two categories:

1. Primary functions
2. Secondary functions

I. Primary Functions

Primary functions can further be subdivided into the following:

1. Receiving deposits
2. Advancing loans

1. Receiving Deposits

This is the function of the formation of capital. Capital is formed by receiving deposits from the accountholders (depositors). Small savers, salaried people, traders, manufacturers and others deposit their money with the bank under the head of savings, current, or fixed deposit accounts and earn interest income. Commercial banks play an important role in the mobilization of savings.

2. Advancing Loans

The commercial bank finances the needs of businessmen in meeting their day to day business requirements. The bank advances loans on an interest rate which is much higher than that allowed on various kinds of deposits. This difference of interest earned and paid is the main source of the bank income. The loans may be secured or unsecured and is mostly for short-term period. Businessmen borrow from the commercial bank to finance the purchase of merchandise, pay salaries,

retire bills, pay off accounts payables, discharge other liabilities, and buy various current assets.

II. Secondary Functions

Secondary functions are of two types:

- a. Public utility services
- b. Agency services

A. Public Utility Services

Under this category, the bank performs the following functions:

1. Accepting and discounting bills of exchange.
2. Transfer of money
3. Creation of credit money
4. Underwriting of shares
5. Issuing letter of credit (L/C)
6. Providing lockers services
7. Credit Cards
8. ATM Cards

The following are the details:

1. Accepting and Discounting Bills of Exchange

Bill of exchange is a negotiable credit instrument used in home and foreign trade. Through it the buyer of goods is allowed a specified period, generally three months, for payment. The bank accepts the bill on behalf of the debtor and discounts it for the creditor. Discounting the bill refers to pay the cash at a discount before the bill becomes matured (due). Discounting process benefits all the parties involved in it viz., the banker, the drawer, and the drawee.

2. Transfer of Money

Commercial banks play a significant role in transferring money from one person, company, city, or country to another. This service is reliable, quick, safe, and inexpensive. On the other hand, if this service is performed by post office, it would be costly, time consuming, and risky. Now, in the business world, money is transferred mostly by banks using cheques, pay orders, drafts.

3. Creation of Credit Money

When banks receive deposits and advance loans out of these deposits,

credit money is created. The whole banking system in a country makes way to the creation of credit money. To keep it in limit the central bank regulates it by requiring all commercial scheduled banks to deposit with it a certain percentage of their deposits.

4. Underwriting of Shares

Underwriting refers to purchasing the whole issue of shares or bonds from the principal company and reselling it to the public. By this underwriting the bank receives commission from the issuing company which becomes free from this painstaking job of selling shares to the public.

The bank also takes the responsibility to sell the new issues without underwriting them.

5. Issuing Letter of Credit (L/C)

Letter of credit is an open letter from a bank requesting the seller to send the goods to the buyer and promises to pay the sum by itself. An L/C is a reliable guarantee for the exporter or seller from the bank. This instrument is used in home and foreign trade and once it is issued the importer can receive the goods. Banks also issue travelers cheques being a kind of L/C to the tourists and travelers.

6. Lockers Services

Banks offer lockers for the safe custody of jewelry, currency, documents and other precious items.

7. Credit Cards

Through credit cards commercial banks provide a facility to their clients to buy goods and services. It is a card issued by a bank or a financial institution that allows credit on short term basis to the cardholder. It is issued to those who are credit worthy. The credit (or loan) allowed is unsecured but backed by the market goodwill of the cardholder.

8. Debit Cards

It is a new concept in a banking business. This card is issued to the bank's accountholders who have sufficient balance with the bank.

Instead of drawing money from their accounts they make direct purchases with their cards and the amount spent is recovered from their account balance. For this service, the bank charges some fee which is deducted from the account. Cash can also be withdrawn from ATM.

9. ATM (Auto Teller Machines)

An automated teller machine is an electronic means of transferring funds. It is an electronic machine that replaces a human and provides needed cash to the credit cardholder, or a bank account holder. The machines provide information about current balances of the account holder. All these functions are provided after the identification of the receiver or depositor of cash. Identification is made by personal identification number (PIN) which is entered on the machine at the time of making a transaction. ATMs are installed at or near the bank entrance. Other places include big stores, supermarkets, petrol pumps, drugstores. In Pakistan, the machines are installed at the bank gates. (For further details see chapter 9)

B. Agency Services

Commercial banks act as attorney for their clients. They buy and sell shares and bonds, receive and pay utility bills, premiums, dividends, rents and interest for their clients. Cheques are used in most of transactions with the bank. The details are as under:

1. Accepting Cheques & Bills

Businessmen receive cheques in payment from other parties. These cheques may be drawn on other banks than theirs. They deposit these cheques with their banks and get the payment. This is very valuable service that the bank performs for its clients.

In addition, the bank also receives payments against electricity, gas, phone bills from consumers. It also receive and pays premiums, dividends, interests, and rents on behalf of its clients.

2. Dealings in Shares & Bonds

On the instructions of its clients the bank buys and sells shares and bonds on the stock exchange.

3. Acting as Attorney

The bank acts as attorney to its clients and thus performs legal and commercial functions for them.

CREDIT CREATION

There are two types of money viz.,

- (i) Cash money
- (ii) Credit money

Cash money is available in the form of currency notes issued by the central bank. Credit money is the amount agreed upon to pay later. It is issued by commercial banks and takes the form of cheques. Cash deposits and cash reserve requirements play an important role in the expansion or contraction of credit money. Credit expansion takes places by means of using cheques.

HOW CREDIT IS CREATED

Credit creation can be understood with two different examples:

- Example No. 1.** Assumptions: 1. The trading area has only one commercial bank.
 2. Cash reserve requirement is ten percent.
 3. People don't draw cash from the bank, and keep their money only there.

Now suppose, a person deposits Rs.1000/= with a bank, ten percent of which will go to the central bank as cash reserve requirement. Hence the commercial bank is left with Rs.900 to be used for advancing loans. The party A that borrows this Rs.900 will either buy goods from or make payment to the other party B. The party B will receive the cheque for Rs.900 and deposit it in its account with the same commercial bank. Now the bank receives the deposit of Rs.900. Ten percent of this amount (Rs.90) will as usual go to the central bank and the rest of the amount (Rs.810) will be utilized in advancing loans. At this stage the bank has net deposit of Rs.1710 (Rs.900 + 810), though the original deposit is Rs.1000/=. In this fashion the credit money will go on increasing at every transaction. What will be the maximum expansion can be determined from the following formula:

$$\text{Maximum Credit expansion} = \text{Original deposit} \times \frac{1}{\text{cash reserve}}$$

$$= 1000 \times \frac{1}{10/100}$$

$$= 1000 \times 10$$

$$= 10,000$$

If the original deposit is Rs.1000 the extent of credit expansion will be Rs.10,000.

Example No. 2 The example No. 1 above is not possible in practice because people must draw some cash. When cash is drawn the credit expansion goes down. Therefore, suppose people are inclined to draw cash at 50 percent and the rest 50 percent is used through cheques. In this case this formula will be used:

$$\text{Maximum credit expansion} = \text{Present cash deposit} \times \frac{1}{\text{Rate of drawing} \times \text{cash reserve}}$$

Original deposit = Rs.1000

Present cash deposit = $1000 - 100 = 900$

i.e. Cash available = 900

(10percent of 1000 , i.e. 100 has been deposited with the central bank)

Rate of withdrawal = 50%

$$\text{Maximum credit expansion} = 900 \times \frac{1}{50 \% + 10 \%}$$

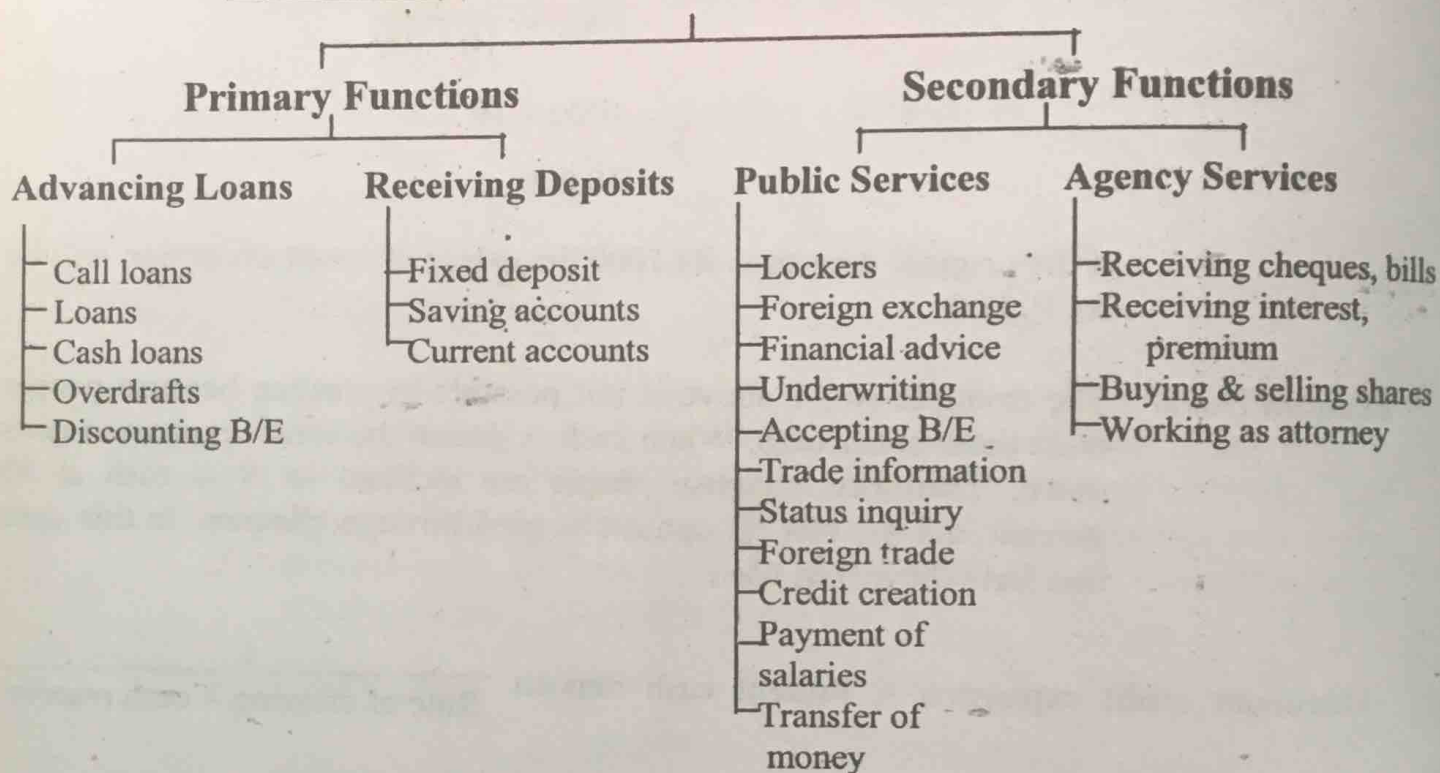
$$= 900 \times \frac{1}{50/100 + 10/100}$$

$$= 1500$$

In this example Rs.1000 will expand up to Rs.1500/=

Note: It makes no difference if there are more than one bank because banking system in an economy is only one. Here the assumption was made just for the sake of simplicity.

FUNCTIONS OF A COMMERCIAL BANK



Exercises

MULTIPLE CHOICE QUESTIONS (MCQs)

1. Banks registered with the central bank are referred to
 - A. Registered banks
 - B. Scheduled banks
 - C. Limited banks
 - D. Commercial banks
2. Central banks advance loans to commercial banks by
 - A. Rediscounting bills of exchange
 - B. Clearing house
 - C. Maintaining cash reserves of the commercial bank
 - D. Credit control.

3. Under public utility services, commercial banks perform the function of
- A. Receiving deposits
 - B. Advancing loans
 - C. Issuing credit cards
 - D. Agency services
4. Issuing letter of credit (L/C) is the function under
- A. Public utility services
 - B. Agency services
 - C. Underwriting of company shares
 - D. None of the above
 - E. All of the above
5. Money is transferred by
- A. Bank draft
 - B. Pay order
 - C. Cheques
 - D. All of the above
 - E. B & C
6. Underwriting of shares refers to
- A. Discounting of shares
 - B. Issuing shares on behalf of the incumbent
 - C. Overwriting of shares
 - D. None of the above
7. Credit is created by
- A. Whole banking system
 - B. Central banks
 - C. Commercial banks
 - D. Industrial banks
 - E. None of the above
8. Letter of credit is the bank's
- A. Order
 - B. Promise
 - C. Request
 - D. All of the above
 - E. B & C
9. Discounting a bill of exchange is a type of
- A. Overdraft
 - B. Loan
 - C. Call loan

D. None of the above

10. Using ATM saves

- A. Excise duty on cheques
- B. Time of account holder
- C. Labor
- D. All of the above
- E. B and C

ANSWER KEY

1	b	2	a	3	c	4	a	5	d
6	b	7	a	8	c	9	b	10	e

SHORT QUESTIONS

1. Define a commercial bank.
2. Distinguish, between a scheduled and a non-scheduled bank.
3. Name the facilities given by the central bank to the scheduled bank.
4. Define any two services of the central bank to the commercial bank.
5. Define lender of the last resort.
6. What do you mean by rediscounting of the B/E?
7. What is a "clearing house" service?
8. Define non-scheduled bank.
9. Briefly discuss primary functions of a commercial bank.
10. Describe function of advancing loan by prob bank.
11. Prepare a list of the bank's secondary functions.
12. Define transfer of money.
13. Define the concept of accepting and discounting bills of exchange.
14. Define credit cards.
15. How does a bank issue an L/C?
16. Write a note on ATM.
17. What do you mean by underwriting of shares?
18. Write a note on locker services by the bank.
19. How does credit money come into existence?
20. List the ways in which money can be transferred.
21. List down primary functions of a commercial bank.

22. Prepare the list of secondary functions of a commercial bank.
23. Write a note on credit cards.
24. Write a note on locker services of the bank.
25. Write a note on bank deposits.

DESCRIPTIVE QUESTION

1. What are commercial banks? Describe their functions / services to various classes of the public.
2. What do you mean by credit creation? How is it created? Is it possible to control credit expansion? Explain with examples.

Chapter 4

BANK ACCOUNTS

Definition

Types of Bank Accounts

Savings

Current

Fixed Deposit

Home Saving

How to Open a Bank Account

Chapter 4

BANK ACCOUNTS

Definition

Banks thrive on three accounts based on commodity and business needs.

1. Safety needs
2. Borrowing needs
3. Debt clearing needs

Bank accounts satisfy all these three needs of an individual or a businessman.

The bank account can be defined as a facility provided to the accountholder to deposit his money with the bank and withdraw it whenever he needs it. He may use the account to borrow and or settle his debts through cheques.

TYPES OF BANK ACCOUNTS

Commercial banks offer its clients a variety of accounts to be opened with them. This variety facilitates the person to open that account which suits his needs.

The following accounts are the types:

1. Savings account
2. Current account
3. Fixed deposit account
4. Home savings account

1. Savings Account

Savings account is offered to the public to encourage their small savings. Those who open it include students, salaried persons, and small traders. These small savings by individuals constitute a huge amount at the bank. The account is subject to *zakat* in Pakistan.

It can be opened with as minimum as five rupees. But in practice banks demand at least one thousand rupees to open it. The

accountholder can withdraw cash only twice a week. The upper limit of the amount of a cheque is Rs. 15000/=. For the amount above this limit the bank requires an advance notice of one week. The conditions are aimed at to discourage withdrawals and encourage savings. Banks offer interest or profit on this account. If the balance falls below the required minimum level, the bank imposes a certain charge on the accountholder.

2. Current Account

Current account is operated by businessmen. Earlier it could be opened with a minimum of five hundred rupees but now a minimum of two thousand is needed. Even some banks require five thousand rupees to open it. It can be operated any number of times a day. Unlike savings account there is no upper limit of the withdrawal. This account serves the businessman as if his cashier is sitting at the bank and dealing in his cheques. A nominal interest may be offered on the balance of account. The account is not subject to *zakat*. Here too, if the balance falls below a certain sum, the bank fines the accountholder at a specified rate.

3. Fixed Deposit Account

This account is opened for a definite period of time without the expiry of which the amount cannot be withdrawn. The rate of interest is higher than that of savings account. The greater the period for which money is deposited the higher the interest rate is offered. The period ranges from three month to ten years. It is usually operated by widows, pensioners, salaried persons, etc. to get regular income. In Pakistan, this account is subject to *zakat* deduction.

4. Home Savings Account

This type of account offers the facility to the accountholder to save money right at home and put it in the locker provided by bank. The key of the locker remains with the bank which sends its officer every week to collect the amount from the locker. Now this type is no longer in practice.

HOW TO OPEN A BANK ACCOUNT

The procedure of opening an account with the bank is quite simple and easy as discussed below.

Selection of a Bank & Type of Account

Having made up his mind to open a bank account the prospective accountholder will select a bank and its branch and decide on the type of account to open. He will choose one from among savings, current

or fixed deposit accounts. Savings account serves the purpose of saving, current account is used for settling business transactions, and fixed deposit is meant for earning regular income.

Application Blank

The bank manager will provide the client an application form to fill in the blanks for getting such information as:

Name, father's name, address, profession, amount to be deposited, introducer's data, date, and signature. After receiving the filled-up form, the bank will scrutinize it and allocate an account number.

Reference Card

Along with the application blank, the bank also gives a blank reference card which requires two signatures of the accountholder as a specimen to be kept at the bank. When a cheque is presented at the bank, it matches the signature on the cheque with the one on the reference card. This practice offers safety to the bank and the accountholder as well. The card also provides a space for accountholder's special instructions.

References

At the time of opening an account the bank requires one or two referees who are already accountholders of the same bank. The referee will sign the name and write his account number in the columns provided in the application blank. This reference ensures the bank's confidence in the new accountholder.

Allotment of Account Number

After thorough scrutiny of the application form, the bank will allot an account number through which all deposits and withdrawals will be carried out.

Provision of Pay-in-slip

At this stage the account has been opened. Now the bank will supply a pay-in-slip to the account holder who will use it to deposit the money.

The stub, a smaller part of the slip, duly signed and stamped by the bank, will be given back to the depositor which will serve as a proof of deposit. The larger part will be detached and retained by the bank for necessary action and record.

In short, the pay-in-slip is used to deposit the money.

Making Deposit

After having the bank account number allotted and received the pay-in-slip the accountholder will fill in the blanks of the slip and deposit the money at the cash counter.

Supply of a Cheque Book	After the first deposit is made, the bank supplies a cheque book that contains up to 25 leaves for savings account, and 25 or more for current account. Fixed deposit account doesn't carry cheque books because it is a non checking account.
Excise Duty	Cheque book is supplied after accountholder has paid excise duty imposed by the Government of Pakistan on cheques. This duty was first imposed by president General Yahya Khan in 1970. The duty is paid either in cash or is deducted from the balance of the account. In 2000, the Govt. of Pakistan withdrew the excise duty.
Enclosures	Along with the application blank a photocopy of the identity card of the accountholder should be attached. For identification purpose the bank may ask to enclose a photograph also.

Exercises

MULTIPLE CHOICE QUESTIONS (MCQs)

- An advance notice is required to withdraw an amount of Rs.15,000 or more in case of
 - Current account
 - Saving account
 - Fixed deposit account
 - B & C
- The following account/accounts are subject to Zakat
 - Fixed deposit
 - Current
 - Savings
 - A & B
 - A & C
- Money cannot be withdrawn from
 - Current account
 - Savings account
 - Fixed deposit account
 - Home savings account
 - None of the above
- The highest rate of interest is enjoyed in

- A. Savings account
B. Current account
C. Fixed deposits
D. A & C
5. The account usually preferred by pensioners is
A. Fixed deposit. B. Savings
C. Current D. Home deposit
6. Excise duty on the cheque is charged by
A. State bank of Pakistan
B. The incumbent bank
C. Provincial government
D. Federal government
7. Current account can be opened by
A. Businessmen B. Ordinary men
C. Industrialists D. All of the above
E. A & C
8. Non-checking account is
A. Savings
B. Current
C. Fixed deposit
D. All of the above
E. A & C
9. Money can be borrowed from the bank by
A. Businessmen
B. Accountholders
C. Rich men
D. Poor men
10. Banks provide loans to
A. Rich people
B. Poor people
C. Financially sound people
D. Middleclass

ANSWER KEY

1	b	2	e	3	e	4	c	5	a
6	d	7	d	8	d	9	b	10	c

SHORT QUESTIONS

1. Define bank account. List down types of bank accounts.
2. What do you know about savings account?
3. Why do businessmen prefer current account, answer briefly?
4. Why are fixed deposit accounts open?
5. Write a note on home savings account.
6. In which account the higher interest rate is offered and why?
7. Why are savings accounts open? Give at least four reasons.
8. For whom are savings accounts suitable and way?
9. If a widow wants to open an account with the bank, which type should she prefer and why?
10. For a salaried person which type of account is better and why?
11. In which type of account lowest or no interest is offered?
12. Prepare a list of the steps in opening a bank account.
13. Why does a bank ask for two references to open a bank account?
14. Give the details of the entries in pay-in-slip.
15. Write a note on excise duty with reference to cheques.
16. What are the enclosures attached to the application for opening a bank account?
17. What are the contents of an application blank for opening a bank account?
18. Once the bank account is opened what documents will the bank hand over to the new account holder?
19. Write a note on reference card.
20. What are the forces that attract opening a bank account?

DESCRIPTIVE QUESTIONS

1. What is a bank account? What are its kinds?
2. How can the bank account be opened?

Chapter 5

LENDING INSTITUTIONS

Savings & Loans Associations
Credit Unions
Life Insurance Companies
Commercial Finance Companies
Factor Companies
Sales Finance Companies
Consumer Finance Companies

CHAPTER 5

LENDING INSTITUTIONS

In addition to banks there are other credit institutions also that advance loans and other financial services. They are as under:

1. Savings and loans associations
2. Credit unions
3. Life insurance companies
4. Commercial finance companies
5. Factor companies
6. Sales-finance companies
7. Consumer finance companies

Savings & Loans Associations

These lending institutions receive deposits in small amounts which are ploughed back in advancing loans to finance the purchases of real estate. The real estate so bought is mortgaged with the creditor.

Credit Unions

They work on cooperative basis. They comprise those people who are friendly and well-known to one another, e.g. the employees of a company. These employees with the cooperation of the employer lay foundation of a credit union, and save up their money with it on monthly basis. The amount is recovered from their monthly salaries. Thus a huge fund is pooled and advanced at a nominal interest rate. Such loans are recovered in monthly installments from the salaries of the debtor employees.

Employees use these loans for purchasing durable consumer goods as TV, refrigerators, furniture, etc. The interest earned is distributed to members as profit.

Life Insurance Companies

These companies receive millions of rupees in the form of premiums against life insurance policies. The amount so collected finds its way into various investments including the purchasing of shares, bonds, and debentures. Purchasing bonds, debentures, and other credit instruments is actually advancing loans to the issuing companies. The life insurance company also directly advances loans to businessmen and manufacturers.

**Commercial
Finance
Companies**

They deal in money in two ways.

- (i) Buying accounts receivables
- (ii) Advancing direct loans

(i) Purchasing Accounts Receivable

They purchase accounts receivable at a discount outright in their names. When these receivables fall due they directly collect money from the debtor at a full price. Buying accounts receivable benefits all the three parties. The seller immediately gets cash against selling accounts receivables, the buyer of the merchandise (debtor) gets sufficient time to make the payment and the commercial finance company gets discount as its income.

(ii) Advancing Direct Loans

They directly advance loans to various classes of businessmen including producers, wholesaler, retailers, importers and exporters, and others. These loans are used in purchasing machinery, equipment, raw materials, and merchandise. Since the loans are secured the influence of the commercial finance company increases on the debtor company. Moreover the rate of interest is twice as bank loans, reasons being greater risk and administrative expenditure.

**Factor
Companies**

The commercial finance company discussed above purchases receivables at a discount on a condition that if they are unpaid the seller of the goods will be responsible and return the amount received against the sale of receivables.

However, the factor company offers a greater facility to business firms. It purchases accounts receivables from them without the above condition. If the purchased accounts receivable are unpaid by the customer the factor company will suffer the loss. Hence, it assumes a fairly greater risk, and, therefore, charges comparably a higher discount. The customer who has bought merchandise on credit from the business firm is required to pay the sum directly to the factor company if his part of the bill has been sold to the factor.

Factors also lend money against the security of fixed and current assets as machinery, equipment, and inventory. They cater to the needs of only small business firms. Hence, large companies contact commercial banks for the financial needs.

**Sales Finance
Company**

Many businesses sell durable consumer goods like refrigerators, TVs, cars, and the like on installments. In such transactions, an agreement between the buyer and seller is drawn. Sales finance companies deal in buying these contracts. As a result, the seller immediately gets his payment, the buyer continues to pay on installments, and the sales finance companies receive interest income resultant from the installment sales. According to the contract between the seller and buyer, the title of ownership to the goods remains with the seller until the buyer makes full payment of the product. After the contract is purchased the sales finance company assumes the title of ownership to the goods sold. If the customer fails to make his payment the finance company will repossess the product. In case the company finds it impossible to repossess the article, it will refer to the original seller for the recovery of the loss. These companies have flourished the installment sales business. They also buy the contracts of installment sales to business firms that buy machinery and equipment.

**Consumer
Finance
Company**

They make small personal loans. Before advancing they look into the repaying ability, income, financial soundness, and job security of the applicant. He is required to deposit a certain amount of money as a security. The company also accepts other types of securities. The interest is charged on monthly basis which is mostly two percent.

Exercises

MULTIPLE CHOICE QUESTIONS (MCQs)

1. **Money can be borrowed from**
 - A. Banks
 - B. Credit unions
 - C. Life Insurance Companies
 - D. All of the above
 - E. A & B only
2. **Installment sales are financed by**
 - A. Consumer finance companies
 - B. Cooperative Societies
 - C. Sales finance companies
 - D. None of the above
3. **Commercial finance companies deal in**
 - A. Installment sales
 - B. Buying account receivables
 - C. Buying fixed assets
 - D. All of the above
4. **Personal loans are issued by**
 - A. Industrial banks
 - B. Sales finance companies
 - C. Factors
 - D. Consumer finance companies
 - E. All of the above except A
5. **Installment sales are applicable to.**
 - A. Consumer goods
 - B. Industrial goods
 - C. Consumer durable goods
 - D. Consumer non-durable goods
 - E. All of the above except B
6. **Accounts receivables are purchased by**
 - A. Sales finance company
 - B. Commercial finance company
 - C. Factors
 - D. Consumers finance company

ANSWER KEY

1	d	2	d	3	b	4	d	5	c
6	b								

SHORT QUESTIONS

1. Prepare a list of lending institutions.
2. What is a role of consumer finance company?
3. Which financial institutions specialize in facilitating installment sales?
4. What do you know of factor companies?
5. Write down the note on sales finance company.
6. Which does financial institution purchase account receivables?
7. Distinguish between labour unions and credit unions.
8. Write a note on life insurance company as a financial institution.
9. Write a note on credit unions.
10. Differentiate between factor companies and sales finance companies. Briefly explain only three reasons.
11. Write a note on savings and loans associations.

DESCRIPTIVE QUESTIONS

1. What are the different types of banks? What are their objectives? Explain in detail.
2. Enumerate and discuss the various kinds of other credit institutions.
3. Write short notes on the following:-
 - (i) Credit union
 - (ii) Factor company
 - (iii) Sales finance companies
 - (iv) Savings and loans association



Chapter 6

CREDIT INSTRUMENT I

CHEQUES

Definition of Credit Instruments

Definition of Cheque

Essentials of a Cheque

Kinds of Cheques

Primary Kinds: Bearer – Order – Cross

Secondary Kinds: Cashier's – Confirmed – Open – Draft

Kinds of Cross Cheques

General Crossing – Special Crossing – Plain Crossing

Dishonor of Cheques

CHAPTER 6

CREDIT INSTRUMENTS I

CHEQUES

Definition of Credit Instruments

Willis defines negotiable instruments as, "it is the one the property in which is acquired by every person who takes it bona fide and for value, notwithstanding any defect of title in the person from whom he took it". In Pakistan Negotiable Instruments Act, 1881 is enforced the introduction chapter of which states that the act only deals with bills of exchange, cheques, and promissory notes although the following also fall in the category of negotiable instruments:

Railway receipts
 Port trust bonds
 Dividend warrants
 Railway bonds

An instrument carrying "not negotiable" is only transferred as ordinary chattels or chose-in.

Credit instruments are those devices which are used in business for credit transactions.

Credit instruments have the following forms:

1. Cheque
2. Bill of exchange
3. Promissory note

CHEQUE

Definition

Cheques are bills of exchange drawn on a banker payable on demand. They are instruments used to withdraw money deposited in the bank.

Essentials of a Cheque

Cheques must fulfil certain conditions without which their status as cheques will not be legally accepted and they would be liable to be dishonored. The following are their essentials.

1. Cheques must be in the form of an order, not a request.

2. The order must be unconditional. If any condition is attached with the order the cheque will lose its legality.
3. The cheque must be in writing. An oral order on the bank for drawing cash will not be accepted as a cheque.
4. The amount demanded must be for certain amount in money, not in kind.
5. The payment must be made to a certain person, bearer, or self.
6. The cheque must be payable on demand.
7. It must be drawn on a banker.
8. It must be signed by the accountholder.

