Unit 3

FINANCING BUSINESS ORGANIZATIONS

Unit Outcomes:

After studying this unit, you will be able to:

- define money and explain its functions.
- identify the source of capital for investment.
- describe the role and functions of financial institutions.
- describe how business firms reduce risks.
- examine the financial and investment policies of Ethiopia.

Introduction

Businesses need funds for running their operations. The acquisition of properties owned by a business, periodic payment of debts, salaries, expenses, etc all require adequate amount of money in the organization. The specific use to which money will be put partly determines the best source for the money.

Unit three focuses on analyzing the financial needs of businesses and describes where and how funds are obtained. These financing needs which include both long term and short term funding can be met either by personal contributions of owners, selling a share in the ownership or by borrowing mainly from banks. Money and its importance and banking system are also covered as sub-topics of the unit. The ways in which businesses can reduce their financial risks are also explored in this unit. Finally, investment related topics pertaining to the current practices of Ethiopia are also included in the unit.

Contents of the unit

In order to achieve the above objectives, the following topics are included:

- Money and its importance
- Source of capital for investment
- Banking system
- Risk and Insurance
- Investment policies in Ethiopia

3.1 Money and Its Importance

? Can you explain some of the uses of money for personal and business operations?

The use of money as a medium of exchange was developed early in most societies. You remember that in barter system specific kinds of goods and services are directly exchanged for other goods or services. Later on, the barter system was gradually replaced by the use of money and money has become the universal medium of exchange. As such, the use of money has many advantages over that of the barter system.

Money is indispensable to our production and exchange systems. All economic activity is measured, guided and facilitated by money. People receive money in exchange for their services, for raw materials to make products available, or for the use of productive equipment that they supply directly or indirectly. By circuitous routes people return the money to society as they spend it for the things they want. In an unceasing process, the money circulates from producers to consumers and back to producers.

Definition: Money is anything that people will accept in exchange for their goods and services in the belief that they may in turn exchange it for other goods and services.

In primitive societies, whatever material proves easiest to store, transport and exchange may be used as money in "monetary transactions". In any society, people may use anything they wish for money if the material being used has the same meaning to all of them. All sorts of things like various metals, gold, salt and etc. have been used as money. Later on paper money came into being replacing metallic money. Our most important money today is in the form of bank deposits on which Cheques are drawn.

Irrespective of their nature and form, if gold, birr or bank deposits are regularly used and generally accepted as a means of payment, they are considered as money. The only common factor in all these payments is general acceptability based on limitation of supply relative to their demand. Such payments are not aspects of the barter system. For example, in a barter system a student may exchange a book for another

book, but books are not generally accepted or used as a means of payment and hence are not money.

Any object can be used as money. But some objects serve well than others, of course. Salt bar served well during early times in Ethiopia because it was hard to come by with the technology of the times. Most societies have designed and produced their currency using substances that are fairly durable and relatively easy to divide and to carry around.

? What makes monetary transactions different from barter transaction?

3.1.1 Functions of Money

Society needs money for several purposes. No matter what types of money a country use, money performs the following universal functions. These are:

a) Standard of Value
b) Medium of Exchange
c) Store of Value
d) Standard of Deferred Payments

a) ***Money Serves as a Standard of Value:*** Money serves as a standard by which the worth of all goods and services is measured and stated. Without money the price of every good or service has to be expressed in terms of exchange ratios with all other goods or services. For example, we would need to know how many loaves of bread would be required to purchase a bottle of milk. These activities require an enormous information burden for both buyers and sellers because it is very difficult to compare the value of bread with the value of milk or the value of milk to the value of coffee, etc. In contrast, the existence of money as a common standard for expressing value permits us to express the prices of all goods and services in terms of monetary unit. For example, in Ethiopia the monetary unit is birr, in Kenya the monetary unit is shilling, in the United States of America the monetary unit is dollar. The prices of all other goods and services are expressed in multiples of the monetary unit irrespective of form and origin of the goods or services. Money serves as a common denominator of measuring value. We express the value of all economic goods in terms of money and these monetary values are called prices. Such nature of money makes commerce easier because it serves as a common standard of value. The value of many different kinds of products can be expressed in a

single standard as 2 meters of cloth may cost 50 birr and a box of nails may cost 15 birr, and etc.

