Chapter 10

# BANKS

## 10.1 Definition of Bank

Bank is a financial institution which receives deposits of surplus money and savings of the people on the one hand and lends these funds, on the other hand, to needy persons (businessmen or traders etc.) for their business/personal usage. Bank accepts deposits at interest rate lower than the rate at which funds are lent. Difference in rates of interest to depositors and borrowers is earning of the banks to meet its expenditure and further financial progress.

In simple words, "bank is a financial institution which accepts deposits from people and give loans to needy persons to earn profit". According to Professor G. Crowther, **" A bank deals in lending of money; receives deposits of the people and advances loans to the needy. Since people accept bank's receipts without any objection, hence bank creates credit".**

## 10.2 Kinds of Banks

### 1. Central Bank

It is the heart and brain of the whole monetary and banking system of a country. It controls all commercial banks and regulates their activities on a particular path. State Bank of Pakistan is the central bank of Pakistan. Central bank enjoys monopoly to issue currency notes. It controls and stabilizes inflation and financial system by regulating circulation of wealth.

It should be noted that profit-making is a matter of secondary importance for the central bank. Its basic objective is to promote and regulate economic development through various tools such as controlling inflation/stabilizing the value of money, creating favourable conditions to promote savings and encouraging investment friendly atmosphere etc.

### 2. Commercial Banks

Profit-earning is the main objective of commercial banks. These accept deposits from general public at lower rate of interest and give loans at a higher interest rate, to needy persons like industrialists, traders etc for their business purposes. At present, beside industrial/commercial activities, commercial banks are also advancing loans for a number of other purposes like property purchase, house building/renovation, car purchase and consumer financing.

In Pakistan, commercial banks are functioning with very good professional efficiency. These commercial banks include Muslim Commercial Bank Limited, Allied Bank Limited, United Bank Limited, Habib Bank Limited, Bank Alfalah Limited ,Faysal Bank Limited, Askari Bank, Punjab Bank, City Bank etc.

**3. Industrial Banks**

This type of banks are set up with the basic objective to industrial development of a country. Industrial banks provide short-term and long-term loans to industrialists for the purchase of industrial plants, machinery, tools, equipment and other industrial needs. Interest rate of industrial banks is comparatively lower than commercial banks. Therefore, industrial development is promoted in the country.

In Pakistan, there are two major institutions in industrial banking. These are Industrial Credit and Investment Corporation (PICIC).

**4. Agricultural Banks**

Agricultural banks provide loans to farmers for agriculture and related activities. This type of banks play a very important role in the development of agrarian economy. These banks provide short-term and long-term loans to farmers for purchasing of agricultural inputs, such as seeds, fertilizers, pesticides, tube-wells, tractors, harvesters and other tools/equipments. Such banks provide agriculture loans on softer terms and conditions as compared to commercial banks, such as lower interest rate and easy repayment terms. In Pakistan, there is only one such bank which is known as 'Zarai Taraqiati Bank Limited'.

**5. Scheduled and Non-Scheduled Banks**

Scheduled banks are those which perform their functions strictly according to the rules and regulations set by the central bank. These banks are liable to keep some part of their assets with the central bank to meet its mandatory reserve requirement. In return, central bank helps scheduled banks at critical times. In Pakistan, examples of scheduled banks are National Bank of Pakistan, Bank of Punjab, and First Women Bank Limited etc.

Non-scheduled banks are those banks which are not attached with the central bank and therefore not bound to follow the rules and regulations formed by central bank.

## 10.3 Functions of Central Bank

Central bank performs the following functions:

**1. Currency Issuing Authority**

Central bank issues currency notes on behalf of the Government. The currency notes issued by the central bank are the legal tender and are generally acceptable to general public within a country. Pakistan's central bank has issued notes of denomination of Rupees 5, 10, 20, 50, 100, 500, 1000 and 5,000. Public uses currency as a medium of exchange for all economic transactions.

There are the following two systems to regulate the issue of currency:

**a. Fixed Fiduciary System**

Under this system, the central bank may issue currency up to a certain limit without having reserves (of gold, silver or foreign exchange). In case if the central bank has to issue currency beyond that particular limit, it shall have to keep 100% reserves (of gold, silver or foreign exchange) against this additional issue of currency. It means that currency issued beyond this limit is fully backed by metallic or foreign exchange reserves.

It can not be followed in Pakistan due to its rigidity and inelasticity because this system restricts government's ability to issue currency according to its financial requirements if it does not have reserves to back up the issue of additional currency.