KINDS OF CHEQUES

Cheques have the following kinds:

I. Primary kinds

1. Bearer cheque
2. Order cheque
3. Cross cheque

II. Secondary Kinds

1. Cashier's cheque or pay order
2. Confirmed cheque
3. Open cheque
4. Bank draft

Primary Kinds

1. Bearer Cheque

This is the cheque which is possessed or owned by the bearer. Any person who presents it at the counter of the bank will receive cash mentioned in it.

2. Order Cheque

When the cheque bears the name of the receiver of cash, it is called order cheque. In such a case the word 'bearer' is cancelled. It is payable to a person named therein or his order. Order cheque can be endorsed or transferred to a third person by the order of the original payee.

3. Cross cheque

It is the cheque that cannot be cashed at the counter of the bank. It must be deposited in the bank account of the drawee. It is known as a cross cheque because two parallel lines are drawn across it. Cross cheques are safer than bearer and order cheques, since they cannot be cashed at the counter and must be deposited in the bank account. Hence the possibility of forgery is minimum.

Secondary Kinds

1. Cashier's Cheque or Pay Order

It is a cheque in which a bank orders the other bank to pay a certain sum of money to a third person. The pay order can be crossed and is payable within a city. It is issued to a person requesting for it only when he has deposited the same amount plus bank charges with the bank.

2. Confirmed Cheque

When a cheque is confirmed by the bank it is known as confirmed cheque. The bank deducts the amount of such a cheque at the time of confirmation and therefore cannot bounce. They are extremely reliable. They may be order or crossed cheques.

3. Open Cheque


When the crossing of a crossed cheque is cancelled it becomes an open cheque and hence can be cashed at the counter of the bank.

4. Bank Draft

It is an order or a cross cheque issued by one bank in one country or city to the bank in other country or city in favor of a third party.

If the draft is issued in favor of a person in a foreign country it is known as a foreign bank draft; and if its issued for a person in the other city within a country, it is called inland draft. It may be an order or a cross cheque.

SPECIMEN OF A CHEQUE

	حبیب بینک لمیٹڈ Habib Bank Limited IQBAL LIBRARY BRANCH. NEAR ISLAMIA COLLEGE, KARACHI.	Date _____ PLS. 1
PAY _____ RUPEES _____		OR BEARER <div style="border: 1px solid black; padding: 5px; display: inline-block;">Rs. _____</div>
DO NOT WRITE BELOW THIS LINE <div style="font-family: monospace; font-size: 1.2em;"> @ 1 2 3 8 8 1 7 @ 0 5 4 0 5 6 5 : 0 0 0 0 0 6 5 1 3 3 @ 0 0 0 1 </div>		

KINDS OF CROSS CHEQUES

If two parallel lines are drawn across the cheque, it becomes a cross cheque which ensures safety and minimizes the possibility of falling into wrong hands. After drawing a crossing on the cheque it becomes no longer payable on demand and cannot be cashed across the counter of the bank.

The two parallel transverse lines drawn across the cheque may or may not carry words "not negotiable", "& Co." "A/c Payee only". Cheque carrying any type of crossing must be deposited into the bank account of the designated person.

Crossing of the cheque have the following types.

1. General crossing
2. Special crossing

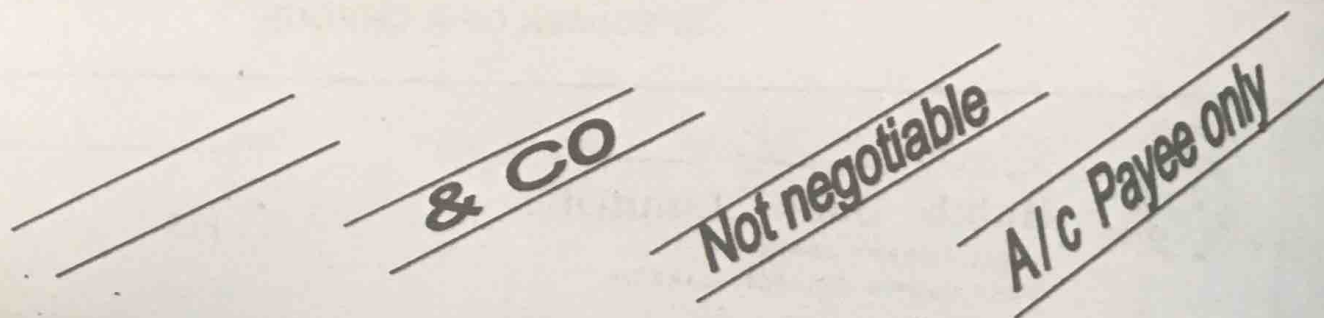
General Crossing

When two parallel transverse lines are drawn across the cheque it becomes a cross cheque with general crossing. General Crossing may be blank or may carry words between it as:

& Co.

not negotiable

A/c Payee only



General crossing may be used for two different purposes:

a. "Not negotiable" crossing

A cheque crossed "not negotiable" loses its negotiability and ceases to be a negotiable instrument. The crossing, however, does not prevent the holder from transferring the cheque to another party. If this cheque is stolen, the true owner will be entitled to recover the loss from the banker who paid out on it.

Not negotiable

b. "Account Payee" Crossing

If a cheque is crossed "account Payee", it ceases to be a negotiable instrument, and the bank is bound to credit the person designated in the cheque.

Account Payee

c. Plain Crossing

When two parallel transverse lines are put across the cheque with or without "& Co" between them, these parallel lines are called plain crossing. Cheques bearing such a crossing stays negotiable and can be transferred to other parties.

2. Special Crossing

If two parallel transverse lines are drawn across the cheque with the name of a bank, the lines are called special crossing. The naming of the bank between the parallel lines offers additional security in the transfer of monies, and the cheque must be presented to the bank designated therein. Now the use of special crossing is no longer in vogue.

Habib Bank, Garden Branch

United Bank

①

Habib Bank, Garden Branch

②

United Bank

1. This crossed cheque can only be deposited in the Garden Branch of Habib Bank.
2. This cheque can be deposited in any branch of UBL.

PARTIES TO A CHEQUE

The cheque has three principal parties as under:

Drawer

It is the person who issues the cheque by signing it to a person named therein. In fact, the drawer issues the order to the bank to pay a certain sum of money to him or to his order.

Drawee

It is the person in whose favor the cheque is drawn. He is usually the receiver of the amount of the cheque but he can transfer it to another person by endorsement. In such a case the cash will be received by the endorsee (to whom the cheque is transferred).

Bank

It is a third principal party involved in the cheque and receives the order of the drawer or endorser and acts upon it. It pays the amount mentioned in the cheque to the payee.

DISHONOR OF CHEQUES

The cheque is an unconditional order in writing drawn on a banker. Through cheques the accountholder draws his money held in trust with the bank. He enjoys and exercises his right to draw the deposit which is payable on his demand. However, the bank is authorized to refuse the payment against a cheque on the following reasons:

Difference in the Signature

The bank possesses in its record the specimen signature of the accountholder. The specimen is secured at the time of the opening of an account. When the bank receives a cheque, its officer compares the signature on the cheque with that in its record. If the signatures differ, the bank will not accept the cheque for payment.

Post-dated Cheque	If the cheque bears a future date it is known as a post-dated cheque. Future-dated cheque cannot be cashed till that date arrives. Bank will cash only present-day cheque or previous-dated cheque provided it is not older than six month.
Stale Cheque	Banks do not honor stale cheques. These cheques are older than six months and as such they cannot be honored by the bank.
Insufficient Amount	If the amount of the cheque is greater than the balance in the account, such a cheque will be bounced. However, if the bank has granted overdraft facility it can be accepted by the bank.
Death	The bank stops the payment against the cheque whose drawer has died. If the cheque has been drawn by the accountholder and dies before it is presented at the counter of the bank, the cheque is liable to be dishonored. However, the bank must be in the knowledge of such a tragedy.
Insanity	If the accountholder loses his sense and goes insane, and the doctor confirms the insanity, and the bank gets this information, the cheque will be dishonored.
Bankruptcy	Banks do not honor the cheques of the accountholder who have become bankrupt. A person can be declared bankrupt only by the court of law.
Garnishee Order	If the court of law issues order to a bank for the stoppage of the payment against cheques drawn by a particular accountholder, the bank is bound to obey.
Drawer's Countermand	After having drawn and issued a cheque, if the accountholder himself directs the bank not to make the payment, the cheque will be dishonored.
Cross Cheque	Cross cheques cannot be cashed at the counter of the bank. They must be deposited in the receivers account with the bank.
Change in the Cheque	If any alteration in the cheque is made without the endorsement of the drawer the cheque is liable to be dishonored. Altered cheques must be endorsed or confirmed by the signature of the drawer to avoid bank's non-acceptance.

Difference in the Amount

The amount on the cheque is written twice, first in words, and second in figures. If both the amounts are different the cheque is subject to be dishonored.

Forged Signature

If the bank has sufficient reasons for the suspicion of the signature or any other content on the cheque being forged, the cheque will be bounced.

Anomaly in the Cheque

If the cheque is not in the proper shape, legible, or is mutilated it is liable to be dishonored.

The main objective of dishonoring a cheque is to safeguard the interest of both the accountholder and the bank itself. However, the bank should take extreme care in dishonoring cheques, or else it would be liable for damages.

SPECIMEN OF PAY-IN-SLIP

حبیب بینک لمیٹڈ Habib Bank Limited				19__
FOR CREDIT OF SAVINGS ACCOUNT TITLED			SAVINGS A/c No.	
میرٹھ والا اکاؤنٹ برائے بچاؤ			سچھو اکاؤنٹ نمبر	
PARTICULARS			AMOUNT	
BY CHEQUE NO	ON	/BY CASH		
/ /	/	/		
/ /	/	/		
/ /	/	/		
TOTAL Rs.				
Rupees				
Nº 584373				
Deposited by			Received by	
محمد کونڈہ			محمد کونڈہ	

Exercises**MULTIPLE CHOICE QUESTIONS (MCQs)**

1. **Credit instrument includes**
 - A. Cheque
 - B. Bill of exchange
 - C. Promissory note
 - D. All of the above
 - E. A & C only
2. **Cashier's cheque is a**
 - A. Bank draft
 - B. Pay order
 - C. Bearer cheque
 - D. Order cheque
3. **Negotiable instruments include**
 - A. Railway receipts
 - B. Dividend warrants
 - C. Railway bonds
 - D. Cross cheque
 - E. All of the above
4. **A cheque is a**
 - A. Bill of exchange
 - B. Promissory note
 - C. Letter of credit
 - D. None of the above
5. **A cheque is**
 - A. An oral unconditioned order
 - B. A written conditional order
 - C. A written unconditional order
 - D. Drawn to the payee
 - E. All the above
6. **Bank can pay this cheque to anyone**
 - A. Bearer cheque
 - B. Cross cheque
 - C. Order cheque
 - D. Pay order
 - E. A & C

7. **When crossing a cancelled the cheque is known as**
A. Confirmed cheque
B. Cross cheque
C. Cashiers cheque
D. Open cheque
8. **Drawee of the cheque is**
A. Accountholder
B. The incumbent bank
C. The payee
D. All of the above
9. **Garnishee order is issued by the**
A. Drawer
B. Drawee
C. The court of law
D. State bank of Pakistan
E. The incumbent bank
10. **Change is the cheque can be made by**
A. Drawer.
B. Drawee
C. Payee
D. Bank
E. Anyone
11. **Change in a cheque must be endorsed by**
A. Signature
B. Initial
C. Name
D. Account number
12. **Stale cheque is**
A. Older than 6 months
B. Older than 3 months
C. Older than one month
D. All of the above
13. **The following cheque cannot be cashed**
A. Cross cheque
B. Antedated cheque
C. Post dated cheque
D. unendorsed cheque
E. All except B
14. **The objective of dishonor is to**

- A. Harass accountholder
- B. Safeguard the accountholder
- C. Safeguard the bank
- D. Safeguard the accountholder and the bank
- E. Payor, payee, and the bank

ANSWER KEY

1	d	2	b	3	e	4	a	5	c
6	a	7	d	8	c	9	c	10	a
11	a	12	a	13	b	14	e		

SHORT QUESTION

1. Define credit instruments.
2. Briefly define various forms of credit instruments.
3. What is a cheque?
4. Define bill of exchange.
5. What do you know of promissory note?
6. "A cheque is a bill of exchange". Briefly explain.
7. List down any five essentials / requirements of cheques.
8. What are the kinds of cheques? Just give a list.
9. Briefly describe primary types of cheques.
10. What do you know about secondary types of cheques?
11. Why are order cheques issued?
12. Differentiate between bearer cheques and cross cheques.
13. Prepare a specimen of an order cheque.
14. Prepare a specimen of a cross cheque.
15. Write a note on bearer cheques.
16. Prepare a specimen of a bearer cheque.
17. What is a cross cheque?
18. Write a note on special crossing.
19. Prepare specimens of a different types of crossings.
20. Explain the following types of crossings.
 - a) Not negotiable

b) Account payee only

c) National Bank

21. Briefly explain parties to cheques.
22. Write a note on general crossing.
23. Explain confirmed cheques.
24. Define a bank draft.
25. How is a cheque converted into a confirmed cheque.
26. Distinguish between the drawer and the drawee
27. Define dishonor of a cheque.
28. Prepare a list of ten reasons of dishonoring of cheques.
29. Explain any two reasons of the dishonor of a cheque.
30. "Insanity and insolvency render a cheque dishonored". Explain.
31. Explain a garnishees order.
32. What do you know about drawers countermand?
33. Can a cross cheque be cashed at the counter of the bank? Why or why not?
34. Can you make a change in your scholarship cheque?
35. Distinguish between a STALE CHEQUE and a POST-DATED CHEQUE.
36. What is an impact of a forged signature on a cheque?
37. What anomalies are there in a cheque?
38. What will happen if there is insufficient amount in the balance against a cheque?
39. Distinguish between antedated and post dated cheques.
40. What are the contents of a cheque?



Chapter 7

NEGOTIABLE AND CREDIT INSTRUMENT II

BILL OF EXCHANGE (B/E)

Definition of Bill of Exchange

Essentials of a Bill

Kinds of a Bill of Exchange

Kinds by Place

Kinds by Time

Kinds by Payment

Other Kinds

Parties to a Bill

Drawer – Drawee – Payee – Acceptor – Holder – Holder in
Due Course – Endorser – Endorsee

Acceptance

Dishonor

Notice of Dishonor – Noting & Protesting – Specimens of
Notice and Protest – Notary Public

Retirement

Rebate

Maturity

Grace Days

Discounting

Holder in Due Course

Endorsement

CHAPTER 7**CREDIT INSTRUMENTS II
BILL OF EXCHANGE****BILL OF EXCHANGE****Definition**

A bill of exchange is “an unconditional order in writing, addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand or at a fixed or determinable future time, a sum certain in money to or to the order of a specified person or to the bearer”.

**Essentials
of a Bill**

1. Bill of exchange must be in writing.
2. It must be an order, not a request or promise.
3. The order must be unconditional.
4. It must be for a specific amount in money, not in barter.
5. The bill must be payable to a certain person or his order.
6. It must be addressed to a specific person.
7. The bill is payable at a certain date or on demand.

KINDS OF A BILL OF EXCHANGE

The bill may be classified as follows:

- i) Bills by place
- ii) Bills by time
- iii) Kinds by documents
- iv) Kinds by payments
- v) Other kinds

These kinds explain when, Where and how the bills are drawn and paid.

**1. Kinds of
Bills by
Place**

Such bills can be further divided into following kinds.

1. Inland Bill

These bills are also known as *hundis*. These are drawn and paid within a country. However, if the drawer and the drawee are in the same country but the payee resides in a foreign country, the bill will still be an inland bill.

2. Foreign Bill

When the drawer of the bill is in one country and the drawee in another, the bill is known as a foreign bill.

3. Bills in Sets

Sometimes foreign bills are made in sets i.e. more than one in numbers and sent by post to the drawee for acceptance. If one or more bills are lost on way the rest may reach their destination. If, in such a case, one bill is accepted and paid the rest of the bills will automatically become invalid. Bills in sets are used to avoid any delay arising out of their missing on the way to the drawee.

II. Kinds by Time

The bill of exchange may be divided on the basis of time, that is, when they are paid. In this sense they are subdivided as follows.

1. Demand or Sight Bill

This bill is payable on demand or on sight. It is also known as '*darshani hundi*'. Such bills are payable immediately and do not contain a particular or specified period of time.

2. Time Bill

They are issued for a definite period of time and payable on the maturity or expiry of that period mentioned therein. Such bills usually carry three months period plus three days as grace time.

III. Kinds by Documents

Document-wise the bill of exchange may be divided as follows:

1. Documentary Bill

Such bills carry with them documents like railway receipt, insurance receipt, bill of lading, mate's and captain's receipts and the like.

Documentary bills are further subdivided as follows:

a. *Documentary bill against payment*

These bills are only paid when the necessary documents are issued and presented. They are also referred to as D/P Bills.

b. *Documentary bill against acceptance*

Such bills are only accepted when documents are released by the drawer.

2. Clean or Non-Documentary Bill

There are times when the bill is drawn and accepted without being attached with the documents of exports. Such bills are known as clean or non-documentary bills.

IV. Kinds By Payments

The bill of exchange can be categorized on the types of payment which are as follows:

1. Bearer Bill

These bills are payable to any person who bears or carries them. There is no restriction as to who should get the payment against the bill.

2. Order bill

The payment of the bill is restricted to the person whose name has been mentioned in the bill.

V. Other Kinds

Other kinds of the bill are as follows:

1. Trade Bill

It is an ordinary and most common type of bill of exchange used in business transactions. It is drawn by the seller (CR) against the buyer (Dr) of goods.

2. Accommodation Bill

These bills are drawn in order to borrow certain sum of money. The bill is not the result of a business transaction. Its main objective is, as its name suggests, to accommodate or do a favor to the drawer.

Suppose, A wants to borrow some amount of money from B. But B is not in a position to lend it to A. However, he asks A to draw a bill of exchange, for the amount he needs, in the name of B and then he (B) accepts the bill. Now A will go to a bank and get it discounted and thus A receives money that he needed. Such a facility used by A is referred to as an accommodation bill. At the time of maturity A will pay off the amount to B, and B will finally pay it off to the bank and thus the transaction will be settled.

SPECIMEN OF BILL OF EXCHANGE

Rs. 20000

Karachi

5 December 2001

On demand pay Mr. Ahmed Wahid or order the sum of
Rupees twenty thousand for value received.

Stamp

(Signature of Mr. Ahmed Imran
across the stamp)

PARTIES TO A BILL

There are many parties involved in the bill and sometimes a single party may enjoy different capacities. Following are the parties to a bill:

1. Drawer or Maker

It is the person who draws the bill and signs it. He is the creditor in the capacity of a seller or exporter. He orders the drawee to pay a certain sum of money to him (drawer) or to his order.

2. Drawee

Drawee is the person in whose name the bill is drawn by the drawer. The drawee is a debtor as a buyer or importer of the goods.

3. Payee

It is the person who receives the amount mentioned in the bill. The payee may be the drawer himself or somebody else (a third party) to whom the drawer owes the amount.

The payee may be of the following status.

- i. Drawer
- ii. The bearer
- iii. Seller
- iv. Creditor
- v. The payee whose name is mentioned in the bill

4. Acceptor

Usually the acceptor is the drawee who accepts the bill by signing it. Now the bill is usually accepted by the banker on behalf of the drawee to speed up the transaction.

The acceptor may have the following capacities:

- i. Drawee

- ii. Buyer
- iii. Debtor
- iv. The banker

5. Holder

The holder is the person who physically possesses the bill. He legally enjoys the right to possess it. He may hold the following positions.

- i. Drawer
- ii. Creditor
- iii. Bearer
- iv. Payee

6. Holder in Due Course

It is the party who rightfully possesses the bill. He receives it in good faith, takes it as complete, regular on the face of it and without the knowledge of its previous dishonour.

7. Endorser

Another party to a bill may be an endorser who transfers or negotiates the bill to another person. This transfer or negotiation of title is effected by delivery.

The endorser may be:

- i. Creditor (as mentioned in the bill)
- ii. Holder
- iii. Seller or exporter (according to the bill)

In fact, endorser is the real creditor as per bill, but he is, however, debtor to the endorsee under a separate transaction.

8. Endorsee

It is a party to whom the bill is endorsed. He is the creditor to the endorser.

ACCEPTANCE

The seller of goods draws a bill on the buyer who on receiving it accepts and signs it. This accepting and signing of the bill by the drawee is known as acceptance. Generally the bill is attached with exporting documents including railway receipt, insurance receipt, bill of lading, mate's receipt etc. in addition to the invoice prepared by the seller i.e. drawer. The drawee on the receipt of the bill along with these documents checks them up and being satisfied, writes 'accepted' across the face of the bill and puts his signature on it. The bill becomes a legal and negotiable instrument after this acceptance. It is

then sent back to the drawer. In modern practice, the acceptance is not processed by the drawee. It is rather accomplished by the banker in the country of the drawer on behalf of the drawee. This alternative procedure of acceptance saves time, cost, and risk.

DISHONOR OF THE BILL

When the bill of exchange is not accepted or not paid on maturity the bill is said to have been dishonored.

From the above it is clear that the bill is dishonored on two accounts:

- a. Dishonor by non-acceptance
- b. Dishonor by non-payment

Dishonor by Non-Acceptance

When the drawee refuses to accept the bill, it stands to be dishonored. The dishonor by non-acceptance may have the following reasons:

1. The drawee doesn't accept the bill within 24 hours of its receipt.
2. When the drawee is not entitled to accept it.
3. When the drawee is a fake person.
4. If the bill is to be conditionally accepted.
5. When the drawee disappears.
6. In case there are many drawees, and all the drawees do not sign the bill.

Dishonor by Non-Payment

Another reason for the dishonor of a bill is its non-payment at maturity. The drawee may refuse to make the payment of the bill when it is presented at maturity; this refusal gives rise to dishonor by nonpayment.

The dishonor affects all the parties to the bill. They include the drawer, all endorsers and endorsees, who are all accountable and liable to the holder.

NOTICE OF DISHONOR

Once the bill is dishonored all the endorsers and the drawer must be informed about it, or these parties will not be held responsible to the holder.

The rules of notice are as follows:

1. The holder must issue notices to the parties involved.
2. Notice of dishonor must be served within a reasonable time.
3. The endorser on receiving the notice must notify it to the previous endorser.
4. Notice may be oral or written.
5. In case of death, the notice must be served to the heir.
6. In case of bankruptcy the notice should be served to the official assignee.
7. Notice can be issued by the agent.

NOTING AND PROTESTING

When the bill is dishonored, the holder lodges his complaint with the notary public. The whole process of taking up the matter with it is known as noting and protesting.

Noting

The notary public is notified by the holder of the dishonor of the bill by non-acceptance or nonpayment. This process is known as noting. This noting is entered in the register of the notary public which becomes a confirmed proof that the bill has been dishonored. Before noting is registered, the notary public requires necessary supporting evidence of dishonor. The noting is also made on a separate piece of paper in addition to the register.

The notary public receives a fee, known as noting charges, for rendering this service. Later, these charges are recovered by the holder from the person responsible for dishonor.

The noting carries the following information:

1. Dishonor of the bill
2. Date of dishonor
3. Reasons for the dishonor
4. Noting charges
5. Signature and seal of the notary public.
6. Serial number on the register of the notary public.
7. If the dishonor does not contain any explicit reason, the explanation of the holder is justified as to why he takes it as dishonor.

If the bill is not dishonored expressly the notary public may note the dishonor as 'office closed' or 'drawer or acceptor not found'.

SPECIMEN OF A NOTICE

NOTICE OF DISHONOUR OF BILL

Address

Date:

To,

.....
.....

Dear Sir,

I hereby give you notice that the under-mentioned bill accepted by you which fell due on has been dishonoured by non-payment (or non-acceptance).

We shall hold you responsible for any loss or charge which we or any other party interested in this bill may be put to or incur on account of dishonour.

Account

Yours faithfully

Drawee Tenor Due

Drawer

Place of payment

Answer given:

Protesting

Protesting is the written affirmation by the notary public of the dishonor of the bill. The certificate issued to this effect to the holder is known as a protest.

The protest has the following contents:

1. The dishonored bill or its attested photocopy.
2. The names of the holder (complainant) and the person responsible for the dishonor
3. Reason for the dishonor

4. Date of the dishonor
5. Signature and seal of the notary public

SPECIMEN OF A PROTEST

PROTEST OF A BILL FOR NON-ACCEPTANCE

On this the day oftwo thousand and andat the request of Mr. ofmerchant, and holder of the original bill of exchange, a true copy of which is on the other side within (or is underwritten), I of the said city, Notary Public, by lawful authority duly admitted and sworn, did produce and exhibit the said original bill of exchange to Mr. on whom it was drawn at

(his address)

for his acceptance, and demanded acceptance thereof to which he replied that it would not be accepted at present (or the answer given). Therefore, I, the said Notary, at the request aforesaid did protest and by these present do solemnly protest against the drawer of the said bill of exchange and all other parties thereto, and all others whom it doth or may concern, for exchange, re-exchange all costs, damages, charges and interest already incurred and to be hereafter incurred by reason of non-acceptance of the said bill of exchange. Thus done and protested at in the presence of andwitnesses.

Date this day ofon thousand nine-hundred andwhich I attest.

(Seal)

Notary Public

OTHER MATTERS OF BILL OF EXCHANGE

Retirement

When the bill is paid before it is matured (due), the bill is said to have been retired. The early retirement entails a discount or concession at a particular interest rate. This concession is known as rebate.

Rebate

Rebate is the discount or concession allowed for payment made earlier than maturity date. The rate of rebate is usually equivalent to the commercial bank's rate of interest. It is paid for the period still running for maturity. The amount of rebate is calculated on the gross amount of the bill.

Maturity	Maturity is the time when the bill falls due for payment. Usually the bill runs for three months plus three days as a grace period. However, the demand or sight bill becomes mature on demand or sight.
Grace Days	Once the bill of exchange becomes matured or due on a certain date, additional three days are given for payment. These three concession or additional days allowed for payment are known as grace days. They are applied only for time bills and not sight bills.
Discounting	Discounting of the bill of exchange is the function of commercial banks. Discounting is opposite to retirement. In retirement the bill is paid earlier than maturity date. In discounting payment is obtained before the bill is matured. The word discounting refers to the cutting of the amount off the bill at a given interest rate for making the payment of the bill before it is due.
Notary Public	Notary public is a solicitor and especially appointed by a competent authority. Their duty it is to deal with the dishonor of the bills by way of noting and protesting. Notary public's protest is accepted in the foreign courts. It also performs the function of attesting deeds. If notary public is not available, the dishonored bill may be protested (affirmed) by any member of a household or a substantial resident with two witnesses. The protest is made at the place of dishonor.
Holder In Due Course	It is the party who took hold of the bill in good faith for value and without knowledge of any defect in the title of the person from whom he took it. The holder in due course is a person who takes a bill complete and regular on the face of it, not overdue, and without notice as of any previous dishonor.

ENDORSEMENT

It refers to writing of a person's name on the back or face of a negotiable instrument or on a piece of paper attached to it for the purpose of transferring the property in the instrument. The endorsement must be unconditional and for the entire amount of the

bill or cheque. The person negotiating the instrument is called an endorser and to whom it is transferred is called an endorsee.

Kinds of Endorsement

1. Blank Endorsement Or General Endorsement

It is made without referring to any person. It is made simply by signing the name without naming the endorsee.

2. Special Endorsement

When the endorser transfers the credit instrument to a particular person by naming him in the instrument it is known as a special endorsement.

3. Partial Endorsement

When the endorsement is made for a part of the amount rather than the full, it is known as a partial endorsement. By law such an endorsement is not acceptable.

4. Qualified Or Conditional Endorsement

When endorsement is made along with a condition it is known as qualified or conditional endorsement. If the endorsee orders to pay a certain sum of money with a condition, say, the endorsee should supply him (the endorser) certain amount of goods, this type of endorsement will be known as a qualified endorsement. In practice such an endorsement does not exist.

5. Restrictive Endorsement

When an endorser transfers the credit instrument to a person and adds the word 'only' after his (endorsee's) name, this endorsement is known as restrictive endorsement. For example if endorser orders "Pay to Salim only", such an endorsement is referred to restrictive endorsement. In other words further endorsement of that instrument cannot be made. In the example above Salim cannot further endorse the instrument.

6. Sans Recourse Endorsement

When endorsement is not revocable it is known as sans recourse endorsement.