Money is also a standard of value for accounting records. Since every thing bought and sold is stated in terms of money, it is possible to maintain accounting records and to make financial statements. It would be very difficult for businesspeople to know whether they were operating at a profit or loss if the only records they kept were in terms of physical inventory. A grocery, for example, could have little knowledge of the success of operations if he/she knew only that the store contained more bottles of soft drinks but fewer kg of coffee.

? What does money serve as standard of value means? Support your answer with examples.

b) ***Money serves as medium of exchange:*** Money can be exchanged for any kinds of goods or services; it is valuable to everyone. This universal acceptability of money makes trade much easier. Money is also divisible. In a barter system axe might worth ten sacks of flour, but what will happen if the owner of the axe needs only one sack? While there is no way to divide an axe into ten parts, money can be divided into units as small as needed. This divisibility of money into "units of account" enables money to measure the relative value of things facilitating satisfactory exchanges.

? Which of the following is best used as a medium exchange? Paper or gold? Why?

a) ***Money serves as a store of values:*** Money also provides a convenient means of storing value. A person's or a company's income does not always match current needs for buying goods and services. There may be excess income that may not be used immediately which needs to be kept for later use. A farmer may produce nearly all of the year's income at harvest season; the farm produce can be sold and thus converted to cash, which is kept for use for many years. Surplus income from a number of years can be accumulated for later use or for investment in enterprises requiring large amounts of capital. Such accumulation is difficult in a barter system.

There are many ways in which this function of money is helpful to society. Money as a store of value gives people a time option. People who are paid once a month are able to spread their expenditures evenly over the days of the month, spending their stored money as their needs require. People are able to put money aside for retirement, for the education of their children, for the purchase of a business, etc. They can defer their consumption as they choose, and they can accumulate funds for investment.

In the absence of money, one could accomplish the same thing by storing commodities. It would be much less convenient and quite expensive, however, to build up a store of meat, vegetables, clothing, gasoline and other goods for later use. Although other commodities besides money are stored for later use, money has the advantage over most of other commodities as it avoids deteriorating (loss of value) in storage. Off course, there may be shrinkage in the purchasing power of money or there may be an increase in the purchasing power of money. But the number of birr that was stored (kept for later use) will be the same as the number of birr later available. In addition, money is much durable as compared to perishable products and can easily be carried from place with little effort.

b) ***Money serves as a means of deferred payments:*** Money functions as a standard of deferred payments means individuals can purchase on credit such items like fuel, clothing, food items, etc and settle the amount at a later date. The importance of money as a standard of deferred payments is even greater in contracts covering a longer period of time. The average person enters into a contract to pay specified monthly amounts over a period of time for ten or fifteen years to as long as thirty years in constructing a house.

Activity:1

Discuss the universal functions of money with examples.

3.1.2 Characteristics of Money

? Can you identify the characteristics of money before reading the next section?

Some of the characteristics of money are:

1) Acceptability
2) Divisibility
3) Portability
4) Durability
5) Homogeneity

1. Acceptability

Money should be acceptable means that people should not hesitate to exchange their goods for money. Precious metals like gold and silver were widely used as money because such metals were in universal demand, that is, were generally acceptable. However, for money to have value and, therefore be acceptable, it must be limited in supply relative to demand and the productive capacity of the country irrespective of its forms.

2. Divisibility

The material used as money must be easily divided into denominations without loss of value. That is, the material must not lose its value as a result of its division. To make exchange as easy as possible, money must have the characteristic of being divided into small parts. For example one birr is divided into one cents, five cents, ten cents, twenty-five cents and fifty cents. Likewise, the paper notes are divided into one birr, five birr, ten birr, fifty birr and hundred birr. This way, money is also divisible into smaller denominations to facilitate exchange.

3. Durability

The material used as money should not be spoiled easily. It has to last for a long time. Some of the early forms of money such as corn, fish, skin, salt were unsuitable in this regard as they can be spoiled or damaged easily. For example when salt gets wet or when it is stored in a humid place, it dissolves. Metals such as gold and silver will last for many hundreds of years. The quality of the metal coins that we use for currency these days can stay for quite a long time without rusting.

