FUNDAMENTALS OF
MONEY AND BANKING

LEVEL BA/ADC/BS

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DPARTMENT OF COMMERCE
ALLAMA IQBAL OPEN UNIVERSITY
ISLAMABD

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COURSE INTRODUCTION

This course is divided in two parts; money and banking. In the first part of this course, the role and functions of money has been discussed. Money plays the central role in the modern economic system and used as unit of measurement for exchange of goods and services. From the ancient times, money has been a medium of exchange and considered as a source of wealth and power. This course has been developed by keeping in view the historic role of money together with its application in the modern economies. The first four units of this course discusses the various forms of money, value of money, financial markets and international monetary system. In each unit, the basic concepts for understanding the role and functions of money have been elaborated with examples.

The second part of this course covers the modern banking system in detail. The modern economic system largely depends on the banks for the movement of funds among different economic agents. In this part of the course, following concepts of banking have been discussed in detail;

i. Basics of banking (forms of banks and credit creation)
ii. Functions of commercial banks (for businesses and individuals)
iii. Bank loans and advances (types and comparative analysis)
iv. Role and functions of the central bank in an economy
v. Growth of banking in Pakistan

The objective of this course is to enable students to understand modern financial and monetary system. The basic terms of money and banking have been explained in simple language with examples. This course will fulfill the basic requirements for understanding the advanced level subjects of finance in higher classes.

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CONTENTS

UNIT–1

INTRODUCTION TO MONEY

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CONTENTS

INTRODUCTION

Money is one of the outstanding greatest inventions of entire history of mankind. Money is anything that is generally acceptable as a means of exchange, measure and store of value. In this unit the concept of money, its characteristics and evolution of money will be discussed. The development of money has progressed through the following stages, commodity money, metallic money, paper money, credit money, and electronic money. The purpose of this introductory chapter is to understand the concept of money and its evolution stages and the role of money in performance of economic activities.

OBJECTIVES

After reading this unit, you will able;

1. to visualize the concept of money and its functions.
2. to perceive the role and importance of money.
3. to identify the stages of evolution of money
4. to understand the ideal qualities of money

1.1 INTRODUCTION TO MONEY

The word money is derived from Latin word ''Monet''. Money used in economic transactions and also serve as medium of exchange. Money can be defined as "Money can be anything that is generally acceptable as a means of exchange that at the same time acts as a measure of value.'' **(**Crowther**)**

OR

"Money is anything that is generally accepted in payment for goods and services or in the repayment of debts". **(**Mishkin**)**

In modern world, money is considered as a basic necessity. The benefit of the discovery of money is to over comes the problems of barter system in which goods were exchanged against other goods. As goods were of different quality and quality, a simple unit of measurement was necessary for conducting the economic transactions. With the help of money people can make payments. Producers buy raw material, plants and heavy machinery with the help of money. Government realizes taxes, fees, and fines through money. Economic growth cannot be possible without use of money.

Money is the backbone of capitalistic economy everyone according to his capacity engaged in economic activities. Individual who owned money has complete right for production decisions and consumption pattern. Consumers and producers receive money income in the form of wages, interest etc. Money is a center of a circle and in capitalist economy money performs the important function of solving the central problem through price mechanism.

Features of Money:

1. **Medium of Exchange**: It is accepted as medium of exchange for the settlement of economic transactions.
2. **Legal Tender:** It is used as legal tender for repayment of debts, wages, interest, profit etc.
3. **Pricing**: It is used as standard in the development of pricing mechanism for economic activities
4. **Unit of Measurement:** It is used as accounting measure for different services/things.
5. **Savings**: It is used as a tool to save and store purchasing power for future period.

1.2 FORMS OF MONEY

In old times, people used to rely on their own produce goods for living purposes and were self-sufficient and there was no need of money at that time. With development of agricultural societies and better tools, excess production was easy to obtain. For this excess production, different societies developed various exchange mechanism for meeting individual needs and barter system was developed. Barter system of exchange of goods and service without using any medium of exchange like money in payment system. Different forms of money used in different countries or regions are discussed below;

1. **Commodity Money:**
   Commodity money is made up of valuable commodity like wheat, goats, etc. people used these commodities for exchange purpose and fulfill their needs. As time passed on, people faced many problems due to commodity money like storing value, durability, divisibility etc.

2. **Metallic Money or Coins:**
   The next step in the evolution of money in payment system is metallic money. Metallic money is made up of precious metal like gold, silver and copper. Metallic money was introduced to overcome the problem of commodity money in term of quality and quantity. There were two kind of metals.

a. Un-coined Metals
Metals were not used as coins but as bullion. This creates the problem of measuring the weight and value.

b. Coined Metal
After the failure of uncoiled metals, standard coins were created. They had a standard a weight and value. Problems of un-coined metals are solved by the use of coined metals.

3. **Paper Money:**
   Paper currency is made up of paper and used for payment system and also used as a medium of exchange. It consists of notes issued by the state or central bank. Paper money can be;

a. **Convertible paper money**: It is converted into coins on demand e.g. gold and silver certificates.

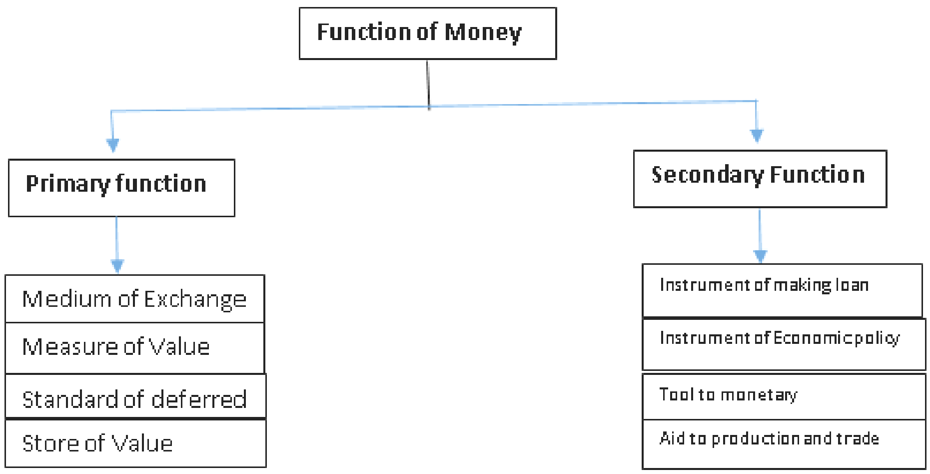
b. **Fiat paper money**: It is not converted into coins on demand and it is accepted in transaction at its face value due to its unlimited legal tender.

4. **Credit Money or Bank Money:**
   The next step in the evolution of money in payment system is the credit money. It means the use of different instrument (cheque) issued by the bank as a medium of exchange. The advantage of bank money is that they are easy and safe to transport for payment purpose.

5. **Electronic Money:**
   The next stage in the development of payment system is Electronic money replaces credit or bank money due to the expansion of technology. Electronic money is consisting of ATM, debit card, credit card and online banking. People can make payments and receive money through online banking system and save their time.

1.3 FUNCTIONS OF MONEY

Money is anything that is widely used as a mean of payments and is generally expectable in settlement of debts. It is also used in economic transactions or medium of exchange purpose.



Primary Functions:

1. **Medium of Exchange**
   Money is used as a medium of exchange and the sale and purchase of different products can be made through money. It is the most important function of money. People sell their products for money and use that money to purchase different products to fulfill their needs.

2. **Measure of Value**
   Money as a measure of value means that money works as a common denomination, the value of all goods and services are expressed in terms of money. As we measures weight in kilograms or pounds and distance in kilometers, similarly we measure the value of money in terms of money.

3. **Standard of Deferred Payments**
   Money also serves as a standard of payment made after a lapse of time to settle debts and make investments.

4. **Store of Value:**
   Money is the most liquid assets from all the assets therefore it is easier to store value in the form of money.

Secondary Functions:

1. **Instrument for Lending:**
   People save money and deposit it in to banks. The banks advance these savings as loans to businessmen and earn profit by charging interest.

2. **Instrument of Economic Policy:**
   Money is an instrument of an economic policy of the government. Money is the powerful factor to achieve growth, reduce unemployment and maintain expansion of economic activity.

3. **Tool to Monetary Management:**
   Money helps in increasing output and employment. Money is also help in determining the distribution of wealth among the members of society.

4. **Aids to Production and Trade:**
   Barter difficulties can be solved with the help of money. It helps in the production of goods and services and facilitates expansion of trade.

1.4 QUALITIES OF IDEAL MONEY

The essential attributes of ideal money are as follows;

1. **General Acceptability:**
   The most essential quality of an ideal money material is that it would be acceptable as a medium of exchange without any objection by others for goods and services.

2. **Portability:**
   Good money has quality of portability means it can be easily and economically transported from one place to the other. In other words it possesses high value in small bulk.

3. **Durability:**
   As money is passed from hand to hand and is kept in reserves it must not easily deteriorate either in itself or as a result of wear and tear.

4. **Homogeneity:**
   All potions of the substance used as money should be homogeneous that is of the same quality so that equal weights have the same value. It is essential that its units are similar in all respects.

5. **Divisibility:**
   The money material should be capable of division and the aggregate value of the mass after division should be almost the same as before**.**

6. **Malleability:**
The money material should be capable of being melted and given convenient shapes. It should be neither too hard and nor too soft. It should also possess the attribute of impressionability**.**

7. **Recognizability:**
One of the very much important essential of a good money material is that it should be easily recognizable by the eye, ear or the touch. It should have certain distinct marks which nobody can mistake**.**

8. **Stability of Value:**
Money should not be subject to fluctuations in value. The value of a material which is used to measure the value of all the other material must be stable**.**

Exercise

Q. 1 Give short answer to following questions:

1. Define money.
2. Write the functions of money.
3. What is barter system?
4. Write down the features of ideal money.

Q. 2 Collect the foreign currency notes of at-least five different countries and compare their features.

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3. Financial Institutions and Markets by Meir G. Kohn

4. Financial Markets and Institutions by Frederic Mishkin and Stanley G Eakins

5. Fundamentals of financial institutions management by Marcia Millon Cornett

6. Money and Banking by M.Saeed Nasir

UNIT–2

VALUE OF MONEY

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CONTENTS

INTRODUCTION

In the previous unit, we have discussed the main role of money is to facilitate exchange. This unit will discuss the value of money and different approaches given by the renowned economists for its measurement. This unit also discusses the change in the value of money due to inflation, deflation, and stagflation. The target of this unit is to enable students to understand the concept of value of money and how it affects our daily life in buying various products.

OBJECTIVES

The study of this unit, will enable you:

1. to understand the value of money

2. to explain the theories about value of money

3. to understand the concepts of inflation, deflation and stagflation

4. to understand the concept of devaluation and depreciation of money

2.1 VALUE OF MONEY

Value of money means the purchasing power and capacity to exchange the goods and services. It refers to the strength of money in the market against which we can buy or sell something. Money is a type of asset in an economy which is used to buy good and service and it serve as store value in an economy. In daily life, we can observe that mere increase in the supply of money does not make us rich rather it hurts the purchasing power of consumers. To know how value of money is determined, we need to understand the following theories:

1. Quantity Theory of Money:

The quantity theory of money presented by Irving Fisher is a relationship between the money supply and the price level. Any change in the money creates an exactly proportionate change in the price level. As per theory, "Other things remaining unchanged, on the quantity of money in circulation increases, the price level also increases in direct proportion and the value of money decreases in direct proportion.

On the other hand if the quantity of money is doubled, the price level will also be double and the value of money will be one half. If the quantity of money is reduced by one half, the level will also be reduced by one half and the value of money will be twice. It is based on the assumption of full employment in the economy.

2. Cash Balance Approach of the Quantity Theory of Money:

The cash balance approach was developed by the group of Cambridge economists in England which includes Alfred Marshall. A. C. Pigou, Robertson and J. M. Keynes. The cash balance approach is differing from the Fishers theory as it focuses on the store of value of function of money.

According to them, the value of money is determined by the demand and supply of money for a particular time. People want to hold real income in cash balances for different reasons i.e unexpected expenditures. The demand for money is that portion of real income that people wants to hold in money form. Therefore, the value of money depends on the cash holding requirements in a country.

3. Modern Theory of Value of Money:

Milton Friedman and group of economists of university of Chicago explained the modern theory of value of money. Milton Friedman said that ''the quantity theory is the theory of demand for money. It is not the theory of output or money income or price level". According to Friedman wealth includes the source of income or consumable services. In Friedman views, wealth can be held in the following five different forms.

a) **Money:** It includes currency, demand deposits and time deposits.
b) **Bonds:** Bonds are defined as a claim for payments that are fixed in nominal units.

c) **Equities**: Equities are defined as a claim for payment that are fixed in real units.
d) **Physical goods**: It includes inventories of producer and consumer goods.
e) **Human capital:** It includes skills, knowledge and experience possessed by an individual.

According to Friedman the demand for money is a function of the following factors:

a) **Rate of returns on shares**: if rate of return on shares increases, the demand for money is decreases and vice versa.
b) **Rate of return on bonds**: If the rate of return on bonds is increased, the demand for money is decrease and vice versa.
c) **Liquidity**: It means how quickly the assets can be converted into cash the liquidity of assets also affects the demand of assets.
d) **Degree of risk:** Degree of risk is also affecting demand for an asset.

2. 2 INFLATION AND ITS TYPES

Inflation is an increase in the general price level of the goods and services in an economy over a period. Inflation occurs when general level of prices and cost are rising. Inflation arises when money income is expending more than proportionate to income earning activity.

Inflation can be classified on the following basis:

a. **Inflation based on Causes**: Inflation can be classified on the basis of causes as:
b. **Demand Pull Inflation:** Demand pull inflation arises in an economy when the demand for goods and services is increased but on the other hand supply of goods and services decreases and the general price level rises. There are many factors that cause the demand pull inflation:
   i. Increase in money supply
   ii. Increase in the demand for goods and services
   iii. Increase in the income level

ii. **Cost Push Inflation:** Cost push inflation arises when the cost for production and operations increases. There are many factors that create cost push inflation:
   i. Increase in wages.
   ii. Increase in cost of raw materials.
   iii. Increase in the cost of important components.

b. **Inflation based on Employment:** Inflation can be classified on the basis of employment as

i. **Partial Inflation**: According to J. M. Keynes, when the general price level increases partly due to an increase in the cost of production of goods and partly due to rise in supply of money before full employment stage is called partial inflation.
ii. **Full Inflation:** It arises when the economy has reached at level of full employment. Increase in money supply and general price level also increase, but without any increase in production and employment.

c. **Inflation based on Degree of Control:** Inflation can be classified on the basis of control as:

i. **Open Inflation**: In open inflation, general price level rises day by day and gets out of control for the government.

ii. **Suppressed Inflation**: In this type of inflation government should take steps and measures to control in the rise in general price level through different methods like rationing.

d. **Inflation based on Rate of Inflation**: Inflation on the basis of rate of inflation can be classified as under:

i. **Creeping Inflation:** In creeping inflation situation the general price rises with slow rate. In creeping inflation situation the general price level rises up to a rate of 2% per annum.

ii. **Walking Inflation**: During walking inflation situation the general price level is increased at lesser level as compared to the creeping inflation. On this inflation situation general price level rises approximately 5% annually.

iii. **Running Inflation**: In running inflation situation the general price level rises approximately 8% to 10% annually.

iv. **Hyperinflation**: Keynes calls hyperinflation as the final stage of inflation that type of inflation arises after the level of full employment attained, but price level increases rapidly.

e. **Other Types of Inflation:**

i. **Monetary Inflation:** Monetary inflation arises in an economy due to rapid increase in money supply. If money supply increases in an economy the value of money falls and the economy faces different problems.

ii. **Budgetary Inflation:** When government of a country overcome the budget deficit through lending and insurance of new currency, that behavior increase the purchasing power and also create rise in the general price level that leads to inflation.

iii. **Profit Induced Inflation:** Profit induced inflation arises, when the business in monopoly position they increase their rate of profit on their production, they may cause inflation in an economy.