Exercises**MULTIPLE CHOICE QUESTIONS (MCQs)**

1. Foreign bill of exchange may be classified as a

- A. Bill by time
- B. Bill by place
- C. Bill by payment
- D. All of the above

2. Bills in sets are categorized as

- A. Foreign bills
- B. Bills by documents
- C. Bills by time
- D. Bills by payment
- E. Bills by place

3. A bill of exchange is

- A. An unconditional request
- B. A conditional order
- C. A conditional promise
- D. An unconditional order
- E. An unconditional promise

4. Like a cheque, a bill may be

- A. Post dated
- B. Antedated
- C. Dishonored
- D. Stale
- E. All of the above

5. Like a cheque, a bill must be

- A. Drawn on a banker.
- B. An order
- C. Written
- D. All of the above
- E. B & C

6. Unlike a cheque a bill should be

- A. Stamped

- B. Drawn on a debtor
 - C. Drawn on a notary public
 - D. Accepted
 - E. A,B & D
7. **Like a cheque a bill**
- A. May be bearer
 - B. May be drawn on a banker
 - C. May be crossed
 - D. Need no acceptance
 - E. None of the above
8. **Holder of the bill may be**
- A. Drawer
 - B. Creditor
 - C. Bearer
 - D. payee
 - E. All of the above
 - F. A. B. & C
9. **One who rightfully possesses the bill**
- A. Holder in due course
 - B. Endorser
 - C. Endorsee
 - D. Acceptor
10. **Accommodation bill is drawn to**
- A. Borrow
 - B. Lend
 - C. Trade
 - D. Sell commodities
 - E. Buy commodities
11. **A clean bill is**
- A. Well documented
 - B. Undocumented
 - C. Need not be accepted
 - D. unwritten
12. **A right bill is payable**
- A. At a certain date
 - B. After the expiry of a certain date
 - C. Both of the above
 - D. On demand

13. A bill for a definite period is known as
 - A. Demand bill
 - B. Time bill
 - C. Trade bill
 - D. Accommodation bill
14. Parties to the bill include
 - A. Maker
 - B. Acceptor
 - C. Payee
 - D. Drawee
 - E. B & C
 - F. All of the above
15. The endorser of the bill is
 - A. Acceptor
 - B. Drawer
 - C. Creditor
 - D. Payer
16. The bill is originally accepted by
 - A. Seller
 - B. Buyer
 - C. Drawer
 - D. Creditor
17. Those who receive money against the bill are
 - A. Payee and drawee
 - B. Drawer and maker
 - C. Payer and acceptor
 - D. Payee and endorsee
 - E. Endorser and acceptor
18. The endorser may be
 - A. Creditor
 - B. Seller
 - C. Buyer
 - D. Holder
 - E. All of the above except C
 - F. All of the above except C & D
19. Dishonor of the bill is on the ground of
 - A. Issuing accommodation bill
 - B. No acceptance

- C. Being a time bill
 - D. Non payment
 - E. B & D only
20. Noting of the bill is done by the
- A. Notary public
 - B. Aggrieved party
 - C. Bank
 - D. Drawer
21. Protesting is
- A. Affirmation by the notary public
 - B. Objection
 - C. Affirmation by the bank
 - D. Affirmation by the aggrieved party
 - E. Speaking strongly against
22. When the bill is paid before due date the extra payment is known as
- A. Rebate
 - B. Discounting
 - C. Retirement
 - D. Maturity
23. Concession for payment before maturity is
- A. Principal account
 - B. Rebate
 - C. Profit
 - D. Gratuity
24. Discounting is undertaken by the
- A. Central bank
 - B. Commercial bank
 - C. Notary Public
 - D. Drawer of the bill
25. In case of dishonor the party referred to is
- A. Notary public
 - B. Central bank where bill is rediscounted
 - C. Commercial bank where bill is discounted
 - D. Drawer
 - E. Drawee
26. The party who holds a defective bill in good faith is known as a
- A. Holder in due course

- B. faithful party
C. Holder of the wrong bill
D. De facto party
27. When the endorsement is made without naming a party, the action is referred to as
A. Special endorsement
B. Unnamed endorsement
C. General endorsement
D. Blank endorsement
E. C & D
28. When a part of the amount is transferred it is through
A. Restrictive endorsement
B. Partial endorsement
C. Conditional endorsement
D. Blank endorsement
29. When an endorsement contains a requirement it is
A. Qualified endorsement
B. Special endorsement
C. Restrictive endorsement
D. Sans recourse endorsement
30. Endorsement without revocation is
A. Restrictive
B. Special
C. Both of the above
D. sane recourse

ANSWER KEY

1	b	2	b	3	d	4	C	5	c
6	e	7	a	8	e	9	a	10	a
11	b	12	d	13	b	14	f	15	c
16	b	17	d	18	e	19	e	20	B
21	a	22	c	23	b	24	b	25	A
26	a	27	e	28	b	29	a	30	d

SHORT QUESTIONS

1. Define bill of exchange.
2. What are the essentials of a bill?
3. What are the kinds of a bill?
4. List down kinds and subkinds of a bill.
5. Explain bills in sets.
6. Explain inland bill.
7. Differentiate between inland and foreign bills.
8. Distinguish between time and demand bills.
9. Define sight bills.
10. Distinguish between documentary and clean bill.
11. Distinguish between bearer and order bill.
12. Explain accommodation bill.
13. prepare a list of parties to a bill.
14. Prepare a specimen of a bill of exchange.
15. Explain any three of the parties to a bill.
16. Define holder in due course
17. Distinguish between endorser and endorsee.
18. Distinguish between payee and acceptor.
19. Write a note on acceptance of a bill.
20. Describe the dishonor of a bill.
21. What do you understand by dishonor by non-acceptance?
22. Explain dishonor by non-payment.
23. Write a note on notice of dishonor.
24. Briefly describe protesting.
25. What do you mean by noting?
26. How would you explain retirement of a bill?
27. Distinguish between rebate and discount on a bill.
28. Explain grace days.
29. What do you mean by maturity?
30. Write a note on discounting of a bill.

31. What is the nature of notary public?
32. Define endorsement.
33. List down the kinds of an endorsement.
34. Distinguish between blank and special endorsements
35. Explain any two of the following:
 - a. General endorsement.
 - b. Partial endorsement.
 - c. Sans recourse endorsement.
30. Explain any one of the following:
 - d. Restrictive endorsement and qualified endorsement.
 - e. Partial and special endorsements.
 - f. General or conditional endorsement.
37. Explain qualified or conditional endorsement.

DESCRIPTIVE QUESTIONS

1. Define bill of exchange. Also name the parties in it.
2. What are the types of bills of exchange. Discuss in detail.

SO

Chapter 8

CREDIT INSTRUMENTS III

PROMISSORY NOTES

Definition

Essentials

Parties to a Promissory Note

Drawer – Payer

Kinds of Promissory Notes

Kinds by Time: Sight Promissory Note – Usance

Kinds by Liability: Single – Joint

Treatment in Accounting

Notes Receivable – Notes Payable

Specimen

Difference between Promissory Note & Cheque

Difference Between Promissory Note & Bill of Exchange

Difference Between Bill of Exchange & Cheque

Examination Questions

CHAPTER 8

CREDIT INSTRUMENTS III

PROMISSORY NOTES (PRONOTE)

Definition

The Bill of Exchange Act 1882 defines promissory note as an "unconditional promise in writing made by one person to another, signed by the maker, engaging to pay, on demand or at a fixed or determinable future time, a sum certain in money to or to the order of, a specified person, or to bearer.

Once signed by the maker, it must be handed over to the payee.

A promissory note is an unconditional promise by the borrower to return the borrowed money on a specified date to the lender or his order.

Essentials

Following essentials make and keep the promissory note or pronote valid:

1. It must be in writing.
2. It must be a promise.
3. The note is always unconditional.
4. Promise contains the return of the borrowed money.
5. It is payable on demand or on a specified period / date.
6. The maker must sign it.
7. The promise must bear a revenue stamp.
8. The maker must be a certain person.
9. Payee must be a certain person.

2.

PARTIES TO A PROMISSORY NOTE

1. Drawer / Maker/ Promisor

It is the person who owes money. He is a debtor. He makes the promise to pay off the borrowed money.

2. Drawee/ Promisee

It is the party to whom the promise is made. He is the creditor.

KINDS OF PRONOTES (PROMISSORY NOTES)

The promissory note may be of the following kinds:

I. Kinds by Time

Under this category, the pronote can be further subdivided:

1. Sight Promissory Note

This is the note which becomes payable on sight.

2. Usance or Time Promissory Note

This type of promissory note is made for a definite period of time after the expiry of which it become payable.

II. Kinds by Liability

Again it can be further subdivided into:

1. Single Promissory Note

Where the promissor (maker) is only one person and makes only himself liable to pay off the sum, such a note is known as single promissory note.

2. Joint Promissory Note

Where there are two or more promissors or makers of the note, such a written promise is known as a joint promissory note. In it two or more persons are jointly or individually liable to pay off the borrowed sum.

TREATMENT IN ACCOUNTING

In accounting records promissory notes are shown as notes receivable or notes payable.

Notes Receivable The creditor shows promissory notes under the head of notes receivable (N/R). They are shown as current assets in the balance sheet.

Notes Payable The debtor or the drawer of promissory notes shows them in his accounting records as notes payable (N/P). In balance sheet they are shown on the current liability side.

SPECIMEN OF A PROMISSORY NOTES

Promissory Note Payable on Demand	
Rs.2000	Karachi
	December 5, 2001
On demand I promise to pay to Mr. Ahmed or order the sum of Rupees two thousand only for value received.	
<div style="border: 1px solid black; width: 80px; height: 60px; display: flex; align-items: center; justify-content: center; margin: 0 auto;">Stamp</div>	
(Signature of M. Wahid across the stamp)	

DIFFERENCES BETWEEN THE PROMISSORY NOTE AND THE CHEQUE

PROMISSORY NOTE	CHEQUE
1. It is unconditional promise in writing.	It is unconditional order in writing.
2. It is drawn on the creditor.	It is drawn on the banker.
3. It is either payable on demand or after a specified date.	It is always payable on demand.
4. It cannot be crossed	It can be crossed
5. Three days of grace can be allowed.	No grace days are allowed
6. Revenue stamp is mandatory.	Revenue stamp is not required. Note: In Pakistan, revenue stamp is affixed just for an excise duty.

DIFFERENCES BETWEEN THE BILL OF EXCHANGE AND THE CHEQUE

BILL OF EXCHANGE	CHEQUE
1. It can be drawn on an individual, institution, or banker.	It is drawn on a banker only.
2. It must be accepted by the drawee.	It requires no acceptance.
3. It is payable on demand or after a specified period.	It is always payable on demand.
4. Three days of grace are allowed.	No grace days can be allowed.

5. It cannot be crossed.	It can be crossed.
6. In case of dishonor, a notice must be given.	No notice is required even if it is dishonored.
7. Revenue stamp according to the value must be affixed.	No revenue stamp is needed.
8. Payment cannot be stopped.	Payment can be stopped.
9. Dishonor requires noting and protesting.	Noting and protesting are not required in the case of dishonor.

DIFFERENCES BETWEEN THE PROMISSORY NOTE & THE BILL

BILL OF EXCHANGE	PROMISSORY NOTE
✓ 1. A bill involves three parties: a. Drawer, b. Drawee, c. Payee	There are only two parties to it: a. Maker, Drawer (Debtor), or Promissor b. Promisee Creditor, or Drawee
✓ 2. It is an unconditional order.	It is an unconditional promise.
✓ 3. It must be accepted, or else it will not be valid.	It requires no acceptance.
4. The responsibility of the drawer is secondary and depends on dishonor.	The responsibility of the drawer is primary and final.
5. Notice must be served in case of dishonor.	No notice is required in dishonor.
6. It may be accepted conditionally.	It cannot be conditional in any case.
✓ 7. It can be issued or drawn in sets.	It cannot be drawn in sets.
✓ 8. The drawer/maker is the creditor.	The drawer / maker is the debtor.

Exercises**MULTIPLE CHOICE QUESTIONS (MCQs)**

1. **A promissory note is**
 - A. An unconditional order
 - B. A conditional request
 - C. An open request
 - D. A pledge
2. **Parties to the promissory note include**
 - A. Drawer and acceptor
 - B. Acceptor and payee
 - C. Notary public and payer
 - D. Drawer and payer
3. **Like a bill of exchange the promissory note must be**
 - A. In writing
 - B. Unconditional
 - C. A promise
 - D. Accepted by the drawer
 - E. All except D
4. **In accounting a promissory note is referred to as**
 - A. Accounts receivable or payable
 - B. Bills receivable or payable
 - C. Notes receivable or payable
 - D. Bonds receivable or payable
5. **A promissory note is different from a cheque**
 - A. Conditionality
 - B. Writing
 - C. Order
 - D. Crossing
 - E. C & D
6. **A promissory note is similar to a cheque in**
 - A. Crossing
 - B. Order
 - C. Writing
 - D. Stamping

7. A bill resembles a promissory note in
- Promise
 - Order
 - Conditionality
 - Acceptance
 - Dishonor
8. The responsibility of the drawer is
- Secondary in case of dishonor of the bill
 - Primary and final in case of promissory note
 - Primary and final in case of dishonor of the bill
 - Secondary in case of promissory note
 - A & B
 - C & D
9. Notice must be served in case of dishonor of
- Cheque
 - Promissory notes
 - Cross cheque
 - Bills of exchange
10. Noting and protesting is not required in dishonor of
- Bill of exchange
 - Cheque
 - Promissory note
 - All of the above
 - B & C

ANSWER KEY

1	d	2	d	3	e	4	c	5	e
6	c	7	c	8	e	9	d	10	a

SHORT QUESTIONS

1. Define a promissory note.
2. List down the essentials of a promissory note.
3. Explain the parties to a promissory note.
4. What are the kinds of a promissory note?
5. What is a usance promissory note?
6. Distinguish between single and joint promissory note.
7. Distinguish between note receivable and notes payable.
8. Tick the right mark against the right statement.
 - 9 a. Promissory note is crossed.
 - 10 b. Bill of exchange is note crossed.
 - 11 c. Promissory note is drawn on a banker
 - 12 d. Cheque must be accepted by the drawer.
 - 13 e. Cheque is payable on demand.
 - 14 f. In a cheque grace days are allowed.
 - 15 g. Revenue stamp is needed on a cheque.
 - 16 h. Promissory note is an unconditional order.
 - 17 i. A cheque is an unconditional promise.
 - 18 j. The drawer of the bill is the creditor.

DESCRIPTIVE QUESTIONS

1. Define a cheque. Explain its kinds.
2. Enumerate and describe the parties to a cheque.



Chapter 9

CREDIT CARD

Definition

To whom are Credit Cards Issued

Debit Cards

(ATM) Automated Teller Machines

CHAPTER 9

CREDIT INSTRUMENT IV CREDIT CARD

Definition It is a card issued by a bank or a financial institution that allows credit on short term basis to the cardholder. It is issued to those who are credit worthy. The credit (or loan) allowed is unsecured but backed by the market goodwill of the cardholder. Banks issue Visa and Master cards while non-banking financial institutions American Express and Diners Club issue cards on their respective names known as American Express Cards and Diners Club cards.

Through credit cards commercial banks provide a facility to their clients to buy goods and services and withdraw cash through ATMS (automated teller machines). Credit cards are of two kinds.

- | | |
|---------------------------------|---|
| 1) Non-Bank Charge Cards | These cards are issued by non-banking institutions which are
a. American Express
b. Diners Club |
| 2) Bank Charge Cards | Such credit cards are issued by commercial banks. These cards are of two kinds.
a. Visa cards
b. Master cards |

Visa card are again of two types:

- i) Gold cards
- ii) Silver cards

Gold card have higher credit limit than the silver cards. Gold and Silver cards are also issued by American Express.

TO WHOM ARE CREDIT CARDS ISSUED

Credit cards of any kind as mentioned above are issued only to credit worthy persons. Before issuing, them the banks makes a thorough enquiry

into the financial standing of the applicant, his credibility, and expected repaying ability and punctuality.

The credit agency (the issuer of credit card) receives a charge of 2% to 3% a month on the credit amounts used or withdrawn. An annual fee is also charged. Due to severe competition many credit agencies forgo the annual fee but their monthly charges are exorbitant. Credit cards are used for shopping of electronic and other types of consumer goods. Those business that accepts these cards have to agree with the credit agency, the issuer of the credit card, to pay a certain percentage of the sales amount as a fee to the bank or credit agency.

At the time of a transaction the seller checks the genuineness of the card and then strikes the transaction. It is necessary for the business (the seller) to confirm that the card is not stolen, lost, or cancelled one. He also checks whether the amount of sales is within the limit of credit allowed.

The bank or credit agency sends on monthly basis a bill showing total purchases and / or cash withdrawn from an ATM during the previous month. The amount due may be payable in lump sum or monthly installments.

It should be borne in mind that Visa and Master are also credit agencies but they sell the cards, through local or foreign commercial banks. On the other hand, American Express and Diner's Club are non-banking financial institutions that issue the cards directly or through banks.

- Advantages**
- 1) The credit cardholder have not to carry money in their pockets and thus are saved from being robbed of.
 - 2) The cardholders pay the spent amount through cheques, and here too the use of cash is not involved.
 - 3) He enjoys the benefits of payment in installments.
 - 4) If the card is lost, the cardholder immediately reports to the bank and gets it cancelled. He is issued with a new card. On the other hand, If cash is lost somewhere outside the home it can not be recovered.

The main disadvantage, on the other hand, is that the cardholder tends to becomes extravagant.

DEBIT CARD

Definition

It is a new concept in a banking business. This card is issued to the bank's accountholders who have sufficient balance with the bank. Instead of drawing money from their accounts they make direct purchases with their cards and the amount spent is recovered from their account balance. For this service, the bank charges some fee which is deducted from the account. Cash can also be withdrawn from ATM.

Advantages

The advantages of using a debit card are these:

- 1) You don't have to carry money, especially large amount of money in your pocket.
- 2) Risk of being robbed of your cash is eliminated.
- 3) Two actions are reduced to one. In other words, you do not have to go to bank, line up, and get cash, and then go shopping. Through the card you make straight purchases thus you save time and hassle.
- 4) These transactions are interest free.

ATM (AUTOMATED TELLER MACHINES)

An automated teller machine is an electronic means of transferring funds. It is an electronic machine that replaces a human and provides needed cash to the credit cardholder, or a bank accountholder. Many ATMs accept deposit against the depositors account. The machines provide information about current balances of the account holder. All these functions are provided after the identification of the receiver or depositor of cash. Identification is made by personal identification number (PIN) which is entered on the machine at the time of making a transaction. ATMs are installed at or near the bank entrance. Other places include big stores, supermarkets, petrol pumps, drugstores. In Pakistan, the machines are installed at the bank gates.

The use of ATMs carries many advantages.

- 1) They work round the clock.
- 2) The shopper doesn't need to carry big amounts with them.
- 3) Shopping is facilitated.
- 4) Cash can be withdrawn during the closure of banking hours, Sundays, and Holidays.

The downside of using an ATM entails the risk of robbery, especially at nights.

It should be kept in mind that use of an ATM must have a valid account with the commercial bank and balance in it.

Exercises

MULTIPLE CHOICE QUESTIONS (MCQs)

1. The higher credit limit is enjoyed by

A. Master cards	B. Gold cards
C. Silver cards	D. All of the above
2. The credit/loan against credit card is secured by

A. The guarantee of a third party	B. Card holder's property
C. Goodwill of the cardholder	D. None of the above
3. Credit cards are

A. Cash coupons	B. Exchange cards
C. Plastic money	D. Credit voucher
E. None of the above	
4. Shopping is facilitated by

A. ATM	B. Credit card
C. Debit card	D. Cheque
E. All except D	
5. Before using it one must have cash balance in the account

A. Credit card	B. Debit card
C. Cheque	D. Bank draft
E. Except A	
6. In online banking a particular cheque can be presented at any

A. Branch	B. Bank
C. Special branches	D. Special banks
E. None of the above	
7. Credit card is issued to only

A. Account holder	B. Persons of goodwill
C. Government employees	D. Businessmen

ANSWER KEY

1	b	2	c	3	c	4	e	5	e
6	a	7	b						

SHORT QUESTIONS

1. Define credit card as a credit instrument.
2. Define non-bank charge card.
3. Explain bank charge cards.
4. Briefly describe to whom credit cards are issued?
5. What is a debit card?
6. Explain advantages of a debit card.
7. Define ATM.
8. What are the advantages of ATM?
9. Write a note on visa and master card.
10. Distinguish between debit and credit cards.

DESCRIPTIVE QUESTIONS

1. Define Credit Card. Also explain to whom credit cards are issued.
2. What are the advantages of Credit Cards.
3. Define Debit Card and also state its advantages.

SSQ

Chapter 10

LETTER OF CREDIT (L/C)

Definition

Explanation

Kinds

Letters of Commercial Credit:

Confirmed L/C – Unconfirmed L/C – Acceptance Credits – Documentary Credits – Clean Credits – Omnibus Credits – Fixed Credits – Revolving Credits – Transferable Credits – Divisible Credits

Letters of Traveler's Facility:

* Travellers' Cheques – Circular Cheques – Travellers' Commercial L/C – Limited L/C – Circular L/C.

L/C and State Bank

Examination Questions

CHAPTER 10

LETTER OF CREDIT (L/C)

Definition

"It is a letter of open request by a bank or other financial institution to a prospective borrower, for an agreed amount and for a definite or indefinite period. It enables the borrower to draw a bill of exchange on the bank which is automatically accepted".

Letter of credit is an open letter of request by a bank requesting a person to lend a certain sum of money to the person named therein and promises that the sum in question will be paid by itself. In other words, the bank guarantees the payment of the debt.

The request may be made by a banker or any individual, but mostly it is the banker which issues it.

Explanation

It is a document issued by a bank or other financial institution to a borrower who is allowed to draw a bill of exchange on the institution and is accepted automatically. The letter of credit is used in local and foreign trade. The buyer requests his bank to open an L/C addressed to the seller in the foreign country or other city within a country. The exporter or seller obtains the payment by presenting all necessary documents which have been accepted and returned by the importer or buyer. The L/C becomes irrevocable when the seller is informed of the credit.

The L/C states the use of the bill, the amount, period, and documents attached.

It consists of an undertaking by a bank that the bill of exchange drawn on it will be honored.

KINDS OF LETTERS OF CREDIT (L /C)

Letter of credit can be divided into two broad categories.

1. Letters of commercial credit
2. Letters of travellers' facility

**Letters of
Commercial
Credit**

These credits are used for business purposes. They are of the following types.

Confirmed or Irrevocable Credit

By issuing this type of credit the bank gives an undertaking to accept and pay the bill of exchange drawn on it.

Unconfirmed or Revocable Credits

When the bank does not give an undertaking to accept and pay the bill drawn on it, it is called unconfirmed credit. It simply states that the bank is willing to honor the bill drawn under the credit unless the credit is cancelled.

Acceptance Credits

When the credits provide for bills to be accepted by the bank instead of the importer, it is called acceptance credit. Such credits save time and risk of loss of the bill during transit.

Documentary Credits

Such credits provide for bills to be accompanied by necessary documents including railway receipts, shipping papers, insurance receipt, and bill of lading.

Clean or Non Documentary Credits

When the credit does not require attaching necessary documents with the bill, it is known as clean or non-documentary credit.

Omnibus Credits

It is granted to those exporters who possess high credit standing. They can draw full amount on a bank against the pledge of a general lien on their goods.

Fixed Credits

When credits are available for a fixed total amount either in one or several bills, it is called fixed credits.

Revolving Credits

Where credits are automatically renewable under certain conditions, they are known as revolving credits.

Transferable Credit

Where fixed credits allows its holder to transfer his right to draw against them to another person, it is known as transferable credit.

Divisible Credit

Where the credit allows its holder to transfer drawing rights in parts of the total amount of credit to the other party, it is known as divisible credit.

Letters of Travellers' Facility

Such letter are issued to the travellers. It is risky to carry money in foreign country and may be lost, stolen, or robbed. These letters are substitute to their money, and can be cashed at the designated bank at the place of visit. These are of the following types.

- Travellers' cheque
- Circular credit
- Travellers' commercial L/C
- Limited letter of credit

Travellers' Cheques

These cheques are drafts which are issued to tourists. These are used for noncommercial purpose and these are drawn by the holder on the issuing bank for round sums. These are specialized cheques made available to overseas travellers and converted into the currency of the country of destination. Travellers' cheques are issued in several denominations in a local or foreign currency. The issuing bank accepts the return of unused cheques at a little commission.

At the time of issue, the holder signs the cheque in the presence of the manager of the issuing bank and then the cashing bank; and the two signatures must agree.

Travellers' cheques can only be issued after fulfilling exchange control regulations set by the central bank of a country.

Circular Cheque / Credit

Banks issue such cheques to their agents, branches, or correspondents in foreign countries to sell them to visitors to the country of the issuing bank. For instance, Habib Bank, Karachi issues circular cheques to its branch in London to sell them to resident Pakistanis who want to visit Pakistan. These cheques are issued under the foreign exchange law of Great Britain.

Travellers' Commercial Letter of Credit

These cheques are issued to businessmen who want to make purchases abroad but are reluctant or afraid to carry with them huge amount in cash. These cheques are accompanied by necessary shipping documents.

Limited Letter Credit

Unlike circular L/C which is useful in many countries at a time, the limited letter of credit is issued only on a branch or an agent of a specified country. It is not useful in other places.

Circular or World-Wide Letter of Credit

This type of cheque is available with any of the bank's correspondents and agents abroad.

L/C AND STATE BANK

State bank of Pakistan plays a vital role in the foreign trade. In case of exports it retains foreign exchange earnings, and in case of imports it provide foreign exchange. Since it has no direct business dealings with the importer or exporter it authorizes commercial bank to deal in foreign exchange matters with their clients. These banks are authorized to issue travellers' cheques under the foreign trade laws of the country. It is required that all L/Cs must be documented. State Bank does not allow revolving and transferable credits. Documentary credit must be accompanied by the following:

1. Railway receipt
2. Insurance receipt
3. Marine insurance
4. Bill of lading
5. Other shipping documents

Exercises**MULTIPLE CHOICE QUESTIONS (MCQs)**

1. The L/C is a/an
 - A. Order
 - B. Request
 - C. Promise
 - D. None of the above
2. The L/C is issued by a /an
 - A. Exporter
 - B. Importer
 - C. Bank
 - D. Drawer of the bill
 - E. Maker of the promissory note
3. The L/C is used with the
 - A. Bill of exchange
 - B. Promissory note
 - C. Bank draft
 - D. Pay order
 - E. Cross cheque
4. Letter of commercial credit is used in
 - A. Traveling abroad
 - B. Traveling inland
 - C. Foreign trade
 - D. All of the above
5. Credits automatically renewed are known as
 - A. fixed credit
 - B. Transferable credits
 - C. Divisible credits
 - D. Revolving credits
6. Travelers cheque is a /an
 - A. Bank draft
 - B. Order cheque

- C. Bearer cheque
D. All of the above
E. None of the above
7. Cheques issued to bankers in foreign countries for the use of visitors are referred to as
A. Circular credit
B. Traveler's cheque
C. Revolving credit
D. Omnibus credit
E. None of the above
8. When railway and other receipts are attached with an L/C it is known as
A. Clear L/C
B. Omnibus credit
C. Limited L/C
D. Document airy L/C
9. L/C not useful in other places/countries other than specified ones, is known
A. Limited L/C
B. Circular L/C
C. Revolving L/C
D. Irrevocable credit
E. Revocable credit
10. Credits granted to exporters with high credit standing are known as
A. Fixed credit
B. Omnibus credit
C. Revolving credit
D. Clean credit

ANSWER KEY

1	b	2	c	3	a	4	c	5	d
6	a	7	a	8	d	9	a	10	b

SHORT QUESTIONS

1. Define letter of credit (L/C)
2. List down the kinds of L/C
3. Distinguish between documentary credits and clean credits.
4. Distinguish between revocable and irrevocable credits.
5. Distinguish between omnibus credit and divisible credit.
6. Write a brief note on following:
 - a. Fixed credits
 - b. Unconfirmed credits.
 - c. Divisible credits.
7. Write short notes on the following.
 - a. Revolving credits.
 - b. Transferable credits
 - c. Omnibus credits
8. Define travelers cheques
9. Describe circular cheques.
10. Describe travelers commercial letter of credit.
11. What is limited letter of credit.
12. Distinguish between circular credit and limited-letter credit.
13. Explain the relation between L/C and the State Bank of Pakistan.

DESCRIPTIVE QUESTIONS

1. Define letter of credit (L/C). What are its contents? What are its kinds. Explain.
2. What do you understand by travellers' cheque? What are its kinds?
3. Elucidate the method of L/C. How is it related to the bill in foreign trade.



Chapter 11

BANK ADVANCES AND FUNDS

Definition

Principles of Employing Funds:

Safety – Liquidity – Diversity – Profitability – Short-term Loans –
Judicious Utilization – Legal Requirements – Financial Liability
Structure

Employment of Funds:

Non Profitable Uses:

Purchase of Fixed Assets – Cash Reserves – Bank Reserve

Profitable uses:

Lending – Investments

Sources of Bank Funds:

Capital – Deposits – Federal Funds Purchased – Borrowings

Precaution in Lending Loans:

In Case of Secured Loans:

Life Insurance Policy – Stock Exchange Securities –
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In Case of Clean Advances:

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Factors Determining Cash Reserves:

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Habits of Using Cheques – Discounting Bill of Exchange –
Savings Habits – Clearing House Facilities – Legal Restrictions.

Credit Management:

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Mortgage – Pawn – Charge – Lien – Hypothecation

Examination Questions

CHAPTER 11

BANK ADVANCES & FUNDS

Definition

Bank funds chiefly consist in public deposits which must be returned one day, and is shown as a liability in the balance sheet of the bank. To follow the principles of using funds is to ensure not only the profit to the bank but also the return of the deposit with interest to depositors. The bank is the custodian of the public money and must use it safely and productively.

