BAF 102 Introduction to Banking

Banking Activities

Current Issues in Banking

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CONTENTS

Objectives of the Topic

- To Understand the Basic Activities of Banking.

- To understand the Modern Banking Services

- To Understand the Types of Accounts that are available in banks

Banks and other financial institutions

While there is no unique, universally accepted classification of financial intermediaries, financial intermediaries can be divided into deposit-taking institutions (DTIs) and non-deposit -institutions. Deposit-taking institutions include:

- ✓ *Banks*
- ✓ *Credit unions*
- ✓ *Building societies*

Non-deposit Institutions Includes:

- ✓ *insurance companies*
- ✓ *pension funds*
- ✓ *investment companies*
- ✓ *Brokerage firms*
- ✓ *Factoring services*
- ✓ *Finance houses*
- ✓ *Etc.*

Banks and other financial institutions

What distinguish banks from other financial institutions?

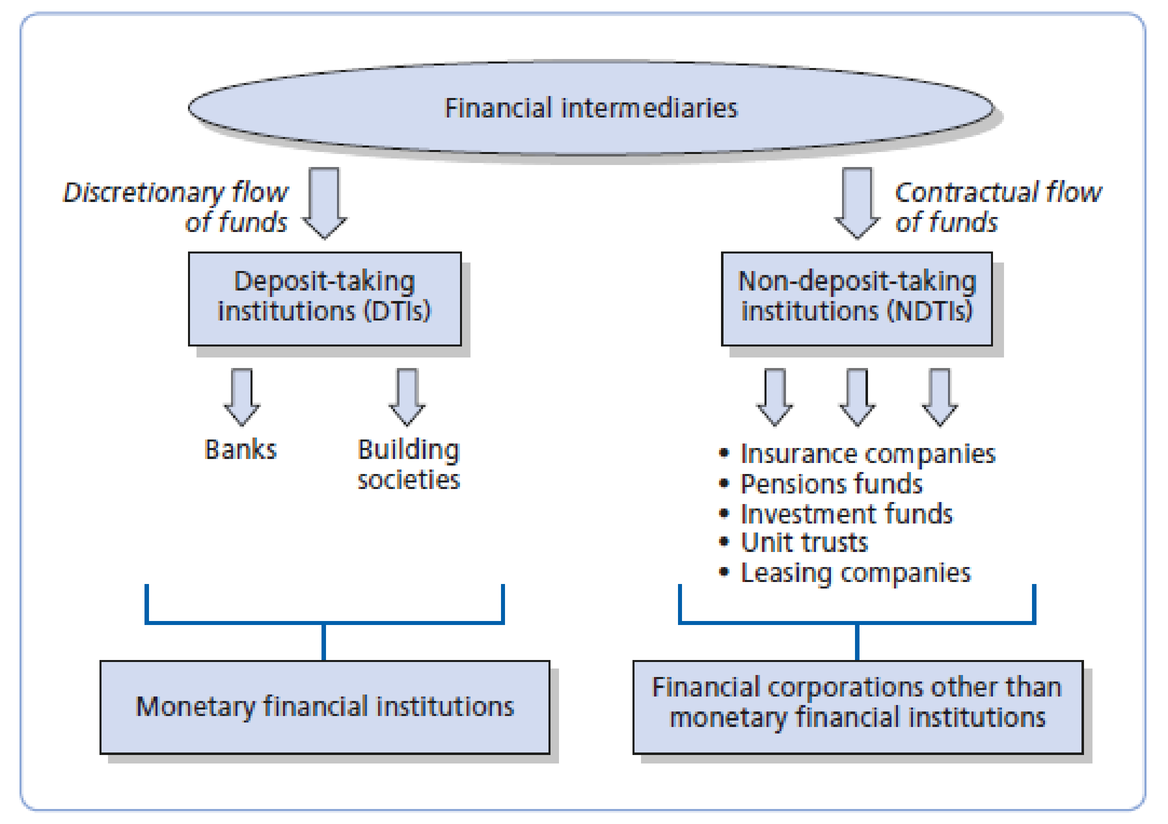
- ❖ Banks are deposit-taking institutions (DTIs) and are also known as monetary financial institutions (MFIs). Monetary financial institutions play a major role in a country's economy as their deposit liabilities form a major part of a country's money supply and are therefore very relevant to governments and central banks for the transmission of monetary policy.