2.3 REMEDIES FOR INFLATION

It is the main duty or objectives of every government to take proper measures and steps to control the inflation. Two major tools to control the inflation are monetary policy and the fiscal policy;

i. **Monetary Policy**:

Monitory policy influences the economy through change of money supply and availability of credit. Monetary policy is set by the central bank of a country who adopts following methods to control the money supply i.e.

a. Variation in reserves requirements of commercial banks.

b. Variation in bank rates for lending.
c. Variation in margin requirements for banks.
d. Credit rationing for allocating capital in various sectors.

ii. Fiscal Policy:
It is the budgetary policy of the government related to the public finance taxes, borrowing and deficit financing. Fiscal policy states the change in the spending and taxes to stimulate the economy by the government. The main fiscal measure is:
a. Changes in taxation by lowering tax rates and increasing consumption
b. Public borrowing is curtailed, and funds are saved
c. Control of budget deficit is achieved, and the deficit financing is reduced
d. Adopting a general austerity policy by reducing govt. expenditures

iii. Other Measures:
Some other measures taken by the government to overcome the inflation are as follows.
a. Control of smuggling as it reduces supply of goods in country.
b. Provisions of subsidies to needy sections of society.
c. Population control to reduce the aggregate demand.
d. Encourage simple living to reduce demand for expensive items.
e. Direct control on the prices of essential items by the government.
f. Encourage Sunday and Friday markets to offer discounts.

2.4 DEFLATION

Deflation is opposite to the term inflation. Deflation is that state of the economy where the value of money is rising, or prices are falling.

Causes of Deflation:
i. **Level of investments decreases** negatively affecting the economy as the demand for goods fall down.
ii. **Decrease in the people income** also cause deflation in the economy. Due to reduction in the income level the demand for goods and services decreases that leads to decrease in price level.
iii. **Increase in supply** affects demand of goods negatively and the price level falls down.

Remedies for Deflation:
i. To increase exports for achieving higher incomes and price support
ii. Central bank should reduce interest rate for increasing the level of lending in economy.
iii. To encourage the private sector investments by giving tax exemptions/credits/rebates.
iv. To encourage the people for consumption by offering discounts.

2.5 STAGFLATION

Stagflation is the co-existence of inflation and unemployment. It is a process in which the economy faces the serious problems at the same time i.e. unemployment and increase in prices. Stagflation involves inflationary rise in prices and wages at the same time. The people are unable to find jobs and firms are unable to find customers for what their plants can produce. is very dangerous for economy then the inflation as output level decreases and unemployment also decreases.

Causes of Stagflation:
There are many causes that help to create stagflation in an economy. The reduction in the supply of goods is a main cause of stagflation. When the supply of goods decreases, the general price level also increases and output and employment level decreases. The decrease in the supply of goods occurs due to the following factors:

i. Cost of resources is increased due to lesser supply
ii. Shortage of labor due to changes in technology
iii. Rise in taxes especially indirect taxes

Remedies for Stagflation:

i. Encourage development programs especially infrastructure related.
ii. Encourage training programs for labor force.
iii. Reduce taxes on goods and services.
iv. Increase in labor supply and ensure minimum wages
v. Providing raw material at lower rates to the industry

2.6 DEPRECIATION AND DEVALUATION OF MONEY

There are two types of decease in the value of a currency:

i. **Devaluation of Currency:**
   Planned devaluation is come into existence by the government decision to reduce a relative value of their country currency. Government takes devaluation of currency against other currencies for the improvement of trading positions.
ii. **Depreciation of Currency**:
   Market driven devaluation does not arise by the government, but it arises due to the market position. Due to the monetary crises the value of currency automatically devalued against the other country currencies.

Effects of Depreciation/Devaluation:
Following are the effects of depreciation and devaluation of currency:

i. When the currency is devalued, the imports tend to be more expensive and exports tend to cheaper.
ii. Devaluation discourages the investors for making investment in that country whose currency devalued rapidly.
iii. Devaluation makes the country currency less attractive at international level.

iv. In devaluation exports increases and imports decrease, that make the balance of payment favorable.
v. The increase in exports and decrease in imports reduced the current account deficit.

Summary:

This unit has discussed the concept of value of money on the basis of two major theories of finance; quantity theory along with its cash balance approach and modern theory of value of money. This unit has also described the factors that causes changes in the value of money; inflation, deflation, devaluation and depreciation of money. The key lesson of this unit is to understand the value of money that affects the purchasing power of a consumer. As a consumer, we need to understand the trends in inflation and the purchasing power of a currency to make correct economic decisions regarding future.

Exercise:

Short Question:

1. What is meant by stagflation?
2. What do you know about the term devaluation of money?
3. Enlist any three types of inflation?
4. What is cash balance approach?
5. Difference between depreciation and devaluation of money.

Long Question:

1. Briefly explain the quantity theory of money.
2. Explain the modern theory of value of money in detail?
3. Describes the devaluation of money in detail.

References: (Books)

1. Financial Markets and Institutions by Anthony Saunders
2. Financial Institution Management by Helen P. Lange
3. Financial Institutions and Markets by Meir G. Kohn
4. Financial Markets and Institutions by Frederic Mishkin and Stanley G Eakins
5. Fundamentals of financial institutions management by Marcia Millon Cornett

UNIT–3

FINANCIAL MARKETS

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CONTENTS

INTRODUCTION

This unit will discuss the concept of financial assets and financial markets. Within financial markets money and capital markets play vital role in the financial sector. Similarly, the exchange rate plays a crucial role in an economy. In this unit, we will discuss the concept of exchange rate and determination of exchange rate. The theories of foreign exchange determination and trade cycle will also be discussed in detail.

OBJECTIVES

After reading this unit, you will able to understand;

1. the concept of financial asset
2. the basics of financial markets
3. role of capital market in economy
4. foreign exchange rates and their determination
5. the trade cycles and its determinants

3.1 FINANCIAL ASSETS

A financial asset is a documentary claim that has a monetary value. In capitalism, markets offer a mechanism to trade goods and services among the buyers and sellers at an agreed price. There are many types of markets in an economy; fruits markets, cloth markets, commodity markets, auto markets etc. The financial market is also a kind of market that coordinates the activities of all other markets. The financial market is a mechanism to trade financial assets among the buyers and sellers at a mutually agreed price. The working in financial market is carried on by the financial institutions, as mentioned above, to facilitate the buyers and sellers of the financial assets.

There are different **types of financial assets** traded in financial markets;

- **i.** **Shares** are the certificates usually bought on a stock exchange that represent the claim of ownership in a company. The shareholders are entitled to claim of profit called dividend and they can sale their shares at any time to earn a capital gain.
- **ii.** **Bonds** are the certificates through which investors provide funds to the businesses at an interest rate for a specific period. The bonds are issued by companies as an alternate of shares if they are not willing to share their ownership of business.
- **iii.** **Investment Certificates** are the term-specific investment tools that offer a periodic return to their holders and are generally issued by the financial institutions to finance a specific project.
- **iv.** **Commercial papers** are short term investment instruments redeemable at maturity and are purchased by the buyers in order to provide funds to the businesses at an interest rate.
- **v.** **Prize Bonds** are financial assets of a fixed value that offer a chance to win a prize in a lottery. These bonds are redeemable at their original value in case of non-winning a prize.
- **vi.** **Futures** are the financial assets that derive their value from an underlying asset whose price is agreed at present and settlement is made in future.
- **vii.** **Treasury Bills** are the investment tolls offered by the government for short term financing requirements that carry an interest rate and are redeemable on maturity.
- **viii.** **Trade Notes** represent the short-term outstanding amounts payable to the creditors by a business. These notes can be discounted by the creditors though banks before maturity or can be used for mutual settlement with another party.
- **ix.** **E-Certificates** are offered by the modern online form of businesses for investing funds in their projects. These certificates carry an explicit interest rate or ownership share claim.
- **x.** **Units** are the investment tools offered by a mutual fund or another investment scheme that carry the rights of a unit holder to participate in the profits and gains of an investment scheme.
- **xi.** **Cheque** is a modern banking tool that is used to settle outstanding liabilities through bank accounts. Generally, cheques are not traded but used to clear the loans and payable amounts.

3.2 FINANCIAL MARKETS

After going through the various types of financial assets, now, we are able to understand the working of financial markets. These financial markets can be understood in several different ways as highlighted below:

i. **Classification by Nature of Claim:**
   a. **Debt market** is a market where debt instruments like bonds, debentures, term finance certificates are traded among the buyers and sellers.
   b. **Equity market** is a market where the equity instruments like common shares, preferred shares etc. are traded among the investors.

ii. **Classification by Maturity of Claim.**
   a. **Money market** is a market for trading the short-term financial assets like trade notes, commercial papers, treasury bills etc. in an economy.
   b. **Capital market** is a market where the long-term maturity bearing financial assets like shares, bonds, certificates are traded among investors.

iii. **Classification by Seasoning of Claim.**
   a. **Primary market** is a market where a financial asset is offered first time for trading in the financial system.
   b. **Secondary market** is a market where the trading of financial asset is carried on after its launching in the primary market.

iv. **Classification by Delivery:**
   a. **Cash or spot market** is financial market where the financial assets are traded on spot without involving any reference to future price or delivery.
   b. **Derivative market** is a market that involves the trading of financial assets whose delivery is expected in future.

v. **Classification by Product Type:**
   a. **Commodity market** is a type of financial market in which the future contracts for metals, oil, gas and crops are bought & sold by the investors.
   b. **Forex market** is a financial market that involves the trading of different currencies of the world in order to earn profit.
   c. **Equity market** is a market where the shares are bought and sold in order to earn capital gains and dividends.

3.3 DIFFERENCE BETWEEN MONEY AND CAPITAL MARKETS

Money Market	Capital Market
Definition: Money market used for short term borrowings	Capital markets are used for long term borrowing.
Time period: Money market lending and borrowing is for short time one year or less than one year.	In capital market lending and borrowing is made for more than one year.
Instruments: Commercial papers, Repurchase agreement, Certificate of deposit and treasury bills	Stock, shares, debentures, bonds, and government securities.
Institutions: Central bank, commercial bank, National financial institutions.	Stock exchange, commercial banks, and insurance companies etc.
Risk: In money market risk factor is very small because time period is less than one year.	In capital market risk factor is more as compared to money market the reason behind this is the time period.
Merit: Increases liquidity of funds in the economy.	Mobilization of saving in the economy.
Purpose: To fulfill short term credit needs of the business.	To fulfill long term credit needs of the business.
Return on investment: Return on money market less as compared to capital market.	Return on capital market is Comparatively high.

3.4 FOREIGN EXCHANGE RATE

Foreign exchange rate also known as FX rate or forex rate is a ratio between the values of two country currencies. Exchange rate tells the value of domestic currency in terms of foreign currency. Exchange rate is the price of the currency of a country can be exchanged for the number of currency of another country. Foreign exchange situation of a country tells us about the financial position of a country.

Economic experts have developed the theories of exchange rates to explain how the foreign exchange rate among different currencies is established. There are many theories for determining the foreign exchange rate and two of these theories are discussed below:

i. **The Purchasing Power Parity Theory:**
The purchasing power parity theory was developed by the Swedish Economist Gustav Cassel in 1918. Purchasing power parity theory is (PPP) which states that exchange rate of two currencies are in equilibrium when the purchasing power is same in each of the two countries. The price level and changes in price level determine the exchange rate of those countries' currencies. The purchasing power parity theory is based on the **law of one price**. The basic principle of this theory is that the exchange rate between different countries expresses the purchasing power of these countries. The change in the price level, means the exchange rate also change.

ii. **The Balance of Payment Theory**
The balance of payment theory of exchange rate is also known general equilibrium theory of exchange rate. According to this theory, the exchange rate of a currency depends upon the demand and supply of that currency in a region or country. The demand of foreign currency arises from the debit side of balance of payment. It equals to the payments **made to the foreign countries** by a country for the purchase of goods and services. The supply of foreign currency arises from the credit side of balance of payment. It equals to the payments **made by the foreign countries to a country** against sale of goods and services.

The exchange rate is determined by the demand and supply of foreign exchange. Exchange rate depends upon the debits and credits of a country. If exchange rate falls below the equilibrium point, it means the balance of payment is unfavorable. On the other hand, when the exchange rate rises above the equilibrium point it means the balance of payment is favorable.

Other Factors that Influence the Rate of Exchange:

There are many other factors that influence the exchange rate:

i. **Inflation rate** affects the value of a currency in an economy thereby affecting the determination of exchange rates.
ii. **Interest rate** also has an impact on the level of investments in an economy and explains the level of investments in an economy. .
iii. **Political stability** affects the inflows and outflows of investments in an economy**.**
iv. **Recession** negatively affects the value of a currency as industrial production and demand is down.
v. **Industrial position:** The structure and performance of the industrial sector also affects the rate of exchange as investments are made or withdrawn on the basis of economic performance.

3.5 TRADE CYCLE

A trade cycle is composed of periods of good trade, characterizes by rising prices and low unemployment percentages, shifting with periods of bad trade, characterized by falling prices and high unemployment percentages.

Phases of the Trade Cycle:

There are four phases that involves in the construction of trade cycle .These are as under

i. **Recovery.**

Recovery is a turning phase in which economy moves toward boom or peak. In recovery phase the economic activities, gross domestic product and the employment level increases. This phase attracts the foreigners for making investments as economy grows rapidly.

ii. **Boom or Peak:**

The highest level in trade cycle is called boom or peak. This phase began after the recovery phase. This stage is also known as prosperity stage. During boom period the production rises rapidly. The economic activities increase to their highest level.

iii. **Recession:**

The recession phase opens after the ending of boom period. Recession slows down the economic activities. The level of buying, selling, production and employment is decreased. The prices of the products rise and wages of the consumers decreases that leads to decrease in demand. Investors feel hesitation to invest in a country having recession situation.

iv. **Depression:**

In this phase, the economic activities fall that leads to decrease in production. In depression phase, the level of investment decreases sharply, and the employment level decreases. The demand for consumers and capital goods also falls down that leads to the lower living standard.

Factors Affecting Trade Cycle:

The theories of trade cycle explain the causes and possible remedies for managing the trade cycle in an economy.

i. **Money Supply** affects the trade cycle as the increase in money supply enhances the buying power of consumers and demand for various products is increased. However, the decrease in money supply reduces demand and production in an economy.

ii. **Aggregate Demand** is the total demand of personal and public goods in a country. If the income of consumers is rising, then there will be higher demand leading to the boom period in trade cycle.

iii. **Level of Investments:** The higher level of investments results in surplus production that increases the supply in the market. However, a decreasing investment level moves the trade cycle towards recession period.

iv. **Political Situation** also affects the future economic events and the investors plan their production decisions based on political stability in future.

v. **Uncontrollable Natural Events:** Sometimes, earthquakes, epidemic or unusual flood highly affects the production in an economy and may leads towards the recession.

Exercise

Short Questions:

1. Define exchange rates.
2. Define money market?
3. What do you know about capital market?
4. Enlist any three financial assets?

Long Questions:

i. Briefly explains the theories for determination of rate of exchange.
ii. What are the financial markets?
iii. Explain in detail the phases of trade cycle.