PRINCIPLES OF EMPLOYING BANK FUNDS (Principles of Investment)

The principles are as follows:

1. Safety
2. Liquidity
3. Diversity
4. Profitability
5. Short-term loans
6. Judicious utilization
7. Legal requirements
8. Financial liability structure

1. Safety

It is the first and foremost principle that calls for the bank to be very cautious in using its funds to ensure their safety. Caution and safety stem from two facts:

- a. It is a common principle of business enterprises to invest their money in such a way as to get it back with profit.
- b. Eighty percent of the bank funds consist in public deposits which must be returned with interest.

Safety and caution in the investment ensure the return of the principal amount at a profit. To achieve it the bank should follow these practices:

- a) It should issue secured loans and avoid unsecured loans.
- b) It should not invest its funds in speculative businesses.

- c) The portfolio of the bank investments should be wide and not restricted to a few.
- d) Investments should be made on strong business houses.
- e) The investment should be easily and readily returnable.
- f) Risky business should be avoided.

2. Liquidity

Liquidity refers to the state of having assets (investments) that can easily be changed into cash.

Bank assets are of two kinds:

- a. **Liquid assets:** Readily changeable to cash
- b. **Fixed assets:** Not readily changeable to cash, e.g. buildings, plots, equipment, machinery, etc.

Fixed assets may take from some months to years in changing them to cash. If the bank invests unnecessarily in these assets its liquidity position will become weak and technical solvency may be threatened. Inability of the bank to pay cash against cheques drawn on it refers to technical insolvency. So the bank funds should not be stuck in the long-term investments.

On the other hand, it only takes from some hours to a few days in converting liquid or current assets into cash.

Short-term investments may be as follows:

Short term loans
Listed shares
Listed bonds
Call loans
Discounting of bills of exchange
Treasury bills

3. Diversity

Successful and safe employment of bank funds lies in its diversity. That is, the bank should have wide portfolio of investment. To ensure this factor it should not invest all or most of its funds in one industry or one company. If the company or the industry goes bankrupt all of the bank's funds will be lost. The bank should not also advance its most funds to only a few borrowers.

It is therefore necessary for the bank:

- a. To diversify its funds to various types of industries.
- b. To advance to a greater number of business enterprises.

- c. Not to advance a big amount to a single party. The bank should not put all its eggs in one basket.

4. Profitability

It is necessary for the bank to employ its funds in profitable projects so that it can meet not only its operational expenses but also its obligations to the deposit holders. It must employ its funds in financially sound projects and business organizations which have track record of paying regular profits.

5. Short-term Loans

Investments are of two types:

- Short term investments: these are the investments which come back with profit within one year.
- Long-term investment: these refer to those investments which have a life over one year and may extend to twenty to twenty-five years or even longer.

Most of the bank deposits are short-term and therefore the bank should concentrate on only short-term investments. If the funds are employed in long-term investments the bank will find itself unable to meet its obligations of short-term deposits. Most of the deposits of the bank are in the current and saving accounts which are considered as short-term and can be withdrawn any time.

Short-term investment includes advancing short-term loans, discounting bills of exchange, buying central bank's treasury bills and other securities.

6. Judicious Utilization

As mentioned earlier, more than eighty percents of the bank funds consists in deposits and other liabilities. In other words, bankers' own equity is less than twenty percent. From this fact it becomes clear that the bank should employ its funds, which is mostly a liability, very carefully and prudently. Injudicious and unwise utilization will render the bank unable to pay off its liabilities in the from of deposits.

7. Legal Constraints/ Requirement

Banks are legally bound to follow rules laid down by the government and the central bank. Some of the legal requirements are as follows.

- All scheduled commercial banks must keep a part of their deposits at the central bank.
- No bank can lend a single party an amount larger than ten percent of its capital and surplus.

- c. No bank can lend to its director an amount above a limit specified by the rules.
- d. The bank can only invest in recognized portfolios.
- e. No bank can invest in companies and businesses on the prohibited list that includes gambling, speculation, raffle schemes, and private establishments.

8. Financial Liability Structure

How the bank employs its funds also depends on its financial structure. One bank may have deposits mostly consisting in time deposit while the other has its most of funds in demand deposits. Both banks will have to follow different investment policies. The former will need less till cash and the latter will have to hold a greater amount of till cash to pay its cheques. Moreover, the former bank will have a greater opportunity to invest its funds more profitably than the latter. Thirdly, the latter bank can prefer advancing call loans to till cash

EMPLOYMENT / USES OF BANK FUNDS

Bank funds can be used in two ways:

1. Non profitable use
2. Profitable use

NON PROFITABLE USES

Banks must use some of its money without any profit. Such a use is compulsory by law and nature of the business. These are:

1. Purchases of fixed assets
2. Maintaining cash reserve / till cash
3. Bank reserve at the central bank

Purchases of Fixed Assets

To carry out its business the bank must invest in (i.e. buy) fixed assets which include building, land, furniture, fixture, equipment, as typewriters, cars, vans, computers, etc. These assets do not yield a direct profit or income but are necessary to carry out the business.

Cash Reserve/ Till Cash

The bank must keep a sufficient amount of cash in the reserve to meet checking obligations.

This cash remains in the vaults of the bank and does bring no profits, but it is essential to keep it up to make payments against the cheques presented at the bank for cash.

Bank Reserve All scheduled commercial banks are bound to keep a certain part of their deposits at the central bank as mandatory bank reserve. This reserve at the central bank yields no profit to the bank. In the USA commercial banks can put their mandatory reserve in other commercial banks also, with no profit as usual.

PROFITABLE USE

Profitable use of funds refers to investment that yields profit to the bank. Banks must invest profitably to meet expenses, distribute dividends, and pay interest.

Profitable use may be classified as follows:

- I. Lending
- II. Investment

Lending

Banks employ their funds in advancing money and in return get interest income. The loans are provided to the following businesses.

1. Commercial and industrial concerns
2. Agriculturists
3. House building companies
4. Individuals
5. Brokers

Banks lend their funds in the following ways

1. Call loans
2. Overdrafts
3. Cash credit
4. Loans
5. Discounting bills of exchange

1. Call Loans

They are made for a very short period of time, which ranges from a few hours to a few weeks, or they may be called back any time. The rate of interest on them is low. The call loan is secured and backed by collateral. In case of default or nonpayment it is forfeited.

2. Overdrafts

The current account holder can, with the sanction of the bank, overdraw money from his account. The bank charges interest on the

amount overdrawn. If the sanction is for Rs.5000 in overdraft but the accountholder overdraws only Rs.2000 the interest will be charged on Rs.2000 only. Overdrafts are secured and short-term loans, and mostly used by businessmen to meet their day to day need for cash.

3. Cash Credits

They are like overdrafts with the exception that here interest is charged on at least 50 percent, no matter the amount has been overdrawn less than 50 percent of the sanctioned amount. Some banks charge on a minimum of 25 percent.

4. Loans

They are different from overdraft and cash loans in that the bank charges interest on the whole amount sanctioned no matter the whole amount is not withdrawn. The payment of the loan is made in lump sum.

5. Discounting Bills of Exchange

Banks employ their funds in discounting bills of exchange. Discounting by the bank refers to purchasing the bill at a discount. Generally, the bill period runs from thirty to ninety days. So is the period for discounting. The interest is charged for the period the bill is cashed or discounted. The discount is the amount deducted by the bank from the bill as an interest for the period for which the bill is still to run. Discounting is an important source of income for banks. Unlike Pakistan, in developed countries the commercial banks' large amount of funds go to the discounting of bills. If the bank needs money before the bills fall due it will go to the central bank for their rediscounting.

Investments

Investments refers to buying shares, bonds, debentures, treasury bills in the open market. Banks earn money in the form of dividends, interests and capital gains. Shares and bonds can be bought and sold at the stock exchange. The bank employs its fund in the following types of investments:

1. Government Securities

They are referred to gold edged securities because they are the safest investments. They are of the following kinds.

a. Treasury bills

Federal governments issue these bills through their central banks for a period ranging from three to twelve months. Their face value runs into millions of rupees. They yield a sizable profit to the bank but much money is stuck up in them.

b. Treasury notes / coupons

They are also issued through the central bank. They are different from the treasury bills in that they are long-term investment and are issued for a period ranging from one year to seven years.

c. Treasury bonds

They are issued for a very long period ranging from 25 to 50 years. In the U. S. they are very common.

Though the last two investments are long-term, they can be sold any time at the stock exchange. Therefore, these investments are also liquid.

2. Provincial and Local Government Bonds

Provincial and local governments need funds to carry out their day-to-day functions. Some of these requirements are financed by the grant-in-aid of the federal government and the provincial and local taxes. Since it takes time to collect taxes and governments cannot stop their functions they issue bonds to raise needed funds. The commercial banks heavily invests in them because income from them is tax-free. These bonds may be both short-term and long-term.

3. Foreign Governments' Bonds

Foreign governments raise funds by issuing bonds on the international markets. The commercial banks prefer them because they are extremely secured, carry good rate of interest, and yield foreign exchange.

4. Other Securities

Other securities include bonds or debentures issued by the following government institutions:

- (i) Municipal Corporations

- (ii) Municipal committees and boards
- (iii) Public utility corporations, as electricity, gas, telecommunication companies, and water boards.
- (iv) Other government and semi-government institutions and banks.
- (v) Port trusts, etc.

Commercial banks invest in all of them because they are also secured and offer fairly large interest rates.

5. Corporate Securities

Public limited companies float their shares and bonds through stock exchanges. Commercial banks purchase them provided the company is financially sound and its business is progressive. Although they are long-term investment but can be sold any time on the stock exchange.

SOURCES OF BANK FUNDS

Banks obtain funds through various sources:

- 1. Capital
- 2. Deposits
 - (i) Demand deposits
 - (ii) Time deposits
 - (iii) Eurodollars
- 3. Federal Funds Purchased
- 4. Borrowings
 - (i) Central bank
 - (ii) Issue of bonds

1. Capital

Capital is the bank's equity. Banks come into being under company ordinance and float shares on the open market to raise capital. The capital of the bank has two components.

- 1. Paid-up-capital
- 2. Retained earnings (Accumulated profits over the previous years)

Ordinarily seven percent of the bank's total assets (except bonds and promissory notes) constitutes capital. Remaining 93 percent are the deposits. That is, the bank is able to attract 93 rupees as deposits with an investment of seven rupees as capital. It means that the bank's

capital in relation to its total assets is 1:14. In Pakistan this ratio is far too great. Habib Bank's capital deposit ratio is 1:34. As such the amount of annual profit is many times greater than the capital itself. This state of affair shows that the banking is a very lucrative business. However, in Pakistan, most nationalized banks are at the verge of bankruptcy for mismanagement, bad loans, heavily writing off loans and other reasons.

2. Deposits

Deposits refer to money received from the accountholder by the bank for safekeeping or else. They are of three kinds:

- i) Demand deposits
- ii) Time deposits
- iii) Eurodollars

Demand Deposits

They can be withdrawn by cheques from the bank any time as needed by the accountholder. According to a survey, demand deposits constitute 38 percent of total deposits. Banks receive them through current accounts. Demand depositors commonly belong to the following categories.

- i) Businessmen and companies
- ii) Government funds
- iii) Foreign government funds

Banks do not offer interest on these deposits, but extend free service to them. In America interest on current account is legally prohibited. Some banks rather receive service charges on such accounts.

Time deposits

Time deposits are of two kinds:

- i) Savings accounts
- ii) Term / Fixed deposits

Both the accounts are interest carrying, with the fixed deposit account offering higher rate. The greater the period the higher is the rate of interest on fixed deposits. However, they are non-checking accounts and cannot be withdrawn until the expiry of the stipulated period. On the other hand, savings accounts is a checking account and the required amount, not above the limit fixed by the bank, can be drawn not more than twice a week.

Eurodollars

Local banks possess branches in foreign countries where they have large deposits in foreign exchange. These deposits in foreign exchange on foreign branches are called Eurodollars. Such deposits are easily convertible into dollars. Such funds are extremely valuable.

3. Federal Funds Purchased

For commercial bank it is mandatory to keep at the central bank a certain percentage of its total deposits. In 1998, the minimum ratio was seven percent as required by the State Bank of Pakistan.

Sometimes the balance at the central bank falls below or mounts above the required ratio. In such a circumstance, the commercial bank with the short balance borrows from the other one with surplus balance at a certain interest rate. The central bank raises no objection to such a transaction which is known as federal funds purchased. The transaction benefits both the banks. The bank with surplus balance earns profit, and the one with shortage is able to raise the balance to the mandatory requirement.

The transaction of the funds purchased or sold is carried out only for one day, and the rate at which it is made is called Fed Funds Rate. This rate is fixed taking into account underlying forces of the financial market, and hence it acts as its barometer.

Federal funds are bought or sold under three methods:

(i) Straight Transaction:

Its status is that of unsecured loans because no collateral is offered by the debtor bank.

(ii) Secured Transaction

Funds transacted under this scheme are secured by collateral offered by the debtor bank.

(iii) Repurchase Agreement

Under it an agreement is drawn between the lending and borrowing banks under which the latter (borrower) sells its purchased funds to the former (lender) and the following day takes them back at a lower rate of interest. In this way not only interest is paid but the condition of security or collateral is fulfilled.

4. Obtaining Loans

Obtaining loans is one of the leading sources for commercial banks. These loans are non-depository in nature and are obtained for a fixed period of time. They can be had in the following forms.

1. Central bank loans
2. Floatation of bonds

Central banks loans

The central bank is one of the sources of funds available for commercial banks. The commercial bank borrows from the central bank by getting its bill of exchange rediscounted and hence it can meet its immediate cash requirement.

Issue of Bonds

The commercial bank may borrow from the general public. The bank floats its bonds on the open market and invites public to invest their surplus money by purchasing its bonds. They are secured, long-term and carry a fixed interest rate. The interest is payable annually. The creditor is known as bondholder.

PRECAUTIONS IN LENDING LOANS

Bank's funds mostly consist in deposits of individuals and large and small business houses. All these deposits have to be returned. Banks enjoy the right to use these funds in advancing loans. If they exercise this right they run a risk of losing this money. If, on the other hand, this right is not exercised, the funds will lie idle yielding no profit making it impossible to pay interest to their accountholders. The only way out left for banks is to utilize these funds in advancing loans judiciously and with precautions which are as follows:

1. In Case of Secured Loans

When loans are advanced against pledge, mortgage, or collateral securities, they are known as secured loans. For advancing such loans the bank follows the precautions as under:

1. Life insurance policy

When life insurance policy is pledged as security the following observations should be made:

- a. Insurance company in question should be financially strong.

- b. Insurance policy should be valid rather than lapsed.
- c. The policy should not be used as a second mortgage. To ensure that the policy is not being used as a second mortgage, the bank gets it registered with the concerned insurance company.
- d. The age of the insured person must be accepted by the insurance company.
- e. The amount of loan should be less than ninety percent of the surrender value of the policy.
- f. The bank must take the risk of the policy being void if the insured person commits suicide, is hanged, or runs away to a foreign country.
- g. The bank must ensure that the insured person will not default the payment of the premium. The policy becomes void by defaulting the payment of premiums.

2. Stock Exchange Securities

Banks accept stock exchange securities as collateral for loans. These securities include shares, bonds or debentures. Before accepting them, the bank should, take the following precautions:

- a. The securities being offered as collateral should be listed with the stock exchange, because there the true market value of such securities can easily be ascertained and they can be easily sold there.
- b. The bank should accept only those securities which are recognized and considered good by its head office.
- c. The shares should be fully paid up and no installment thereof left due.
- d. The bank should have the authority to sell the securities in case of default. But this authority can only be exercised by memorandum or it will be unable to sell them.
- e. The shares with falling prices should not be accepted as a pledge.
- f. Under Bank Ordinance 1962, no bank can advance loan more than thirty percent of the value of shares or bonds.
- g. Before advancing loans the bank should get the transfer deed of shares signed by the borrower.

3. Immovable Properties

Banks also advance loans against immovable property as mortgage including land, building, plant, and machinery. In such a case these precautions should be taken:

- a. The immovable property should be sound enough to sell in the market without any difficulty.
- b. The purchasing price and market value should be determined.
- c. There should be no outstanding tax on the property.
- d. Property should not be pre-mortgaged.
- e. The title of ownership to the property should be in the name of the borrower.
- f. The bank must physically inspect the property.
- g. The bank should ensure that the property should not have second mortgage.
- h. The depreciation on the property being mortgaged must be taken into account.
- i. The bank should work out repairing cost of the property in question.

4. Other Items / Articles

Other articles that can be pledged include jewelry, bills of lading, railway receipts, delivery orders, dock warrants, warehouse receipts. When the bank accepts them as collateral securities it must observe the following:

- a. The bank should carefully check these documents as to their genuineness, nature of goods, quantity, amount.
- b. The weight and value of pure gold in the jewelry must be determined and the kinds of alloy and artificial gems in it should be excluded.

II. Clean Advance

Clean advances are referred to as unsecured loans. The bank must take extra care in making such advances. Usually, it avoids them. However, if it advances unsecured loans, the following precautions are necessary.

a. One-name paper advance (I.O.U)

If the bank makes advance on the basis of I.O.U. (I owe you), the borrower offers his personal surety. The bank should be very careful in accepting the personal surety of the borrower who should be reliable and must enjoy market goodwill.

b. Two-name paper advance

It refers to advances made on the basis of two sureties, one that of the borrower and the other a guarantor. Such loans call for the following considerations:

- i. Review of the goodwill of the business firms of the guarantor and the borrower.
- ii. Ability of the business to pay off the loans.
- iii. Nature and type of business. (banks avoid advancing loans to the speculative business)
- iv. Profit position of the previous years.
- v. Whether the business is a sole proprietorship, partnership or company.
- vi. Debt-equity ratio of the business.
- vii. The objective of getting loan.
- viii. Guarantor's reliability, and financial soundness.

FACTORS DETERMINING CASH RESERVES

Banks continuously face a problem as to how much cash they should maintain in the reserves to meet their obligations of paying cash on cheques drawn on them. The reserve to meet checking obligation are called till cash. If the till cash is unnecessarily greater than what is needed, the bank will lose on the amount lying idle because it would yield no profit or interest. If the bank, on the other hand, keeps its till cash less than required it will be unable to pay on all cheques drawn on it. This inability may lead the bank to technical insolvency. In the light of the above, it becomes imperative to maintain the till cash at the optimum level which is only possible if the following factors are kept in view.

Nature of Accounts

The nature of accounts at the bank goes far in the determination of the cash reserve level. The bank accounts are of three types:

1. Currents account
2. Savings account
3. Fixed deposit account

If the current deposits are the major constituent of the total amount, the bank will have to maintain high level of cash reserves because current depositors carry out a large turnover of cash transactions with the bank. On the other hand, if the bank deposits comprise mostly savings and fixed deposit accounts, it need not maintain a high level of till cash because such depositors do not take out much money from their accounts. Moreover, the fixed deposit is a non-checking account. Here the possibility of withdrawals is the least. Hence a little till cash will be needed.

Nature of Business

The bank must analyze the nature of business of its accountholders. If most of them belong to such businesses as speculation, accepting and discounting or buying bills, they are forced to quickly deposit and withdraw cash. In such a case the bank must keep up a high level of cash reserves. In case of manufacturers' accounts too the same situation prevails.

Size of Deposits

In some banks the number of account holders is large but they deposit small sums of money. These banks should keep low reserves. Other banks may have a small number of depositors but with large amounts in which case banks should maintain a high level of cash reserves.

Habits of Using Cheques

In developed countries, like the USA, people have developed the habit of using cheques and plastic money (credit cards). Whether it be shoppers or businessmen, most use these credit instruments and avoid carrying and using cash. In such countries the bank need not keep a large amount of cash reserves which find their way into profitable investments. Inversely, in undeveloped countries, as Pakistan, people are inclined to avoid cheques in shopping and business transactions. They prefer cash in all types of dealings. Banks in these countries have to maintain a high level of till cash, because the accountholder first withdraws the cash from the bank and then pays in cash.

Discounting Bills of Exchange

Commercial banks largely invest in the bills of exchange by buying and discounting them. If the banks enjoy the facility of rediscounting the bills, they will need small cash reserves. Rediscounting facility brings in cash readily.

Saving or Thrift Habits

In societies where pomp, extravagance, and showing off are common, banks will have to retain large cash reserves. Conversely, in countries with the people having developed saving and thrifty habits, banks need relatively small cash reserves.

Clearing House Facilities

Clearing house facility offered by the central bank affects the level of till cash to be maintained by the commercial bank. The presence of the facility allows the commercial bank to keep low its till cash because receivable and payable cheques cancel each other bringing down the need for cash.

Legal Restrictions

There are many countries, as U.S.A. and India that require commercial banks to compulsorily maintain a minimum balance of cash reserves all the time. This mandatory requirement affects cash level at the bank.

CREDIT MANAGEMENT

(5Cs of Credit Management)

Credit management is defined as, "banks should use their funds safely, profitably and ensure timely return of the interest or dividend and the principal amount and to achieve this objective it should plan well and determine attractive venues for safe investments and carry out control to ensure their security and accomplishment of the objective".

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The credit management can be explained in 5Cs.

1. Capital
2. Character
3. Collateral
4. Capacity
5. Conditions

These 5Cs not only make credit management effective but they also ensure the implementation of the principles of employment of the bank fund discussed in the beginning of this chapter.

Capital

Before lending, the bank should determine the financial soundness of the applicant by examining his paid-up capital. It should analyze as to how the capital has been used. If the employment is in risky, speculative, or unprofitable schemes or merchandise, the bank should avoid lending to him. It should also study financial statements and review income and expenses for the last three years. In case of a company, the bank should ensure that all financial statements have been audited.

In the event of making loans to individuals, their employers are the best source of knowing the financial standing of applicants.

Character

It refers to the goodwill, image, and paying habits of the prospective borrower. The bank should also gather knowledge of his personal character. It should ensure that the applicant will pay interest and the principal amount on time.

Collateral

The bank must sanction only secured loans. A collateral security may be in the form of mortgage, pledge, or hypothecation. In other words, security includes bonds, shares, insurance policies, land, building, jewelry and other precious articles. In case of default the bank can realize them into cash to settle the account.

Capacity

The capacity of the business should be worked out in order to decide the soundness and viability of the business. It is determined by knowing:

1. Working capital
2. Retained earnings
3. Average annual profit
4. Debt-equity ratio

The above concepts are related to the field of accounting. You can learn them from a good accounting book.

Conditions

Before advancing money, the bank should take into account the economic, financial, and political conditions of the country, government policies, level of business cycle, seasonal fluctuations, currency position, inflation rate, and international affairs. Business cycle refers to long-term changes in the economic conditions which may persist for as long as ten years. On the other hand, seasonal changes are short-lived and die down in a year.

KINDS OF SECURITIES

Securities refer to something given as a guarantee of repayment. They afford rights that a creditor acquires to the property of the debtor.

Securities offered on loans may be of the following types.

1. Mortgage
2. Pawn or Pledge
3. Charge
4. Lien
5. Hypothecation

Mortgage

Mortgage refers to "the transfer of interest in specific immovable property for the purpose of securing the payment of money advanced by way of loan". It must be borne in mind that only immovable property can be mortgaged. Lands, buildings, installed machinery are included in the immovable property. The mortgagor (debtor) remains the owner of the property. However, he parts with only that portion of it that has been mortgaged.

Kinds of Mortgage

1. Simple mortgage
2. English mortgage
3. Usufructuary mortgage
4. Sub mortgage

Simple mortgage

When the possession of the mortgaged property is not delivered, the transaction is known as simple mortgage.

English mortgage

It is an absolute transfer of ownership in the mortgaged property. After the transfer, the mortgagor remains bound to pay the mortgage money.

Usufructuary mortgage

If the mortgagor delivers the possession of the mortgaged property and allows the mortgagee (the creditor) to receive any income thereupon adjustable to the interest and or the principal amount, it is known as usufructuary mortgage.

Sub-Mortgage

Where the mortgagee (the creditor) transfers his interests in the mortgaged property, such an act is known as sub-mortgage.

Pledge or Pawn It is a contract under which an article is surrendered to the lender as security against the loan. The articles used as a pledge may include jewelry, share certificates, documents, and other valuables. The contract as a pledge can only be effected when the article is delivered to the lender.

Charge Where immovable property of the debtor is used as security for the payment of money to the creditor, but the transaction is not tantamount to mortgage, the creditor is said to have a charge on the property. It is different from the mortgage in that the charge does not involve the transfer of interest in the property, while the mortgage does.

Lien It refers to the right of holding in the goods of the debtor till he clear the debt. Lien may be particular or general. In particular lien specific

property is retained as a security. General lien is the right to retain all the goods of the debtor. It is exercised by bankers, stock brokers, factors, insurance companies, and warehouses.

Hypothecation Hypothecation refers to the mortgage of the movable property without transferring the possession of the goods. It is a right to recover the debt against the security of the specific goods.

Exercises

MULTIPLE CHOICE QUESTIONS (MCQs)

1. **Judicious utilization of banks funds refers to**
 - A. Legal utilization
 - B. Profitable use
 - C. Wise use
 - D. Unbiased utilization
2. **As a safety principle the bank fund should be used in**
 - A. Long term loans
 - B. Medium term loan
 - C. Short term loans
 - D. B and C only
3. **To maintain liquidity, the banks funds should be used in**
 - A. Call loans
 - B. Treasury bills
 - C. Listed shares
 - D. All of the above
 - E. None of the above
4. **Diversity in employing bank's funds refer to**
 - A. Investing all money in a particular industry
 - B. Advancing a big amount to a single party
 - C. Not putting all eggs in one basket
 - D. Investing all funds with most reliable and trustworthy businessmen
5. **The bank fund should go to**
 - A. More profitable, less credit worthy
 - B. Less credit worthy, less profitable
 - C. More credit was they less profitable
 - D. Speculative business

6. Short term loans include
 - A. Call loans
 - B. Loans for 18 months
 - C. Loan for 12 months
 - D. Loans for 15 months
 - E. A & C
7. Discounting bill of exchange is
 - A. Short term loan
 - B. Not a loan
 - C. Long term loan
 - D. Medium term loan
8. Banks lend in the form of
 - A. Overdrafts
 - B. Demand drafts
 - C. Cash credits
 - D. Call loans
 - E. All except B
9. Bank investment is
 - A. Lending
 - B. Accepting cheque
 - C. Accepting bills
 - D. Accepting drafts
 - E. A & C
10. Overdrafts are
 - A. Treasury bills
 - B. Secured bonds
 - C. Corporate securities
 - D. Secured
 - E. Unsecured
11. Bank borrows from
 - A. Central banks
 - B. Public
 - C. Accountholders
 - D. All of the above
 - E. None of the above
12. Two-name paper loans have
 - A. I.O.U. standing
 - B. One surety
 - C. Two sureties

- D. Two creditors
 - E. Two debtors
13. **I.O.U. stands for**
- A. I owe you
 - B. I own you
 - C. I order you
 - D. I offer you
 - E. None of the above
14. **I.O.U is**
- A. One-name paper
 - B. Two-name paper
 - C. Three-name paper
 - D. Unsecured loans
 - E. A & D
15. **Federal funds purchased refers to**
- A. Borrowing and lending between banks
 - B. Borrowing from central bank
 - C. Borrowing from public
 - D. Replenishing shortage in the deposit at the central bank
16. **These are short-term financial transactions**
- A. Treasury notes
 - B. Treasury bills
 - C. Treasury bonds
 - D. None of the above
17. **One of the sources for banks funds is**
- A. Discounting bills
 - B. Issuing letters of credit
 - C. Advances to the accountholder
 - D. Federal funds purchased
18. **Bank fund sources include**
- A. Time deposit
 - B. Demand deposit
 - C. Borrowings from central bank
 - D. Eurodollars
 - E. All of the above
 - F. A & B only.
19. **Eurodollars are**
- A. American currency
 - B. European union's currency
 - C. IMF loans

- D. Bank deposits abroad
 - E. World bank loans
20. Commercial banks can borrow from
- A. Central bank
 - B. Other commercial bank
 - C. General public
 - D. Accountholders
 - E. All of the above
 - F. All except D
21. A contract between lending and borrowing banks to sell and buy bank purchased funds is known as
- A. Purchase agreement
 - B. Sales contract
 - C. Repurchase agreement
 - D. All of the above
22. Insurance policy being used as security should be
- A. Of high premium
 - B. Second mortgage
 - C. Near maturity
 - D. 1st mortgage
23. Large cash reserves at the bank are required in case of
- A. High savings habit
 - B. No. of accounts is high
 - C. Cheques commonly used
 - D. Rediscounting facility not available
24. Small cash reserves at the bank are needed in case of
- A. Fixed deposits are in large number
 - B. Low savings habit
 - C. Clearing house facility not available
 - D. Size of individual deposits is large
25. Before lending, the bank should check applicant's
- A. Authorized capital
 - B. Subscribed capital
 - C. Called-up capital
 - D. Paid-up capital
26. The soundness of business depends on
- A. Working capital
 - B. Paid-up capital
 - C. Collateral
 - D. Registered capital

27. It determines the reliability of the borrower
 A. Capital
 B. Goodwill
 C. Size of business
 D. Accounting results
28. It is a contract under which jewelry is surrender to the lender as security against the loans
 A. Charge
 B. Lieu
 C. Pawn
 D. Mortgage
29. Surrendering immovable property to the lender as security against the loans is known as
 A. Mortgage
 B. Hypothecation
 C. Lieu
 D. Pledge
30. It is the right of holding in the goods of the debtor till he clears the debit
 A. Pledge
 B. Pawn
 C. Charge
 D. Lien
31. It is the mortgage without transferring the possession of the goods in question
 A. Charge
 B. Hypothecation
 C. Pawn
 D. Mortgage

ANSWER KEY

1	c	2	c	3	d	4	c	5	c
6	e	7	a	8	e	9	e	10	d
11	d	12	c	13	a	14	e	15	a
16	b	17	d	18	e	19	d	20	e
21	c	22	d	23	d	24	a	25	d
26	a	27	b	28	c	29	a	30	d
31	b								

SHORT QUESTIONS

1. Define bank funds.
2. List down the principles of employing bank funds.
3. Write a note on any three of the principles of the employing bank funds.
4. Explain the following principles:
 - a. Safety
 - b. Judicious utilization.
 - c. Liquidity
5. Define the following principles:
 - a. Diversity.
 - b. Short-term loans
 - c. Profitability
6. Distinguish between principles of liquidity and judicious utilization.
7. List down the uses of bank funds.
8. Write a note on non-profitable uses of bank funds.
9. Write notes on the following:
 - a. Till Cash
 - b. Bank reserves.
10. Write a note on lending from bank funds.
11. In what forms a bank lends? Your answer should be limited to two /three lines for each forms.
12. Distinguish between call loans and overdrafts.
13. Write a note on cash credits and investment.
14. Why is discounting bill of exchange a loan by the bank.
15. Write brief note on the following:
 - a. Discounting as a form of lending.
 - b. Investment in government securities as a use of bank funds.
16. Distinguish between treasury bills and treasury notes.
17. Distinguish between treasury bills and treasury bonds.
18. Prepare a list on sources of bank funds.
19. Write a note on capital as one of the sources of banks fund.
20. Highlight deposit as a source of bank fund.