- o The monetary function of bank deposits is often seen as one of the main reasons why DTIs are subjected to heavier regulation and supervision than their non-deposit-taking institution (NDTI) counterparts.

- ❖ Another feature that distinguishes monetary financial institutions from other financial corporations lies in the nature of financial contracts: deposit holdings are said to be discretionary, in the sense that savers can make discretionary decisions concerning how much money to hold and for how long.

Banks and other financial institutions

- Meanwhile, holding assets from other financial institutions requires a ***contract,*** which specifies the amount and frequency of the flow of funds. For example, the monthly contributions to a pension fund or to an insurance provider are normally fixed and pre-determined. Therefore the flow of funds in and out of other financial intermediaries is described as ***contractual***.



Banks and other financial institutions

What are the main financial activities of banks?

The United Kingdom's Financial Services and Markets Act of 2000 provide the following range of activities that banks can engage:

- Accepting deposits
- Issuing e-money (or digital money), i.e. electronic money used on the internet.
- Implementing or carrying out contracts of insurance as principal.
- Dealing in investments (as principal or agent)
- Managing investments
- Advising on investments
- Safeguarding and administering investments
- Arranging deals in investments and arranging regulated mortgage activities
- Advising on regulated mortgage contracts
- Entering into and administering a regulated mortgage contract
- Establishing and managing collective investment schemes (for example, investment funds and mutual funds)
- Establishing and managing pension schemes

Banks and other financial institutions

The activities of Banks and the activities of other financial institutions are increasingly becoming intertwined. This is as a results of deregulation, financial conglomeration, advances in information technology and financial innovation, increased competition, globalization, and the global financial crisis.

Universal Banking: This is a new form of banking that enable banks to engage, directly or through its subsidiaries, in other financial activities such as financial instruments, factoring, leasing and investment banking.

Modern banks offer a wide range of financial services, including:

- Payment services.
- Deposit and lending services.
- Investment, pensions and insurance services.
- e-banking, among others.

Therefore, banks nowadays are ***diversified financial services firms***.

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Banking Services

Modern banks offer a wide range of financial services, including:

1. Payment Services.
2. Investment, Pensions and insurance Services.
3. E-banking
4. Deposit and Lending Services.

Banking Services

Payment services: An important service among banks' offerings is the facilities that enable customers to make payments. A payment system can be defined as ***any organized arrangement for transferring value between its participants***.

For personal customers the main types of payments are made by writing cheques from their current accounts (known as 'checking accounts' in the United States) or via debit or credit card payments.

Payments services can be either paper-based or electronic, and an efficient payments system forms the basis of a well-functioning financial system. Payment services include:

- **Giro or Credit transfers:** This are payments where the customer instructs their bank to transfer funds directly to the beneficiary's bank account. Consumers use bank giro transfer payments to pay invoices or to send payment in advance for products ordered.

Banking Services

- **Standing orders**: These are instructions from the customer (account holder) to the bank to pay a fixed amount at regular intervals into the account of another individual or company. The bank has the responsibility for remembering to make these payments.

- **Direct debits**: are originated by the supplier of the goods/service and the customer has to sign the direct debit. The direct debit instructions are usually of a variable amount and the time at which debiting takes place can also be either fixed or variable (although usually fixed). If a payment is missed, the supplier can request the missed payment on a number of occasions. If the payments are continually missed over a period of time, the customer's bank will cancel the direct debit.

- **Credit cards**: These provide holders with a pre-arranged credit limit to use for purchases at retail stores and other outlets. The retailer pays the credit card company a commission on every sale made via credit cards and the consumer obtains free credit if the bill is paid off before a certain date. If the bill is not fully paid off, it attracts interest. Credit cards are important source of consumer lending.

Banking Services

- **Pre-paid credit cards**: are a form of pay-as-you-go credit card on to which you need to first deposit your money, then use it to pay for goods or services. Unlike normal credit or debit cards, you spend only the amount that you put on the card.

- **Debit cards**: These are issued directly by banks and allow customers to withdraw money from their accounts. They can also be used to obtain cash and other information when used through automated teller machines (ATMs).