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2. Financial Institution Management by Helen P. Lange
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UNIT–4

INTERNATIONAL MONETARY SYSTEM

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CONTENTS

INTRODUCTION

International monetary system is a set of internationally agreed rules, conventions and supporting institutions that facilitate international trade & investments across borders. This unit will explain the concept of international monetary systems and its functions. As the global financial system is a broader framework in which the domestic financial system works, there is a need to understand the working of the international financial system in order to know the links between the domestic monetary system and the global financial system. We will discuss the role of international financial institutions i.e IMF, World Bank, Asian Development Bank, Islamic Development Bank and Asian Infrastructure Investment Bank.

OBJECTIVES

After reading this unit you will able to;

1. know the international monetary system
2. understand the working and functions of IMF
3. know the working and functions of the World Bank
4. understand the working and functions of Asian Development Bank
5. know the functions of the Islamic Development Bank.
6. know the functions of the Asian Infrastructure Investment Bank

4.1 INTERNATIONAL MONETARY SYSTEM

The international monetary system is a set of agreed rules and frameworks that determine the flow of funds among the different nations. These rules help to set the foreign exchange rate for different currencies of the world. As the global trade and investments occurs among different nations, the exchange of one currency against the other requires setting commonly agreed rules. To overcome this problem, each country has introduced the foreign exchange rate. Foreign exchange rate help to determine the value of Pakistani currency with the other countries currency.

There are three types of foreign exchange rate system in the world:

i. **Fixed Exchange Rate System:**
Fixed exchange rate system is also known as pegged exchange rate system. In fixed exchange system, exchange rate for currency is fixed by the government of a country. The basic purpose of adopting this system is to maintain the stability in foreign trade. In this system value of domestic currency is tied to the value of gold. This system was based on the gold standards from 1880 to 1913. In this system, countries value their currency according to the rate of gold.

ii. **Floating Exchange Rate System**: In flexible exchange rate system, the exchange rate is determined by the forces of demand and supply of different currencies in foreign market. The value of national currency is allowed to move freely with respect to the demand and supply of other currencies. Exchange rate is not influenced by the government. The value of currency is fluctuated according to the change in demand and supply of the foreign exchange.

iii. **Managed Floating System:** In managed floating system, the exchange rate is determined by the forces of market (demand and supply) and interventions of the government or central bank. In this system the government and central bank intervenes in the foreign exchange market to restrict the fluctuation in the exchange rate within certain limits. This system was adopted by the world since 1971. Many developing countries re using managed floating system in which central bank intervenes to guide currency.

4.2 INTERNATIONAL MONETARY FUND

During the early years of the 20^{th} century the world suffered though the great depression. This happened during 1930 and World War I & II has weakened the international payments system. In July 1944, 730 delegates from the 44 major countries met at the Mount washing hotel. The primary purpose of that conference was about the establishment of an institution that take care of the international finances on the other hand that institution could help the member countries during any emergency or crises. The institution will work like a bank.

Formation of the IMF:

During the Bretton Wood Conference, a lot of agreements were signed to establish General Agreement on Tariffs and Trade (GATT), the International Bank for Reconstruction and Development (IBRD) and the International Monetary Fund (IMF). The international monetary fund was founded on 27thDecember 1945 by an agreement signed by the 29 member countries. The IMF started their financial operations on 1stMarch 1947. The establishment purpose of IMF was to give financial assistance and overcome the crises in any member country. Now the IMF has approximately 188 member countries.

How IMF Works?

The member countries deposit some amount of money as subscription fee. The member countries are also responsible for the rules and regulations made by the organization IMF. The basic function of the establishment of the international monetary funds was to help out those countries that face financial crises. IMF lend loan to these countries on some low interest policies. The decision making in the IMF is done by the board of governor considered as general body of IMF. They are responsible for the formation of general policies of IMF on the other hand the board of executives responsible for day to day management of funds. For each country in IMF the lending quota depends on the contribution made by a country, number of votes it has and the maximum limit of borrowing based on the following points.

Functions of IMF:

- **i. To Promote Exchange Stability:** The IMF has the objective to promote exchange rate stability and overcome the problems arises in the world trade system.
- **ii. Borrowing Facility:** IMF provides borrowing facility to the member countries. If member countries face any problem or crises. IMF provides loans according to the IMF policies and overcome the member countries problems.
- **iii. Balance of Payment Stability:** IMF helps the member nations to eliminate disequilibrium in the balance of payment by selling and lending foreign currencies to the member countries.
- **iv. Technical assistance**: IMF also provides technical assistance to the member countries by providing services of experts to the members of IMF on economic and financial matters.
- **v. International monetary cooperation:** IMF also helps to establish monetary cooperation between member countries, and it provides assistance to solve international monetary problems.

IMF and Pakistan

The Pakistan became a member of IMF in 1956.The basic purpose of IMF was to maintain the stability of world monetary system. Pakistan has faced many problems i.e. natural disasters, population growth, deficit budget, more expenditure with respect to revenue and terrorism issues etc. These issues had created financial issues for Pakistan; to overcome these issues Pakistan borrow money from IMF. Since joining IMF as member, Pakistan has taken more than 15 times loans from the IMF.

4.3 INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT (IBRD)

International bank for Reconstruction and Development is also known as the World Bank. IBRD was established in 1944 and became operational in 1946 as the original institution of the World Bank group. The IBRD head quarter is in Washington DC, USA and approximately 15000 staff from the member countries. The structure of IBRD is like cooperative society that is operated for the benefits of 188 member countries. All powers of the bank are vested in its board of governors. The board meets annually in annual board meeting. The board of Governors delegated most of its authorities to the executive directors and the bank president elected by the executive directors.

Objectives of IBRD:

i. To assist the member countries.
ii. To promote foreign investment.
iii. To promote balanced growth of international trade.
iv. To provide loans for reduce poverty

Membership:

All the IMF members are also members of IBRD. A country to want to hold its membership must subscribe to the charter of the bank. If any country wants to resigns its membership that country pay back all loans with interest to IBRD.

IBRD Fund Sources:

i. Member countries contribute according to their Quota in IMF, that contribution is a source of fund for IBRD.
ii. Sometimes IBRD raises their funds through selling of bonds in the international capital market and increased their funds.
iii. IBRD advance loans to the member countries and received back loan amount with interest as well, that also helps IBRD to raise their funds.

IBRD Role in Pakistan:

IBRD has helped Pakistan many times and provided loans and technical assistance for;

i. Poverty reduction
ii. Social development
iii. Infrastructural development
iv. Capacity development of govt. institutions

4.4 ASIAN DEVELOPMENT BANK (ADB)

The Asian Development Bank (ADB) is a regional development bank established on December 19, 1966 with an authorized capital of 58 billion dollars which is headquartered in Manila, Philippines. The basic purpose of ADB is to promote social and economic development. The bank has a board of governors, a board of directors, a president and a vice president.

At the time of establishment 31 members, but ADB now have 67 members of which 48 members are from within Asia and the pacific and 19 outsides. The voting system is distributed in proportion with member's capital subscription. At the end of 2014, Japan holds maximum proportion of share at 15.7%. The ADB lends loan to the member countries and promote social and economic development

Sources of Finance:

i. ADB raises fund through bond issues in the world capital markets.
ii. Member's contribution as subscription fee and raises the funds of ADB.
iii. ADB raises fund through lending operation, and the repayment of loans.

Functions of ADB:

i. ADB promote investment in the region of public and private capital for development process.
ii. It provides loans for economic and social development of the member countries of the region.
iii. It helps member countries in coordinating their development policies and plans.
iv. It provides technical assistance for the preparation, financing and executive of development projects and program.
v. It provides financial and technical assistance to member countries for environmental protection.
vi. It supports public resources mobilization and management to member countries.
vii. It acts as financial intermediary by transferring resources from global capital markets to developing countries.
viii. It cooperates with the United Nations for getting investment and assistance.

ADB and Pakistan:

ADB remains one of the largest development partners and has provided more than 23 billion dollars in loans and over 531 million dollars in grants. The ADB has helped Pakistan many times and has provided technical and financial assistance in the following sectors:

i. Educational sector development
ii. Energy and health sector development and capacity development
iii. Industry and trade development
iv. Information and communication technology
v. Public sector financial and technical management
vi. Social protection and poverty alleviation
vii. Transport and water infrastructure development
viii. Agriculture sector development
ix. Development of capital markets

4.5 ISLAMIC DEVELOPMENT BANK (IDB)

The Islamic development bank (IDB) is a multilateral development financing institution located in Jeddah, Saudi Arabia. It was founded in 1973 by the finance ministers at the Islamic conference (now called the Organization of Islamic Cooperation OIC) with the support of the King Faisal of Saudi Arabia and started its activities on 20 October 1975. There are 56 shareholding member states. In 2013 IDB tripled its authorized capital to 150 billion dollars to better serve Muslims in member and nonmember Countries.

The basic condition for membership is that the member country should be member of organization of Islamic corporation (OIC), Saudi Arabia holds one quarter of the bank paid up capital. The purpose of IDB is to foster the economic development and social progress of member countries and Muslim communities individually as well as jointly in accordance with the principles of Shariah i.e. Islamic law. The DB has a board of governors, board of executive directors, president, Vice president and officers and staff. The purpose of IDB is to foster the economic development and social progress of member countries and Muslim communities individually as well as jointly in accordance with the principles of Shariah i.e. Islamic law. The DB has a board of governors, board of executive directors, president, Vice president and officers and staff.

IDB Groups

IDB has group of five entities;

i. Islamic Development Bank (IDB)
ii. Islamic Research and Training Institute. (IRTI)
iii. Islamic Corporation for Development of the Private Sector. (ICD)
iv. Islamic Corporation for Insurance of Investment and Export Credit (ICIEC)
v. International Islamic Trade Finance Corporation. (ITFC)

Functions of IDB:

i. To invest in economic and social infrastructure projects in member countries.
ii. To provide loans to private and public sector for the financing of productive projects.
iii. To assist in the promotion of foreign trade.
iv. To provide technical assistance for economic growth in members countries.
v. To conduct operations according to the principles of Shariah i.e. Islamic law.
vi. To corporate with all international institutions having similar purpose.
vii. To participate in the productive projects in the member countries. To promote savings and investments.

4.6 ASIAN INFRASTRUCTURE INVESTMENT BANK (AIIB)

The **Asian Infrastructure Investment Bank** (**AIIB**) is a multilateral development bank that aims to support the building of infrastructure in the Asia-Pacific region The bank was proposed by China in 2013 and the initiative was launched at a ceremony in

Beijing in October 2014. Presently it has 102 members and headquarter of the bank is in Beijing. The bank started operation after the agreement entered into force on 25 December 2015, after ratifications were received from 10 member states holding a total number of 50% of the initial subscriptions of the Authorized Capital Stock. The Authorized Capital Stock of the bank is 100 billion US Dollars, divided into 1 million shares of 100 000 dollars each. The allocated shares are based on the size of each member country's economy (calculated using GDP Nominal (60%) and GDP PPP (40%)), whether they are an Asian or Non-Asian Member, and the number of shares determines the fraction of authorized capital in the bank. The 'One Belt One Road' program of China

Functions of the AIIB:

i. Development of physical infrastructure in emerging economies
ii. Financing for large scale investment projects in low to medium income countries
iii. Enhancing trade and bilateral cooperation among member countries
iv. Development of modern technological networks for emerging economies
v. Providing equity and debt support for large scale infrastructure projects

AIIB and Pakistan:

Pakistan has been a traditional ally of China and the establishment of AIIB has further strengthened this bond. The AIIB has provided financing for the following projects:

i. Development of Motorways
ii. Development of Hydro Power Plants

There are many other areas for cooperation in the AIIB framework for social and economic development of Pakistan. Many other infrastructure related projects are funded by China in Pakistan through debt and equity investments besides AIIB financing.

Summary

International monetary system binds together different nations to settle their transactions as per commonly agreed rules. The IMF has mandate to facilitate member countries in addressing their foreign exchange issues and balance of payments crises. The International Bank for Reconstruction and development (IBRD) has been explained. IBRD is established in 1944 and operational in 1946 as the original institution of the World Bank group. Asian Development Bank (ADB) is a regional development bank established on December 19, 1966 with an authorized capital of 58 billion dollars which is headquartered in Manila, Philippines. The basic purpose of ADB is to promote social and economic development in low income countries of Asia. Further the role of IDB and AIIB has been explained to improve the understanding of students on multilateral bodies.

Short Questions:

i. What do you know IMF?
ii. Write three objectives of IBRD.
iii. Differentiate between AIIB and ADB.
iv. Write any three functions of IDB.

Long Questions:

1. Briefly explain IDB.
2. Briefly explain the organizational structure of ADB.

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UNIT–5

BANKING

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CONTENTS

INTRODUCTION

A bank is a financial institution that accepts deposits and lends advances and provides other related services. Banking sector plays very important role in the development of a country. In this unit, the concept of banking, evolution of banking and characteristic of banks will be discussed. Broadly speaking, banking system is a chain of financial institution that provides financial services accepting deposits and lending to individual and institution. Banks are divided into different kinds according to their functions they perform. Banking system plays the role of an intermediary between the ones saving and the ones who borrow money for investments.

OBJECTIVES

The study of this unit will therefore enable you;

1. to understand the banking and its core concepts
2. to recognize stages of evolution of modern banking system
3. to know the different kinds of banks.
4. to explain the role of banks in economic development
5. to know the concept of credit creation and credit instruments

5.1 INTRODUCTION TO BANKING

The banking system is a lifeline of an economy and as it plays very important role in the development of any country. Banking sector have a significant influence in supporting economic development through financial services. A bank is an institution which accepts deposits and lends advances. It accepts deposits from general public and institutions and lend money to the eligible investors for productive purposes. Protection of deposited money of people is the major responsibility of banks.

A general definition of a bank is **"**Bank is an institution which gets loans to lend and, in this way, creates credit".

A bank is an intermediate party between the borrower and lender. It borrows from one party and lends to another".

Generally, a bank performs the following functions:
i. Acceptance of deposits.
ii. Advancement of loan.
iii. Issues and pays cheque.
iv. Transfer money from one place to another.

Banking plays an important role in economic growth of any country. Major Development for a country depends on banking sector as bank maintain the currency value and stability of foreign exchange. People trust banks and deposit their surplus money in bank accounts which banks used it for investment and making loans to needy.

Functions of Bank:

i. Acceptance of deposits:
Banks accepts money from the people in the form of deposits which are usually repayable on demand and pays interest on deposited money after specific time period.

Advancing money:
The funds collected as deposits are then given as loan to the businesses and individuals as per their requirements.

ii. Agency Services:
The agency services include transfer of funds from one account to another, regular periodic payments, collecting cheques, managing investment accounts etc. The banks charge fee to their clients for performing these services.

iii. Utility Services:
The utility services offered by a bank include services accepting utility bills payments, Govt. dues acceptance, distributing govt. prescribed funds etc.

Banks are useful in following ways:

i. Money deposits in banks is safe and other precious good and documents in bank locker.
ii. Banks provide credit facilities to needy people.
iii. Bank encourage the habit of saving by offering interest against deposited money.
iv. Bank provides safe way of transferring money from one place to other.
v. Foreign trade constantly increases through banks.

5.2 EVOLUTION OF BANKING

Different banking experts have different opinion about the beginning of word "**Bank**''. The word bank is derived from Italian word "**Banque**''. Whereas German experts says that it is originated from German word "**Back**" It denoted to a bench for keeping, lending and exchange of money or coins in the market place by money lender and money exchangers. The Bank of Venice in 1157 was the first public banking institution. The Bank of Barcelona was established in 1401.