21. Distinguish between demand and time deposits.
22. Explain Eurodollars.
23. Write a note on federal funds purchased.
24. Briefly describe precautions in lending loans.
25. What is the role of life insurance policy as a pledge against secured loans.
26. How do stock exchange securities act as a safe guard against secure loans?
27. Write a note on immovable properties as a mortgage against secured loans.
28. Write a note on clean advance as an unsecured loans.
29. Differentiate between one-name paper advance (IOU) and two-name paper advance.
30. Explain "I owe you"
31. List down the factors that determine the level of cash reserve.
32. Write a note on nature of accounts as a determining factor of the cash reserves at the bank.
33. Size of deposits determine the level of cash reserve at the bank. How?
34. Cheques habit determines the extent of cash reserve. How?
35. Write notes on the following as cash reserves determinants:
 - a. Saving habits
 - b. Discounting bills of exchange
 - c. Clearing house facility
36. Define credit management.
37. What are the 5Cs of credit management.
38. List down kinds of securities.
39. Distinguish between mortgage and hypothecation.
40. Write a note on the following:
 - a. Pawn
 - b. Charge
 - c. Lien
41. Differentiate between mortgage and charge.
42. Hypothecation is the mortgage of the moveable property . Discuss.
43. What are the kinds of mortgage.
44. Explain simple mortgage and English mortgage.
45. Explain usufructuary mortgage.

46. Write a note on the following:
- Sub mortgage
 - English mortgage
 - Simple mortgage

DESCRIPTIVE QUESTIONS

1. What are the principles of employing (using) bank funds? Explain in detail. Do you think Pakistani banks follow them?
2. In what ways do the bank employ their funds? Write in detail various uses of funds.
3. Enumerate and discuss various sources of bank funds.
4. Do you think banks should employ their funds in long term investments? Why or why not?
5. Differentiate between profitable and non profitable uses of bank funds.
6. What are the factors that determine the level of cash reserves that the bank must maintain? Explain.
7. What are the 5Cs of credit management?
8. What are the precautions in lending that a bank must follow? Discuss in detail.
9. What are various kinds of mortgage?



Chapter 12

CENTRAL BANK

Definition

Origin & Growth

Functions:

Government's Bank:

Monopoly of Note Issue – Controller of Credit –
Custodian of Foreign Exchange – Issue of Public
Debts – Development of Financial institutions

Banker's Bank

Lender of Last Resort – Rediscounting Bill of
Exchange – Clearing House – Cash Reserve –
Counseling Service

Methods of Issuing Currency

Minimum Reserve System – Fixed Fiduciary Reserve
system – Proportional Reserve System – Simple Deposit
System.

Chart of Functions

CHAPTER 12

CENTRAL BANK

Definition

It is a bank which is responsible for the financial and economic stability of a country. The bank is a symbol of its sovereignty and solidarity. Every country, whether developed or not, capitalist or otherwise must have a central bank. It has a pivotal position in the banking system and regulates and formulates policies for the scheduled commercial banks in a country. In Pakistan the central bank is known as State Bank of Pakistan.

Origin and Growth

The origin of the central banking system can be traced back to 1694 when the Bank of England came into being as the first ever central bank. The bank was established to help the King William III out of his government's financial crisis.

Earlier the functions of the central bank including the issue of currency notes, would be performed by several commercial banks separately. Every bank's notes were different from each other's in value, size, color, and even market goodwill. That is, the notes lacked uniformity producing an immense chaos in the smooth running of the trade. Consequently, the paper currency system was unstable, unreliable, and used to yield to gold and silver currencies. However, the metallic currency system could not keep pace with the Industrial Revolution and later the fast industrial development and fast pace of trade and industry phenomena and resultant commercial banking role spurred the need for a bank to centrally issue currency notes. So this function fell into the central bank. The shift of this function strengthened the concept of the financial and economic aspects of the paper currency, uniformity and public confidence.

In the beginning the central bank was mainly confined only to issuing paper currency, but at later stages it was entrusted with other crucial functions like credit control, clearing house, management of public debts, rediscounting of bills, custodian of foreign exchange, and the like. Now a central bank has become a must for every country and its economy. It controls other banks, DFIs, inflation, and formulates economic and fiscal policies and advises the government on foreign

trade, development of financial and capital markets, balance of trade, foreign aids etc.

The world has turned into a global village, every country being increasingly dependent on one another. Consequently, it has not only augmented the role of a central bank but also necessitated the establishment of a world central bank that regulates the functions of all central banks under the sun. Hence, the World Bank (IBRD) and International Monetary Fund (IMF) have come into being exercising their full control over all central banks, especially those in the Third World countries. Even, an international currency named Special Drawing Rights (SDR) has been evolved. Every country, being the member of the UN, has no option except to follow the dictates of the IMF and the World Bank.

FUNCTIONS OF THE CENTRAL BANK

The functions of a central bank can be placed in two broad categories:

1. Government's bank
2. Bankers' bank

I. Government's Bank

As a government's bank, the central bank performs the following functions:

1. Monopoly of note issue
2. Controller of credit
3. Custodian of foreign exchange
4. Issue and management of public debts
5. Development of financial institutions

1. Monopoly of Note Issue

One of the most important functions of the central bank is to issue currency notes for the country. Earlier this function would be performed by commercial banks individually. Every commercial bank could issue its own currency notes. This system was inherited with lack of uniformity, loss of public confidence, inflation, and different purchasing power of the different banks' notes of the same denominations. Then followed the existing modern banking system which requires the note issue only by a central bank of the country to overcome the above evils. Notes are now issued on certain principles

including a fixed ratio of a reserve of gold, silver, and approved foreign exchange to back the issue of every note. Under the modern banking practices, the following note issue systems are followed:

- i. Fixed fiduciary system
- ii. Proportional reserve system
- iii. Minimum reserve system

2. Controller of Credit

The central bank controls and regulates credit money in the country in order to expand or contract it to the requirement of the economy. Credit money is the bank money created by the use of cheques and its expansion or contraction has no direct relation with the amount of currency in circulation. The central bank controls the credit money for keeping it at certain level by using one or more of the following methods.

- a. Bank rate policy
- b. Open market operations
- c. Bank reserve ratio
- d. Rationing of credit
- e. Other miscellaneous methods

3. Custodian of Foreign Exchange

Every country exports goods and services to earn foreign exchange. This earned and other foreign exchange is held in the custody of the central bank – which in turn, uses it to finance the imports.

When businessmen export their goods they earn foreign exchange which is not handed in to them and instead it is held with the central bank. The bank pays to them in the local currency equivalent to the earned foreign exchange.

4. Issue and Management of Public Debts

When the central or the provincial government issues public debts, the central bank, on behalf of it, manages its issue, payment of interests, and retirement. Public debts are usually issued annually to general public. This function is performed by the central bank. It maintains its record, pays annual interests, and returns the principal amount on maturity. Above all, it holds the cash thus received and the government utilizes this cash according to its requirements.

5. Development of Financial Institutions

The central bank is responsible to develop financial institutions, which play a vital role in industrial, agricultural, and capital development of the country. It also facilitates the establishment and running of money markets and stock exchanges. In Pakistan, it helped establish National Bank of Pakistan, and provided million of rupees to Agricultural Development of Pakistan and other DFIs (development financial institutions).

II. Banker's Bank

The central bank also acts as bankers' bank. In this capacity it performs valuable services to its scheduled commercial banks. These indispensable services are as under.

1. Lender of the last resort
2. Rediscounting of bill of exchange
3. Clearing house services
4. Cash reserve
5. Counseling services

1. Lender of the Last Resort

A friend in need is a friend indeed, as a popular saying goes. It exactly applies to the relations of the central and commercial banks. In crisis, when a commercial bank has exhausted all its resources and still finds itself unable to meet all its obligations and outstanding dues the central bank comes forward to rescue it. The central bank provides loans to the bank in crises to enable it to discharge its liabilities and thus prevents it to go bankrupt. One of the ways to help is to rediscount bills of the commercial bank. Rediscounting refers to again discount the bills of exchange which the commercial bank has already discounted for its clients.

2. Rediscounting Bills of Exchange

Another invaluable service performed by the central bank is to rediscount bills of exchange. Commercial banks discount bills of exchange of businessmen. Discounting means encashment of the bill before it matures, at a certain rate of interest. As a result commercial banks fall short of cash. This shortage may create many problems for them so they approach the central bank for rediscounting of the same bills. By this exercise they overcome their cash shortage.

3. Clearing House Services

The central bank provides clearing house facility to commercial banks. Every bank receives cheques drawn on other banks, because of which every bank becomes creditor or debtor to the other bank or banks. All these cheques are sent to the central bank where it settles all the accounts of the banks by adjusting their debit or credit balances. Clearing service is possible because the central bank possesses cash reserves of the commercial banks.

4. Cash Reserves

Under banking law, every commercial scheduled bank is bound to deposit a certain percentage of all its deposits (time and demand deposits) with the central bank. This cash reserve serves many objectives. Firstly it provides safety to the accountholders of the commercial bank. Secondly the central bank finds itself in a better position to control credit money. Thirdly, this reserve may be used to help scheduled bank in need of cash. And, lastly, this reserve serves as a means to settle banks' obligations to one another, the practice which is known as a clearing service.

5. Counseling Services

The central bank offers precious advice and counseling services. In the light of its expert opinions and advice commercial banks formulate and readjust their policies.

METHODS OF ISSUING CURRENCY

Issuing currency is one of the core functions of the central bank. The power entrusted to it yields the following advantages.

1. Money supply is in complete grip of the bank.
2. The currency system becomes uniform.
3. The system enjoys complete confidence of the public which is necessary for the success of any currency.

A currency can be issued under the following systems.

1. Minimum reserve system
2. Fixed fiduciary system

3. Proportional reserve system
4. Simple deposit method

The explanation of these methods is given here:

Minimum Reserve system

Under it a certain level of gold reserve is fixed against which any amount of currency can be issued.

This system enjoys the following benefits.

Advantages

1. It facilitates savings of gold.
 2. It is flexible and allows to expand and contract money supply to the need.
- It, however, suffers the following setbacks too.

Limitations

1. The system is exceedingly prone to inflation leading to the collapse of currency.
2. It may lose public confidence for over-issue of the currency.

Fixed Fiduciary Reserve System

It is opposite of the above system. Under it, currency is issued up to a certain amount without any reserve of gold, but against government securities. However, when currency is needed more than the fixed level it must be backed by gold penny for penny. This method was adopted by Japan and Norway in early twentieth century.

Merits

The merits of the system are as under:

1. It is a safe system.
2. Inflation is well controlled.
3. It enjoys public confidence to the highest.

Demerits

1. The system is inelastic.
2. It adversely affects industrial growth.
3. It lacks frugality, because it requires much gold.
4. It is a costly system.

Proportional Reserve System

This system calls for a proportionate gold and silver reserve to the total issue of currency. It allows increase or decrease of the ratio as the need be. Due to its strong benefits it has become internationally - accepted currency-issuing system.

The following countries have adopted it showing their respective ratios.

U.S.	40 percent reserves
France	35 percent reserves
Germany	40 percent reserves
Russia	25 percent reserves
Pakistan	30 percent reserves
India	40 percent reserves

Advantages

1. It is flexible.
2. It is helpful in industrial growth.
3. Gold and silver are required in comparatively small amounts.

Disadvantages

1. Inflation to some extent is possible.
2. Keynes declared it an extravagant and wasteful system.
3. Governments have tendency to violate and deviate from the proportionate reserve requirement.

Simple Deposit System

This system necessitates a hundred percent gold reserve for the issue of currency.

Pros

The system enjoys the following advantages:

1. It is absolutely safe.
2. Inflation is not possible.

Cons

It suffers the following disadvantages:

1. It is inelastic and cannot be changed to the requirement.
2. It restricts business and industrial growth.
3. A large amount of gold and silver is needed, and as such the system is costly and wasteful.
4. It faces the risk of deflation.
5. It is impracticable.

FUNCTIONS OF CENTRAL BANKS

Government's Bank

- Monopoly of note issue
- Controller of credit
- Custodian of foreign exchange
- Issue and management of public debts
- Development of financial institutions
- Custodian of national reserve
- Internal & external stability of the currency
- Control of economic crisis

Banker's Bank

- Lender of the last resort
- Rediscounting of B/E
- Clearing house services
- Cash reserve
- Counseling services

Exercises

MULTIPLE CHOICE QUESTIONS (MCQs)

1. It is responsible to the financial stability of the country
 - A. Central Bank
 - B. Industrial Bank
 - C. Commercial Bank
 - D. All of the above
2. People's bank is
 - A. State bank of Pakistan
 - B. Commercial bank
 - C. Central bank
 - D. All of the above
3. Bank rate policy is determined by
 - A. Provincial government
 - B. Central bank
 - C. Federal government
 - D. Commercial bank

4. **Buying and selling treasury bills is the function of**
 - A. Government of Pakistan
 - B. State Bank of Pakistan
 - C. Commercial Banks
 - D. Scheduled Banks
5. **Open market operation refers to**
 - A. Military operation
 - B. Buying and selling government securities
 - C. Receiving deposits from markets
 - D. Selling treasury bills
6. **Bank rate of an economy is determined by**
 - A. Bank of England
 - B. State Bank of Pakistan
 - C. Central Bank
 - D. Any type of bank
7. **Rationing of credit refers to**
 - A. Sale of wheat and sugar in quotas
 - B. Setting of upper and lower limits of loans
 - C. Setting quota of foreign exchange
 - D. All of the above
8. **Credit is controlled by**
 - A. Refixing interest rate
 - B. Selling /buying treasury bills
 - C. Changing bank reserves requirements
 - D. All of the above
 - E. B & C only
9. **Currency notes are issued by**
 - A. Federal Government
 - B. Provincial Government
 - C. Central bank
 - D. Commercial bank
10. **In Pakistan currency notes are issued on the basis of**
 - A. Fixed fiduciary system
 - B. Proportional reserve system
 - C. Minimum reserve system
 - D. None of the above
11. **Central bank is banker's bank because it**
 - A. Rediscounts bills

- B. Issues L/C
 C. Draws bills
 D. Settles disputes between importer and exporter
12. **Clearing house services of the central bank refer to**
 A. Clearing accounts of creditors and debtors
 B. Clearing accounts between accountholder
 C. Clearing accounts between scheduled banks
 D. Clearing accounts between scheduled and non-scheduled banks
13. **Cash reserve requirement is fulfilled by maintaining certain cash level of**
 A. Commercial bank
 B. Central bank
 C. Branch of a commercial bank
 D. All of the above
14. **Lender of the last resort is**
 A. Commercial bank to commercial bank
 B. Central bank to central bank
 C. Commercial bank to central bank
 D. central bank to commercial bank is
15. **Discounting and rediscounting of bills the function of**
 A. Central bank
 B. Commercial bank
 C. Scheduled bank
 D. Non-scheduled bank
 E. None of the above

ANSWER KEY

1	a	2	b	3	b	4	b	5	b
6	c	7	b	8	d	9	c	10	b
11	a	12	c	13	b	14	d	15	e

SHORT QUESTIONS

1. Define central bank.
2. Briefly describe the origin of central banking system.
3. Prepare a list showing the functions of central bank.
4. Write a note on the functions of a central bank to the Government.
5. Write a note on central bank as a bankers bank.
6. Central bank acts as a government's bank. Discuss.
7. Describe the monopoly of note issue as a central bank's function.
8. Write a note on central as controller of credits.
9. Central bank is a custodian of foreign exchange elaborate.
10. Central bank carries out management of public debts. Discuss.
11. Briefly describe the methods of note issue.
12. Write a note on following:
 - a. Bank rate policy to control credit.
 - b. Open market operations as a means to control credit.
13. What is a role of bank reserve ratio to control credit?
14. Rationing of credit as a means to control credit should be used cautiously. Discuss.
15. Cash reserves requirement should be raised to control inflation. Discuss.
16. What is a relation between inflation and bank rate policy?
17. Write a note on clearing house service.
18. List down the functions of the central bank as banker's bank.
19. Central bank acts as the lender of the last resort. Discuss.
20. Write notes on the following :
 - a. Rediscounting of bill of exchange
 - b. Cash reserve requirement
21. How can deflation be controlled by bank reserve ratio requirement.
22. How does rationing of credit affect inflation.
23. The central bank uses the rationing of credit technique to control inflation or deflation. How?
24. Do you think inflation can be controlled by changing bank rates? Elaborate your answer.

25. Clearing house services help commercial banks to a great extent. Discuss.
26. Write a note on proportional reserve system in issuing notes.
27. Distinguish between minimum reserve system and fixed fiduciary reserve system in issuing currency notes.
28. Write merits and demerits of minimum reserve system of note issue.
29. Write advantages and disadvantages of simple deposit system of currency note issue.
30. Write notes on the following with reference to credit control:
 - a. Direct action
 - b. Legislation
 - c. Moral persuasion
 - d. Publicity
31. Distinguish between direct action and legislation as measures of credit control.



Chapter 13

CREDIT CONTROL

Definition

Reasons for Credit Control:

- Safety of Gold Reserve
- External Stability in the Currency
- Internal Stability of the Currency
- Stability in Production & Employment

Methods of Credit Control

- Bank Rate Policy
- Open Market Operations
- Change in Reserve Ratios
- Rationing of Credit
- Direct Action
- Moral Persuasion
- Legislation
- Publicity

Examination Questions

CHAPTER 13

CREDIT CONTROL

Definition

Credit control is one of the principal functions of the central bank. Credit money expands through commercial banks by means of cheques. It is the responsibility of the central bank to keep the credit money at the optimum level.

REASONS FOR CREDIT CONTROL

The central bank makes efforts to control the expansion or contraction of credit in order to keep it at the required level with a view to achieving the following ends.

1. To save gold reserves
2. To achieve external stability in the currency
3. To bring internal strength in the currency
4. To strengthen employment and production

Safety of Gold Reserves

Gold reserved are drained for two reasons.

1. Internal factors

Internal factors bring the gold reserve down when prices increase. Excessive expansion of credit money causes inflation which results in the increase in the cost of living. The increase in the cost of living compels people to draw more money from banks which, in return, draw more gold from the central bank. As such the central bank experiences the drain of the gold reserves.

2. External factors

External factors include the excess of imports over exports requiring the outflow of gold from the country. This negative balance of payment springs from various reasons including excessive supply of credit money. The exhaustion or shortfall in the gold reserves create economic and currency crises. Hence, the central bank endeavors to stabilize gold reserves through credit control.

**External
Stability in
the Currency**

It refers to stability in the foreign exchange rate of the local currency. Foreign exchange rate refers to ratio at which a currency can be converted into the other. The unstable and fluctuating exchange rate harms the country's economy. It impairs foreign trade, especially, the export. Impaired foreign trade adversely affects internal trade. Hence, the currency should be stable in relation to its foreign exchange rate. Credit control and measures help achieve this objective.

**Internal
Stability
of The
Currency**

Internal stability of the currency refers to stability in the price of commodities within the country. Absence of proper credit control creates instability and uncertainty in the prices bringing down the prosperity of the common man. Price stability can be ensured by effective credit measures.

**Stability in
Production &
Employment**

Production and employment are inter-woven. The greater the production the higher will be the employment rate. The higher employment rate brings prosperity to the common man. Both ends can be achieved by effective credit control.

METHODS OF CREDIT CONTROL

The central bank adopts the following methods to control credit .

I. General or Quantitative Controls

1. Bank rate policy
2. Open market operations
3. Change in reserve ratios
4. Rationing of credit

II. Selective Controls

1. Direct action
2. Moral persuasion
3. Legislation
4. Publicity

I. General Methods / Controls

1. Bank Rate Policy

Bank rate is the interest rate at which the central bank rediscounts the first class bills of exchange of the commercial bank . If the central bank wants to expand the credit money it lowers the bank rate making the availability of loan less expensive. Consequently, commercial

banks will borrow more from the central bank and lend more to the businessmen at a lower rate of interest, hence, increasing the credit money on the market. Inversely, if the central bank wants to contract the credit money supply it would raise the bank rate making the loan more costly. The step will bring down the credit money to a lower level. Bank rate policy also affects inflow, outflow, and the rate of foreign exchange.

This method is effective in the following situations.

1. When the financial market is well-organized.
2. The economic structure of the country is flexible to the extent that the procedure should beneficially affect wages, rents, commerce, production. However, Lord Keynes suggests that the method of controlling credit has become obsolete.

2. Open Market Operations (OMO)

This method is also adopted by the central bank to expand or contract credit money in the market. Under this method the bank either sells or purchases government securities to control credit. When it wants to expand credit it starts purchasing government securities with the result that more money is pumped into the market. This money in return, is deposited with the commercial banks which become more competent to grant a greater amount of loans thereby expanding credit in the market.

On the other hand when the central bank wants to contract credit it starts selling the government securities owing to which market money goes to the central bank with the result that money in the market is reduced. The deposits of commercial banks go down, weakening their power to lend.

This method will work when the following conditions are fulfilled.

1. The method should affect the reserves of commercial banks. They should contract or expand as a result of OMO. The method would fail if the bank reserves remain unaffected.
2. Demand for bank loans should increase or decrease in line with the increase or decrease in the bank cash reserves and rate of interest.
3. Circulation of bank credit should remain unchanged.

3. Change in the Reserve Ratios

Every commercial bank is required to deposit with the central bank a certain part of its total deposits. When the central bank wants to expand credit it decreases the reserve ratio as required for the commercial banks. And when the central bank wants to contract credit the reserve ratio requirement is increased. By adopting this mechanism the central bank is able to either expand or contract credit supply in the market according to the need of the economy of the country.

4. Rationing of Credit

Rationing of credit refers to fixation of the upper limit of the loans (credits) to the commercial banks. By increasing or decreasing the upper limit of the loan available to commercial banks directly affects expansion or contraction of credit money. This method should be adopted only in special cases or emergencies. It should not be adopted frequently.

Selective Controls

The central bank under certain conditions adopts the following measures.

1. Direct Action

The central bank may take direct action against commercial banks who violate the rules, orders or advice of the central bank. The direct action may include the refusal of accepting the bills of exchange presented by the commercial banks. This punishment is very severe for a commercial bank.

2. Moral Persuasion

It is another method by which central bank may get credit supply expanded or contracted. By moral pressure it may prohibit or dissuade commercial banks to deal in speculative business.

3. Legislation

The central bank may also adopt necessary legislation for expanding or contracting credit money in the market. For example new laws may be made to introduce changes in the reserve ratio requirement.

4. Publicity

The central bank may resort to massive advertising campaign in the news papers, magazines and journals depicting the poor economic conditions of the country suggesting commercial banks and other financial institutions to control credit either by expansion or by contraction.

Exercises

MULTIPLE CHOICE QUESTIONS (MCQs)

1. **One of the objective of credit control is to**
 - A. Strengthen foreign exchange rate
 - B. Defend the country
 - C. Control inflation
 - D. Maintain law and order
 - E. A & C only
2. **Price stability can be achieved by**
 - A. Economic reforms
 - B. Open market operation
 - C. Regulating import and export
 - D. Credit control
 - E. All of the above
3. **By lowering bank rate**
 - A. Credit money expands
 - B. Credit money contracts
 - C. Credit expansion remains unchanged
 - D. Savings is encouraged
4. **Direction against a bank includes**
 - A. Closure of the bank
 - B. Heavy cash penalty on the bank
 - C. Suspension of rediscounting bills of the bank
 - D. All of the above.
5. **Selective credit control includes**
 - A. Legislation
 - B. Rationing of credit
 - C. Publicity

- D. Direct action
 E. All except B
6. Open market operation will fail if
 A. Bank lending is affected
 B. Bank reserves remain unchanged
 C. Demand for bank loans is adjusted
 D. All of the above
 E. None of the above

ANSWER KEY

1	e	2	d	3	a	4	c	5	e	6	B
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SHORT QUESTIONS

1. Define credit control.
 2. List down the methods of credit control.
 3. Write a short note on reasons for credit control.
- For more question on credit control see chapter twelve.

DESCRIPTIVE QUESTIONS

1. What do you mean by Credit Control? Also explain who is responsible for the control of credit.
2. is it possible to control credit expanded by commercial banks? Explain your answer in detail.
3. Describe various devices of credit control.
4. Write notes on the following?
 - a. Reasons for credit control
 - b. Selective methods of credit control
 - c. General methods of credit control
 - d. Reserve requirements
 - e. Bank rate policy
 - f. Open market operation
 - g. Moral Persuasion.

Chapter 14

STATE BANK OF PAKISTAN

Preamble

Administrative Organization

Central Directorate – Field Office

Share Capital

State Bank & Scheduled Banks

Scheduled Banks in Pakistan

State Bank and Islamization

Functions of State Bank

Balance Sheet of State Bank

Examination Questions

CHAPTER 14

STATE BANK OF PAKISTAN

Preamble

As a result of partition of India, Pakistan came into being on 14th August, 1947. To run the financial affairs of the new-born country the governor general of India issued an order called Pakistan Monetary System and Reserve Bank Order, according to which Reserve Bank of India, the central bank of India, would undertake and manage the financial and currency system of Pakistan up to September 30, 1948. Consequently, Indian currency notes were overprinted 'Pakistan' for circulation in the new-born country.

However, the Reserve Bank of India could not discharge its functions in line with the particular situation in the country, as such the need for establishing its own central bank was felt.

Hence three months before the expiry of stipulated period set under the order, State Bank of Pakistan came into being on 1st July, 1948, opened by the Quid-e-Azam. The bank was entrusted with the functions of issuing Pakistani currency and maintaining the financial and economic stability of the country. The term period of directors is on the discretion of the federal government. However, governor and deputy governor are appointed for a period of five years each.

Administrative Organization

To run and monitor the bank it is divided into three parts:

1. Central Board of Directors: High level management
2. Central Directorate: Middle level management
3. Field Office: Low level management

Central Board of Directors

This board comprises:

Governor	1
Deputy governor	1
Directors	8
Total	10

Governor, deputy governor, and seven directors are nominated by the federal government. The eighth director is the head of the ministry of finances. All seven directors except the head of the ministry of finance are non-government officials hailing from the field of business, industry, and agriculture and are elected by the four provinces. The directors are appointed for a period determined on the discretion of the federal government. Governor and deputy governor are appointed for a period of five or more years.

The central board is responsible for all functions and matters of the bank. The governor presides all meetings of the board and with the help of deputy governor monitors all banking affairs.

Central Directorate

The central directorate consists of fifteen departments. Every department is headed by a director. Of these departments, Public Relations Department and Secretary's Department are directly accountable to deputy governor. Research and Statistics departments work under economic advisor. The remaining eleven departments work under four executive directors.

Field Office

The head office of the bank is in Karachi. In other cities which are business hubs have field offices. These cities are:

Lahore, Islamabad, Peshawar, Rawalpindi, Quetta, Faisalabad, Hyderabad, Multan, Sialkot, Sukkar, Dera Ismail Khan, Gujranwala. All the field offices except two are headed by chief managers. The bank has also its two field offices in Karachi one is located at the Civic Center and the other North Nazimabad, each headed by chief manager. The National Bank of Pakistan works in behalf of the State Bank in populous and in those cities where field offices don't exist.

Share Capital

At the time of its establishment the state Bank of Pakistan was Semi-government. Its 51 percent shares were held by the government and 49 percent by the general public. At the time of nationalization in 1974 its paid-up capital was Rs.30 million. On June 30, 1991, its paid up capital reached at Rs.100 million. Its reserved funds was Rs.250 billion and total assets, had exceeded 102 billion.