4. Portability

Money must be easy to carry. Since it has to be moved from place to place, it must be possible for us to carry it from one place to another without difficulty or expense or inconvenience. Precious metals such as gold and silver may be relatively easy to carry. Even paper money is most ideal or convenient to carry.

5. Homogeneity

The material out of which coins are made or the paper out of which the paper notes are printed should be of the same quality. One coin or material should not be superior to another. Homogeneity of money is the basis for money to be universally acceptable and serve as a measure of value.

? **Discuss the characteristics of money in relation to the exchange processes that you observe around your locality.**

3.1.3 Forms of Money in Ethiopia

Recorded history tells us that in Ethiopia, barter trade started to give way to primitive money beginning as far back as 525 A.D. The salt bar called "amole" was the primary article of exchange followed by pieces of cloth, iron bars, bracelets, gold and cartridge, etc. Later gold and other coins made of other types of metals were introduced. Every country has gone through the long history of using so many "odd" things as money. As trade expanded, metal coins outshined the other articles of exchange. Among such coins, the Maria Theresa dollar was very popular.

The Maria Therese dollar was introduced in 1751 in Austria during the reign of Queen Maria Theresa. It was an attractive silver coin that was very popular in the Middle East. It found its way to Ethiopia at the end of 18th or the beginning of the 19th century. The Maria Theresa dollar was so popular that the Austrians continued issuing it until 1858, long after the queen's death in 1789. In Ethiopia, the Maria Theresa dollar was used as a medium of exchange for a long period of time.

Figure 3.1 Maria Theresa dollar

Emperor Menelik made an effort to introduce the "Thaler" in 1894. Since then coins, paper money and other forms of money were in use as a medium of exchange in Ethiopia.