There are three stages of evolution of banking:

i. Merchants:

Merchants were first inventor of the banking system as they were considered as trustworthy and responsible people because of their strong financial background and repute of dealings in money. In 14thcentury, Italian traders emerged in the business of lending money to people on interest basis. Due of their fair dealings and financial position, even the king can borrow money from them. With the passage of time their business expended and they begum to give written acknowledgment against which people withdraw money from friends or any agent of merchants.

ii. Goldsmiths:

The next stage in the evolution of banking system was goldsmith who were also considered as the trustworthy people due to their strong financial position and heaving safe places or strong iron safe for the safety of valuable metals. Because of these safety measures, people keep their metals like (gold, silver) with them. Most of deposits with them rested idle and needy people requested them for money on interest basis. Goldsmith started lending money to the needy people against interest and with the passage of time they issued written receipts to depositor to get their valuable back. These receipts are transferred from one to another for the settlement of different transactions. The modern type of that receipt is now called cheque.

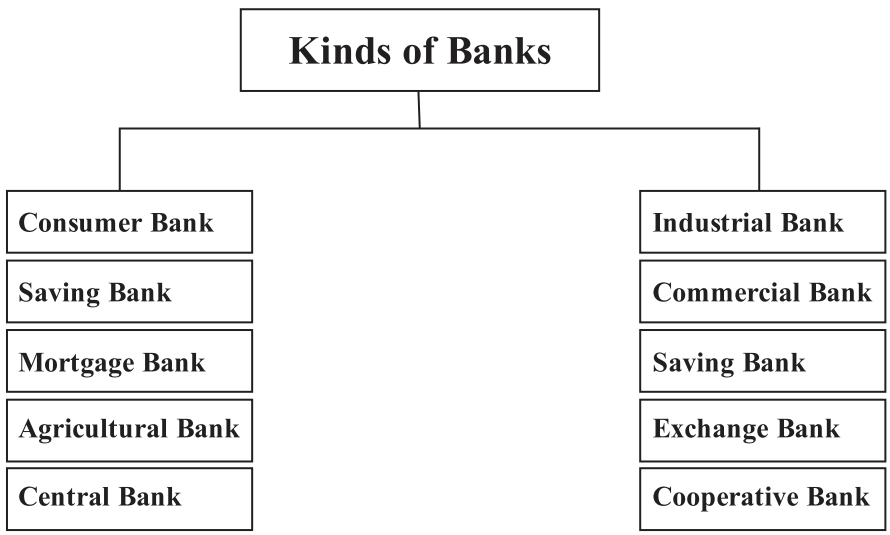
iii. Money Lenders:

The next stage in development of banking system was money lenders who lend their excess money or own resources to the people who need money by charging interest against loan. Initially, they started lending with their own capital but with the expansion of business they started borrowing money from those who have in excess at lower interest rate and lend to those who need it at high interest rate.

Gradually, this practice evolved over the time and shaped the modern form of banking as present today.

5.3 KINDS OF BANKS

With the increase in population and people interest in banking sectors the banks perform many other different functions to facilitate different economic sectors. By increasing demand of banks, it becomes difficult for banks to perform all functions properly. So, banks were divide into different types based on their functions:



i. Central Bank:

Central bank does not deal directly with general public but acts as regulator of other bank. Its main function is to regulate the monetary policy and to control the working of all commercial bank for the proper regulation of monetary and economic policy. A central bank has sole authority of issuing currency.

ii. Commercial Bank:

A commercial bank main objective is to earn profit by lending to the eligible businesses. Bank receives deposits from people and pay interests and lends apportion of those deposits to the people who need it and charge high interest. Commercial banks also perform functions like collecting cheque, safe locker, transfer of money.

iii. Exchange Bank:

Exchange bank provides foreign exchange to importers and exporters of country. Main functions of exchange bank are as: discounting of foreign bills, helping import and export trade and transfer of money from one country to another.

iv. **Industrial Bank:**
These banks are established for the promotion of industrial sector of country. Provide loan for the setup of new industries or the extension of already existing industries. Industrial development bank of Pakistan (IDBP) is an example of the industrial banks in Pakistan.

v. **Mortgage Bank:**
These banks provide financing for buying property i.e. houses, flats, shops, etc. on installment basis and charge interest on them. House Building Finance Corporation (HBFC) is the major example of mortgage bank in Pakistan.

vi. **Investment Bank:**
Investment banks are a bank which deals in sale and purchase of securities and financing long term projects against higher interest rates. These banks work mainly in the capital markets for facilitating customers for buying securities.

vii. **Agriculture Bank:**
Agriculture banks are formed for the development of agriculture sector by providing finance for the purchase of machinery and other tools. Zarai Tarqiati Bank of Pakistan is working as agricultural bank in Pakistan.

viii. **Consumer Bank:**
It is the modern form of bank. It provides loan for purchase of consumer goods. The basic purpose is to provide short term loans for basic consumer goods i.e. electronics items.

ix. **Foreign Bank:**
Foreign bank are owned by foreign based shareholders and they provide services in another country.

x. **Domestic Bank:**
These are owned by local shareholders and provide services in their own country of origin as commercial or other type of bank.

xi. **Saving Bank:**
These banks are established for collecting saving through collection of money that is lying idle with people. Directorate of National Savings is working in Pakistan on this pattern for promoting savings.

xii. **Cooperative Bank:**
These banks are formed to facilitate the small formers or workers to increase their income level. Usually, governments support these types of banks by providing subsidized credit.

5.4 CREDIT INSTRUMENTS

Credit instrument is a document which is used as an evidence of debts. It is issued to meet the deficiency of money, because currency money and metallic money are not enough to meet the modern business requirements. It provides a written proof for future references and acts as money for buying and selling purposes. It may specify the payment process and parties involves in it. Cheque, bill of exchange, and bank draft etc. are used as credit instruments.

Features of Credit Instruments:
i. It is a written evidence of transaction
ii. It is used as a substitute of money
iii. It should be unconditional
iv. It reduces risk of theft.
v. Credit instruments facilitates large size trade.

Cheque:
Cheque is a credit instrument used in the banking system. It is a form of money through which payments can be made to other parties thorough the banks. Banks issue cheque books to their customers for using them instead of dealing in cash.

"Cheque is a bill of exchange drawn on a specified bank and not expressed to be payable otherwise than on demand''

Parties to a Cheque:
Drawer: A drawer is the person who draws cheque upon a bank. He is account holder of the bank who uses a cheque to withdraw amount from its accounts. The one who sign the cheque is drawer who directed the bank to pay certain amount.

Drawee: A drawee is the branch of bank upon which cheque is drawn for payment. It is the party to whom customers order to pay specific amount in the name of person written on cheque or to the bearer of cheque.

Payee: A payee is the person who receives the payment from bank against cheque. He might be drawer itself or any third party whose name is written on cheque. Other parties involved in cheque are;

Holder: Holder is the person who has legal authority to receive amount of cheque. This person may be bearer or any other party.

Endorser: Endorser is the person who transfers the rights of a cheque to other, transfer of rights is also called endorsement.

Endorsee: An endorsee is that person to whom endorser transfer the rights of cheque.

Elements of Cheque:

i. Name of bank is written on the cheque.
ii. Cheque number is printed on the cheque in a series.
iii. The name of the person to whom cheque is to be paid is written on it. If cheque is drawn by account holder itself, it should be write self.
iv. Date should be mentioned on cheque
v. Amount to paid write in figures and in words clearly.
vi. Account number is also printed on the cheque.
vii. At the end name of account holder is written where drawer sign the cheque.

Requirements of a Valid Cheque:

i. Cheque must be in written form. An oral order cannot be constituted by bank.
ii. A cheque should be drawn on specified branch with whom drawer has account.
iii. Cheque cannot be payable conditionally. It should be unconditional to pay a certain amount written on cheque.
iv. Cheque cannot be accepted without signature of account holder and date.
v. Validity period of cheque must be checked as postdated cheque cannot accepted by bank.
vi. The drawer must direct the bank for the mode of payment, i.e. by making the cheque ‘’bearer’’, ‘’crossed’’ or ‘’order’’.

Types of Cheque:

There are four basic kinds of cheque.

i. Order Cheque:
Order cheque is payable to particular person. The name of payee must be clearly written on cheque. The order cheque is only paid by bank to payee if the bank is satisfied about the identity of payee.

ii. Open Cheque:
Open cheque is one against which cash is receive over the customer. The holder of cheque can receive payment of transfer to any third party by signing on the back of the cheque.

iii. Bearer Cheque:
Bearer cheque is the cheque which is paid to the bearer of the cheque. A bearer cheque does not need endorsement.

iv. Crossed Cheque: Holder of crossed cheque cannot enchased at counter of the bank. The payment of crossed cheque is only made by credited the amount in the account of payee whose name is written on cheque. Two parallel lines are drawn across top left corner of the cheque.

5.5 CREDIT CREATION

Credit creation is the major function of a commercial bank. A bank can create credit by advancing loans to a person and it results in increase in money in circulation. Usually, a bank acts as a factory for the manufacturer of credit in a modern economy. The process of credit creation is the central pillar of modern economies and therefore banking has got a key position in the modern economic system. Without credit creation through banks, the economic transactions in a modern economy will be reduced by at-least 70%-80%.

Methods of Credit Creation:

i. **By Loan:** Bank provides loan facility to customer against securities. Bank do not provide loan in form of cash. It open account in the name of customer cannot draw money by itself only it may issue cheque to other person for payment who may deposit the cheque in his account through which process of credit creation starts.

ii. **Discounting of Bills:** Banks creates credit through discounting of bills of exchange. When bank discount bill it credits the amount in customers account who draws through cheque. Through these measures banks creates deposits equal to bill amount.

iii. **Through Investment:** A bank creates credit by making investment by purchasing government securities and payment is made through cheque to central bank. Every cheque deposited in a bank enables it to create more credit.

5.6 ROLE OF BANKS IN THE ECONOMIC DEVELOPMENT

i. **Capital Accumulation:**
Banks plays important role in capital accumulation which is important for economic development of a country. They mobilize the saving of people from all over the country and made it available for businesses for productive use.

ii. **Channelizing Funds for Productive Use:**
Banks invested the save amount for productive purpose. Capital accumulation is not the only function of commercial bank. Accumulated saving should be distributed among different sectors of economy with a view to increasing the productive capacity of country.

iii. **Development of Agriculture and Industrial Sectors:**
Bank provides loan for purchase of machinery, modern tools, fertilizers and pesticides etc. which makes the economy self-sufficient of food. Moreover, commercial banks also provide loam to industrialists resulting in increase in economic development.

iv. **Market Expansion:**
Generally, businessmen lack funds for investing in new and risky enterprises. Banks provides short- and long-term loans to entrepreneurs to invest in new market and use modern technology.

v. **Level of Employment Increase:**
A country economic development depends on the promotion of trade, agriculture, industrial and communication sectors. Bank finance these sectors through investment and it automatically generate employment opportunities.

vi. **Promotion of Foreign Trade:**
Foreign trade is an important element of economic development. Commercial bank helps businessmen of two countries to do work with each other, i.e. letters of credit and banks discount foreign bills of exchange and issue LOC.

Summary

Banking sectors plays an important role in growth and development of an economy by providing funds to businesses and companies. Modern banking is evolved from different stages of evolution as merchants, money lender and goldsmiths have acted as banks in the past. A modern bank is an institution which gets loans to lend and, in this way, creates credit. Banks are of different types and cater to the diverse segment of economy by developing profitable savings and investment schemes.

Exercise:

Question No.1: Short questions:
1. What are the commercial banks?
2. What is an investment bank?
3. Define credit creation.
4. What is a cheque?

Question No.2: Long questions:
1. Detailed note on Evolution of Banking system.
2. Discuss in detail the concept of cheque.

References

1. Financial Markets and Institutions by Anthony Saunders
2. Financial Institution Management by Helen P. Lange
3. Financial Institutions and Markets by Meir G. Kohn
4. Financial Markets and Institutions by Frederic Mishkin and Stanley G Eakins
5. Fundamentals of financial institutions management by Marcia Millon Cornett

UNIT–6

FUNCTIONS OF COMMERCIAL BANK

Written By: Moazzam Ali
Reviewed By: Prof. Dr. S.M.Amir Shah

CONTENTS

INTRODUCTION

A commercial bank is a financial institution that is authorized by law to accept deposits from businesses and individuals and lend money to them. The commercial baking is the backbone of economy. Different types of accounts are offered by bank to attract customers by offering attractive interest rates and saving schemes. They also perform different services provides such as receiving money, advancing loan, and other agency services on behalf of customer. Credit instruments are used instead of money like cheque, bill of exchange and promissory note for the settlement of transactions in the commercial baking. Generally, regarded as the central pillars of modern economy, commercial banks are vital for economic growth and development.

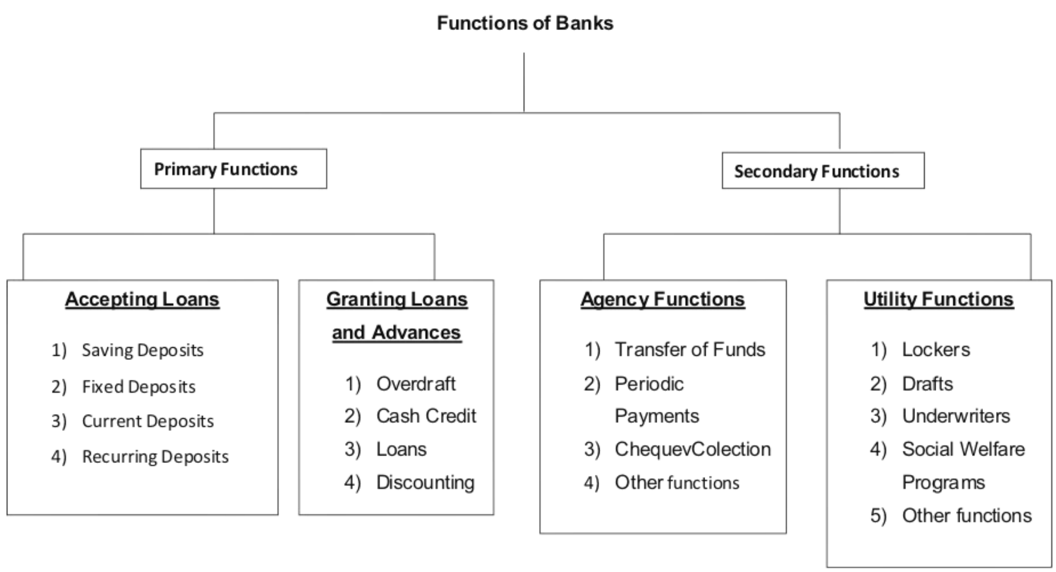
OBJECTIVES

After reading this unit you will able;

1. to understand commercial banking and its scope
2. to know the functions of commercial banks
3. to know the different accounts offered by the commercial banks
4. to understand rights and duties of banker and customer

6.1 FUNCTIONS OF COMMERCIAL BANKS

Commercial banks receive money from those who have surplus and lend it to those who need them. The role of commercial banks is to provide financial intermediation services to general public and business, ensuring economic and social stability of the economy. In this respect, "credit creation" is the most important function of commercial banks. While advancing loan to a customer, they do not provide cash to the borrower. Instead, they open a deposit account from which the borrower can withdraw. In other words, while sanctioning a loan, they automatically create deposits, known as a "credit creation from commercial banks". The central bank is responsible for the oversight of the commercial banking system of their respective countries. They will impose a number of conditions on the banks that they regulate such as keeping bank reserves. In Pakistan there are many commercial bank e.g. National bank, Habib bank, Bank of Punjab, United bank, Allied Bank etc. **(A complete list is given at the end of the unit.)**



6.1.1 Primary Functions: Primary functions of commercial banks are as follows;

Accepting Loans (Deposits):
The primary function of commercial bank is receiving funds from people who have surplus money but do not use it for production purpose. Bank accepts money and pay interest to the depositors. It attracts the saving of people by offering different types of accounts and schemes. A commercial bank usually receives funds from general public and businesses in the following way;

i. **Current Account:** Current account is suitable for business, because withdrawal and deposits are made at any time without any limit. Usually bank does not pay interest on current account. Account holder receives cheque book and bank statement on annual or semiannual basis which shows the details of deposit and withdrawal during specific period.

ii. Saving Account: People with excess money deposit their money in saving account. Bank pays interest on saving accounts. However, the banks normally restricted account holder on their withdrawal. Zakat is deducted from saving account.

iii. **Fixed Account or Term Deposits:** In fixed account money is deposited for fixed time period. People who want to deposit their excessive money for long period prefer the fixed account. Terms and condition and time period decided at the beginning to avoid any misunderstanding.

iv. **Recurring Deposits:**
The commercial banks allow businesses to deposit and withdraw funds continuously throughput the year as per their needs in order to meet their financing needs.