**b. Proportional Reserve System**

Under this system, the central bank issues currency which is backed by a certain percentage of proportion of reserves. The government decides this percentage or proportion which is different in different countries. Pakistan follows this system and Government of Pakistan has fixed this proportion at 33%, which means that State Bank of Pakistan (the central bank) has to maintain reserves (gold, silver or foreign exchange) equivalent to 33% of the issue of currency

This varition in reserve percentage makes this system easily manageable because the government can control money supply by adjusting reserve ratio, keeping in view requirements of the economy.

**2. Banker to the State**

Central bank performs all those functions for the government which commercial banks perform for general public.

Central bank is called banker to the government because it acts as economic advisor to the government, besides performing following banking functions for the government:

- i). It advances long-term loans to the government for completion of development of projects.
- ii). It collects revenues and makes payments on behalf of government.
- iii). It collects loans from internal and external resources, on behalf of the government.
- iv). It controls and manages foreign exchange and balance of payments.
- v). It acts as financial advisor to the government. It advises government on all financial matters such as change in value of money, managing deficit in balance of payment, controlling inflation etc.

**3. Banker to the Banks**

Central bank regulates the whole banking system. In this capacity, it also acts as a banker to the banks and provides the following services to commercial banks:

i). It provides loans to the commercial banks by re-discounting their bills of exchange (hundies).

ii). It helps commercial banks at the time of financial and liquidity crises.

iii). It grants permission regarding formation of the new banks and to existing commercial banks to open new branches.

v). Commercial banks deposit a certain percentage of their assets with the central bank as mandatory reserve.

vi). Central bank regulates and controls all activities of commercial banks.

**4. Lender of the Last Resort**

Central bank advances loans to commercial banks during financial crisis and resolve their difficulties. For example, a commercial bank may be unable to meet requirements of depositors due to giving excessive loans. Therefore, its credibility and solvency may be in danger. Under these difficult circumstances, the central bank issues cheap loans to such banks by rediscounting their bills of exchange. This is why the central bank is called a lender of the last resort.

**5. Clearing House for the Banks**

Since entire banking system of a country is interlinked, numerous transactions of billions are settled daily among different banks. The central bank provides its services for clearing financial transactions among banks by holding collective meeting of their representatives. In this way, central bank performs its function of the clearing house.

**6. Custodian of Money Market**

The central bank also acts as controller of money supply. In this capacity, the central bank issues currency on the one hand and on the other hand, it also assures economic stability by managing the money supply. The ways and means adopted by central bank to control money supply for achieving specific objectives are called its monetary policy. This policy helps the central bank to effectively manage undesired situations of inflation and deflation. The central bank controls these situations by using the following tools:

**i. Bank Rate Policy**

Bank rate is the rate at which the central bank issues loans to commercial banks by rediscounting their bills of exchange. The central bank implements desired changes in credit money by changing bank rate. During inflation, bank rate is raised to make bank loans costly. At higher bank rate, neither commercial banks get costly loans from central bank, nor people get loan from them. It reduces money supply and therefore helps in controlling inflation. During deflation, the central bank lowers the bank rate and commercial banks get cheap loans from the central bank. It increases quantity of money and deflation is controlled.

**ii. Open Market Operations**

The central bank buys and sells government securities (prize bonds, saving certificate etc) in the open market to control inflation or deflation. In situation of 'inflation' the central bank shall start selling the government securities by receiving value in cash. In case of deflation, the central bank shall start buying government securities at higher rates. In this way, the central bank controls inflation and deflation.

**iii. Cash Reserve Ratio**

All scheduled banks are compulsorily required to deposit a certain percentage of customers' deposits with them. This mandatory deposit is known as 'cash reserve'. During times of inflation, the central bank raises cash reserve ratio to reduce cash availability. Conversely, during deflation, cash reserve ratio is relaxed.

**iv. Credit Rationing**

It is another effective tool to control money supply. Credit Rationing means putting a limit on the volume of credits by commercial banks. Credit rationing restricts commercial banks' ability to create more credit money. Similarly, the Central bank relaxes credit rationing during times when increase in money supply is required.

**7. Custodian of Foreign Exchange**

The central bank secures foreign exchange reserves of a country by maintaining a balance between imports and exports. In Pakistan, exporters have to surrender their foreign exchange earnings to the central bank which pays them equivalent amount in local currency. In the same way, the central bank is also a custodian of metallic currency in the country.

## 10.4 Interest Free Banking in Pakistan

Islam puts a great emphasis on justice, fair-play and mutual cooperation. It strongly condemns exploitation in any form and manner. It induces people to give interest-free loans to the needy ones. Pakistan is an Islamic country and Islam strictly prohibits interest in each and every form. Based on Islamic concepts, Islamic banking system can only be run on profit and loss sharing basis.