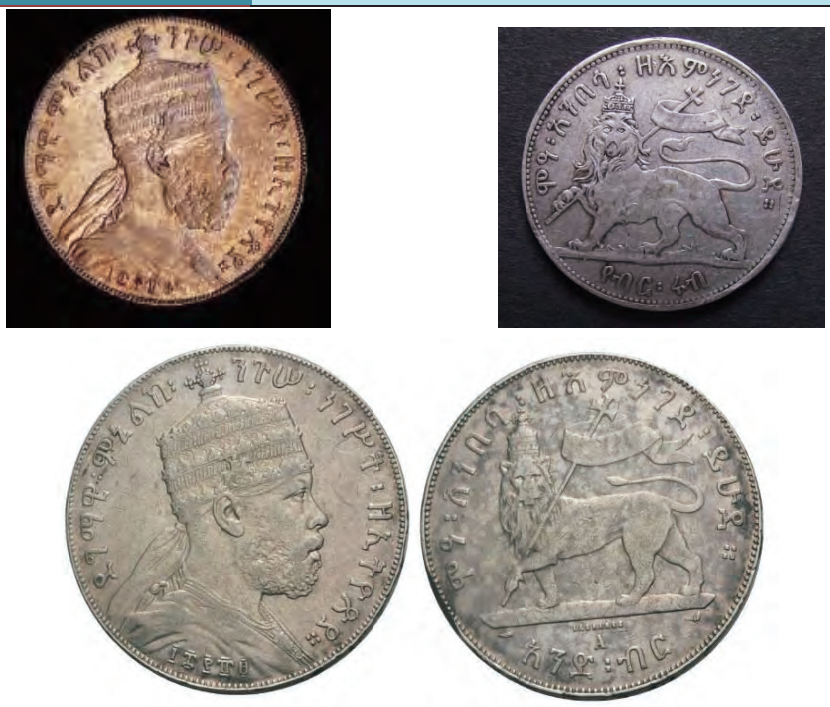

Figure 3.2 Emperor Menelik's currency first introduced in Ethiopia

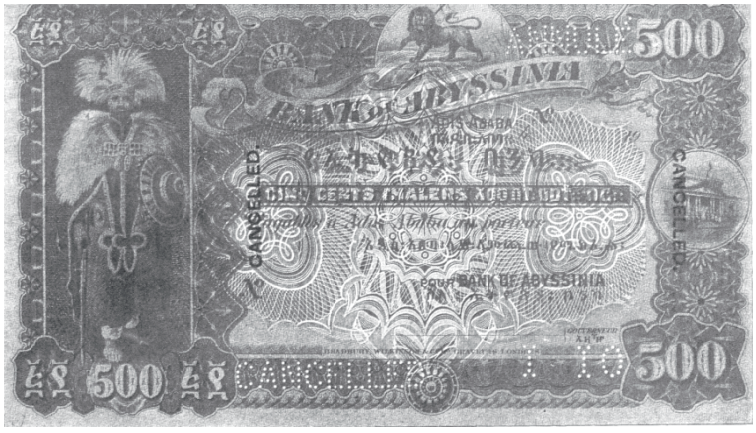

Figure 3.3 A 500 dollar Bank Note issued in May 1914

Today we use three forms of money in Ethiopia: Cents, Paper Money and checking deposit (or demand deposits). When you think of money, you may consider cents and paper money you usually use as the only forms of money. These are called currencies. But the basic money supply also includes checking deposits or demand deposits, money kept in checking accounts in a bank. Cheques are considered to be money because they can be used like cash and exchanged immediately for goods and services. Demand deposits are claims against a bank, which can be transferred by means of cheques from one person to another. Checking deposits are so close to coins and paper money in immediate purchasing power, which makes them to be considered to be a form of money. The details on how the cheques will be issued and

used will be discussed later in this chapter.

The coins issued are 1 cent, 5 cents, 10 cents, 25 cents, 50 cents and 1 Birr. Only the National Bank of Ethiopia issues cents.

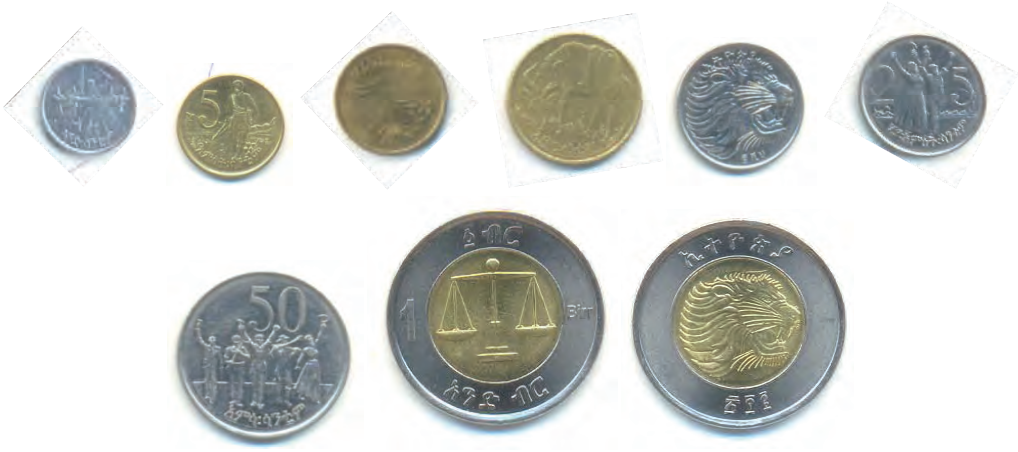

Figure 3.4 Current Coins used in Ethiopia

Paper money is issued in terms of money notes. The paper money notes consist of 1 birr, 5 birr, 10 birr, 50 birr and 100 birr notes. These birr are legal tender, which means that they are accepted in payment of taxes and public debts in the country. No one has the right to reject the birr as far as they are in good conditions. It is the National bank of Ethiopia that issues the birr notes. The details of the role of the National bank of Ethiopia will be discussed later in this chapter.