Advancing of Money: Bank receives deposit to lend it to the businesses and individuals who want to fulfill their financing needs. Advancing money is more important function as the strength of a bank is judged through soundness of its advances. Bank demands different kinds of securities against loan i.e. shares, documents of property, gold, or silver. The advancing of money may be in following ways;

i. Call Loans:
Call loans are the loans which can be recalled or demanded by the bank at any time. Call loans are mostly advanced to those who have strong financial position. Usually the time period of call loan is seven to fourteen days.

ii. Short Term Loans:
Short term loans are issued to meet day to day needs and requirements of businesses for the period of thirty to ninety days.

iii. Long Term Loans:
Long term loans are issued for the purpose of making investment or purchase of assets. Time period for long term loan is three to ten years under some conditions.

iv. Overdraft:
An overdraft is the extension of credit from bank to its customer when an account is reached at zero balance. Overdraft means that banks allow its customer to borrow a set amount of money. The interest is charged only on the negative balance which the customers' deposits back in time.

v. **Discounting of Bills:**
Banks provide loan to their customer by discounting their bills before the date of maturity. Discounting the bills means bank accept bills as a security of loan by deducting nominal amount as discounting charges from the total amount in order to make payments.

6.1.2 Secondary Functions

Agency Services:

i. **Transfer of Funds:**
Banks helps its customer by transferring funds many from one place/person to another with the help of credit instruments like cheques, drafts, mail transfer, telephone transfer etc.

ii. **Cheque Collection:**
Commercial bank collect cheques, bills, dividend, promissory notes, rents and other receipts on the behalf of their customer and make payment like insurance premium, rent according to instructions of customer.

iii. **Facilitation of Foreign Trade:** Central bank authorizes some commercial bank to deal in foreign exchange. Commercial bank sale and purchase foreign exchange on behalf of customer which is helpful for promotion of international trade.

iv. **Periodic Payments:**
Banks receive and pay various periodic payments like salaries and pensions on the instructions of their clients as per the agreed terms and conditions.

6.1.3 General Functions:

Utility Services:

i. **Locker Facility:**
Commercial bank provides locker facility to its customer for safe custody of valuable, documents, gold, and silver. Bank charge commission against locker facility.

ii. **Draft:**
Commercial bank provides the facility of traveler's cheques to their customer to avoid the risk of taking cash with them. Bank also issue Letter of credit which is a security and surety of making payments to foreign traders by bank.

iii. **Underwriters:**
Commercial bank acts as an agent for sale and purchase shares & securities on the behalf of its customer and charge nominal commission for its services.

iv. **Govt. Services:**
Banks also perform numerous other services that include accepting Govt. dues, utility bills collection, Hajj applications collection, accepting tax payments etc.

6.2 BANK ACCOUNTS

Bank accounts refer to a financial arrangement between an account holder and a bank. People put their money in their accounts for different purposes and banks use deposits for investment purpose or for loan making. Depending on the duration of deposits and the terms and conditions attached with an account, a commercial bank can open various types of personal and corporate accounts to provide services to different persons.

6.2.1 Types of Bank Accounts

Saving Account: Saving account are suitable for salaried person. It is an interest-bearing account. Banks may limit the number of withdrawals from saving account.

Features:
i. Account holder can use cheque for the withdrawal of money.
ii. Bank pays profit after every six months.
iii. Bank issued passbook and cheque book.
iv. Zakat is deducted on saving account.
v. Certain withdrawal rules are determined by bank on saving account.
vi. Bank issued statement of account after regular interval.

Current Account: Current account is also known as running account. Current account is generally suitable for businessmen because they withdraw money without notice. It is an active account for frequent deposit and withdrawal by cheque.
i. Current account is suitable for businessmen.
ii. It is open with minimum amount fixed by bank.
iii. Cheques are used to withdraw money.
iv. There is no restriction of withdrawal.
v. Bank does not pay profit on current account.
vi. Overdraft facility is provided to current account holder on interest.
vii. Zakat is not deducted.

Fixed Deposit Account: The person who has surplus money for long period can deposit it in fixed account. Banks offer high rate of interest on deposited amount. Amount can only be withdrawn after maturity of fixed date.
i. It is suitable for people who have surplus money for long period.
ii. The amount deposited remains fixed for maturity period.
iii. Term deposit receipt issued to customer who contain amount and terms of deposit.
iv. Bank pay higher rate of interest as compared to other schemes.
v. Further deposits are not allowed amount is deposited and withdrawn only once.

Business Accounts: These accounts are offered to the corporate customers for providing them various agency and facilitation services. Depending on the terms and conditions of various schemes, business accounts can be customized as per the needs of individual corporate customers to provide them better services. As corporate customers provide high amounts to the banks, extra care and services are provided to these customers.

6.2.2. Procedure for Opening of a Bank Account:

i. **Selection of Accounts**: There are different types of accounts. People open accounts according to their needs, current account, fixed term account or saving account.

ii. **Getting Application Form:** Printed form is issued by bank to customer for account opening. It is different for different accounts. It contains following.

a. Name of the bank.
b. Name of applicant.
c. Address and phone number of applicant
d. Identity card number of applicant
e. Profession
f. Name, identity card number, address, profession of introducer.
g. Nature of account.
h. Amount to be deposited by applicant.
i. Account opening date.
j. Signature.

iii. **Documents required**: Individual should attach copy of identity card with application form. In case of partnership copies of all partners identity card, copy of registration form of partnership is attached. In case of company Memorandum of association, articles of association. List of directors and approvals for account opening and certificate of incorporation are attached with application form.

iv. **Specimen Signature Card (SSC):** Bank issued specimen signature card and obtain signature of account holder for future use. It contains name of bank, Account number, and title of account, current date and account holder signature.

v. **Deposit Slip:** Deposit slip is a document which is used for the purpose of deposit in the bank. Account holder makes initial deposit in bank when account is opened. It contains title of account, account number, Deposited amount, date and signature of depositor.

vi. **Issuance of Cheque Book:** When account is opened bank officer issued cheque book. A cheque is in printed form heaving name, account number, date, and Bank name on it. It is used by the customer for withdrawal or for payment purpose.

6.3 BANKER-CUSTOMER RELATIONSHIP

A bank and its customers are bounded by the laws of the land regarding banking operations. As customers put their funds at the disposal of banks, regulations are developed to safeguard the interests of the customers. Similarly, a bank is also legally protected against all the frauds and other illegal means which a customer can inflict on it. Therefore, both banker and customer are protected by the rules and regulations to ensure their smooth functions.

6.3.1 Rights and Duties of Customer:

Rights of customer of a bank are as follows:

Rights of Customer:

i. Customer has right to draw a cheque to the extent of his credit balance.
ii. Customer has right to receive statement of account after regular interval.
iii. Customer can sue a bank for dishonoring cheque by mistake.
iv. Customer has right to correct its record in case of wrongly debit or credit.

Duties of Customer:

i. Customer must present the cheque or any other instrument during banking hours.
ii. Customer should present the cheque within due date.
iii. A customer should keep his cheque book in safe place to prevent its misuse by unauthorized person.
iv. Customer immediately tells bank if any cheque is lost or stolen for stop of payment.

6.3.2 Rights and Duties of Banker:

Rights and duties of bank are as follows:

Duties of Banker:

Its duty of banker to make payment on customer behalf and should honor the cheque for payment issued by customer.

i. Bank performs agency services on customer behalf according to customer instruction.
ii. It is the duty of bank not to disclose the financial position of customer to any other.
iii. Sale and purchase of securities on customer behalf as directed by him/her.

Rights of Customer:

i. Bank has right to charge interest on overdraft or any other facility.
ii. Bank has right to retain the securities until customer pays his debts.
iii. Bank has right to adjust debit and credit balances of customer.

6.3.3 Nature of Banker Customer Relationship:

The kind of relationship between bankers and customer are of different forms and includes;

i. **Debtor and Creditor:** The relationship between bank and customer is like debtor and creditor customer deposit money in bank and withdraw at any time. The bank is known as debtor and customer is creditor. The relationship is inverse when bank advances loans.

ii. **Bailer and Bailee**: When customer deposit valuable in bank for safe custody the bank become bailer and customer is bailee.

iii. **Principal and Agent**: The customer deposits cheque, drafts etc. for collection. He also give instructions to the bank to purchase securities, payment of insurance premium on customer behalf. When bank perform agency services for customer he become an agent and customer is principal.

iv. **Mortgager and Mortgagee**: When bank accept immovable property as a security against loan advance to customer. The customer becomes the mortgager and banker is mortgagee.

v. **Pawner and Pawnee:** When customer pledges goods and documents as a security against loan then he became Pawner and bank become Pawnee. Goods or document are returns when debts are paid.

vi. **Lessor and Lessee:** When bank provides advances to customer based on lease financing then customer become lessee and banker lessor.

vii. **Trustee and Agent:** The banks act as trustee when customer deposits his securities for safe custody and when bank sells securities on customer acting as agent of the customer.

6.3.4 Kinds of Bank Customers:

Following are the major kinds of banks customer.

1. **Individual Customer**: Account with name of person and operated by account holder himself individual customer and it may include following types of persons;

i. **Minor:** Minor is a person who do not attain the age of 18 years. Bank can only open minor account after the prior permission of guardian court. Court authorized a person (Guardian) who operate the account and give his specimen signature. He can withdraw after court permission and may not enjoy full banking services.

ii. **Lunatic:** Lunatic is a term used for person who is mentally ill. If he already have account with bank. Bank immediately stop payment ad suspends account when bank comes to know that customer lunatic. Account can only be operated after the court evidence received from court.

iii. **Illiterate Person:** Illiterate person is one who cannot read or write. Illiterate person can use thumb impression as a specimen signature. Photographs of customer are posted on the signature card. Illiterate person do not make payment through cheque he can only withdraw amount from account by himself.

iv. **Purdah Nasheen Women**: Purdah nasheen women are one who remains in complete hijab. Bank is very careful while opening Purdah nashee women account. A very close reference is required in case of married women his husband is used as reference and natural guardian in case of unmarried girl.

v. **Married Women:** Married women can open account as other people. She can perform all the function and operate account, but she has to write her husband name and earning of her husband.

2. **Joint Account:** Joint account is an account which can be open and operated by two or more person. And may include following

i. **Partnership Firm:** Partnership is an arrangement in which two or more people are agreed to share profit of business. Partnership firm can open joint account of all the partners. The account open and operated at the name of the firm not at individual name. Bank obtains signature of all partners' ad deceleration and consent of all that who can operate the account. In case loan is obtained, the banker must require sign document which shows the consent of all partners.

ii. **Joint stock Company:** Joint stock company can open current account company nominates the directors who are authorizes to deal with the bank. Two or three directors have to sign specimen signature card for future correspondence. They provide name, phone number, identity card number, and address of director who operate account, Memorandum of Association, Articles of Association, Certificate of Incorporation, Certificate of Commencement and copy of resolution submitted by partnership firm to bank.

iii. **Trustee**: Trustee is a person to whom property is legally committed to be administered of any other person. Account should be opened in the name of trust and opening form should contain signature of the entire trustee with a copy of trust deed. Bank gets clear instruction that who can operate account. In case of death of trustee, the power will be decided according to trust deed.

iv. **Non-Profit Institutions**: Individuals with activities other than trade is called nonprofit institutions. E.g. clubs, hospitals, and college etc. Bank open account of a society which is registered as corporative body under corporative society act. A copy of memorandum of association and article of association should be submitted to bank which help the banker to know the objectives and rues of society. A copy of resolution which indicates that society authorized person for operating account should also be submitted in bank.

Summary

This unit has explained the key concept of commercial banks and their functions. Commercial banks perform many functions at the same time. They receive money from those who have surplus and lend it to those who need it. Commercial banks contribute to the growth of the economic development of any country by advancing loans to underdeveloped sectors like agriculture, industrial sectors. This unit has also described the various types of bank accounts offered by commercial banks to their customers. The lasts section of the unit has discussed the banker-customer relationship, Duties and rights of banker & customer in detail.

Exercise:

Question No. 1: Short Questions
1. Define bank? Write any four functions of banks.
2. Write duties and rights of customer.
3. Write types of individual customers.
4. What is a saving account?

Question No. 2: Long Questions
1. Define bank and discuss its functions in detail.
2. Discuss the types of bank customers in detail.
3. Discuss rights and duties of banker and customer.

References (Books):

1. Financial Markets and Institutions by Anthony Saunders
2. Financial Institution Management by Helen P. Lange
3. Financial Institutions and Markets by Meir G. Kohn
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UNIT–7

BANK LOANS AND ADVANCES

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CONTENTS

INTRODUCTION

In the previous unit you have learnt the function of commercial banks and its features. The commercial banks accept deposit and lend money to the people who require it for the various purposes. This unit will introduce the concepts of bank loans and advances. The bank loan and advances granted by the commercial banks are highly beneficial to the individual, firms and companies meeting their financing needs. The growth of business is affected to a large extent by the quantity and quality of financing available on time.

OBJECTIVES

After reading this unit you will able;

i. to understand the concept of running finance.

ii. to know the concept of cash and demand finance.

iii. to differentiate running finance, cash finance, and demand finance.

iv. to understand the precautions and procedure of loan/advances.

v. to understand letter of credit and its major types.

7.1 BANK CREDIT ANALYSIS

Primary function of a bank is to receive deposits and advances loans. Bank accepts money from the holders of surplus funds and lends it to the needy people or invests for productive purpose. Bank collects funds from different sources; deposits, paid-up capital, loans etc. and distribute it to the eligible investors as per the agreed terms and conditions. Credit analysis by a lender is used to determine the risk associated with making a loan. Regardless of the type of financing needed, a bank or lending institution will be interested in both your business and personal financials. While giving credit to a person or business, a bank conducts the credit analysis in order to make the appropriate lending decisions.

Credit Analysis is governed by the "5 Cs:" character, capacity, condition, capital and collateral.

i. **Character**: Banks need to know the borrower and guarantors are honest and have integrity. Additionally, the banker needs to be confident the applicant has the background, education, industry knowledge and experience required to successfully operate the business. Lending institutions may require a certain amount of management and/or ownership experience. As history is the best predictor of the future, a lender will examine the personal credit of all borrowers and guarantors involved in the loan.

ii. **Capacity (Cash flow):** The banks want to know that a business is able to repay the loan. The business should have sufficient cash flow to support its business expenses and debts comfortably while also providing principals' salaries sufficient to support personal expenses and debts. Examining the payment history of current loans and expenses is an indicator of the borrower's reliability to make loan payments.

iii. **Condition**: The lender will need to understand the condition of the business, the industry, and the economy, which is why it is important to work with a lender who understands the particular industry. The lender will want to know if the current conditions of the business will continue, improve or deteriorate. Furthermore, the lender will want to know how the loan proceeds will be used- working capital, renovations, additional equipment, etc.

iv. **Capital**: The bank will ask what personal investment you plan to make in the business. Not only does injecting capital decrease the chance of default, but contributing personal assets also indicates that a person is willing to take a personal risk for the sake of his business.

v. **Collateral**: A banker will consider the value of the business' assets and the personal assets of the guarantors as a secondary source of repayment. Collateral is an important consideration, but its significance varies depending on the type of loan. A lender will be able to explain the types of collateral needed for a loan.