- **Delayed debit cards**: These are also sometimes called ***deferred debit cards*** are issued by banks and enable the holder to make purchases and withdraw money up to an authorized limit. The delayed debit cards allow the cardholder to postpone payment, but the full amount of the debt incurred has to be settled at the end of a pre-defined period.

- **Cheque guarantee cards**: These were introduced because of retailers' reluctance to accept personal cheques. Typically, the payer provides further identification by presenting the cheque guarantee card and the retailer writes details from the card on to the cheque in order to guarantee payment.

Banking Services

- **Charge cards**: These are also known as travel and entertainment cards. These cards are form of credit cards that provide payment facilities and allow repayment to be deferred until the end of the month, but they do not provide interest free credit. Unlike credit cards, all bills have to be repaid at the end of the month and no rollover is allowed Typically, unpaid balances are charged at a higher interest rate than for credit cards, to discourage late payment.

- **Smart, memory or chip cards**: are cards that incorporate a microprocessor or a memory chip. The microprocessor cards can add, delete and otherwise manipulate information on the card and can undertake a variety of functions and store a range of information.

- **Plastic cards**: these include cards given by a retailer or service provider that allows the holder to gain some credit point (In monetary terms) any time he/she purchase the firm product. Example is cinema card, vendor cards etc.

Banking Services

Investment, Pensions and insurance Services: These includes:

- **Investment products:** These offered to retail customers various securities-related products including: mutual funds (known as unit trusts in the UK), investment in company stocks and various other securities-related products (such as savings bonds).

- **Pensions**: Pension services provide retirement income to those contributing to pension plans. Contributions paid into the pension fund are invested in long-term investments, with the individual making contributions receiving a pension on retirement. ***The pension services offered via banks are known as private pensions to distinguish them from public pensions offered by the state.***

- **Insurance services**: Insurance products protect individuals (policyholders) from various adverse events. Policyholders pay regular premiums and the insurer promises compensation if the specific insured event occurs.