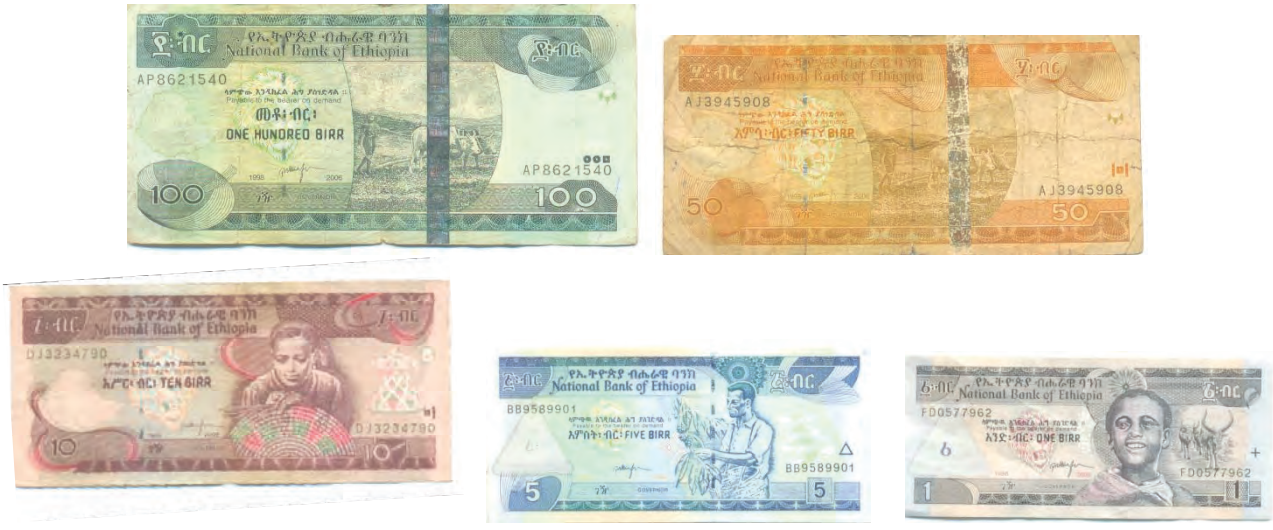

Figure 3.5 Currently used Birr notes in Ethiopia

3.1.4. Money Supply

Demand deposits in banks plus currency make up money supply, that is, the total amount of money which could be spent for goods and services at any one time. Economists often are concerned with the question of what size of money supply is

right for a certain level of economic activity. Too little money may slow down the smooth flow of economic activities and thus economic growth. Too much money relative to our needs and productive capacity may increase prices thus making life relatively difficult.

Individuals and organizations that want to use money as a means of exchange, storage of value and investment create the demand for money. The effect of money supply on the economy and the demand for it is complex. There are, however, two general effects that are widely recognized.

Firstly, if the demand for money remains constant and the supply of money increases, the prices of goods and services increase. One interpretation of this effect is that an increase in the money supply leads to more buying. These increase the demand for goods and services and thus increase their prices. This increase in price is called inflation.

Secondly, if the supply of money remains constant and demand increases, economic production decreases since businesses would not get additional money to invest in production. Limits on the supply of money reduce purchasing power and limit the total amount of goods and services that can be produced and sold. If this brings a drop in prices, it is called deflation.

? Could you identify the difference between inflation and deflation?

3.2 Source of Capital for Investment

In many parts of the country, people earn money by selling goods produced by other producers. The aspiring retailer cannot simply make available the products that he/she sells from someone's property. The retailer needs capital- money used to buy inputs, supplies, machines and machineries, etc to be used in production or merchandize to be sold to consumers. This is called investment. The capital-the money for investment- can come from a number of sources. For example, the retailer might have 1000 birr in cash to buy products for resale or he/she might take a loan from friends or family. Credit associations or local banks might provide loan to the retailer to operate the business with more capital. These simple transactions for starting retail business illustrate the alternative sources of fund available for investment. The alternative sources of capital for investment are **Equity financing (Owners' contributions)** and **Debt financing**.

3.2.1. Equity Financing

Most companies try to finance the operations of their enterprises at least in part by reinvesting profits from ongoing operation. This is a sound, stable method of financing for established companies. Most businesses, however, will be financed from outside source when they first begin operations, and most businesses need additional financing at certain points in their growth.

When funds are raised through the contribution of the owner, it is called equity financing. This can be done in various ways. In equity financing, funds are raised by selling a portion of ownership, or equity, in the business through selling stock to shareholders in the corporation or inviting new partner or owner in the case of a partnership. With this type of financing, the original owners of the business agree to share the ownership, risks, and profits of the firm with new owners or investors. The advantages and disadvantages of financing businesses through equity financing are discussed in the succeeding paragraphs.