The five components that make up a credit analysis help the lender understand the owner and the business and determine credit worthiness. By knowing each of the "5 Cs," a business will have a better understanding of what is needed and how to prepare for the loan application process.

Important Terms Used in Bank Credit:

i. **Pledge:**
Pledge means actual delivery of rights as well as possession of goods as security against loan. Subject of pledge is returned to the customer when he has been paid. In case of nonpayment bank has right to sell security to recover its losses.

ii. **Mortgage:**
It is a written agreement between mortgager and mortgagee. Customer transfer legal rights of property to bank but possession of goods is remains with customer.

iii. **Lien**:
It is a right of the bank to retain the possession of property against loan until customer repay loan along with interest.

iv. **Hypothecation:**
Under hypothecation neither ownership nor possession of goods transfer to bank. It is just an agreement between banker and customer but in case of failure of repayment bank approach court of law to receive full rights of selling the hypothecated property.

7.2 BANK ADVANCES

A bank advance is provided to a borrower for meeting small level financing needs. These advances are usually payable within one to three months period and carries interest rate along with other terms and conditions. The advances are classified as running finance, cash finance, and short-term demand finance.

7.2.1 Running/Revolving Finance

Running finance is a short-term loan facility from commercial banks to its account holders. If account holder bill are greater than its account balance he requested bank manager to overdrawn his account by specific amount for short period. Once finance limit is approved then account holder can borrow money to extent of that limit but pays mark up on amount, he drawn on monthly basis. Running finance is also known as revolving finance. It is only allowed to current account holder. Overdraft facility is provided against security of deposit receipt or shares.

Features of Running Finance are;

i. Current account holder:
Running finance facility is only provided to his current account holders.

ii. Contract:
Contract is made between bankers and its account holder on the maximum amount.

iii. Security:
In running finance most of the time personal security is taken as security against overdraft facility. It is in form of credit worthiness of account holder and sometime bank may demands security in form of another financial asset.

iv. Withdrawal rule:
Account holder can withdraw access amount at full or in installments.

v. **Time period:**
Time period for running finance is short may be number of days 30-90.

vi. **Interest:**
Bank charges interest on the amount which is withdrawn in access.

Benefits of Running Finance:

i. **Easy Access to Funds**:
Sometime account holder makes payments but balance in account is not enough, so he requested bank to allow him to withdraw access money for short period due to which it manages money.

ii. **Timely payments**
Timely payments are made from bank accounts even balance is not enough due to overdraft facility.

iii. **Minimize paperwork**
In running finance paperwork is reduced as compared to other advancing facilities offered by bank.

Limitations of Running Finance

Following are the limitations of running finance;

i. **Current account holder**
Running finance facility is only availed by current account holder. All other account holder is excluded.

ii. **Higher interest**
Interest rate is higher as compare to other borrowing facilities/schemes is charged.

iii. **Reduction of limit**
Overdraft facility is a temporary advance facility. There is a risk of decrease in limit of access borrowing from account may also reduce if the performance of company is not good.

7.2.2. Cash Finance

Cash finance is also known as cash credit. It is process through which bankers allow its customer to borrow certain sum of money up to limit fixed by commercial banks. Security should be provided by customers against such loans. As compared to running finance, cash finance is issued for longer period. Mostly banks provide cash finance facility to current account holders. Bank allows customers to withdraw either in lump sum or installments. So, customer can used money according to his/her requirements.

Features of Cash Finance:

i. **Current account holder**
Cash finance facility is provided to current account holder only.

ii. **Time period**
Time period for cash credit is not as long but its time period is more than running finance.

iii. **Interest/Mark Up:**
Bank charges interest against amount withdrawn. If customer does not withdraw up to allowed limit. Then he has to pay interest on half of total amount or quarter of amount. If customer withdraw half or more than half amount from sanction limit than he has to pay full interest.

iv. **Separate Cash Finance Deposit Account:**
Bankers do not gave amount in form of cash. It open new account with the name of cash finance deposit and transfers amount in that account and customer withdraw money through cheque in lump sum or installments.

v. **Security**
Bank provides cash finance facility against security. If bank provide loan at personal security than loan may be in secured and bank may face losses if customer refuse to repay. Secured securities are demanded by bank to secured loan in case of nonpayment.

vi. **Repayment of loan**
Loan may be repaid in lump sum or in installment within due date as per the agreed terms and conditions.

Limitations of Cash Finance:

Limitations of cash finance are;

i. **Time period**
Time period for cash finance is short for further loan customer has to renew his deposit by bank.

ii. **Interest/mark up**
Customer must pay interest if he used only little amount of loan than pay interest on half or quarter amount.

iii. **Current account holder**
Cash finance facility is only provided to current account holders. Other account holder like saving and fixed deposits should not avail this facility.

7.2.3 Demand Finance

Demand finance is formal form of bank loan. Bank advances large amount for fixed period. Loan is repaid after fixed time period or on demand.

Features of Demand Loan

i. **Nature of Deposit**
As compare to running finance and cash finance, demand loan is granted to all account holders who wanted loan.

ii. **Securities:**
Acceptable securities against loan are government securities, and tangible goods etc.

iii. **New Account:**
Bank never gave money to customer while advancing loan. It open separate new account in the name of customer and customer can withdraw amount through cheque which helps in credit creation.

iv. **Time period:**
Demand loan is repayable on demand. It depends on the terms and conditions of the bank.

v. **Interest:**
Interest is paid on whole/full amount of loan doesn't matter either customer withdraw whole amount or not.

vi. **Purpose of Demand Loan:**
Usually, the purpose of demand finance is to meet the requirements of working capital.

Limitations of Demand Finance

Limitations of demand finance are as follows;

a. **Interest**
The customer must pay full amount of interest against loans no matters that withdraw half or full amount.

b. **Renewal**
The loan is not is renewed if customer has additional loan requirements.

c. **Security**
Security should be provided against loan if one cannot provide security it may not avail loan facility.

Comparison among running finance, cash finance and demand finance.

Feature	Running Finance	Cash Finance	Demand Finance
Time period	Time period for running Finance if very short as number of days.	Cash finance is also short time but more than running finance.	Demand finance is issued for longer period.
Interest	Interest is only paid on amount drawn.	Interest is paid on amount withdrawn if withdrawn amount is very little than bank charges interest on quarter or half amount.	Interest is charged on full amount of loan.
Type of Account	It is only provided to current account holder.	It is only provided to current account holders.	Demand finance is issued to all account holder not restricted to current accounts.
Renewal	At maturity renewal facility is available.	At maturity it also renewed as running finance at customers request.	Demand finance cannot be renewed. New request should be made.
Security	Personal security is enough.	Personal and material security against loan.	Material security is required.

7.3 BANK LOANS

Medium- and long-term loans are called term finance. Term finance is issued for more than one year and payment of this loan is spread over larger period. These loans are advances for the purpose of starting new business or the expansion of existing business. Term finances are secured against mortgage of property or machinery.

7.3.1 Medium-Long Term Loans

i. It is issued in both local and foreign currency.
ii. Terms loan are granted against securities/collateral.
iii. Bank imposes restrictions on borrower for recovering interest.
iv. Term finance is repaid after semiannual of annual intervals.

i. Car Finance:
Car finance is issued for financing a car for individual and corporate customers usually for a period of one to five years. These loans are provided against secured streams of incomes (i.e. salary) to the individual customers and carry an interest rate.

ii. House Finance: House finance loan is provided for building or renovating a house to the eligible customers. Generally, the house loans are provided for longer period i.e. five to ten years and carries higher rates of interest. The repayment schedule and installment are worked out at the start of the loan period and the house remains property of the bank till the repayment of all installments with interest.

iii. Asset Finance: Asset finance facility is provided to the corporate clients for meeting the financing needs for new plant, machinery, vehicles, buildings etc. As these assets require huge amount of funds, banks finance businesses for their longer term needs on higher rate of interest along with other terms and conditions.

iv. Infrastructure Finance: A bank also support the development of physical infrastructure i.e bridges, roads, airports, seaports, large govt. projects etc. Generally, in infrastructure finance, a bank works jointly with other banks by forming a syndicate or consortium and jointly advance funds to the clients based on their needs.

7.3.2 Letter of Credit

A letter of credit is a letter from a bank guaranteeing that a buyer's payment to a seller will be received at proper time and against correct amount. In case buyer unable to make payment on purchases the bank will be required to cover the full or remaining amount of the purchase. It is a document issued by third party to make sure that in case of failure of payment by buyer it may liable for payments. Banker's letter of credit is of two types.

i. Commercial LOC.
ii. Personal LOC.

Commercial letter of credit is issued for business purposes.

Kinds of Commercial Letter of Credit
Kinds of commercial letter of credit are as follows.

i. **Clean LOC:**
It is letter of credit in which no conditions are attached.

ii. **Documentary LOC:**
It is letter of credit which requires document to be attached with it.

iii. **Fixed LOC:**
Letter of credit issued for some specific transaction and automatically cancels after those transactions.

iv. **Revolving LOC**:
Revolving letter of credit is renewed automatically after payment of transaction.

v. **Confirmed LOC:**
It is letter of credit which is properly attested by bank and after its issuance bank is liable for payment to exporter in any condition.

vi. **Revocable LOC:**
Revocable letters of credit may be canceling at any point due to any reason.

vii. **Negotiable LOC:**
Negotiable letter of credit is one whose receiver has right to transfer it to any other party and instruct its bank to transfer rights in partial of full.

Personal Letter of Credit
People who visit foreign countries avoid taking cash with them to avoid chance of theft. Bank issues personal letter of credit to facilitate those people which are known as personal letter of credit. Any person can avail this facility by deposit amount in bank.

Kinds of Personal Letter of Credit;

i. **Traveler's Letter of Credit:**
Travelers letter of credit issued by bank to facilitates its customer. Bank order all its branches and offices in other countries to pay particular amount to a specific person.

ii. **Circular Note:**
Circular note is issued by bank to its branches and offices in other countries to facilitate traveler during their journey. Circular note is nonnegotiable instrument.

iii. **Travelers Cheque:**
Bank takes the signature of travelers it is drawn on different branches of bank in foreign country. When customer wants to encased traveler's cheque officers take signature is it match then payment is made.

Advantages of Commercial Letter of Credit

i. **Increase in Bank Income:**
Through letter of credit income increased because bank charges interest against issuance of letter of credit.

ii. **Facility for Importer:**
It is the bank who pay debts to exporters the importer does not worry about payment at spot he can make payment in installment. Burden is lowered Importer has to pay interest against letter of credit facility.

iii. **Facility for Exporter:** Exporter also facilitated through letter of credit because it is assured that payment is made against goods he/she sold which is not possible without involving bank

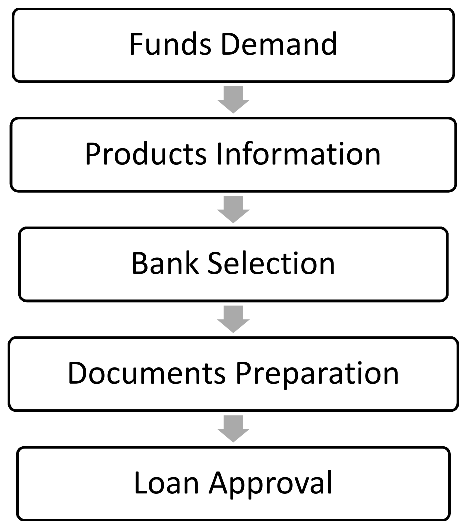
7.4 PRINCIPLES OF BANK LENDING

While advancing money to any party bank should observe certain strict rules to avoid future losses. Following precautions are taken for advancing money.

i. **Diversification of Loans**: Diversification of loans means to advance loan to different sector. Someone truly quoted that ‘. Due to granting of loan to different people risk is divided and chances of loss are minimized as compare to advance huge amount to single person.
ii. **Profit Margin**: Bank earns profit by making loan. While grated loan it should be checked that a loan is a secured source of reasonable profit.
iii. **Liquidity of Loan**: Loan should be easily recoverable in case of emergency. Bank mostly preferred liquid nature advances.
iv. **Custody of Goods and Documents**: Goods taken as security should be in bank custody and banker may demand documents of title to that property to secured loan.
v. **Value of Security**: Banker must search market value of security because increasing value goods are accepted as securities otherwise there may be chance of loss.
vi. **Financial Position of Bank**: Financial position of the bank should be checked, and appropriate reserves funds should be allocated for the running of day to day operations.
vii. **Amount and Duration of Loan:** Bank is more careful about advancing large amount for loan and short duration is preferred for repayment and it generally avoids long term loans.
viii. **Directions of the Central Bank:** While granting loans, directions of the central bank are followed for allocating capital to various sectors of economy as per the policy guidelines.
ix. **Determination of Interest Rate**: As every loan carries interest rate, it is determined as per the prevailing economic situations, risks in transactions and required returns.
x. **Compliance with Applicable Laws:** While granting loans, compliance with all applicable taxation and business laws is required to avoid any legal action against the bank.

7.5 PROCESS OF OBTAINING BANK LOANS

The loan process refers to those set of activities which are required to be performed by the lender to grant the loan. When a business wants to obtain a loan from a bank or any other financial institution, it has to fulfill certain procedures to get the required funds. These tasks are performed by the business to raise the desired debt capital activities. These include the necessary steps to be taken by the business to get the loan from a financial institutional. A set of these activities is given below to understand the steps and documents required for a loan application:



Step 1: Finance Requirements:
The first step to acquire loan by a business is to estimate the requirements of funds for the business in the upcoming period. If the existing funds are not sufficient to meet the operational needs of a business, then the option for obtaining a loan is considered generally from a bank. The finance manager in a business estimates the requirements for cash in the coming months to avert any situation in which a business is unable to make payments to its creditors and other bills.

Step 2: Products Information:
The second step for obtaining a loan is to gather the required information from the market for different options to obtain the loan. This information includes the maximum amount of loan that the business can obtain, the rate of interest on the loan, repayment period, conditions for obtaining the loan and the security or guarantee required for obtaining the loan. A business should avail the maximum possible information from all the banks operating in the area before selecting a bank for obtaining the loan.

Step 3: Bank Selection:
At third step, after the examination of all available information regarding different banks, a business selects a bank for getting the loan. The selection of a bank depends on the

analysis performed by the finance manager to obtain the loan. The selection of a bank is generally made by comparing the terms and conditions of the loan with the other banks and the most favorable bank are selected for applying the loan.

Step 4: Documents Preparation:
In the next step, the required documents for the loan application are prepared by the finance manager. These documents include the present financial position of the business, owners details, security details, estimated profit and loss account and the loan repayment plan. Further, any other detail of the assets or liabilities can be requested by the bank to verify the eligibility of the applicant. The documents for making a loan application should be verified and submitted in a timely manner for processing to the bank.

Step 5: Loan Approval:
At last step, the loan application of a person is approved by considering the various factors: repayment capacity of the business, amount of loan, rate of interest and other terms and conditions. The loan application of a person is approved by the manager of a bank by evaluating it as per the defined criteria. Once a loan application is approved, the amount of loan is credited in the account of the business which it can use for meeting the functional needs of the business.

Summary
This unit has elaborated the concept of bank advances and loans. Bank advances are usually of short term nature and include cash finance, running finance and demand finance which carries lower interest rates with shorter maturity periods. The bank loans are medium to long term financing arrangements and include car finance, house finance, asset finance, infrastructure finance etc. Both bank advances and loans are given by a bank after careful credit analysis and observing the principles of lending.