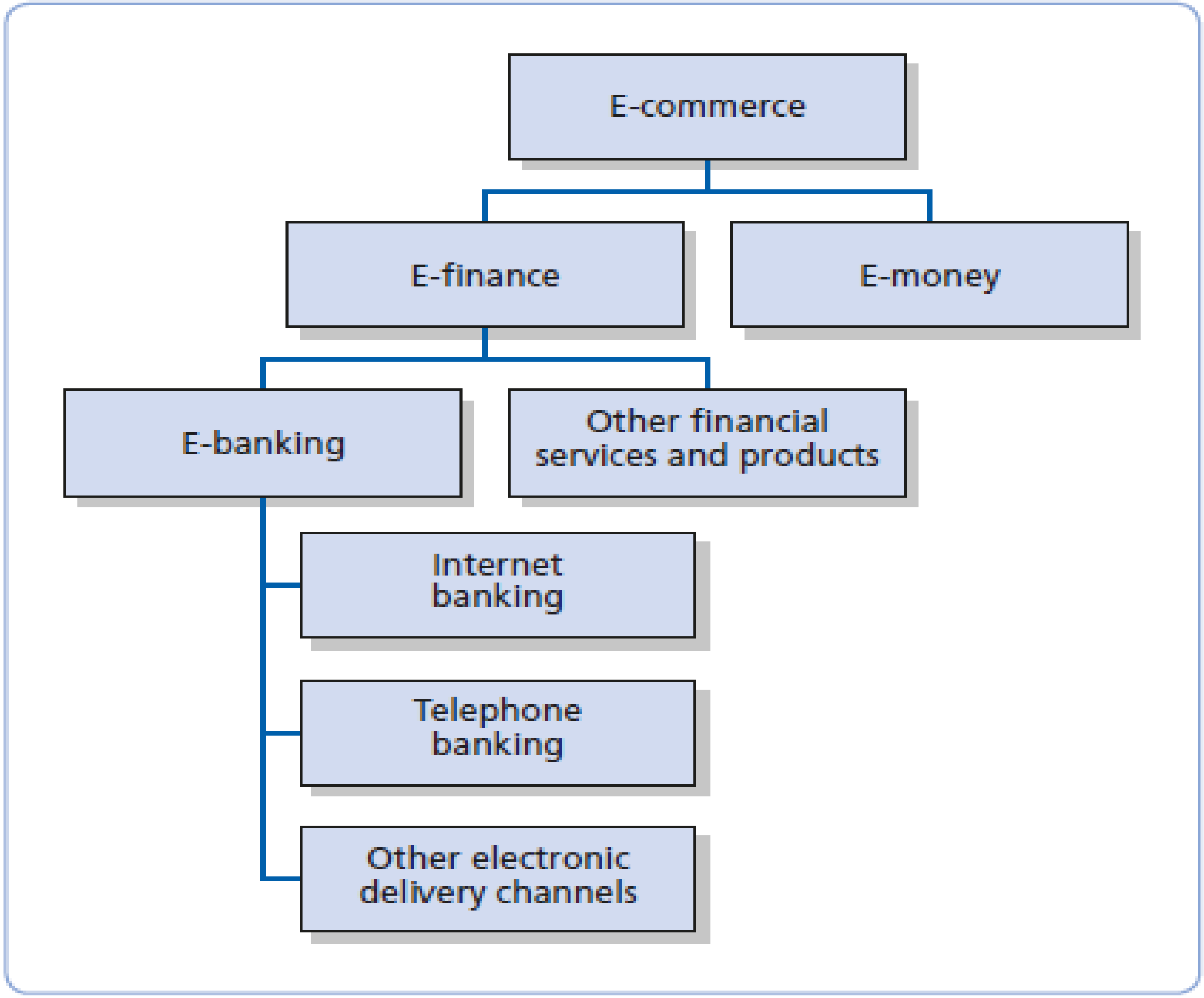
Banking Services

E-banking: A number of innovative financial products have been developed taking advantage of rapid technological progress and financial market development. Transactions made using these innovative products are accounting for an increasing proportion of the volume and value of domestic and cross-border retail payments. Mainly, we can refer to two categories of payment products:

- **E-money**: This includes reloadable electronic money instruments in the form of stored value cards and electronic tokens stored in computer memory. Electronic money is broadly defined as an electronic store of monetary value on a technical device that may be widely used for making payments to entities other than the e-money issuer. The device acts as a prepaid bearer instrument which does not necessarily involve bank accounts in transactions.

- **Remote payments**: This are payment instruments that allow (remote) access to a customer’s account.

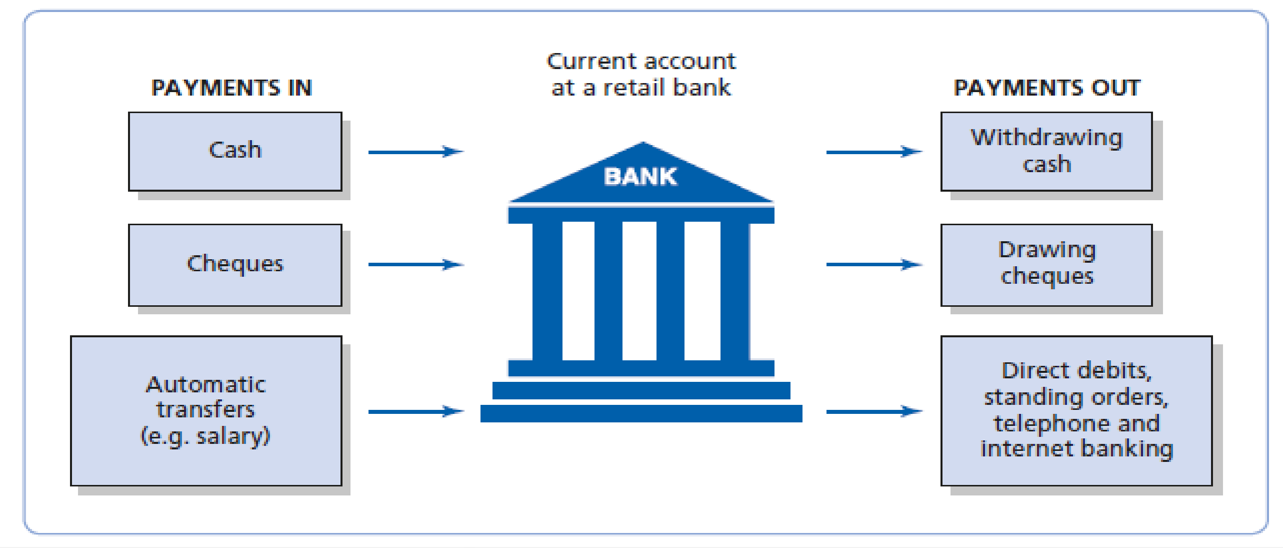
Banking Services



Types of Accounts

Deposit and lending services: In addition to payment services, personal banking includes the offer of a broad range of deposit and lending services. This services are best explained by knowing the types of accounts that exist in commercial banks:

- **Current Account**: This is also known as checking account. This account holder typically received no or very low rates of interest and are used mainly for payments. The holder of this account are issued a cheque that they can use for paying or withdrawing money from their account. Example of this account is a salary account.