On June 30, 2006 the financial position of the State Bank of Pakistan was as follows

	Rs.
Capital Paid up	100,000,000
Reserve Fund	15,414,474,000
Rural Credit Fund	2,600,000,000
Industrial Credit Fund	1,600,000,000
Export Credit Fund	1,500,000,000
Loans Guarantee Fund	900,000,000
Housing Credit Fund	4,700,000,000
Deposits:-	
(a) Federal Government	80,452,535,000
(b) Provincial Government	61,945,988,000
(c) Azad Jamu & Kashmir Government	4,698,599,000
(d) Banks	207,574,257,000
(e) Others	104,641,242,000
Allocation of special drawing Rights	1,525,958,000
Bills Payable	472,733,000
Revaluation Account	18,747,014,000
Unrealized Appreciation on gold reserves	74,406,912,000
Unappropriated profit	19,142,000,000
Other liabilities	222,684,125,000

Total Capital Liabilities	823,105,837,000

Notes held in the Banking Department	139,340,000
Notes in Circulation	784,235,946,000

Total Notes Issued	784,375,286,000

State Bank and Scheduled Banks Those commercial and cooperative banks which are members of the central bank are called as scheduled banks. Scheduled banks enjoy valuable services offered by the State Bank of Pakistan, as clearing house services, rediscounting services, counseling, and loans. Scheduled banks also enjoy tremendous public confidence.

In Pakistan the following are the conditions to become a scheduled bank.

1. The bank should have at least Rs.3 billion as its paid-up capital and reserve by December 31st, 2006. Cooperative banks may be exempted from this requirement.

2. The applicant bank must ensure that it will not indulge in activities injurious to deposit holders. As such it must sign a declaration to this effect.

All nationalized, privatized, foreign and private sector banks, and financial institutions are all scheduled banks.

Scheduled Banks in Pakistan
Reporting Scheduled Banks & Their Branches by Group
(December 31, 2006)

Sr. No	Bank	No, of Branches
A)	Public Sector Commercial Banks	1,570
1	First Women Bank Ltd.	39
2	National Bank of Pakistan	1,234
3	The Bank of Khyber	30
4	The Bank of Punjab	267
B)	Specialized Banks	539
1	Industrial Development Bank of Pakistan (IDBP)	20
2	SME Bank Ltd.	15
3	The Punjab Provincial Cooperative Bank Ltd. (PPCB)	159
4	Zarai Taraqati Bank Ltd. (ZTBL)	345
C)	Domestic Private Banks	5,535
1	Allied Bank Ltd.	743
2	Arif Habib Rupali Bank Ltd.	8
3	Askari Commercial Bank Ltd.	121
4	Atlas Bank Ltd	21
5	Bank Al-Falah Ltd	189
6	Bank Al-Habib Ltd	151
7	BankIslami Pakistan Ltd	10
8	Crescent Commercial Bank Ltd	19
9	Dubai Islamic Bank Pakistan Ltd	10
10	Faysal Bank Ltd.	75
11	Habib Bank Ltd.	1,437
12	Habib Metropolitan Bank Ltd.	82
13	JS Bank Ltd.	4
14	KASB Bank Ltd	36
15	MCB Bank Ltd.	990
16	Meezan Bank Ltd.	62

17	My Bank Ltd.	51
18	NIB Bank Ltd.	41
19	PICIC Commercial Bank Ltd	130
20	Prime Commercial Bank Ltd	73
21	Saudi Pak Commercial Bank Ltd.	50
22	Soneri Bank Ltd.	73
23	Standard Chartered Bank(Pakistan) Ltd.	115
24	United Bank Ltd.	1,044
D)	Foreign Banks	60
1	ABN Amro Bank NV	12
2	Al-Barka Islamic Bank BSC	11
3	Citi Bank NA	18
4	Deutsche Bank AE	2
5	Oman International Bank SAOG	2
6	The Bank of Tokyo-Mitsubishi Ltd.	1
7	The Hong Kong Shanghai Banking Corporation Ltd.	5
	Indian Banks*	9
8	State Bank of India	2
9	The Bank of India Ltd.	1
10	The Central Bank of India	3
11	The Oriental Bank of Commerce Ltd.	1
12	The Punjab National Bank	1
13	The United Commercial Bank	1

*Indian Banks vested in the custodian of enemy property since sept. 1965

State Bank & Islamization

The process of Islamicization of economy in Pakistan started in July, 1979. Consequently, the interest system was abolished in three financial institutions. They were:

1. National Investment Trust (NIT)
2. Investment Corporation of Pakistan (ICP)
3. House Building Finance Corporation (HBFC)

Later in October 1979 Bankers Equity Limited was established as a private company to introduce interest-free loans for industries. In July, 1980 Small Business Corporation also abandoned interest on loans.

These actions on the part of the government started the process of Islamization in the country.

On June, 1980, the legal structure of the financial and corporate system was modified abandoning interest-bearing debentures for

Participating Term Certificates that changed over to profit or loss. On the same date an ordinance was issued allowing the establishment of modaraba companies and issuance of the Modaraba Certificates. By 1st October 1991 the number of the modaraba companies registered at the Karachi Stock Exchange had reached 23. The number reached 53 on June 30, 1999.

January 1, 1981 witnessed the start of interest-free accounts in all nationalized commercial banks. Accountholders were invited to change from interest-bearing bank accounts over to profit or loss sharing account. The banks were asked to advance loans on mark-up basis rather than interest, and to accept export bills on the basis of difference in foreign exchange rates.

In march 1981, the Islamization process was stepped up. Imports, exports, inland bills, and all the transactions at Rice Export Corporation, Cotton Export Corporation, and Trading Corporation of Pakistan were changed over to the mark-up system. The State Bank of Pakistan was allowed to accept as a pledge or mortgage Participating Term Certificates and Modaraba Certificates for advancing loans.

House Building Finance Corporation (HBFC) also began advancing loans against participation in rents replacing interest. The company is now lending to Investment Corporation (ICP) and others on profit or loss basis.

In July, 1982, all commercial banks were allowed to lend to businessmen and industrialists on the principle of Musharaka (temporary partnership) Musharaka is an interest-free system and allows lender and borrower to form a temporary partnership and settle their accounts on the principle of profit or loss. Banks can apply musharaka only in special cases.

Later, the government allowed leasing and hire-purchase on Islamic principles.

In June 1984, the whole banking system was Islamized. The system included all specialized financial institutions in Pakistan, like ADBP and IDBP being required to do away with interest by June 1985.

In July, 1985, all banking deposits were barred from interest and converted into profit or loss accounts.

In 1992, the Federal Shariat Court in its verdict declared the whole banking system based on interest as *haram*. It said interest in any form and irrespective of the terms used for it is a *riba* and hence un-Islamic. The Government of Pakistan filed an appeal in the Supreme Court against the judgment. On 23 December, 1999 the Supreme Court upheld the decision of the Federal Shariat Court and directed the Government of Pakistan to bring an end to the interest based economy by June 30, 2001. In the mid 2001, the United Bank Limited, a bank owned by the Federal Government, filed an appeal in the Supreme Court praying the review of its decision. On 14 June 2001, the Supreme Court accepted the review appeal and extended the deadline to 30 June, 2002 to establish the interest free economy.

The State Bank adopted business transactions and practices under Islamic principles as specified in its annual report.

The permissible modes of financing identified by the State Bank and advised to the banks are as follows:

(A) Financing by lending:

- (i) For loans not carrying any interest on which the banks may recover a service charge.
- (ii) Qarz-e-Hasana loans given on compassionate ground free of any interest and repayable only if and when the borrower is able to pay.

(B) Trade-related modes of financing:

- (i) Purchase of goods by banks and their sale to clients at appropriate mark-up in price on deferred payment basis.
- (ii) Purchase of trade bills on mark-up / mark-down basis.
- (iii) Purchase of movable or immovable property by the banks from their clients with buy-back agreement or otherwise.
- (iv) Leasing
- (v) Hire-purchase
- (vi) Financing for development of property on the basis of a development charge.

(C) Investment type modes of financing:

- (i) Musharaka or profit and loss sharing
- (ii) Equity participation and purchase of shares

- (iii) Purchase of Participation Term Certificates and Modaraba Certificates
- (iv) Rent-sharing.

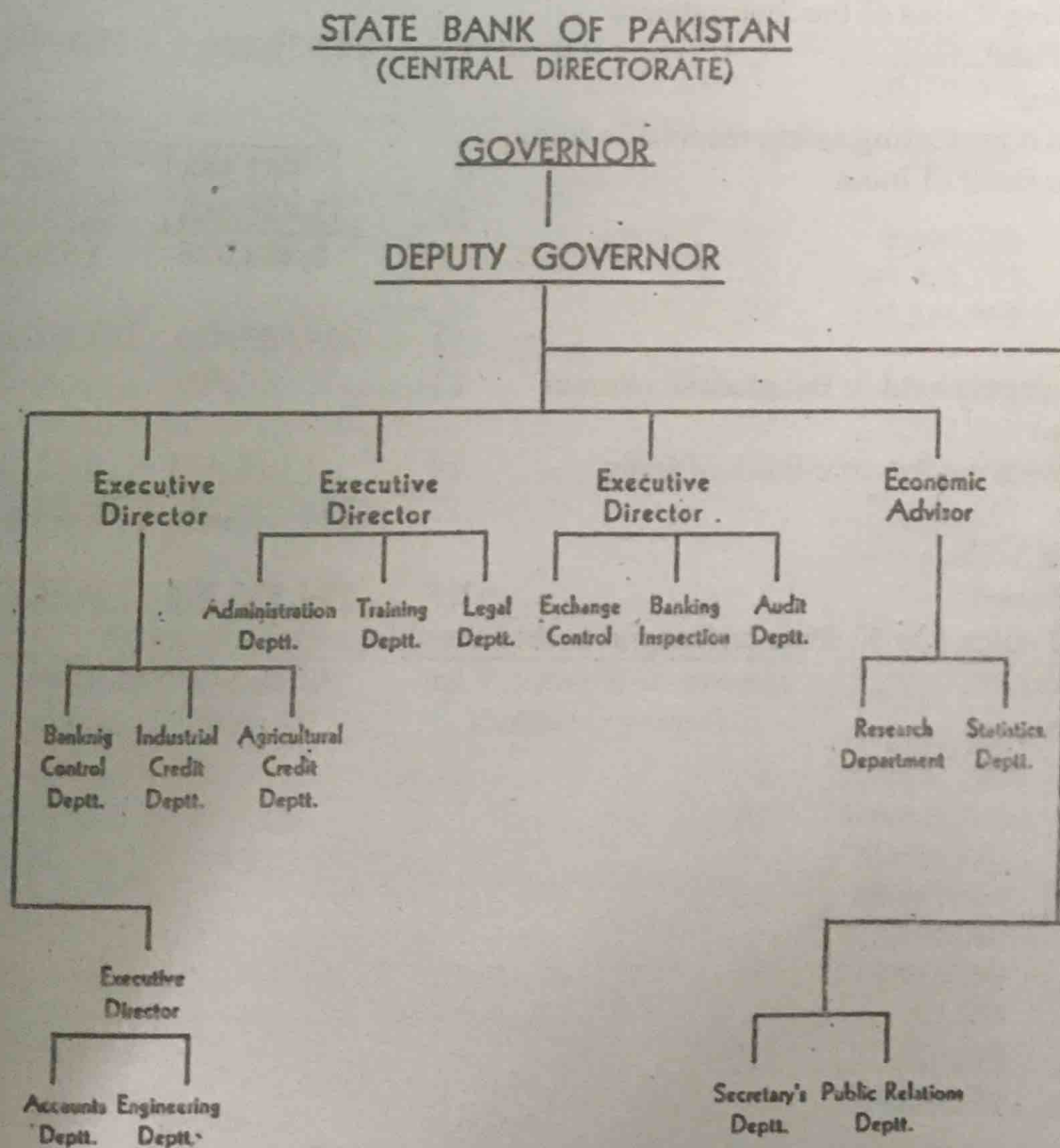
Functions of State Bank

The State Bank of Pakistan performs all those functions that a central bank anywhere does.

These functions include issue of currency notes, credit control, clearing house, issue and management of public debts, aid in foreign trade, control of foreign exchange. It also helps scheduled banks in rainy days, rediscounts their bills of exchange and offers other valuable services to them. It formulates policies to strengthen country's economy and financial structure.

The detail of these functions are given under the functions of the central bank.

ORGANIZATION CHART OF STATE BANK OF PAKISTAN



State Bank of Pakistan and its Subsidiaries – Issue Department

Consolidated Balance Sheet

As at June 30, 2006

	Note	2006 (Rupees in '000)	2005
ASSETS			
Gold reserves held by the Bank	5	76,317,295	53,870,004
Foreign currency reserves	6	555,312,089	472,513,815
Special Drawing Rights of the International Monetary Fund	7	12,035,520	11,794,613
Notes and coins:			
- Indian notes representing assets receivable from the Reserve Bank of India	9	562,568	592,981
- Coins	10	2,865,468	2,961,213
		3,428,036	3,554,194
Investments	12	135,585,429	162,802,630
Commercial papers held in Bangladesh (former East Pakistan)	13	78,500	78,500
Assets held with the Reserve Bank of India	14	1,618,417	1,251,952
		<u>784,375,286</u>	<u>705,865,708</u>
LIABILITIES			
Bank notes issued	15	784,375,286	705,865,708
The annexed notes 1 to 52 form an integral part of these financial statements			
Shamshad Akhter	Mansur-ur-Rehman Khan	Aftab Mustafa Khan	
Governor	Deputy Governor	Director Accounts	

State Bank of Pakistan and its Subsidiaries – Banking Department
Consolidated Balance Sheet
As at June 30, 2006

	Note	2006	2005
		(Rupees in '000)	
ASSETS			
Local currency	10	139,340	145,618
Foreign currency reserves	6	134,568,948	144,020,471
Earmarked foreign currency balances	8	-	11,937,000
Special Drawing Rights of the International Monetary fund	7	1,088,559	1,774,629
		<u>135,796,847</u>	<u>157,877,718</u>
Reserve tranche with the International Monetary Fund under quota arrangements	16	10,525	10,315
Securities purchased under agreement to resale	11	-	9,115,545
Current account of the Government of Balochistan	22.5	8,904,268	2,114,045
Investments	12	408,378,142	199,272,646
Loans, advances and bills of exchange	17	233,366,050	224,254,125
Balances due from the Governments of India and Bangladesh (former East Pakistan)	18	4,374,048	4,082,161
Property, plant and equipment	19	19,547,984	7,111,835
Intangible assets	20	115,681	20,871
Other assets	21	12,612,292	7,938,056
Total assets		<u>823,105,837</u>	<u>611,797,317</u>
LIABILITIES			
Bills payable		472,733	1,099,683
Current accounts of the Governments	22	147,097,122	104,917,734
Securities sold under agreement to repurchase	23	60,491,003	1,208,613
Deposits of banks and financial institutions	24	207,574,257	196,312,269
Other deposits and accounts	25	104,641,242	91,129,271
Payable to the International Monetary Fund	26	89,866,240	96,653,981
Other liabilities	27	60,997,960	24,010,325
		<u>671,140,557</u>	<u>515,331,876</u>
Deferred liability – staff retirement benefits	28	10,812,990	9,779,959
Capital grant rural finance resource center		59,431	-
Deferred income	29	426,608	414,061
Total liabilities		<u>682,439,586</u>	<u>525,525,896</u>
Net assets		<u>140,666,251</u>	<u>86,271,421</u>

Share capital	30	100,000	100,000
Allocation of special drawing rights of the International Monetary Fund	31	1,525,958	1,525,958
Reserves	32	26,714,474	16,714,474
Unappropriated profit		<u>19,142,000</u>	<u>10,060,000</u>
		47,482,432	28,400,432
Unrealized appreciation on gold reserves	33	74,406,912	51,646,593
Surplus on revaluation of property, plant and equipment	19.2	18,747,014	6,194,503
Minority interest		<u>29,893</u>	<u>29,893</u>
		<u>140,666,251</u>	<u>86,271,421</u>
CONTINGENCIES AND COMMITMENTS			
The annexed notes 1 to 52 form an integral part of these financial statements.			
Shamshad Akhter Governor	Mansur-ur-Rehman Khan Deputy Governor	Aftab Mustafa Khan Director Accounts	

State Bank of Pakistan and its Subsidiaries
Consolidated Profit and Loss Account
For the year ended June 30, 2006

	Note	2006	2005
		(Rupees in '000)	
Discount, interest / mark-up and / or return earned	35	69,940,502	29,757,649
Interest / mark-up expense	36	<u>4,047,802</u>	<u>2,284,108</u>
		65,892,700	27,473,541
Commission income	37	441,033	692,958
Exchange gain-net	38	4,376,273	13,827,713
Dividend income		1,974,628	1,502,639
Other operating income-net	39	<u>799,545</u>	<u>327,904</u>
		73,484,179	43,824,755
Less: Direct operating expenses			
Note printing charges	40	2,431,476	2,486,249
Agency commission	41	2,190,528	1,743,991
Provision for:			
- loans, advances and other assets		-	4,687,861
- diminution in value of investments		-	395,129
- other doubtful assets		547,691	1,551,419
		<u>547,691</u>	<u>6,634,409</u>
		68,314,484	32,960,106
Less: General administrative and other expenses	42	<u>6,956,813</u>	<u>5,779,637</u>
OPERATING PROFIT		61,357,671	27,180,469
Other income	43	7,288,864	4,203,976
		<u>68,646,535</u>	<u>31,384,445</u>
Less: Other charges	44	462,747	335,209
PROFIT FOR THE YEAR		<u>68,183,788</u>	<u>31,049,236</u>

The annexed notes 1 to 52 form an integral part of these financial statements.

Shamshad Akhter Governor	Mansur-ur-Rehman Khan Deputy Governor	Aftab Mustafa Khan Director Accounts
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Exercises**SHORT QUESTIONS**

1. Briefly describe the history of State Bank of Pakistan.
2. Write a note on administrative organization of State Bank of Pakistan.
3. List down the names of scheduled banks in Pakistan.
4. List down the functions of State Bank.

(For more questions see chapter-12)

DESCRIPTIVE QUESTIONS

1. Define central bank. Why do an economy need it?
2. What are the functions of a central bank? Does the State Bank of Pakistan perform the same functions?
3. Why is a central bank said to be bankers' bank? Discuss.
4. What are the methods of currency issue? Why is the central bank responsible for this function?
5. Define credit control. Discuss its methods.
6. Do you think credit should be controlled? Why and how?
7. Write short notes on the following.
 - a. Central bank as a state's bank
 - b. State Bank
 - c. Bankers' bank
 - d. Clearing house
 - e. Scheduled banks in Pakistan
 - f. Bank rate policy
8. What are the functions and services of the State Bank of Pakistan? Explain in detail.
9. Describe the organization and share capital of the S.B.P.
10. Write a note on Islamization.



Chapter 15

BALANCE OF TRADE

Balance of Trade

Balance of Payment

Chart of Balance of Payment

Examination Questions

CHAPTER 15

BALANCE OF TRADE

Definition

Every country has to import and export goods and services. Import is the buying from a foreign country and export refers to selling abroad. The difference between import and export bill of a nation during a given period is known as balance of Trade / balance of payment.

Balance of trade includes only flow of goods (visible item), ignoring services (invisible items) into or out of a country.

Balance of trade of a country will be positive or favorable if its exports exceed imports. The balance will be negative or unfavorable if its import bill is greater than export.

Note: According to some Indian and most Pakistani authors, balance of trade includes only goods but services are excluded from it. That is, only visible items are taken into account, and not invisible items, in determining balance of trade. But American and British economists and authors include both goods and services (visible and invisible item) in working out the balance of trade ignoring the term balance of payment. In this book, however, Pakistani concept has been adopted.

BALANCE OF PAYMENT

The balance of trade of a nation does not truly reflect its overall international economic and business conditions. It is quite possible that a country may have unfavorable balance of trade but favorable balance of payment. Hence to determine correct economic position it is necessary to know balance of payment since it reflects a better and truer picture of an economy.

Definition

Balance of payment is an **income and expense** account of a country during a given period. It **includes all flow** of goods, services (visible and invisible items), current **account and** capital account items. It gives a complete and detailed **account and** record of all types of imports and exports in the light of which a nation formulate its economic, industrial, and business policies greatly affecting its foreign

trade and determines or adjusts foreign exchange rate of its currency. If a country's foreign receipts are greater than payments the balance of payment will be favorable, and if receipts are less than payments, the balance will be unfavorable (negative). The continuous negative balance of payment may cause devaluation of the currency in an effort to bring the balance favorable. On the other hand consistent and stable favorable balance may call for upward revaluation which is a rise in the value of a currency in the foreign exchange market.

To figure out the nature of the balance of payment the flow of following items is taken into account:

Imports and exports of goods and services, short-and long-term foreign loans, aids, gifts, medical, educational, and hotel services, experts' fees, interest incomes and expenses, foreign visits and tours of tourists and government delegations.

The outflow of foreign exchange brings negative balance and the inflow positive or favorable balance of payment. The details of items included in the balance of payment are shown in the following chart.

CHART SHOWING ITEMS ON THE BALANCE OF PAYMENT

I. Current account transactions

A. Merchandise

1. Exports of goods (+)
2. Imports of goods (-)

B. Services

1. Military (net)
2. Travel and transportation (net)
3. Investment income (net)

Balance of goods and services = A+B

C. Unilateral transfers

1. Government grants and aids
2. Remittances, pensions, gifts, and charity

Balance on current account = A+B+C

II. Capital Account

D. Long-term Capital flows

1. Direct investment
2. Portfolio investment

E. Short-term capital flows

Official reserves transactions balance = $A+B+C+D+E$

III. Financing (deficit or surplus) Method

F. Official reserve assets (net)

1. Gold
2. Foreign exchange
3. Special Drawing Rights (SDR)
4. Reserve position at the IMF

G. Official liabilities

1. Liabilities to foreign countries / governments
2. Liabilities to foreign agencies

HOW TO IMPROVE BALANCE OF PAYMENT

Governments can exercise their powers to control the balance of payment in their favor only to a certain and limited extent beyond which it becomes uncontrollable and they have to act according to the pressure. We will discuss some of the measures that nations adopt to improve their balance of payment.

1. Bank Rate Policy

The nation may raise the rate of interest and make necessary arrangements to ensure the safety of investments. Under such conditions foreign investments begins pouring in and the balance of payment starts improving. But this method is limited in scope.

The rate of interest can be raised only to a certain level beyond which it will have damaging effects on the economy and cause inflation, which in turn hinder the inflow of foreign investment. Rate of interest method will also become ineffective when local currency is volatile and unstable in the foreign exchange market. The continuous devaluation will wipe the benefits of high interest rates. Especially, the long-term investment will suffer more than the short term investment which may absorb the shock of devaluation.

2. Devaluation

The second method to avert the negative balance of payment is the devaluing the currency in the foreign exchange open market. As a result, the goods and services will become cheaper in the international markets and exports will bump up. Increased exports will improve balance of payments.

3. Foreign Investment

Nations try to receive foreign investments. They offer attractive investment climate to foreign investors by such incentives as tax holiday, better infrastructure, free outflow of their incomes, freedom of prices, duty-free flow of raw material and machinery, soft labor laws, etc.

5. Science & Technology

The country may endeavour to concentrate on the growth of science and technology through education and aid of the developed countries. In this way standard of production can be raised and goods of advanced technology can be produced to have better position in the foreign markets.

Exercises

MULTIPLE CHOICE QUESTIONS (MCQs)

1. **Services are included in**

A. Balance of trade	B. Balance of payment
C. Balance rate policy	D. All of the above except C
2. **Unfavorable balance of trade refers to**
 - A. Exports greater than imports
 - B. Imports greater than exports
 - C. Imports less than exports
 - D. Exports less than imports
 - E. B & D only
3. **Balance of payment includes**
 - A. Goods only
 - B. services only
 - C. goods and services
 - D. Current and capital accounts
 - E. C & D
 - F. All of the above
4. **Services with reference to balance of payment include**
 - A. Military
 - B. Travel and transportation
 - C. Investment income
 - D. Merchandise
 - E. All except D

5. **Balance of payment can be improved by**
 A. Devaluation
 B. Increase in bank rate
 C. Attracting foreign investment
 D. A & B
 E. A & C
 F. All of the above
6. **Continuous negative balance of payment results in**
 A. development of the economy
 B. High confidence level of foreign investors
 C. Devaluation
 D. All of the above
 E. None of the above

ANSWER KEY

1	b	2	e	3	f	4	e	5	f	6	C
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SHORT QUESTIONS

- What do you know about balance of trade?
- Define balance of payment.
- Distinguish between balance of trade and balance of payment.
- Write a note on bank rate policy as measure to better balance of payment.
- How does devaluation improve balance of payment?
- How can foreign investment improve balance of payment.
- Write a note on science and technology as a means to improve balance of payment.
- Prepare a chart of current account transactions on the balance of payment.
- Prepare a list of capital account on balance of payment.
- Write a note on financing method in relation to balance of payment.

DESCRIPTIVE QUESTIONS

- Define and distinguish balance of trade and balance of payment.
- What are the items included on the chart of balance of payment?
- How can the balance of payment be bettered? Explain briefly.



Chapter 16

FOREIGN EXCHANGE

Definition

Factors of Foreign Exchange

Mechanism

Determination: Rate fixed by the Government – Free

Float – Dirty Float

Development of Foreign Exchange Concept

Determination of Rate of Exchange

Mechanism to Determine Foreign Exchange

Factors of Exchange Rate

Transfer of Money / Remittances

Draft – TT – Bill o Exchange – Postal Orders

Purchasing Power Parity Theory

Definition – Assumptions – Criticism

Examination Questions

CHAPTER 16

FOREIGN EXCHANGE

Definition

It is a system under which commercial nations pay off their debts.

It can be defined as the system of foreign bills of exchange under which foreign payments are made.

Black and Daniel define it as:

"The term foreign exchange refers to funds available for use in international transactions and may include foreign currency, deposits in foreign banks, and other liquid, short term financial claims payable in foreign currencies".

FACTORS OF FOREIGN EXCHANGE

Foreign exchange always involves two elements:

1. Mechanism of foreign payments
2. Determination of exchange rate

Mechanism of Foreign Payments

A third party always exists in the settlement of transactions between importer and exporter. This third party is either a bank or a discounting house. These two institutions play an important role in the foreign trade as under:

1. The local bank appoints its representatives posted in banks in foreign countries through whom foreign payments are cleared.
2. The local bank maintains in foreign countries its own branches which are used in settling transactions relating to foreign exchange.
3. Some banks establish independent banks in foreign countries. These banks offer services to importers, exporters, and governments and help them in foreign payments. These foreign banks purchase foreign exchange in the local market in order to supply the exchange to the importer.

Determination of Exchange Rate

Foreign exchange rate is determined in the following methods.

1. Rate Fixed by the Government

The government fixes its currency rate in terms of foreign currency. The rate remains fixed and stable over a long period of time. In the determination, the state keeps in view market forces, demand for local and foreign goods, and dictates of the World Bank and IMF.

2. Free Float

In this method the government leaves its currency in the open market where it (currency) finds its genuine place. Market forces, like demand and supply, push the currency at a certain level which becomes its rate. The rate of exchange will be high if the currency has a good demand abroad and will be at low level if the demand is poor.

3. Dirty Float

It is the mixture of the above two methods. The government uses its discretion up to a certain level and the rest is left to open market forces in the determination of exchange rate.

DEVELOPMENT OF FOREIGN EXCHANGE CONCEPT

No country in the world is self-sufficient. Poor countries produce raw materials but lack in manufactured goods for want of technology. Rich and developed countries possess abundance of manufactured goods but are deprived of raw materials. Thus both poor and rich countries trade with each other. Trade between two countries is referred to as foreign trade.

The most crucial problem in foreign trade is to make payments to the exporting country in its currency. In those days when trading nations were on gold standard, there was no problem in discharging each other's debts. The transactions were settled through paying or receiving gold coins or currencies convertible into gold and silver.

But now gold standard no longer exists. Every country possesses its own paper currency which is not convertible into gold or silver, and is quite different from other country's in value, size, shape, design, and mechanism. The trading countries are not willing to accept each

other's currencies. The difference in currency systems creates the need for the development of foreign exchange that refers to a system by which trading nations can discharge one another's debts. However, these countries are inclined to accept those currencies which enjoy a great demand, readily convertible into any currency, and enjoys the confidence of businessmen, common men, and governments around the world. On this standard come dollars, pounds, marks, yens, etc. All trading nations are ready to accept these currencies in imports and exports which enjoy the status of foreign exchange.

DETERMINATION OF RATE OF EXCHANGE

The rate of exchange is the ratio at which one country's currency can be exchanged for another.

If one American dollar can buy Pakistan's fifty rupees, the rate of exchange for a dollar and a rupee would be:

$$1 \text{ US } \$ = \text{Pak Rs. } 70$$

$$1 \text{ Pak Re.} = \$ 0.014 \text{ (i.e. less than 1.5 cents)}$$

MECHANISM TO DETERMINE EXCHANGE RATE

The mechanism of determination of exchange rate varies with the currency systems which may be as followed:

1. When both countries adopt gold standard.
2. When one country is on gold standard, and the other is on non convertible paper currency.
3. Both countries have non-convertible paper currencies.

1. When Both Countries Adopt Gold Standard

When two trading nations are on gold standard or their paper currencies are convertible into gold and silver, the exchange rate between their currencies would depend on the weight of gold contained in the coin. If a Pakistani coin contains two grams of gold and India's coin one gram, the exchange rate would be:

$$1 \text{ Pakistani coin} = 2 \text{ Indian coins}$$

Or 1 Indian coin = 0.50 Pakistani coin

Exchange rate thus determined is called as "mint par of exchange". Gold standard allows free flow of coins among countries with it.