Test Questions
1. Write a detail note on running finance.
2. Write about characteristics of cash finance.
3. Detail note on principle of bank lending.
4. What is credit analysis?

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UNIT–8

ROLE OF CENTRAL BANK

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CONTENTS

INTRODUCTION

Central bank is a bank which manages the money supply, national currency and interest rates in a country along with overseeing the commercial banking system. A central bank controls monetary policy and flow of currency within country and maintains value of local currency in foreign exchange market. It sets rules and regulations for all commercial bank and all banks are required to follows instructions of central bank. A central bank also provides different facilities to commercial banks in the form of liquidity support and inter-institutional transactions. The State Bank of Pakistan is the central bank of Pakistan and in this unit we will describe its key functions.

OBJECTIVES

After reading this unit you will able;

i. to understand monetary policy and instruments of monetary policy.

ii. to explain central bank and its functions.

iii. to know the difficulties in controlling credit in economy

iv. to elaborate the role of the state bank of Pakistan

8.1 INTRODUCTION TO CENTRAL BANK

A central bank is an independent institution that manages a state currency money supply and interest rates. The goal of central bank is to stabilize the national currency by keeping unemployment low and inflation at lowest possible levels. A central bank has authority to supervise the activities of the commercial bank.

Definitions

"Central bank is defined as an institution charged with the responsibility of managing the expansion and contraction of the volume of money in the interest of the general public welfare'' **(R. P. Kent)**

"A central bank is to help, control and stabilized the monetary and banking system'' ***(Hawtrey)***

"A bank which controls credit". ***(W. A. Shaw)***

In simple words central bank is the bank which controls the monetary policy and regulates the banking sector in a country. It is owned by the government of country in which it established. Central bank has sole authority of note issue. It made policies for commercial banks and give advices to government which in important for economic development. It can contract or expand supply of money in economy to control inflation or deflation. Central bank provide many other services to banks like clearing house, cash reserve etc.

8.2 FUNCTIONS OF A CENTRAL BANK

i. Sole Authority of Currency Issuance:
A central bank has sole right to issue currency in a country. This sole authority to central bank is given to maintain the uniformity of notes and to efficiently regulate the currency within a country. There are two principles used by a central bank while issuing currency;

a. Fixed Fiduciary System:
It means the currency issuance criterion is fixed. A central bank can issue currency up to a certain fixed limit. If there is need for more currency, then the central bank should maintain 100% reserves in the form of gold or foreign currency against it.

b. Proportional System:

c. It means issuance of currency according to the economic requirements of a country. Under proportional system, proportional reserve is made in form of gold or other metal and foreign exchange while remaining reserve is in the form of trade bills and government securities. Issuance of currency can be made without any such reserves in the proportional system and it is called deficit financing.

ii. **Bank of Government:**
A central bank acts as a banker of government. The govt. makes deposit with the central bank. It provides loan to government for different developing purpose. It makes payment on the behalf of government. A central bank also gives different advices to government to improve economic development. Central bank represents government in international market.

iii. **Authority to Regulate Commercial Banks:**
Central bank keeps a proportion of the deposits of all registered commercial banks. The central bank controls the working of all the commercial bank. The commercial banks are required to obtain approvals from the central bank for opening new branches. They got permission of central bank for doing it. It gives the facility of discounting of bills to commercial banks. It provides loans to other banks for meeting liquidity requirements.

iv. **Regulator of Foreign Exchange:**
Acentral bank manages the foreign exchange rate and maintains the value of local currency in foreign market. It also made foreign reserve for importers help and also for making of balance of payment favorable.

v. **Custody of Monetary Reserves:**
Monetary reserves are kept by central bank, it either in form of Gold, Silver or foreign currency. The purpose of making reserve is to maintain the value of local currency. In emergency situation these reserves are disposed to meet the requirements.

vi. **Clearing House:**
A central bank acts as a clearing agent for all the commercial bank by settlement of their mutual obligations. Every bank has reserve with central bank so it shifts the reserve from one to other for the settlement and clearing of bills.

vii. **Lender of Last Resort for Banks:**
A central bank acts as a lender of last resort to other banks which means if any commercial bank faces liquidity problem central bank provides help in form of rediscounting of bills or in the form of loan.

8.3 MONETARY POLICY

The primary function of the central bank is to regulate and control money supply in the country to achieve the targets of economic policy set by the government. For this purpose, the central banks develop monetary policy and determine the policy/bank rate for the banking sector that affects all economy.

Definitions:

"Monetary policy is the attitude of the political authority towards the monetary system of the community under its control". (Paul Einzing)

"It is a policy of central bank to control the supply of money with the aim of achieving macroeconomic stability'' (Harry G. Johnson)

8.3.1 Objectives of Monetary Policy

i. **Promoting High Employment:**
Employment level in the country is affected due to unstable price and value of money. The objective of monetary policy is not only to maintain the money value and employment but also create more employment opportunities with the help of responsive private sector investments.

ii. **Economic Development**
Stable monetary policy plays key role for the growth of economic development by providing loan to the productive sector. The objective of policy is to regulate the credit to ensure their effective and productive use in different sectors of economy.

iii. **Maintain Price Stability:**
One of the objectives of the monetary policy is to maintain stable price level to avoid inflation and deflation situation in an economy.

iv. **Exchange Rate Stability:**
It means to maintain the stability of exchange rate as it affects the prices of imports and exports in a country.

v. **Investment Increased:**
Through changes in interest rates in the monetary policy a central bank encourage both private and public sectors for investment which is helpful for the growth of economic development.

8.3.2 Instruments of Monetary Policy:

There are following two methods that control monetary policy.

Quantitative Controls:

i. **Change in Bank/Policy Rate:**
A policy or bank rate refers to the rate at which central bank rediscounted the bills of commercial bank. A central bank may change the policy rate for increasing or decreasing the flow of money for the commercial banks.

ii. **Open Market Operations:**
It means sale and purchase of securities in the financial market. When central bank wants to increase the volume of money it purchases securities from open markets and for reduction of volume of money supply, the central bank sales the securities.

iii. **Change in Reserve Ratio:**
Central bank affects the supply of money by changing the reserve ratio. Every bank has to maintain the specific reserve ratio (in the form of cash) with central bank. A central bank may increase or decrease the reserve ratio to change the money supply in the economy.

iv. **Credit rationing:**
This method of credit is used by central bank is case of financial crisis. The central bank fixed the rationed credit ratio for each bank and also specifies its sector-wise allocation in the economy.

Qualitative Controls:

i. **Margin Requirements:**
It is the difference between value of securities and the value of loan advanced by the central bank. The rate of margin may affect the amount of loans disbursed by a commercial bank.

ii. **Direct action**
If commercial banks do not follow the directions and orders of the central bank then the central bank may take direct action in the following situations;
   a. By refusing to discount bills
   b. Does not provide the facility of clearing house.
   c. May increase the cash reserve ratio.
   d. May charges fine or penalties

iii. **Moral Persuasion**
A central bank advises the commercial banks not to involve in any illegal activities and should work in best way i.e. issuance of loans only for productive or investing purpose.

iv. **Publicity for Awareness**
Central bank published the policies and function through media which enables the people and other banks to understand the economic condition of the country.

8.4 STATE BANK OF PAKISTAN

After independence in 1947, there was many problems arises but the major problem for Pakistan was to establish the central bank as old Indian currency and the British-era Reserve Bank of India were dominating the financial sector of Pakistan. The purpose of the establishment of the State Bank of Pakistan was the issuance of independent currency and controls the flow of money supply. The Governor General of Pakistan' 'Quaid-e-

Azam Muhammad Ali Jinnah'' issued the order for the establishment of State Bank of Pakistan on 1st, July 1948. This order has been substituted by the State Bank of Pakistan Act 1956.

Management of the SBP:

The State Bank of Pakistan was established to regulate the money supply and commercial banking in Pakistan. The board which regulates the policies consists of one Governor, one deputy governor and nine directors. There is also an executive committee of the bank which empower to work on behalf of the director, central bank has 14 different departments with almost 5000 employees. The departments are accounts department, administrative department, exchange department, inspection department, and many other departments for performing different functions.

Role of State Bank:

i. **Regulator for Commercial Banks:**
The SBP supervises the working of all commercial bank. It provides facility of clearing house and acts as the lender of last resort by providing loan in difficult situation. It also helps to stable credit worthiness for banks. The policies developed by the SBP are compulsory to be followed by the commercial banks.

ii. **Assistance to Government:**
A central bank acts as the advisor for government. It provides loan to government for different financing needs. The SBP represents the government in international market. The SBP ALSO advises the government to make policy according to existing monetary and economic situation.

iii. **Controller of Money Supply:**
The SBP supervises the monetary system and controls the supply of money to cater inflation or deflation. It also maintains the value of currency for price stability in country. In inflationary situation in country central bank contracts the supply of money in circulation and in deflation central bank expands the supply of money.

iv. **Stability in Exchange Rate:**
The SBP is responsible to maintain the exchange rate for the stable value of money for price stability. When exchange rate of currency is stabilized the purchasing power of general public enhanced and overall economy grows.

v. **Distribution of Credit:**
The SBP develops policies for the allocation of credit among different sectors of economy to develop a balanced economy. It also helps government to implement is credit plans and goals. It advances subsidized loans through other banks for the development of underdeveloped areas in country.

vi. Training

Staff training is very important for stable growth of banking industry. The SBP through its training institution, National Institute of Banking and Finance, provides training to employees according to modern technology requirements.

8.5 STATE BANK OF PAKISTAN -BANKING SERVICES CORPORATION (SBP-BSC)

The SBP Banking Services Corporation (SBP-BSC) was established as a wholly owned subsidiary of State Bank of Pakistan in January, 2002, under the SBP Banking Services Corporation Ordinance 2001.As an operational arm of the Central Bank, SBP Banking Services Corporation is engaged in managing currency, foreign exchange operations and foreign exchange adjudication; providing banking services to the federal and provincial governments and financial institutions regulated by State Bank of Pakistan, conducting development finance activities in support of the development finance group of the SBP, implementing export refinance schemes, and performing agency functions like sale/ purchase of national prize bonds including managing prize money draws, sale and purchase of national saving schemes or any other functions assigned by State Bank of Pakistan.

Management Structure of the SBP-BSC:

The Managing Director (MD) is the Chief Executive Officer of SBP BSC and controls the affairs of the Bank on behalf of the Board of Directors. The Managing Director has been empowered to conduct business and manage the affairs of the Bank except for the matters that fall, specifically, under the purview of the Board. The Managing Director is assisted by a team of Group Heads / Regional Heads / Heads of Departments and Chief Managers.

Functions of the Regional/Field Offices of SBP-BSC:

Regional / Field Offices of the Bank typically provide the following Banking Services:

i. Currency Management Services (Issuance, Exchange & Destruction of Currency Notes).
ii. Coins Management (Supply & Receipt).
iii. Receipts of Governments' Taxes & Levies.
iv. Management of Governments' Payments (Salaries, Pensions & Suppliers).
v. Public Debt Management (Management of National Prize Bonds & SSCs/DSCs Schemes on behalf of Central Directorate of National Savings (CDNS), National Savings, Ministry of Finance, Government of Pakistan, Islamabad.
vi. Provision of Governments' Funds Transfer Facility.
vii. Locker facilities to the Government for Safe Deposit of Articles.
viii. Customers' Facilitation for General Banking Complaints.
ix. Other Banking Services as and when required by the Government Departments.

Regional Offices:

The sixteen (16) Field Offices of the BSC-Bank are structured into the following three Regions:

S. No.	Regions	Regional / Field Offices
1.	**Southern Region** (5 Field Offices)	Karachi
		North Nazimabad
		Hyderabad
		Sukkur
		Quetta
2.	**Central Region** (6 Field Offices)	Lahore
		Faisalabad
		Sialkot
		Gujranwala
		Multan
		Bahawalpur
3.	**Northern Region** (5 Field Offices)	Islamabad
		Rawalpindi
		Peshawar
		D.I. Khan
		Muzaffarabad

Summary

In this unit central bank and its functions has been explained. Central bank control and stabilized the monetary and banking system. The central bank plays vital role in economic development of country. One of the fundamental responsibilities of the central bank is regulation and supervision of the financial system to ensure its soundness and stability as well as to protect the interests of depositors. The central bank acts through the issuance of the monetary policy to affect the growth of the money supply. The purpose of establishment of State Bank of Pakistan was the issuance of independent currency and controls the flow of that currency. The SBP performs many functions it provides services to all banks as well as government and it controls the working of all commercial banks.

Exercise:

Question no: 1. Long Questions:

1. Define central bank. Explain its function in detail.
2. Define monetary policy. Explain the tools of monetary policy.

Question No: 2. Short Questions:

1. Define bank.
2. Write any three objectives of monetary policy.
3. What is credit rationing?
4. List down four functions of a central bank.
5. What is SBP-BSC?

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UNIT–9

GROWTH OF BANKING IN PAKISTAN

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CONTENTS

Page #

INTRODUCTION

In this last unit, the growth and development of banking sector in Pakistan will be discussed. Starting from the 1947 when banking sector was in its infant phase, the commercial banking made a lot of progress in 1950s and 60s. Then came the he nationalization program in 1972 with the vision to promote the economic democracy, liberalization and maintain goal to put Pakistan in line with state modernism. Reversing nationalization, the privatization of banking sector was made with objectives of making it efficient and responsive. Lastly, the new trends of Islamic banking, micro-finance banks and digital banking will also be discussed briefly.

OBJECTIVES

After reading this unit you will able;

i. to know the history of banking in Pakistan
ii. to understand the objectives of nationalization
iii. to know the objectives of privatization
iv. to understand the evolution of Islamic banking in Pakistan
v. to know the growth of digital banking in Pakistan

9.1. EARLY YEARS OF BANKING IN PAKISTAN

Banks plays an important role in the economic development of a country. The banking system in India was started during the time of British colonialism. When Pakistan was declared a separate state in 14th August 1947 large number of non-Muslims migrated from Pakistan to India which negatively affected the number of bank branches in Pakistan. Habib Bank Limited and Allied Bank Limited were major private sector banks of that time. Later on National Bank of Pakistan was created. As the business of banking was controlled by Hindus, their emigration to India left the banking sector of Pakistan in shambles. The Govt. sector cooperative banks were ill-equipped to deal with such situations.

In this situation Quaid-e-Azam inaugurated State Bank of Pakistan on Friday July 1, 1948. The state bank starts with Rs. 30 million paid up capital. In which government held 51% share and 49% was held by private sector. The primary motive of state bank was to replace the Reserve Bank of India as a central bank. The first Pakistani notes were issued in October 1948. Later on, other private sector banks were formed in Pakistan and the State Bank of Pakistan played an active role for the development of banking in Pakistan as the number of branches was increased significantly.

9.2 NATIONALIZATION OF BANKS

In early years of Pakistan banks plays very important role in economic development of Pakistan. But afterward it was felt that bank did not advance loan/funds to needy people. Banking sector was nationalized under bank nationalization act 1974.There were 13 scheduled banks with 2906 branches in Pakistan. Government of Pakistan took control of all banks under bank nationalization act 1974 and merge financially weaker bank with financially strong banks and make five nationalized banks.

1. National Bank of Pakistan.
2. Habib Bank Limited.
3. Allied Bank Limited.
4. United Bank Limited.
5. Muslim Commercial Bank Limited.