The major advantages of equity financing are:

- Complete Ownership of Profits: Profits produced by a business financed by owners rather than by lenders belong to the owners and are not reduced by loan payments.
- Stable Operations: Businesses with a high proportion of equity financing are generally more stable. Business performance is less likely to be threatened by an inability to meet obligations to lenders.
- No interest charges must be paid: This is a particular advantage in an economic slump when sales and revenues may be reduced.

The major disadvantages of equity financing are:

- Capital needs of business vary over time. If requirements decrease, invested money may remain idle and does not produce income.
- A greater total investment by owners is required to maintain a given scope of operations, which limits scope of operations, when little or no borrowed money is used.
- The original owners sacrifice a portion of their control and profits.

? State the basic features of equity financing with examples from your locality.

3.2.2 Debt Financing

Debt financing is accomplished by borrowing funds. The business owner may borrow money (take loans) from credit associations, micro finance institutions, banks, individuals or other business organizations.

? Discuss the nature of debt financing. Name out financial institutions that you may encounter in your surroundings.

3.2.2.1. Credit Associations

One of the sources of loans for investors is credit association. A credit association is organized as a cooperative. It provides its members with a means of saving as well as borrowing money. Members save some percentage of their income on regular basis. These savings provide funds from which loans are made. A credit union lends only to its members. Like other cooperative organizations organized on voluntary basis, the members of credit associations are people with a common interest. They may be employees of the same firm, members of labor union or members of same kebeles.

For those who qualify for membership, credit associations may be the best sources for obtaining loans.

Characteristics of credit associations.

a) They lend only to members and rarely have to investigate loan applicants
b) Much of their work is done by members
c) Office space is sometimes provided free of charge by the businesses for which the members work.
d) Like all true cooperatives credit unions are non-profit organizations

3.2.2.2. Commercial Bank Loans

Banks make loans for businesses and individuals. Because banks lend other people's money, their credit requirements are very strict. Not everyone is able to meet these requirements. For those who do, however, banks are one of the best alternative sources of loans. Their charges are regulated by law and vary according to the type of loan, the method of payment and the total demand for money.

Bank loans are usually short-term loans because funds are available from the saving accounts of the customers and the customers should get their money when they request. Generally, the bank loans are classified as short term, middle term, over draft and long term loans.

a) ***A short-term loan:*** is usually re-paid within one-year limit. This type of loan is given for the businesspersons in order to meet their working capital needs. That is the fund, which is needed to cover expenses and other costs related to the operations of the business. Such loans usually paid on monthly, quarterly or the total payment could be made when the loan matures.

b) ***Middle term loan:*** usually due from one to five years time. In order to secure such loans the bankers usually request personal possessions like machinery, commercial vehicles, or production facilities as a collateral- property guaranty for the repayment of the loan. The repayment for the loans is usually based on the agreement between the banks and the borrowers. For example, Dashen bank has two to three years middle-term loans.

c) ***Over-drafts:*** This type of loan facility provides the users to withdraw more than the amount they kept in a checking account. The banks usually grant loans to specific customers to use up to a certain maximum limit. For example, the bank can offer a maximum limit of 55,000 birr for specified customer. In such circumstances, even though the customer only 20,000 birr in his/her checking account balance, he/she can withdraw money up to 55,000 birr. The bank will cover the remaining 35,000 birr considering that the borrower will deposit the amount in the mean time. The bank provides such loans for those customers of the banks with good cash flows, high growth potential, commitment of the management, and the manner in using bank cheques and other criteria.

d) ***Long-term loans:*** When funds are available, banks frequently make loans for a period of over five years. These are called long term loans. They often stipulate certain restrictions for the borrower such as requirement to get the lender's permission before assuming more debts. The most common long-term loan is a mortgage loan. This is a long term loan secured by giving some kind of valuable and tangible property such as buildings and equipment as collateral.