2. When One Country is on Gold Standard, and the Other on Non-convertible Paper Currency.

In such a case currencies of two trading countries cannot freely flow. They will settle their foreign debts through the bills of exchange. The rate will be determined on the demand and supply of their bills, whose demand depends on that of goods and services. High demand will put the rate of currency at a high level and vice versa.

3. When Both Countries are on Non-convertible paper Currencies.

Here also the above method involving bill of exchange is used. In this modern world all countries run non-convertible paper currency system. Under it payment in foreign trade is made through bill of exchange. If the goods and services have a good demand abroad, the demand for bill of exchange will consequently be high. High demand for the bill will fetch a high exchange rate for the currency. Because of poor demand for Pakistani goods, consequently the currency, and high demand for dollar, the exchange value of a dollar to the rupee in mid 1999 was Rs.52 and in 30 July 2001 the dollar value shot up to Rs.67. Drop in the exchange rate is the indication of sustained negative balance of payment and other negative factors..

FACTORS OF EXCHANGE RATE

The following parameters play a vital role in the fixation of exchange rate.

1. Business conditions
2. Influence of stock exchange
3. Banking influence
4. Currency position
5. Speculation
6. Role of the World Bank
7. Foreign loans
8. Planned use of incomes

**Business/
Conditions**

Business conditions are the result of production, business cycle, employment, balance of payment, balance of trade, inflation, and government policies. If business conditions are poor, the rate of exchange will fall, and vice versa.

**Influence/
of Stock/
Exchange**

The functions of stock exchange include buying and selling of stocks, shares, and bonds, offering investment opportunities, and mobilization of capital. The stock exchange is the index of a country's economy. Inflow of foreign currency on the stock exchange, that is, foreign buying of shares and securities pushes the foreign exchange rate high.

**Banking/
Influence**

The use of bank drafts, travellers' cheques, letters of credit, bills of exchange, and plastic money (credit cards) has a bearing on the rate of exchange. Their incoming raises and outgoing drops the rate of exchange.

Bank rate also affects the rate of exchange. The rate is the ratio at which a central bank rediscounts bills of exchange presented by commercial banks. High bank rate may attract foreign exchange throwing a good impact on the exchange rate.

**Currency/
Position**

If currency notes are over-issued the inflow of foreign investment will stop. Consequently, the demand for local currency will fall resulting in the drop of the exchange rate. Deficit financing and subsidies also weaken the currency.

Speculation

Speculation in currencies and gold greatly affects the local currency. Speculative buying of a currency may indicate the possibility of the increase in its value compared with other currencies. Speculative buying of gold, on the other hand, portends the expected fall in the value of a country's currency.

**Role of/
World/
Bank**

Monetary systems all over the world have fallen under the purview of the World Bank and International Monetary Funds (IMF). All borrowing countries have to follow the dictates of the IMF in the determination of the exchange rate for their currencies and other monetary policies.

**Foreign/
Loans**

Foreign loans go a long way in strengthening local currency. However, if these loans are not properly utilized and spent on non development work the local currency does not become strong, and the government finds itself in a difficult situation when due date for the repayment of the loan falls.

**Planned Use
of Incomes**

If national and foreign incomes are not properly channeled and are spent unproductively the currency will get weakened. A substantial part of incomes should go for economic and industrial growth.

TRANSFER OF MONEY / REMITTANCES

In foreign trade money must be transferred in the settlement of debts from one country to another. International financial system uses the following means.

1. Bank draft
2. Telegraphic transfer (TT)
3. Bill of exchange
4. Postal order

Bank Draft

Where the creditor doesn't accept the debtor's personal cheque, the bank draft is used. It is a cheque drawn on and issued by a particular bank to the debtor to make his payment.

Bank draft can also be used within a country. Its charges are much less than those of money order which is used in transferring money through the post office. Money transferred through bank drafts are much safer than the money order.

**Telegraphic
Transfer
(TT)**

Under this method money can be transferred from one city or country to another in the shortest possible time. The bank orders its representatives or agent posted in the other city or country through telecommunication to pay a certain sum of money to the specified person. TT charges are greater than those of bank drafts.

**Bill of
Exchange**

A bill of exchange is "an unconditional order in writing, addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand or at a fixed or determinable future time, a sum certain in money to or to the order of a specified person or to bearer".

The importer receives and sends it back by post after accepting and signing it. On receiving it back, the exporter gets it discounted at his bank and receives cash. The bank will receive its money back from the importer at the maturity of the bill. Under modern practice the bill is not sent to the importer for his acceptance. It is accepted by an

authorized person or a banker in the exporter's country saving much time and cost.

Bill of exchange is used not only in foreign but also in the local trade. It is one of the most common methods used in transferring money in foreign trade.

Postal Orders In drafts, telegraphic transfers, and bills of exchange banks are involved and play a vital role. But in postal orders the post office is involved. They are quite simple in use for transferring small amounts. They are bought at the post office for the amount to be remitted and sent to the relevant party in a foreign country who will get it cashed at his country's post office.

PURCHASING POWER PARITY THEORY

Definition When two countries trade with each other there must be a definite exchange rate between them. If both the countries are on gold standard, it will be quite simple to establish a exchange rate. But if they are under non-convertible paper currency system it will be difficult to determine exchange rate. Purchasing Power Parity Theory tries to solve this problem. The theory suggests that the determination of exchange rate should depend on the purchasing power of the currencies in their respective countries. For example if a shirt in Pakistan can be purchased for a hundred rupees, and in Great Britain one pound, the exchange rate will be:

Pakistani Rs. 100 = UK £ 1

Or 1£ = Rs. 100

Or Pakistani Re. 1 = 0.02 £

In other words the purchasing power of a currency in its own country will determine its external value. The promoter of this theory was Gustav Castle, an economist of Sweden.

- Assumptions**
1. The economic conditions of both the countries should be identical, whether good or bad.
 2. The rate of exchange should include expenditure on custom tariffs, shipping charges and other duties and taxes.
 3. Those goods and services should be taken into account which are common in production and used in both the countries.

Criticism

1. The theory will not operate in the short run.
2. The price level of goods and services is taken into account only for two countries, though they may be available in other international markets too where they have the identical prices.
3. The price determination is based on 'price index' which is an arbitrary mechanism.
4. Increase in exports raises the exchange rate, and increase in import reduces the exchange rate, and in both cases internal purchasing power of a currency remains unchanged.
5. The theory calls for 'other things remaining the same' which is not possible in the real world. The world now is fast changing, especially in science and technology, greatly affecting productive factors.
6. Frequent restrictions on imports and exports, different social, business and economic standards, government price control, new inventions, etc. have rendered this theory non-operant.
7. The theory ignores the roles of banks, movement of capital, foreign investment, speculative business.
8. The interference of IBRD, IMF, and the introduction of SDR (a type of foreign exchange system) have made the theory obsolete.
9. The theory does not consider the flexibility of demand for good and services.

Exercises**MULTIPLE CHOICE QUESTIONS (MCQs)**

1. **Factors of foreign exchange include**
 - A. Mechanism
 - B. Determination of exchange rate
 - C. Float
 - D. All of the above
 - E. A & B only
2. **Foreign exchange is**
 - A. Local currency
 - B. Inland bills of exchange
 - C. A system of foreign bills of exchange
 - D. Funds used in foreign transactions
 - E. C & D
3. **Dirty float refers to**
 - A. Exchange rate determined by demand and supply
 - B. Fixation by the government and market forces
 - C. Rate fixed by the government only
 - D. All of the above
 - E. A & C
4. **Foreign exchange problem is faced by**
 - A. Developed nations
 - B. Underdeveloped nations
 - C. Developing economics
 - D. B & C only
 - E. All of the above
5. **Gold is used in foreign trade when**
 - A. Importing and exporting countries have paper currencies
 - B. One country has gold standard, the other paper currency
 - C. Importing and exporting countries are on gold standards
 - D. B & C
6. **One of required assumptions of purchasing power parity theory is**
 - A. Price mechanism
 - B. Barter system
 - C. Price Index
 - D. Monopoly

7. **The theory calls for condition that**
 - A. Things vary
 - B. Prices vary
 - C. Condition vary
 - D. Other thing remains the same.
8. **The theory ignores**
 - A. Currency rate
 - B. Restrictions of imports and exports
 - C. Exchange rate
 - D. Quality of goods
9. **The theory provides a mechanism for establishing**
 - A. Barter system between two countries
 - B. An exchange rate for all countries
 - C. Inconvertible paper currency system
 - D. An exchange rate between two countries
10. **The theory doesn't take into account**
 - A. Rate of banks
 - B. Capital movement
 - C. Foreign investment
 - D. All of the above
 - E. B & C only
11. **When trading nations have non-convertible currency systems foreign bills are paid by**
 - A. Gold
 - B. Silver
 - C. Bills of exchange
 - D. Local currency
12. **Foreign exchange rate is affected by**
 - A. IMF
 - B. Influence of stock exchange
 - C. Influence of World Bank
 - D. All of the above
 - E. A & C
13. **High amount of foreign loans**
 - A. Brings down exchange rate
 - B. Raises exchange rate
 - C. Doesn't change exchange rate
 - D. Damages country economy
 - E. Strengthens exchange rate

14. **High spending on defence results in**
A. High exchange rate (local currency costlier)
B. Low exchange rate (foreign currency costlier)
C. Strong economy
D. Weak economy
E. B & C only
15. **High imports may indicate**
A. Economic development
B. More use of foreign exchange
C. Unproductive use of national income
D. All of the above
E. B & C
16. **It is used in foreign payment**
A. Pay order
B. Cross cheque
C. Bank draft
D. Cashier's cheque
17. **Telegraphic transfer refers to**
A. Payment through post office
B. Payment through commercial bank
C. Payment through central bank
D. All of the above
18. **Small amounts are paid in foreign markets through**
A. Telegraphic transfer (TT)
B. Bills of exchange
C. Bank draft
D. Postal orders
19. **Post office is involved in**
A. Telegraphic transfer
B. Bill of exchange
C. Postal orders
D. Bank drafts
E. None of the above
20. **The most common use of foreign payment is**
A. Bank draft
B. Bill of exchange
C. Postal order
D. Money order
E. A & B

(Purchasing power parity theory)

21. Under the theory exchange rate depends on
 A. Value of currency internationally
 B. Value of the currency in the neighboring country
 C. Value of currency locally
 D. A & B only
22. The theory ignores
 A. Foreign exchange reserves
 B. Pressure of World Bank and IMF
 C. Trading capacity of the importing country
 D. Demand and supply for goods and services
 E. B & D only
23. The theory doesn't take into account
 A. Different social and economic norms
 B. Roles of banks
 C. New inventions
 D. All of the above
 E. A & B
24. One of the basic assumptions of the theory is
 A. The exchange rate includes customs tariffs
 B. Interference of IMF
 C. Role of banks
 D. Restrictions on imports or exports
25. The theory will work only when
 A. Importing and exporting countries have different economic systems
 B. Political systems are identical
 C. Trading countries have identical economy
 D. B & C

ANSWER KEY

1	d	2	e	3	b	4	e	5	c
6	c	7	d	8	b	9	d	10	d
11	c	12	d	13	e	14	b	15	d
16	c	17	b	18	d	19	c	20	b
21	c	22	e	23	d	24	a	25	c

SHORT QUESTIONS

1. Define foreign exchange.
2. Briefly describe factors of foreign exchange.
3. Explain in your own words mechanism of foreign payments.
4. Write a short note on determination of exchange rate.
5. Distinguish between free float and dirty float.
6. Write short notes on the following:
 - a. Free float
 - b. Rate of exchange fixed by the government
 - c. Dirty float
7. How is exchange rate determined?
8. Write a short note on mechanism to determine exchange rate.
9. How is rate of exchange determined when both countries are on gold standard.
10. How is exchange rate fixed when one country is on gold standard and the other on non-convertible paper currency.
11. Write the method of setting exchange rate. When both countries are on non-convertible paper currencies.
12. Prepare a list exchange rate factors.
13. Write a note on three of the following with reference to exchange rate.
 - a. Business conditions
 - b. Influence of stock exchange
 - c. Currency position
 - d. Speculation
 - e. Banking influence
14. Differentiate between the role of World Bank and foreign loans with reference to exchange rate.
15. How does planned use of incomes affect rate of exchange.
16. Write a note on methods of transfer of money.
17. Write a note on remittances.
18. Write a note on bank draft as a means of remittances.
19. Distinguish between bill of exchange and postal order as means of transfer of money.

20. Distinguish between bank draft and postal order.
21. Define purchasing power parity theory.
22. Write three assumptions of purchasing power parity theory.
23. How would you criticize purchasing power parity theory? Give three criticisms.
24. Explain how IMF and World Bank affect purchasing power parity theory.
25. How does import and export affect purchasing power parity theory?

DESCRIPTIVE QUESTIONS

1. Define foreign exchange. What are the factors involved in it.
 2. Write a detailed note on the evolution of foreign exchange.
 3. What is the rate of foreign exchange? How is it determined under different monetary standards?
1. What are the factors affecting the rate of exchange?
 2. What methods a businessman can use in transferring his money? Discuss
 3. Explain in detail Purchasing Power Parity Theory along with its assumptions and limitations.



Chapter 17

EXCHANGE CONTROL

Definition

Aims of Exchange Control

Control Devices

Examination Questions

CHAPTER 17

EXCHANGE CONTROL

Definition

Regulating all foreign exchange activities and matters by and bringing them under the jurisdiction of a centralized authority is referred to as exchange control.

To import goods the importer pays to the commercial bank amount in the local currency. The bank, in turn, surrenders the local currency to the central bank for foreign exchange in order to pay it to the exporter. Conversely, in exporting goods, the central bank receives foreign exchange which it retains with itself and deposits with the commercial bank the equivalent amount in the local currency which is finally paid to the exporter.

In short all receipts and payments of foreign exchange are made through a central bank.

AIMS OF EXCHANGE CONTROL

The objectives of exchange control are as follows:

1. To stabilize exchange rate which may fluctuate without a proper control endangering the stability of the local currency and foreign trade.
2. It facilitates meeting effectively competition with the foreign goods.
3. Flight of capital is easily and efficiently controlled.
4. Foreign exchange reserves can be maintained at a proper or desired level. These reserves gives strength to the local currency and the economy.
5. It stops depleting gold reserves.
6. The control improves balance of payment.

CONTROL DEVICES

The following devices are used in controlling foreign exchange.

Exchange Pegging

As a result of inflation the currency loses its purchasing power. Faced by such a situation, the government tries to keep up the exchange rate of its currency. The maintenance of the exchange rate is cited as exchange pegging. It is, however, an artificial and short-term remedy and entails many risks.

Clearing Agreement

Before making or receiving payments in the foreign exchange the trading countries settle exchange rate, thus preventing its unnecessary fluctuation. This agreement entails such advantages as:

- (a) Imports are regularized and come under a regulated system.
- (b) Balance of payment is bettered.
- (c) Exchange rate remains under control.

Standstill Agreement

Under this method debt servicing of foreign loans is delayed stopping the outflow of foreign exchange. This delay or moratorium helps keep up foreign exchange rate. It should be borne in mind that the depletion in foreign exchange and gold reserves is one of the main causes of fall in the exchange rate.

Transfer Moratorium

This method allows a country to pay off its foreign debts in the local currency. Later, the lender country uses this currency in the borrower's country. The U.S. had been lending to Pakistan under PL 480 which allowed repayment in Pak currency.

Block Account

Where the foreign debt servicing is carried out in the local currency with the special permission of the government, it refers to as block account. It is important to note that the foreign debts include import bills.

Exchange Equalization Fund

It is a short-term method to achieve stability in the exchange rate. The fund allows to allocate some assets which are used to buy foreign exchange when needed in order to keep up the exchange rate at a certain level. The fund is also called an "exchange stability fund".

Exchange Rationing

Because of foreign exchange crunch, the government may be constrained to assume all exchange business in order to save exchange reserves. This method is very risky for economic growth.

**Import
Quota**

To save exchange reserves from depletion, the government may ban imports partially. Importers are required to obtain import license, without which imports are not possible. Such a restriction brings savings in the exchange reserves.

Bank Rate

Bank rate is the one at which a central bank rediscounts bills of exchange presented by commercial banks. It is the interest rate fixed by the central bank for commercial banks. If the rate is increased the foreign exchange starts flowing in to earn a higher rate of interest. However, this practice causes the increase in the internal prices.

Exercises

MULTIPLE CHOICE QUESTIONS (MCQs)

1. **Exchange control is bringing the system under a**
 - A. Centralized authority
 - B. Decentralized authority
 - C. Group of commercial banks
 - D. Group of financial institutions
2. **Exchange control facilitates**
 - A. Depletion of gold reserves
 - B. Depletion of foreign exchange reserves
 - C. Maintaining optimum level of gold reserves
 - D. None of the above
 - E. A & C
3. **Flight of capital from an economy**
 - A. Facilitates economic development
 - B. Alarms economic prosperity
 - C. Both of the above depending on conditions
 - D. Alarms the world bank
 - E. Alarms the government
4. **Debt servicing refers to**
 - A. Paying interest on foreign loans
 - B. Paying dividend on loans
 - C. Paying on any loan
 - D. Paying off principal and interest

5. Exchange pegging refers to
- Keep up exchange rate
 - Keep up budgetary deficit
 - Keep up budgetary surplus
 - None of the above.

ANSWER KEY

1	a	2	c	3	c	4	c	5	a
6	b	7	a						

SHORT QUESTIONS

- Define exchange control.
- Write down any three aims of exchange control.
- List down exchange control devices.
- Explain any two of the control devices of foreign exchange.
- What do you understand by exchange pegging?
- Write a note on a transfer moratorium.
- Distinguish between exchange pegging and block account.
- Write a note on the following in reference to exchange control devices.
 - Import quota
 - Exchange control device
- Distinguish between standstill agreement and clearing agreement.
- How does exchange equalization fund act as a control device.
- What is a role of exchange rationing and bank rate as exchange control devices?

DESCRIPTIVE QUESTIONS

- Define exchange control. What are its objectives and methods?
- Define the following:
 - Bank rate
 - Import quota
 - Exchange equalizations fund

Chapter 18

PAKISTAN'S SPECIALIZED FINANCIAL INSTITUTIONS

Investment Corporation of Pakistan (ICP)

National Investment Trust (NIT)

Agricultural Development Bank of Pakistan (ADBP)

Industrial Development Bank of Pakistan (IDBP)

Pakistan Industrial Credit & Investment Corporation (PICIC)

PICIC Commercial Bank

CHAPTER 18

PAKISTAN'S SPECIALIZED FINANCIAL INSTITUTIONS

INVESTMENT CORPORATION OF PAKISTAN (ICP)

Highlights

Date of Establishment	22 February, 1966
Head Office	Karachi
Authorized Capital When Established	Rs. 200 million
Authorized Capital on 30 June, 1988	Rs. 200 million
Authorized Capital in 1999-2000	Rs. 200 million
Paidup Capital When Established	Rs. 50 million
Paidup Capital on 30 June, 1988	Rs. 100 million
Paidup Capital in 1999-2000	Rs. 265.35 million
Total Income in 1999-2000	Rs. 511.053 million
Net Profit in 1999-2000	Rs. 49.394 million
Shareholders :	Nationalized Banks, Foreign Banks, Insurance Companies 11 Members
Board of Directors	
Borrowings from State Bank of Pakistan up to 30 June, 1988	1243 million
Lending to the Industries	393.602 million
Number of funds on 30 June, 1998	26
Market Value of the Funds on June 30, 1998	6.4 billion
Number of Certificate holders on 30 June, 1998	154898
Paid up Capital of 26 Mutual Funds	1920 million
ICP Investment Portfolio	Shares, FIBs, & Government
Financial Relief Provided in 1996-97	124,135 million
Amount written off in 1996-97	1289 million
Outstanding Liabilities on the Opening of 1996-97	378,152 million
Senior Officers on June 30, 1988	19
Junior Officers on June 30, 1988	271
Non-managerial Staff on June 30, 1988	273

Background

In the decade of 1960s Pakistan entered the industrial era. It was the time when many famous financial institutions were formed including Agricultural Development Bank of Pakistan, Industrial Development Bank of Pakistan, Pakistan Industrial Credit Investment Corporation, National Investment Trust, etc. To hone the industrial growth in the country, Investment Corporation of Pakistan was also established. Its other objectives were to increase the number of industrialists, attack and weaken monopolies and cartels, and bring about a strong middle class – which should have a direct interest in the country's economic development and could perform by pulling its weight.

Management

The management is vested with the board of directors. The board comprises the following:

Chairman (appointed by the government)	1
Managing director (appointed by the government)	1
Directors (appointed by the government)	4
Directors (elected by shareholders)	5
Total	<hr/> 11

Board of Directors

1. Joint Secretary, Ministry of Finance
2. Joint Secretary, Ministry of Industries and Production
3. MD, National Energy Services Ltd.
4. Chairman, State Life
5. Director, Muslim Commercial Bank
6. MD, National Investment Trust
7. President, National Bank of Pakistan
8. President, Habib Bank of Pakistan
9. Vice Chairman, Allied Bank of Pakistan
10. Chief Financial Controller, United Bank of Pakistan

Resources

The ICP possessed the financial resources on June 30, 1988 as follows:

Paid-up capital provided by nationalized and foreign commercial banks, and insurance companies	Rs.100 million
Loans from the federal government and State Bank	Rs.1.243 million

Functions / Services

ICP performs the following functions:

1. To encourage and enhance industrial investment.

2. To develop capital market.
3. It receives deposits from investors which are ploughed back productively.
4. It offers investment counselling to its clients.
5. The ICP deals in shares, bonds, and other securities.
6. It issues ICP Mutual Funds as a means of collecting funds from the general public for the purpose of reinvestment. On July 31 1999, it had issued 26 mutual funds.
7. To raise industrial investments
8. To develop capital market
9. It underwrites new issue of shares and bonds.
10. it buys and sells marketable securities on the stock exchange.
11. It receive huge amount of money through the sale of mutual funds.

By 1998, it had issued 26 mutual funds for public subscription. The total amount of subscription from these 26 mutual funds reached at Rs.13.14 billion. It paid an average dividend as follows:

1996	36 %
1997	20 %
1998	19 %

NATIONAL INVESTMENT TRUST (NIT)

Some Basic Data	Date of establishment:	November 12, 1962
	Head office:	Karachi
	Paid up capital at establishment:	Rs. 1,200,000
	Paid up capital on June 30, 1989:	Rs. 3,732,420,000
	Rate of profit on units on June 30, 1989	19%
	Investment & loan granted, June 30 1980	Rs. 2166.241 million
	Capital account (1997)	Rs. 25,951,445,029
	Total assets (1997)	Rs. 29,043,526,153
	Decrease in value of investment (1997)	Rs. 1,100,187,438
	Management	Board of 11 directors
	Senior officers, June 30, 1988	11
	Junior Officer, June 30, 1988	83
	Non-managerial staff, June 30, 1988	108

Background & Objectives

Economic and industrial growth requires a large amount of capital which one or a few banks or financial institutions cannot make it available. Large funds can be raised by collecting small savings. National Investment Trust receives small deposits from the general public by selling units in the denomination of Rs. 1, 5, 50, 100, 1000, 10000. Consequently, it manages to raise huge funds on which it pays handsome returns on non-interest basis. The trustee of the NIT is National Bank of Pakistan. The NIT was created by a Deed of Agreement of November 12, 1962 between the National Bank of Pakistan as the trustee and the National Investment Trust Limited as the management company. The National Bank acts as the custodian of the property of the trust. The administration of the investment is carried out by the management company.

Kinds of Units

The NIT issues two types of units:

1. Bearer certificates
2. Registered certificates

Bearer Unit Certificates

These certificates are available without signing the name of the buyer. Anybody who holds them is taken as the owner of the certificate. It is issued in the denominations of Rs. 5, 10, 50, 100, and 1000.

Registered Unit Certificates

They are also issued in the same denominations as the bearer units. It carries the name of the buyer. The principal amount and the profit are payable only to the person named therein.

Income on the units is distributed through the coupons attached to the certificates.

Units are bought and sold through the trustee bank and other nominated banks which act as agents of the trustee. The units can easily be sold back to the management company.

Economic Adviser to the Government of Pakistan defines Unit Trust as a device whereby a great number of individual investors pool their resources and create funds large enough to be soundly invested in a diversified portfolio of shares.

Management

The management of the trust is vested in the board of directors comprising twelve members. The board is headed by a managing director who is appointed by the Federal Government. The remaining eleven directors are elected by shareholders.

Advantages of Holding Units

1. The units have been declared approved securities and investment for the purposes under Insurance Act 1938 and Company Ordinance 1984.
2. Provident funds and benevolent funds can be invested in these units.
3. The buyer of the units is eligible for getting income tax exemption.
4. Non-resident Pakistanis can buy them.
5. Resident foreigners can also buy them.

AGRICULTURAL DEVELOPMENT BANK OF PAKISTAN (ADBP)

Highlights

Date of establishment	18 Feb, 1961
Head office	Islamabad
Authorized capital at establishment	Rs.200 million
Authorized capital on June 30, 1988	Rs.1500 million
Paid-up capital at establishment	Rs.100 million
Paid up capital on June 30, 1988	Rs.988.323 million
Loans granted March 31, 1961	Rs.670.86 million
Loans granted June 30, 1988	Rs.8960.556 million
Management	Board of 12 directors headed by a chairman
Senior officers, June 30, 1988	10
Junior officer, June 30, 1988	564
Non managerial staff, June 30, 1988	7033

ADBP in 1996

Authorized Capital	Rs. 4 billion
Issued & paid up capital	Rs.3,214,323,000
Reserves	Rs.3,479,987,124
Deposits	Rs.2,093,118,190
Borrowings From:	
State Bank	Rs.39,983,894,320
IDA	Rs.1,346,195,683
World Bank	Rs.2,952,867,540
IFAD	Rs.605,048,680
ADB	Rs.3,514,066,272
DECF Japan	Rs.2,126,340,640
Profit	Rs.193,000,332

Background

The Agricultural Development Bank of Pakistan came into being under Agricultural Bank Ordinance 1961 under which Agricultural Development Finance Corporation (ADFC) formed in 1952 and Agricultural Bank of Pakistan (ABP) formed in 1957 were merged to give way to ADBP.

Capital

At the time of its establishment its authorized capital was Rs. 200,000,000 which gradually increased to Rs.4billion. The paid up

capital which was 100,000,000 at the time of its formation increased to 988,300,000 on June 30, 1988, and to Rs.3.214 billion on June 30, 1996.

In addition to capital its financial resources include deposits, bonds, foreign loans, and aids from the government. The bank has also obtained loans from International Development Association under UNO aid program.

Objectives & Services

The main objective of the bank is to hone the agricultural development of the country. To achieve this end the bank undertakes the following functions:

Short Term Loans

1. It advances loans in cash and kind to persons belonging to cottage industry.
2. The bank advances loans for purchasing light machinery, agricultural implements, means of transportation.
3. It offers loans to finance livestock, dairy farming, cattle breeding, poultry farming.
4. The bank also helps farmers in the reclamation of land.
5. Farmers can obtain loans to finance the cost of raising crops and marketing the harvest.
6. Purchasing seeds and fertilizer are also financed from the bank loans.

Note: The above loans are usually short term and do not exceed 18 months.

Long Term Loans

The long-term loans are offered exceeding 5 years for the following purposes.

the construction of warehouses
purchase of tractors
installation of tube wells
plantation of orchids
purchase of agricultural machinery
plantation of cold storage

The rate of interest is smaller for long-term loans than for short-term loans.

**Income Tax
Exemption**

Along with cooperative societies and banks the ADBP is exempted from payment of income tax. The reason for tax exemption is stated to allow for affording high amount of bad loans..

Management

The ADBP is run by a board of directors which comprises 12 members who are appointed from the following places;

Ministry of Finance	one director
Ministry of agriculture	one director
State Bank of Pakistan	one director
Four Provinces	four directors
Feudal's Representatives	four directors (one from each province)
Azad Kashmir	one director

The chief executive of the bank is the head of the board of directors.

INDUSTRIAL DEVELOPMENT BANK OF PAKISTAN (IDBP)

Highlights	Date of formation	August 1, 1961
	Registered office	Karachi
	Nominal capital when established	Rs.30 million
	Loans granted, 30.6.1963	1. 146.6 million in (foreign exchange) 2. 50.58 million rupees (in local currency)
	Loans granted, June 30, 1968	2386.17 million
	Nominal capital on June 30, 1988	Rs.200 million
	Paid up capital when established	Rs.30 million
	Paid up capital on June 30, 1988	Rs.157 million
	Authorized, issued, subscribed & paid up capital in 1996	Rs.157 million
	Reserves in 1997	Rs.342.311 million
	Foreign currency borrowing in 1997 (ADB, IDA, Netherlands, Germany, Sweden, Belgium, France)	Rs.913.605 million
	Total borrowings June 30, 1997	9.59 billion
	Investments in Government Securities in 1997	2024.458 million
	Other investments in 1997	267.534 million
	Advances in foreign & local currencies, 30, June 1997	Rs.15.565 billion
	Management:	Board of directors (9 members)
	Senior officers on June 30, 1988	15
	Junior officers, June 30, 1988	400
	Non-managerial staff	418

Board of Directors:

1. Nominated by Federal Government	2 directors
2. Nominated by four provinces	4 directors
3. MD, Bankers' Equity	1 directors
4. Chairman nominated by Federal Government	1 chairman
5. M.D. nominated by Federal Government	1 M.D.