Rights of ownership and management of nationalized banks were transferred to federal government. Objectives of nationalization were as follows:

i. Directing banking activities toward national economic development
ii. Achieving fair distribution of resources by bank
iii. Ensuring the safety of depositor money
iv. Availability of credit for agriculture sector
v. Controlling Unproductive expenditures
vi. Availability of credit for small entrepreneur
vii. Improving the efficiency of banking sector

Effects of Nationalization of Banks:

i. **Low Efficiency of Bank Employee**: Due to nationalization employee efficiency was decreased as there was no check and balance on the working with relaxed environment and system of punishment or reward for dealing with customers.
ii. **Low Competition:** Competition was very low between nationalized bank because all banks were state owned.
iii. **Favoritism/Nepotism**: Political parties influenced the hiring of staff and loans were allocated on political basis without economic rationale.
iv. **Increase in Corruption**: Nationalized institutions are under government control due to which level of corruption increased and people at higher positions misused their authorities.
v. **Private Sector Discourage:** The nationalization policy discouraged private sector which leads to decrease in level of investment. People abstained from investing their money in private institution due to the fear of nationalization.

9.3 PRIVATIZATION OF BANKS

Privatization is process of transferring of business from public to private ownership. It is also defined as ''Privatization is the denationalization of an industry''. Government of Pakistan was not satisfied with the performance of nationalized banks as the quality of banking services was decrease. Government therefore decided to privatize the banks. Privatization commission was formed on 22nd January 1991. Commission transferred two banks Allied Bank Limited and Muslim Commercial Bank Limited to the private sector.

Objectives of Privatization:
i. To provide better standard of services to general public.
ii. To improve performance of banking sector improved.
iii. To promote competition among different sectors.
iv. To develop capital market
v. To increase deposits and saving habits.

Advantages of Privatization:
i. **Efficiency Improved:** Efficiency and productivity of banking sector was improved as private sector strives for profit and cuts cost.
ii. **High competition**: Competition is improved in private sector that results in improved service standards and improved customers dealings
iii. **Political interference Decrease:** Privatization decreased the political interference as private banks are not fully owned by state. People have concern about profit and quality services so they cannot take any government pressure.
iv. **Pressure of shareholders:** private sector has pressure of shareholders to perform efficiently because if firm is inefficient than firm could be takeover.
v. **Quick decision:** Quick decision making is only possible through private sector banking that improves credit allocation and improves customer satisfaction.

9.4 DEVELOPMENT FINANCE INSTITUIONS (DFIs)

> "An institution which carries on any activity, whether for profit or otherwise, with or without any Government funding, with the purpose of promoting development in the industrial, agricultural, commercial or other economic sector, including the provision of capital or other credit facility; and for the purposes of this definition, "**development**" includes the commencement of any new industrial, agricultural, commercial or other economic venture or the expansion or improvement of any such existing venture".

As specialized institutions, DFIs provide a range of specialized financial products and services to suit the specific needs of the targeted strategic sectors. Ancillary services in the form of consultation and advisory services are also provided by DFIs to nurture and develop the identified sectors. DFIs therefore complement the banking institutions and act as a strategic conduit to bridge the gaps in the supply of financial products and services to the identified strategic areas for the purpose of long-term economic development. The DFIs have, to a large extent, contributed to the development and growth of the targeted sectors. DFIs are created with a key objective to boost trade and economic relationship between the sponsoring country and Pakistan.

Development Financial Institutions in Pakistan:

House Building Finance Company Limited (HBFCL) - It is Pakistan's leading housing finance institution. JCR-VIS Credit Rating Company Limited has assigned initial medium to long-term entity rating of 'A' (single A) and short –term rating of 'A-2' (A-Two) to HBFCL.

Investment Corporation of Pakistan - It was founded in February 1966 through an Ordinance with the objectives to broaden the base of investments and developing the capital market in Pakistan.

Pakistan Kuwait Investment Company (Private) Limited (PKIC) - It is Pakistan's leading Development Financial Institution (DFI) engaged in investment and development banking activities in Pakistan. PKIC was founded as a joint venture between the Governments of Pakistan and Kuwait in 1979.

PAÏR Investment Company Limited (PICL) - It was formed as a result of a joint venture between the Governments of Pakistan and Iran. PICL came into existence in 2007 as a company operating in Pakistan registered under the Companies Ordinance, 1984 and classified as a "Development Finance Institution" under the regulatory control of the State Bank of Pakistan.

Pak Brunei Investment Company - It is an Investment Finance Company established as a joint venture between Government of Pakistan and Brunei Investment Agency (BIA).

The Company started operations in August 2007 after its notification as a Development Finance Institution.

Pak China Investment Company Limited (PCICL) - It is a Development Financial Institution formed under the initiatives taken by Government of Pakistan and Peoples Republic of China for promotion of Trade, Investment and Economic Growth of Pakistan.

Pak Libya Holding Company (Pvt.) Limited - It is a joint venture between Pakistan and Libya symbolizing the ever strengthening relationship between the two countries. It was founded as a joint stock company on 14 October 1978.

Pak Oman Investment Company Limited - It is a specialised Financial Institution formed as a joint venture between the Governments of Pakistan and Sultanate of Oman in July 2001.

Saudi Pak Industrial and Agricultural Investment Company Limited - It was incorporated in 1981 under a joint venture agreement signed between the governments of Islamic Republic of Pakistan and Kingdom of Saudi Arabia. It provides a full range of financial products and services including Project Financing, Working Capital Loan, Term Finance Certificates and Leasing Facilities.

9.5 ZARAI TARQIATI BANK OF PAKISTAN

Pakistan economy is largely dependent on agriculture sector. Agriculture includes production or processing of crops, livestock, dairy products and poultry activities. To meet the financial needs of the agriculture sector, the government of Pakistan formed Agriculture Development Bank of Pakistan in 1957 with the objective to provide credit facilities to agriculture sector in the form of short- and long-term loan. This specialized institution is also working as commercial bank too and is now called the Zarai Taraqiati Bank Limited (ZTBL).

Functions of ZTBL:

- **i. Financing for technology:** ZTBL provides different types of medium and long term loans for technological upgrading the agricultural sector.
- **ii. Financing for purchase of input:** ZTBL provides short term loans to farmer for the period of less than one year for the purchase of input like seeds, fertilizers etc.
- **iii. Finance for fishery and forestry**: ZTBL also provides loan for fishery, poultry and forestry to improve the conditions of rural areas which helps to increase the employment level.
- **iv. Finance to agriculture related industries:** ZTBL provides loan to industries which are directly or indirectly related or interlinked with agriculture sector.
- **v. Advance loan for storage houses: ZTBL** provides loans to farmers for the construction of storage houses which enables the farmer to produce excess amount of production.

9.6 MICRO FINANCE BANKS

The **micro-finance institutions** are established to provide the financial support in the form of small loans and other financial services to the economically poor segments of the society. Generally, a micro-finance institution works to extend the micro loans to the poor on easy conditions in order to enhance their incomes. Unlike the commercial banks, the micro-finance banks do not ask for some security or pledge of an asset to seek a loan. Instead of this, microfinance institution has designed some other criteria to secure the repay ability of the granted loan. For seeking loan from a micro-finance institution, a poor person has to declare his/her conditions openly with a promise to utilize the amount of loan in a productive manner to ensure its timely repayment. The **structure of a micro-finance institution** may be the in form of a non-government organization or a bank. In case of micro-finance bank, it will have to get license from the State Bank of Pakistan and all operations of the micro-finance banks are monitored by the State Bank of Pakistan.

The Functions of Micro Finance Banks (MFB):

i. Loans to the Poor:
The MFB extend small loans to the poor individuals to enable them to start their own micro businesses for generating a reasonable income. In the absence of MFBs, the poor individuals and micro businesses are unable to obtain loans from the commercial banks and other financial institutions. The presence of MFBs provides a forum to the poor to access the required funds with minimum efforts.

ii. Investment Opportunities:
The presence of MFBs in the financial markets encourages the investors to pay attention to the needs of the micro enterprises. The presence of MFBs in the poor localities facilitates the partnership between the large size businesses and micro enterprises for variety of low value-added tasks resulting in increase of overall business activities.

iii. Income Opportunities:
The poor individuals with lack of funds are unable to generate sufficient income for their families. The MFBs fulfill this gap by providing micro loans on easy terms and conditions to the micro enterprises who utilizes these funds to start small businesses or expand their existing income earning activities.

iv. Support to Micro Businesses:
The provision of funds to the micro businesses by the MFBs enhances the volume of operations of these businesses and provides them necessary capital to expand their business operations. The micro businesses are generally vulnerable to the economic shocks and their access to the funds in the formal financial system is limited. The MFBs ensures the level playing field to the small businesses enabling them to meet their capital deficiencies.

v. **Financial Inclusion:**
The participation of poor individuals and micro enterprises in the financial system through the MFBs provides a way for enhancing the financial inclusion in the country. A large majority of poor has no bank account in Pakistan and this impacts their ability to access the formal financial markets. The MFBs fills this gap and increases the overall financial inclusion of the poor in the financial system.

9.7 ISLAMIC BANKING IN PAKISTAN

Islamic banking is consistent with the principles of Sharia and its practical application through the development of Islamic economic. Islamic Shariah Law prohibits acceptance of amount in the form of interest which is also known as Riba. According to constitution of 1973: ‘’Islam was declared state religion “steps should be taken to enables the Muslim to manage their lives in accordance with the teaching of Islam as set by Islam and Sunnah”. The process of wide Islamization of the banking system in Pakistan was started after a declaration in February 1979. Government has taken following steps for removing of interest from economy;

i. In February 1979 the operation of three institutions, Investment corporation of Pakistan (ICP), National investment trust (NIT), and House building finance corporation (HBFC) were targeted to re oriented for elimination of interest.
ii. In 1981, government directed all banks to open profit and loss sharing accounts along with interest bearing accounts and its open choice for customers either deposit their money in profit and loss Sharing account or interest bearing.
iii. 1981, ordinance promulgated for the establishment of Modaraba companies and flotation of Modaraba certificates.
iv. July, 1, 1982 under technique of Musharaka banks can provide finance to trade and industry for meeting working capital requirement.
v. July 1, 1985 all banks in Pakistan were made interest free. No bank could receive deposits other than interest free. Existing deposits were also converted based on profit and loss sharing.

Governor of State bank of Pakistan has stated that interest free Islamic banking and interest-based banking are run parallel and it up to customer that either go for Islamic interest free banking or deposit money under interest-based banking. A Shariah Board was established at SBP which advises SBP about regulations pertaining to Islamic banking. This board consists of five members; two Shariah scholars, one chartered accountant, one lawyer and one banker. Its responsibility is to review the instruments of SBP for conducting banking under Islamic modes.

Main Modes of Islamic Financing:

Musharaka:
Musharaka is a non-interest-based agreement between two or more parties who agree to combine their resources for profit making. This agreement is between bank and its clients for carrying a business for specific agreed time period. Profit and losses are shares according to the ratio as per the agreement. Key features of Musharaka are;

i. **Capital:** Capital contributed by partners should be clearly mentioned in agreement because further working and profit is distributed based on investment made by partners.

ii. **Management**: According to Musharaka principles all partners have a right to take part in its management and work for partners. But it depends on partners if they agreed that affairs of management are managed by one of them than other partner's only share profit up to their investment.
iii. **Distribution of Profit or Loss**: The ratio of profit or loss for each partner must be determined according to profit or loss earned by business. Fixed lump sum is not paid to anyone. Sharing is made according to agreed ratio fixed at the time of agreement.

Modaraba: Modaraba means a business in which some partners contribute capital and the Modarab (manager) contribute his managerial skills. Profit sharing among partners is done according to the contribution made by each partner and the ratio mentioned in the agreement.

Key Features of Modaraba:
i. It is an agreement where one party provides managerial skills and other provides capital.
ii. It is registered under Modaraba Companies Ordinance 1980.
iii. Profit/loss shared according to agreed ratio.
iv. Modaraba Management Company is regulated by registrar of Modaraba, SECP and religious board.
v. Clearance certificate must be obtained from religious board that business is not against Islamic laws.

Ijarah (Leasing): Ijarah is an agreement of Islamic banking. It is long term investment. Here an owner (Lessor) leases its assets to lessee for some specific time and pay rent. Ownership of asset is remained with lessor. Lessee has only right to use the property against charges to pay. In context of Islamic banking it is a lease contract under which bank lease equipment or building to their clients against a fixed charges (rent).

Features of Ijarah:
i. **Tangible asset:** To lease the specific goods or assets like property and transport etc.
ii. **Labor**: To lease out the Self Skills. Workers that work only for the interest of particular employer or contractor and does not have rights to work for other during that time.
iii. **Description of assets:** Asset is described in advance. Asset is not available during contract it must be delivered at some specific date.

9.8 ELECTRONIC BANKING IN PAKISTAN

Electronic banking is also known as internet banking. It enables its customer to conduct financial transaction through financial institution websites. With the help of E. banking customer can conduct various transactions from any place. It not only provides the ATM facility but also provides all other banking facilities like payment etc.

Now customer demands 24 hours banks at anywhere. Due to internet technology entire banking structure has been changed. Banking services become economical due to technology. There is a saving time and money by using E. banking. Online banking facility has been provided by large number of commercial bank. All banks provides number of facilities to attract customer. The banks are quite aware the changing needs of customers. They realize that if they compete they shall provide facilities of electronic banking to their customers.

Forms of E-Banking:

i. Internet Banking:
It refers to the provision of funds receipts and payments services through internet on the particular website of the bank. In this age of IT, almost all commercial banks have developed the interactive websites for facilitating customers to access their accounts through website from their homes and make desired transactions in online mode.

ii. Mobile App Based Banking:
Mobile application-based banking is modern concept of digital banking in which a specialized mobile application is developed and customers can install that application on their mobile phones. This application enables the customers to access their accounts from their mobiles and receipts and payments can be made through this mode.

iii. Phone Banking:
Phone banking enables customers to access their accounts from mobiles through special interfaces developed with the help of telecom companies. It is relatively older concept than the app-based banking and majority of banks are now shifting their digital operations towards app-based mobile banking discussed above.

iv. ATM:
The Automated Teller Machines (ATM) are used for many banking services. Usually installed at bank branches and shopping malls, these machines disburse cash to the desired customers and funds can be transferred through them in an easy way.

Benefits of Electronic Banking:

Internet banking is also called online or home banking. It is started with the use of proprietary software. Following are the advantages of electronic banking.

i. **Reduction of Paperwork:** Generally, banking work is paper based. Electronic banking has reduced the use of paper resulting in lower costs.

ii. **Time Saving:** By using electronic banking, time and cost of customer is saved. Burden of work on bank employees are reduces which increases their productivity.

iii. **Number of Customer Increased:** Electronic banking is expanding due to modern technology. It attracts large number of customer as it offers ease and less costly.

iv. **Checking of Balance**: Every customer can check its account balance by sitting at home and can make payment through internet banking without visiting the banks.

v. **Payment of Utility Bills**: Utility bills like gas bill, electricity bills and telephone bills paid to the concerned department even sitting in any other country through internet banking.

vi. **Market Expansion**: Due to electronic banking, both national and international market has expended as we can make payment through internet by purchasing anything from other countries.

Summary

This unit has briefly discussed the concepts of nationalization of banks in 1970s and their privatization in 1990s. A comparative analysis has been made for both nationalization and privatization programs. DFIS and Micro-Finance banks and their functions have been discussed to improve the students' ability to understand different forms of banking. Lastly, Islamic banking and digital banking concepts have been discussed. All these banking forms have increased the capacity of banking sector and have improved services for the customers.

Exercise:

Short Questions:

1. Define Islamic banking.
2. Explain any four advantages of nationalization.
3. What are the DFIS?
4. What are the MFBs?

Long Questions:

1. Detail note on Islamic banking and its modes.
2. Why Islamic banks are important for Pakistan development?

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