Types of Accounts

- **Savings Account**: This is a normal account that depositors maintain and deposit their money in it in anticipation of receiving interest. Savings account is easier to open and maintain. While current account may have minimum required starting balance, savings account normally does not have a minimum balance requirement. The holder of savings account receives interest for the deposit in the account.

- **Fixed Deposit Account**: this is also known as "***Time or savings deposits***". The holder of this account deposits funds for a set period of time for a pre-determined or variable rate of interest. Banks offer an extensive range of such savings products, from standard fixed term and fixed deposit rate to variable term with variable rates.

Typically, deposits that can be withdrawn on demand pay lower rates than those deposited in the bank for a set period.

Types of Loans

Consumer loans and mortgages are commonly offered by banks to their retail customers. Consumer loans can be divided into:

- ✓ Unsecured Loan
- ✓ Secured Loan

Unsecure Loans: These are loans given by banks without collecting any collateral from the buyer. Such loans are usually up to a certain amount of money and for a short to medium time period: for Example, in the UK unsecured loans are up to £25,000 and repaid over five years.

Secured Loan: These are loans secured on property typically from £25,000 to £100,000 and repaid over ten years, and their interest rates are mainly variable but can be fixed through negotiations between the borrower and the bank representative.

In addition, banks also offer an extensive array of mortgage products for the purchase of property.

Sustainable and Ethical Banking

In modern days, the increased pressure from shareholders and environmental organizations has resulted in more banks taking up the challenge and offering investment products that are ethical or sustainable.

Sustainable and ethical banking involves investments in companies that have demonstrated socially responsible practices, are respectful of the environment and human rights, do not lend to oppressive regimes or companies making weapons, and are not dealing with '***immoral***' products such as alcohol, gambling and tobacco.

Sustainable banking can be defined as a decision by banks to provide products and services only to customers who take into consideration the environmental and social impacts of their activities.

Sustainable and Ethical Banking

International Finance Corporation (IFC), in 2007 stated that, the definition of sustainability as applied to financial institutions should include four aspects in relation to good business performance, These are:

- The ***financial sustainability*** of the financial institution and its client-companies, so that they can continue to make a long-term contribution to development.

- The ***economic sustainability*** of the projects and companies the financial institution finances, through their contribution to host economies.

- ***Environmental sustainability*** through the preservation of natural resources.

- ***Social sustainability*** through improved living standards, poverty reduction, concern for the welfare of communities, and respect for key human rights.

Sustainable and Ethical Banking

One notable example of this policy framework that has been adopted by many international banks operating in developing countries is the Equator Principles

Equator Principles: The Equator Principles are a voluntary set of rules aimed at the development of socially responsible projects that reflect sound environmental management practices. These principles were first set out in 2003, and it follows the environmental and social guidelines of the IFC and have been restated and reviewed in a document published in July 2006. In extreme cases, signatory banks will avoid lending to borrowers that fail to comply with the Equator Principles.

The purpose of the Equator Principles is to encourage those seeking funds to approach projects, from inception, in a way that is consistent with Sustainability.

Any Question?

THANK YOU

Question Bank

1. What differentiate banks from other financial institutions? Explain
2. Banks nowadays are diversified financial service institution. Explain with example.
3. Briefly discuss the differences between the following
   a) Standing order and direct debit
   b) Credit card and pre-paid credit card
   c) Debit card and delayed debit card
   d) Charge cards and credit cards
4. Explain e-banking and the categories of e-banking.
5. List and explain the three types of accounts
6. What is the different between secured loan and unsecured loan?
7. Define sustainable and ethical banking, and explain the IFC 's four aspect of ethical and sustainable baking definition.