Various countries made a number of plans in the past to introduce and implement interest free banking. In Islamic countries, Egypt was the first country that started Islamic banking in 1963, by setting up a financial institution for accepting deposits and granting loans to agriculture sector. Its name was '**Mit Ghamar Social Bank'**. The bank occupied an important position among Egyptian financial institutions till 1970, when it was abolished by the then president of that country Jamal Abdul Nasir, due to certain political reasons.

In the year 1963, Malaysia also established a financial institution, basically, to assist people desiring to perform pilgrimage. Name of this bank was **'Pilgrim Management and Fund Board'** or **'Tabung Haji'**. The bank used to accept deposits from people and also advanced loans to them.

Similarly, an Islamic bank under the name of **'Al-barka Investment and development Company'** was formed in Saudi Arabia. Basic objective of this bank was to provide interest free loans to the Islamic countries. Islamic Bank of Saudi Arabia, Faysal Islamic Bank of Bahrain and Islamic Development Bank of Jeddah are also providing services in the field of interest free banking. Alarab Islamic Bank and Sudanese Islamic Bank are also operating in Sudan to promote interest free banking.

Pakistan took initiative in this direction in July-1981, by introducing profit and loss sharing bank accounts. Further, element of interest has been abolished from the banking system of the country, since July 1, 1985. The government has introduced steps to Islamize country's whole economic system:

**1. Musharika**

Under this mode, finance/loan is provided to businesses on the basis of sharing in profit or loss with the borrower. Finance provider and borrower, both, share profit or loss of the business on already agreed terms and conditions.

**2. Mudaraba**

Under this mode, one party provides finance and other party invests his skills/profession to set the venture operating. Results of business are shared among both parties on already settled terms.

**3. Hire and Purchase**

In this mode of financing, the bank provides loan to its customer for a specified period, for the purchase of an asset. The customer repays loan and bank's share in asset's rental value. After complete repayment of loan, asset becomes customer's property. For example, House Building Finance Corporation (the HBFC) provides loan for the purchase of homes. The loan installment, repayment period and rental value of the home is settled at the time of financing agreement. The rental value is again divided among borrower and lender according to their equity in the purchase of home. The borrower shall pay the loan installment (principal and rent) to the HBFC. On full repayment of loan, the borrower shall become owner of the house.

**4. Equity Participation**

Under this system, the bank provides finances to companies/businesses by purchasing their shares at market price. Profit or loss of that institution is shared among all shareholders according to their respective equity participation.

**5. Interest Free Loans with Service Charges**

Under this mode, the banks provide interest free loan and recover service charges from borrower, at agreed rate. This type of loans is usually provided to exporters.

**6. Qarz-e- Hasna**

Under this scheme, interest free loans are provided to needy ones. Usually, students are given such kinds of loans to meet their educational expenditures. These loans are normally long term loans.

The government has made necessary amendments in relevant law to give boost to the above forms of interest free (Islamic) financing. According to these amendments, majority of loans are issued, interest free and banking system shall become according to teachings of Islam.

## Exercise

Q.1: Each statement has four possible options. Tick (✓) the best one:

1. The institution which accepts deposits and advances loans is called:
   - a. Central bank   b. Commercial bank
   - c. Industrial bank   d. Agricultural bank
2. Which of the following function is not performed by the central bank?
   - a. Issuing currency notes   b. Managing and securing foreign exchange reserves
   - c. To control credit money   d. Earning profit on deposits
3. Which of the following accounts are used by the central bank for advancing loans to the commercial banks:
   - a. Time deposits   b. Hundies
   - c. Demand deposits   d. Saving deposits

Q. 2: Complete the following statements by filling in the missing words or phrases:

1. The rate used by the central bank to advance loans to commercial banks is called ....................................
2. State bank of Pakistan issues currency notes following .................. system.
3. Issuance of loans on profit and loss sharing basis was introduced in ............
4. Under ..........................., the bank provides finance (capital) and the borrower invests his skill/profession to set the venture operational.
5. Central bank has ........... to issue currency notes.

Q. 3: Match the statement in column A with statement in column B; choose the best answer to write in column C:

| A | B | C |
|---|---|---|
| Fixed fiduciary system | Controller of money supply | |
| Under the central bank | Inelastic | |
| Deflation | Central bank | |
| Issuance of notes | Decrease in purchasing power | |
| Central bank | Scheduled banks | |

Q. 4: Answer the following questions in three sentences:

1. Explain the principles of note issuing?
2. Why the central bank is called banker to the state?
3. What is meant by bank rate policy?

Q. 5: Answer the following questions in detail:

1. What is meant by a commercial bank? Also explain its functions.
2. What are important kinds of banks?
3. What is the central bank? Write down its functions.
4. How does the central bank control credit money as the controller of money supply?
5. What steps have been taken for the success of interest free banking in Pakistan? Write in detail.