Background

The Industrial Development Bank of Pakistan was established on August 1, 1961 under the report prepared by Credit Enquiry Commission in 1959. Its prime objective was to provide long-and medium-term loans to industrialists. Prior to its formation this function was performed by Pakistan Industrial Finance Corporation (PIFCO) which was established in the early days of independence in 1949. It had limited functional areas and could only lend to existing industrial units. It was not in its jurisdiction to make loans for establishment of new industries and factories. It was replaced by the IDBP in order to perform reinforced functions.

It promotes and finances the establishment of small and medium industries.

Management

The management, policy making and execution come under the jurisdiction of the board of director's comprising:

Federal government appointed directors	= 2
Provincial government appointed directors	= 4
Managing director of the Banker's Equity	= 1
Managing director appointed by federal government	= 1
Chairman appointed by federal government	= 1

	9

Capital

At the time of establishment the authorized and paid up capital of the bank was Rs.300 million each. On June 30, 1997 paid up capital touched Rs.157 million of which the federal government contributed 56.59 percent and the remaining 43.61 percent came from all the four provinces and the following institutions:

State Bank of Pakistan
 State Life Insurance Corporation
 Trustee of Karachi Port Trust
 Pakistan Insurance Corporation
 National Bank of Pakistan
 Investment Corporation of Pakistan
 National Investment Trust

Resources

The IDBP's sources of finances are as follows:

1. Its own equity
2. Deposits

3. Borrowings from the federal government
4. Advances from the State Bank
5. Loans from National Bank secured by the government
6. Rediscounting bills of exchange with the State Bank
7. Issue and sale of bonds, debentures
8. Fees from preparing feasibility reports and other counselling services

Foreign Exchange

IDBP's resources comprise foreign exchange also in addition to rupee resources. The government allocates its share out of loans received from the IMF, World Bank, and other international donor agencies. In mid 60s it managed to borrow from the formerly U.S.S.R., Switzerland, China, Poland, and the defunct Yugoslavia.

Problems Facing the Bank

The IDBP faces many problems in financing the medium and small industries. Firstly, the loan seekers do not provide full, necessary, and correct information about their proposed projects. If the bank carries out its own studies they become costly and time consuming. Secondly, many new industrialists are inexperienced and unable to plan and execute the project properly. To finance them becomes quite risky. Thirdly, loan defaults, especially on political ground, have become order of the day. Fourthly, the bank finds it difficult to obtain needed foreign exchange and rupee resources.

Functions

The IDBP performs the following functions:

1. To finance the mid- and long-term needs of small and medium industries.
2. To help establish new and stabilize and modernize existing industries.
3. The bank conducts research and prepares feasibility reports.

PAKISTAN INDUSTRIAL CREDIT & INVESTMENT CORPORATION (PICIC)

Highlights

Date of establishment	2 nd October 1957
Head Office	Karachi
Authorized capital at establishment	Rs.150 million
Authorized capital on June 30, 2000	Rs.1000million
Paid up capital at establishment	Rs.40 million
Paid up capital on 30 th June 2000	Rs.640.68 million
Loans issued on 30 th June 1963	Rs.530 million in foreign currency Rs.38.60 million in local currency
Loans issued on 30 th June 1988	6562.421 million in local and foreign currency
Senior officers on 30 th June 1988	168
Junior officers on 30 th June 1988	154
Management	Board of directors consisting 12 members

Background

Any industrial unit needs not only working capital but also long-term capital to finance the purchase of land, building, machinery, and equipment.

To achieve this objective Pakistan Industrial Finance Corporation was established in as early as 1949, which flipped the industrialization process in Pakistan. But it had two limitations. First, it could only finance the needs of existing industries. Second, it could not make available foreign exchange to import new machinery and equipment.

Because of these two weaknesses the need was felt to set up a specialized financial institution that could help establish new industries, and finance the existing industries to carry out their programs for expansion, balancing, and modernization. And it could also provide for foreign exchange to finance the import of machinery and equipment. Similar institutions had already been set up in India, Turkey, and many other Third World countries. These needs and examples brought into being Pakistan Industrial Credit & Investment Corporation (PICIC). The PICIC not only provides long-term loans for the establishment or expansion of industrial units but also makes

arrangements of foreign exchange for them to finance the import of machinery and equipment. It has been established with foreign investment.

Management. The management of PICIC is under the control of a board of directors consisting of Twenty members. The composition of the board is as under:

Representative of Japan shareholders	1 Director
Representative of the Government of Pakistan	1 Director
Representative of Pakistani shareholders	9 Directors
Representative of four provinces	4 Directors
Total Members	15

The board is helped by an executive committee that consists of nine members. The head of the company is called the managing director. The staff of the PICIC consists in financial analysts, engineers, economists, chartered accountants, market specialists, and MBAs.

Resources PICIC enjoys the following resources:

1. Its capital on June 30, 1988 was Rs. 110 million sixty percent of which was subscribed by Pakistani government and its investors. The remaining forty percent was provided by US, UK, Germany, Japan's private investors and IFC. The capital is composed of 72.25 in local currency and 27.80 in foreign exchange.
2. Government of Pakistan and State Bank of Pakistan provide loans on soft terms.
3. PICIC borrows under US AID programs also.

Functions & Services

1. It helps set up new mills and industrial units.
2. It finances the import of machinery by providing foreign exchange.
3. PICIC spends some of its resources in advancing loans meant for purchasing land or building for factory and for buying machinery and equipment.
4. It aids in the implementation of expansion, renovation, and modernization programs of industries.
5. PICIC offers technical assistance through its foreign experts.
6. It prepares feasibility reports on new projects, expansion, and modernization programs.

7. Counselling services on administrative problems are offered.
8. It purchases shares and bonds on the stock exchange.
9. PICIC underwrites the issue of new shares floated by companies.
10. It provides guarantee on loans.

PICIC & Merchant Banking

In 1990, the PICIC announced the launching of merchant banking to facilitate more availability of loans to industrialists, promote further industrial growth, and revive sick industries that have been closed for want of capital.

The merchant bank acts as follows:

1. PICIC provides one-window facilities.
2. It would obtain working capital to the tune of Rs.2 billion by selling bearer bonds.
3. Letter of credit facility is provided to foreign traders.
4. Term deposit scheme is underway.
5. As a merchant bank the PICIC provides loans ranging from Rs.5 million to Rs.200 million.

PICIC & Expansion Programs

PICIC under its expansion program has started the following functions.

1. Rupee Resources Mobilization
2. Working Capital Operation
3. Bridge Financing
4. Export Import Financing
5. House Financing
6. Lease Financing
7. Modaraba & Mutual Funds
8. Establishment of Insurance Companies

Summary of PICIC's Functions

- Long and medium term loans
- Working capital finance
- Direct participation in shares and Term Finance Certificates (TFCs)
- Underwriting public issues
- Repayment guarantees and counter guarantees
- Syndicated loans and co-financing
- Fund management services
- Deposit schemes
- Establishing import letters of credit and negotiable export documents
- Safe deposit lockers facility

PICIC COMMERCIAL BANK

On 28 June, 2001 the PICIC took a leap forward when it bought the controlling shares of the Gulf Commercial Bank, previously known as Schon Bank, and got them transferred to its name. The bank has been named as PICIC Commercial Bank Limited and got the status of the scheduled bank. It is also listed at the Pakistan's three stock exchanges. Being the listed company its non-government shares can be bought and sold at the stock exchange. It performs all those functions that a commercial bank does. However, it has focused on the following:

1. Credit and loan facilities offered to businessmen;
2. Offering Unique Deposit Schemes
3. Allowing foreign currency accounts
4. Issuing on request drafts and other modes of transfers
5. Furnishing credit cards

NATIONAL DEVELOPMENT FINANCE CORPORATION (NDFC)

Highlights as of 30th June, 1995

Authorized capital	Rs. 500 million
Paid up Capital	Rs. 390 million
Reserve	Rs. 2.082 billion
Fixed Deposits	Rs. 22.161 billion
Advances	Rs. 21.523 billion
Borrowings	Rs. 5.522 billion
Investments	Rs. 7.803 billion
Total Assets	Rs. 32.642 billion
Net Profit After Taxation	Rs. 0.718 million (330.3 million in 1992)
Dividend Paid	Nil (90.0 million in 1992)
Board of Directors	6 members
Senior Management Personnel (CEO, SEVP, EVP etc.)	25 members
Junior, middle level professional and managers	582
Employees (non-managers)	1037

Board of Directors

The corporation is headed by a chairman and chief executive appointed by the government. Under him are five directors who have been taken from the following various organizations by virtue of their office.

1. Executive Director General, Board of Investment, Govt. of Pakistan
2. Additional Secretary Finance (Budget), Finance Division, Govt of Pakistan
3. Managing Director , Investment Corporation of Pakistan
4. Executive Director, State Bank of Pakistan
5. Managing Director, Bankers Equity Limited

NDFC Deposit Schemes

The NDFC has so far established following deposit schemes:

1. Monthly Income Certificates (MIC)

The maturity of the certificate is five and a half years. The minimum amount of investment is Rs. 10,000. Profit is payable monthly. No

profit is permissible if the certificate is cashed within three months. The certificate is subject to *zakat* and withholding tax.

2. Special Deposit Account (SDA)

This scheme has been devised especially for individuals, housewives and institutions. The account allows multiple deposits and withdrawals, profit included. If the minimum balance is maintained at Rs. 10,000, profit is calculated on daily basis. The account is liable to *zakat* and withholding tax.

3. Standard Certificate of Deposit (SCD)

The maturity period of SCD is flexible ranging from one month to five years. The higher the period the greater is the rate of return. The profit plan is as follows :

One month maturity	8%
6 months maturity	11.5%
1 year maturity	12.5 %
5 year maturity	15%

If the maturity period is up to one year the profit is payable at maturity. However, if the certificate is for above one year, the profit is payable every six months. *Zakat* and withholding tax are compulsorily deducted according to the law.

4. Special Golden Certificate of Deposits (SGCD)

This scheme runs for five years. Profit is only payable if it is not cashed before the expiry of one year or at the time of encashment. The minimum investment requirement is Rs. 10,000. The scheme of profit is given below.

If Rs. 100 is invested, it grows as follows :

On the completion of 1 year	_____	Rs. 113
On the completion of 2 years	_____	Rs. 130
On the completion of 3 years	_____	Rs. 151
On the completion of 4 years	_____	Rs. 172
On the completion of 5 years	_____	Rs. 200

It is also subject to zakat and withholding tax.

5. Investment Account

This scheme is referred to as INVESTAR introduced in 1994 for individuals, corporations, partnerships, and trusts. The scheme is managed by financial analysts and experts. Under it the NDFC purchases promising shares, stocks, and bonds listed at the stock exchange out of the money invested by the account holder.

The scheme has the following features :

1. Account is opened with at least Rs. 100,000.
2. Individuals, corporations, trusts, partnerships can open this account.
3. The objective is to maximize returns and minimize risks.
4. Financial and stock market professionals try their best to invest in the best possible portfolio.

Under this scheme the investor has two choices.

- a. **Discretionary Account:** Here the investor authorizes the corporation to decide where to invest.
- b. **Non-Discretionary Account:** In it the investor exercises his choice, preference about where to invest.

Terms and Conditions for Advancing Loans

The NDFC puts the following terms and conditions for advancing loans to the applicant.

1. Investigation / Appraisal

It involves the scrutiny and processing of the application and the feasibility of the project. The NDFC charges non-refundable preliminary scrutiny fee of Rs. 25,000 if the amount of loan requested for is up to Rs. 20 million, and Rs. 50,000 for the loan above Rs. 20 million. The corporation also charges $\frac{1}{2}$ of one percent of the loan for preparing detailed feasibility report of the project in question.

2. Security

The NDFC requires the borrower to furnish the following:

- a. Hypothecation of all movable properties and receivables

- b. First mortgage on the entire company assets
- c. First floating charge on all businesses, undertakings, and assets of the borrower
- d. Pledging of shares with blank transfer deeds
- e. Pledging of promissory notes
- f. Personal guarantees

3. Fees

The following charges are paid by the borrower.

- a. Legal documentation fee @ $\frac{1}{4}$ percent of the loan
- b. A half percent of the loan as project examination fee
- c. Commitment fee at the rate of $\frac{3}{8}$ percent per quarter of the unutilized borrowings.
- d. A quarter percent ($\frac{1}{4}$ %) project monitoring fee is charged on outstanding balance of the due installment.
- e. Equity administration fee @ $\frac{1}{4}$ percent of the agreed equity participation.
- f. A quarter percent as consortium management fee.
- g. If the project is closed or withdrawn half way during the appraisal of the project Rs. 20,000 or 10 percent of the project examination fee whichever is higher is held back by the NDFC.

4. Commission

- a. The corporation charges guarantee commission @ 1.6 percent per annum.
- b. Underwriting commission @ 2.5 percent is charged on the shares being issued by a company through NDFC.
- c. Commission is charged @ 2.5 percent of the face value of the un-subscribed shares underwritten by the NDFC.

Functions and Services

The NDFC performs the following functions and services:

1. Banking Operations

The corporation performs banking operations by receiving deposits under various schemes and issuing loans.

2. Mobilization of Capital

The corporation receives deposits and invest them in various portfolios like shares, stocks, bonds, treasury bills etc.

3. Capital Market Operations

The corporation deals in capital market activities. In Pakistan there are three stock exchanges viz., Karachi, Lahore, Islamabad stock exchanges. It buys and sells shares, bonds, and stocks through these exchanges. It also carries out its own investment schemes such as INVESTARS.

4. Financing Energy Projects in the Private Sector

The NDFC finances energy projects in the private sector. For this purpose it needs heavy amount. Hence it entered into agreement with World Bank, Bank of China, Japan Eximbank, US Eximbank for arranging for financial assistance to establish Private Sector Energy Development Fund (PSEDF). The corporation has so far invested in the following energy sectors.

- a. Hub Power Project (HUBCO)
- b. Rousch Power Project (RPP)
- c. Uch Power Project (UPP)
- d. 117 MW Southern Electric Power Project
- e. Hubco Pipri Fuel Oil Pipeline Project
- f. 135 MW Diesel Japan Power Project
- g. Habibullah Coastal Power
- h. Enpak Power
- i. Star Energy
- j. Spencer Power Generation
- k. Karachi Hydrocracker Project

5. Research & Development Activities

For this purpose the NDFC has formed two separate research departments:

- a. Economic Research Department (ERD)
- b. Market Research Department (MRD)

ERD has so far carried out research for Board of Investment (BOI) and the pharmaceutical industry. It also undertakes internal functions including preparation of annual reports, corporate strategy papers, economic evaluation of projects, Pakistan's statistical publications etc.

MRD had conducted 12 market studies by the end of 1995. The research related to the fields of chemicals, hotels, resorts, and textiles. The department has also carried out coordination work for SAARC Fund (South Asian Association of Regional Cooperation Fund)

SHORT QUESTIONS

1. Write a note on International Monetary Fund.
2. Give a brief history of IMF.
3. Who are big participants of IMF and what are its resources?
4. Write the note on the management of IMF.
5. Explain the functions of IMF.
6. Write a note on SDR.
7. Who are the custodian of IMF's gold reserves?
8. Define World Bank.
9. What do you know of IBRD?
10. What is the back ground of the World Bank?
11. Briefly describe the management of IBRD.
12. Write the note on the resources of the World Bank.
13. What are functions and resources of the World Bank?.



Chapter 19

INTERNATIONAL FINANCIAL INSTITUTIONS

International Monetary Fund (IMF)

International Bank for Reconstruction and Development (IBRD)

World Bank

CHAPTER 19

INTERNATIONAL FINANCIAL INSTITUTIONS

INTERNATIONAL MONETARY FUND (IMF)

Highlights

Date of establishment	December 27, 1945
Beginning of Operations	May 1946
Registered office	Washington
Funds:	
May 1946	\$ 8.8 billion
January 1961	\$ 14.74 billion
April 1963	\$ 15.23 billion
Annual meeting of the board	September each year
Members, 2007	185
Total Staff, 2005	2693 from 141 countries
Area Department	African, Asia and Pacific, Middle East, Central Asia, Western Hemisphere
Total Credit, April 30, 2006	\$28.28 billion or SDR 19.227 billion
Total Arrangements, April 30, 2006 between IMF & Members	10 Standby 1 Extended 27 Poverty Reduction & Growth Facility (PRGF)
Value of 38 Arrangements billion	\$ 16.642 billion or SDR 11.313

Background

On July 1, 1944 the U.S. invited 44 countries to attend united Monetary & Financial conference at Bretton Woods, New Hampshire. The conference prepared not only the articles of the proposed IMF but also the World Bank (IBRD). The agreement signed by 27 countries became effective on December 27, 1945. In May, 1946 the IMF became operational. The articles were amended in 1969, 1978, and 1992 following the collapse of fixed exchange rates system and oil price crisis in early 70s. The first amendment gave rise to the creation

of Special Drawing Rights (SDR). The second amendment was on the review of the IMF's responsibilities. The third was on empowering the Fund to suspend the membership of its member that failed to fulfil its obligations. In mid 90s the IMF provided \$ 8 billion to Mexico and \$ 9 billion to Russia and Ukraine. These were the largest ever packages in the history of IMF which squeezed its financial resources. The Group of seven summit in Halifax, arranged in June 1995 recommended to double the IMF's general arrangement to borrow up to \$ 55 million.

IMF has adopted a strategy to lend to those countries on following conditions.

1. Public spending cuts including defense expenditure
2. Credit controls
3. Trade liberalization

The IMF is coming close to act as an international central bank. It performs many central banking functions as:

1. It acts as a lender of last resort at the international level.
2. It has the ability to create international money (e.g. SDR)
3. It has the ability to act as a clearing house in the settlement of multinational deficits and surpluses.

Management

The fund is run by a board of governors consisting of one governor from each member country. The member is either a finance minister or the governor of the central bank. The board delegates its power to the executive board which includes 24 executive directors and is headed by a managing director. Six executive directors one each from the U.K., U.S.A., France, Germany, Japan, and India are permanent members and the rest are elected for two years. The executive board operates under the advice of Interim Committee which enjoys a ministerial level.

Big Participants US, UK, Germany, Japan, France, and India

Resources

At the time of establishment the IMF had \$ 8.8 billion as its fund provided by member countries. The amount was raised to \$ 14.74 billion on January 1, 1961. It was further raised in 1962 by borrowing from ten rich countries. Every member is required:

1. To pay 25 percent of its share in dollars or in gold.

Quotas & Exchange Operators

2. Or to pay two percent of its total gold and dollar reserves.

Each member is assigned a quota that establishes its voting power, subscription, and the limit of foreign exchange amount which it can borrow. Each member is required to subscribe partly in gold and partly in its own currency.

The Fund has designated the following banks as the custodian of its gold reserves:

1. The Federal Reserve Bank of New York
2. The Bank of England
3. The Bank of France
4. The Reserve Bank of India

The IMF holds its currency subscription for the most part in the form of non-interest-bearing and non-negotiable notes that may be cashed on demand.

Every member is required to contact IMF to buy gold for its reserves. However, if gold is available at better terms in the open market the member can buy from there.

Every member can withdraw from its quota up to 25 percent each month.

If a country is compelled to borrow from the Fund time and again, the fact indicates that the country is facing the problem of balance of payment. Under such circumstances the fund will take the following measures:

1. The IMF will warn the country and demand of it to investigate into excess of imports over exports.
2. It will propose to the member to lend to the IMF in its own currency.

If the above measures fail the Fund will declare the country's currency as 'Short' and will resort to rationing of its currency.

Functions

The IMF performs the following functions:

1. Multilateral Payment System

To establish multilateral payment system among its member countries

to facilitates free trade and eliminate foreign exchange restrictions.

2. Exchange Rates

It helps its member to maintain exchange rates stability among themselves.

3. Interim Relief

It provide interim relief to the members for improving their balance of payment.

4. Buying & Selling of Gold

The Fund buys and sells gold under certain circumstances. It also controls and monitors buying and selling or movement of gold among the members.

5. Expert Services

It prepares feasibility reports on large projects for its members. It provides technical and managerial information and offers its expert services on them.

WORLD BANK

International Bank for the Reconstruction and Development (IBRD)

Some Basic Facts

Date of establishment	July, 1944
Date of Commencing business	June, 1946
Head office	Washington
Total members	139 (in 1982)
	146 (in 1985)
	174 (in 1994)
	185 (2007)

Management

1. Board of governors :
Governor and alternate governors
one each from member countries

2. 24 executive directors

Authorized Capital in 1944	\$ 10 billion
Authorized Capital April, 1988	\$ 142 billion
Paid up Capital June 30, 2005	\$ 11,483 million
Outstanding borrowings in 2005	\$ 105.691 billion
Issue of loans (2005)	\$ 107.549 billion

Background

The main objective of the formation of the World Bank was to eliminate the effects of the calamities wreaked by the World War II, and reconstruct Europe. On July 1, 1944 the US with the help of the U.K. and U.N.O. invited 44 countries at Pertainwoods, a city of an American state, New Hampshire to attend a meeting of "United Nations Monetary and Financial Conference". The conference prepared the bylaws and articles of the World Bank and International Monetary Fund (IMF) thus both the international institutions came into being. The conference was not attended by the then U.S.S.R. and Liberia.

It should be noted that to get a membership of the World Bank a country must first become a member of IMF.

The World Bank Group consists of IBRD, International Development Association (IDA), and International Finance Corporation (IFC). Their main objective is to boost up the economy of the Third World Countries and sustain private investment for development.

The World Bank requires that all loans except those to member governments must be guaranteed by the member government concerned. It provides loan capital and does not invest in shares. It finances foreign exchange requirements for certain projects. It does not provide loans for local expenditure or working capital. The bank finances large public projects. It finance small projects in the private sector only through the development banks.

Management

The management of the bank is as follows:

1. Bank has a board of governors represented by each country through one governor and one deputy governor.
2. An executive board of directors has been formed consisting of 24 members of which five are permanent and 19 elected.
3. The bank staff and personnel are managed by a president who is appointed or nominated by executive directors.

Resources

The financial resources of the bank have been determined as follows:

1. In 1959 the authorized capital of the bank was US \$ 10 billion divided into 100,000 shares worth \$ 100,000 each.
2. In 1963 it was raised to US \$21 billion. However, most of the bank's funds come from loans which are received from its rich and developed member countries, as US, U.K., France, Japan, etc.
3. In April 1988, the authorized capital stock of the bank had been increased to 1,420,500 shares (\$ 142 billion).
4. Every member country contributes funds as its share in capital two percent of which is in the form of gold and American dollars, and 18 percent local currency. The rest 80 percent is retained by the member country, and this amount can be called by the bank anytime. The local currency held by it is used with the advice or permission of the concerned country.
5. When a member country devalues its currency it must make up the resultant loss in its share or quota in the capital of the bank by providing more fund to maintain its proportionate position with the bank.

Voting Rights

Every member possesses 250 votes. They can be increased by making additional contribution of one lakh dollars for one vote.

**Functions &
Objectives**

The World Bank has been formed for the following objectives:

1. Reconstruction

The pioneer objective of the bank was to reconstruct the countries greatly afflicted in World War II. Now it aims at providing funds to member countries for productive and economic purposes.

2. Foreign Investment

It encourages foreign investment by providing bank guarantees and through participation. If a member country finds itself unable to obtain foreign investments on suitable conditions, the World Bank is approached for help.

3. Balanced Foreign Trade

The bank helps its member countries maintain their balanced foreign trade. It tries to find ways and means to attract international foreign investments in needy countries.

4. Lending

The IBRD grants loans to its member countries and also arranges loans for them from elsewhere and offers guarantee for such loans.

5. Expert Services

It prepares feasibility reports and offers expert services on technical, managerial, financial, and other services.

**SPECIAL DRAWING RIGHTS
(SDR)**

SDR is a form of international money created by the IMF. It is used by its members in settling transactions with each other. The SDRs are not a physical money, they are merely entries on the books of the IMF. Initially, the exchange rate between the SDR and US dollar was at par. But now the valuation of the SDR is based on weighted average of the exchange rates of the currencies of big IMF members.

In September 1967, the Board of Governors of the IMF decided to create a new money named special drawing right (SDR). The scheme became effective in January 1970. SDRs are allocated to members in proportion to their IMF quotas. They are used in foreign payments. A

deficit country can use its SDR to get the currency of the relevant surplus country. In other words, it can import goods from the surplus country for SDRs. Hence the SDR of the deficit country slip into the surplus country which gets interest on them from the deficit country.

No country is obliged to accept SDR from other countries if the amount is greater than twice its own allocated SDRs.

The development of SDR is to avert international liquidity problem and to solve the issue of disequilibrium in balance of payment.

Exercises

MULTIPLE CHOICE QUESTIONS (MCQs)

1. **IMF is a /an**
 - A. Sister organization of the World Bank
 - B. Part of Reserve Bank of the US
 - C. Part of Bank of England
 - D. Independent body
2. **World Bank is referred to as**
 - A. IMF
 - B. IBRD
 - C. IFC
 - D. SDR
 - E. IDA
3. **World Bank is an organ of**
 - A. IBRD
 - B. IFC
 - C. IDA
 - D. IMF
4. **SPECIAL Drawing Rights refer to**
 - A. International money in physical form
 - B. International money on the books of IMF
 - C. International money used as Foreign exchange
 - D. American dollars
5. **The big participants of the IMF are**
 - A. US UK & France
 - B. Japan & India
 - C. Germany & Japan
 - D. India and Pakistan
 - E. A & B
 - F. A & C
6. **Exchange rationing is a**
 - A. Risk free step
 - B. Risky measure

C. Measure to control the shortfall of exchange reserves

D. B & C

E. A & C

7. Import quota as an exchange control measure refers to

A. Allowing partial import

B. Disallowing total imports

C. Allowing free imports

D. A & C

E. B & C

ANSWER KEY

1	d	2	b	3	d	4	b	5	e
6	e	7	a						

SHORT QUESTIONS

- What is E-Banking?
- What are the advantages of E-Banking?
- What are the disadvantages of E-Banking?
- Explain kinds of E-Banking.
- Write a note on the following:
 - Internet Banking
 - Distinguish between mobile phone banking and telephone banking
 - Distinguish between PC banking and ATM banking
- Write notes on any three of the following:
 - Internet banking
 - Mobile phone banking.
 - ATM banking.
 - PC banking.
 - Telephone banking.
- Define credit card.
- What do you understand by debit card?
- Distinguishes between credit card and debit card.
- Distinguish between visa, master, and Diner's card.
- What are the kinds of credit cards?

Chapter 20

E - BANKING

E – Banking

Instruments and Equipments Required in E-Banking

Advantages

Disadvantages

Kinds of E-Banking

CHAPTER 20

E-BANKING (ELECTRONIC BANKING)

When banking transactions are struck electronically rather than face-to-face, it is referred to as electronic banking. It is just like e-commerce or e-marketing in which business transactions including buying and selling are performed electronically.

The term electronic banking is wide in scope and includes PC banking, virtual banking, online banking, phone banking, mobile phone banking and ATM banking.

Instruments and Equipments Required in E-Banking

The following instruments and equipments are required for electronic banking.

1. Credit card
2. Credit card machine
3. Debit card
4. Phone / mobile phone
5. PC (personal computer)
6. Internet
7. ATM card
8. ATM machine

The details of these have been given elsewhere in this book.

Advantages

E-banking affords many advantages which the clients will not otherwise enjoy.

1. To draw money from the bank you don't have to line up in long queues that cost time and labor.
2. Transactions are processed at a fast-speed .
3. For consumers and businessmen better and efficient financial management is facilitated.

4. Utility bills are promptly paid without queuing and late payment is avoided.
5. You can access to your account round the clock over the week. That is, no closing hours, no holydays and no Sundays can stop you making a transaction on your account.
6. Bank charges are saved, as checks that have cost are not used in e-banking.

Disadvantages Online banking faces many disadvantages to customers and banks too.

1. Online transactions are exposed to frauds.
2. Online bank charges are liable to come down if competition among banks increases. This fact is a disadvantage to the bank but an advantage to the customer.
3. If confidential information given to the bank is leaked out fraudulent transactions can be struck for which the customer will be fully responsible.
4. Credit card frauds and identity thefts are common.
5. Customer information may be leaked to others causing fraudulent transactions

KINDS OF E-BANKING

Internet Banking

It is also referred to as online banking. The system uses internet for the purpose of transferring funds, confirming checking account balances, and paying utility bills. For using internet World Wide Web server is essential. Internet banking is also known as virtual, web, cyber, net, or interactive banking.

Mobile phone Banking (M-Banking)

It is also known as M-Banking or mbanking. Banking transactions are made through SMS.

3. Telephone Banking

When a bank allows its customers to make transactions over the telephone, it becomes telephone Banking. The system uses an automated phone answering machine with voice recognition capability. For security purpose password or a confidential number, is

verbally told at the time of transaction. In addition other confidential information as mother's name is also used.

PC Banking

It is also a variation of online banking for making banking transactions. It uses personal computer (PC) and a modem. For running this system the bank provides its clients a financial software on ownership basis.

ATM Banking

It refers to Automated Teller Machine through which cash in the account can be drawn. These machines are usually installed outside the bank premises. It works round the clock. The machine accepts credit or debit, or ATM cards.