The advantages of borrowing funds are:

a. Borrowing is convenient for short-term needs. It makes it unnecessary to keep large amounts of cash for peak needs.
b. Borrowed money provides additional capital without giving up any ownership or control of the business.

c. Owners who are able to borrow money and make profits on it can enjoy the increased profits without increasing their investment.

However, debt financing has the following disadvantages.

a) Borrowing money is sometimes unavailable or can be obtained at high interest rates; companies that have come to rely on debt financing may encounter severe difficulties in this situation.

b) Companies that use borrowed money must meet interest payment regularly. This can be a burden or even impossibility when revenues are down or the company is facing other financial difficulties.

? Differentiate between the various sources of financing, types of loans with their advantages and disadvantages.

3.3. Bonds and Stocks

3.3.1 Bonds

A bond is another alternative way for obtaining investment money, usually long term, through borrowing. A bond is a written pledge to lenders stating the borrower's intention to repay a loan. A bond is a debt of the issuing corporation which matures at a stated future date and on which the corporation pays interest. A bond specifies

a) the amount of money that has been borrowed, which is called the principal
b) the date the principal will be repaid, or the maturity date, and
c) the rate of interest that will be paid periodically over the life of the bond.

If the company wishes to borrow a million birr, which will mature after two years, for example, it might issue a thousand bonds worth 1000 birr each at 12 percent. In return the investor receives a bond certificate that may promise to pay the bondholder 1,000 birr after two years plus 12 percent interest every year up to maturity. The bond certificate serves as an evidence for the lender. Accordingly, the principal of the bond is 1000 birr, the maturity date is 2 years and the rate of interest is 12%. The maturity value of the bond is computed as follows.

Principal × Rate of Interest × Maturity date = Interest

1,000 × 12% × 2 years = 240 birr

Principal + Interest = Maturity value

Thus, the maturity value of the bond will be 1000 + 240 = 1240 birr

? What makes bonds different form bank loans?

3.3.1.1 General Features of Bonds

All bonds issued have the general features described below:

a) Provision of Trustee
b) Various Denominations
c) Maturity Dates

a) Provision for Trustee

Bonds, which represent a debt of the issuing corporation, are usually held by a large number of investors. These investors may be widely scattered over the country and may need someone to safeguard their interests and act on their behalf in the action required. Such a person is known as a *trustee* and is chosen by the corporation at the time the bond is issued.

The duties of the trustee are included in the legal agreement under which the bonds are issued called the *indenture*. In the indenture, the trustee certifies that the bonds are genuine, holds any collateral that may be used as security for the issue, and collects money from the corporation to pay the interest and repay the principal. In addition to these specific duties, the trustee makes sure that all provisions of the indenture are carefully followed during the lifetime of the issues.

b) Various Denominations

Most bonds are issued in different denominations. The value of money printed on a bond is called its face value, or denomination. Sometimes the denominations of part of the bond issue will run higher, such as 5,000 birr, 10,000 birr and 50,000 birr or the denominations may be in lower amounts 500 birr or 100 birr. If bonds have a face value of less than 500 birr, they are frequently referred to as baby bonds.

c) Maturity Dates

Bonds must be repaid at some future date. The length of time between the issue and the repayment dates of the bond is called the maturity date. Usually the maturity date of the bonds varies. The maturity date could be 10 or more years.

3.3.1.2 Types of Corporate Bonds

Although there are many types of bonds available, three of them are commonly in use. They are: 1) Mortgage bonds 2) Debenture bonds 3) Convertible bonds

- ***Mortgage bonds:*** This is a bond secured by property owned by the issuer like buildings and other movable properties. Mortgage bonds are relatively safe investments because the collateral can be sold to settle the loan if the issuing company is unable to make payments.
- ***Debenture bonds:*** A debenture bond is an unsecured bond, and as such it has no lien against specific property as security for the obligation. In practice the use of debenture bonds depends on the nature of the borrowing firm's assets and its general credit worthiness. For issuing debenture bonds, the company does not need specific security. For this reason, their use is restricted to large, stable companies with long records of consistent earnings.
- ***Convertible Bonds:*** These are bonds that can be exchanged for common stock at a rate specified in the bond. A 1000 birr bond can be converted to ten shares having a price of 100 birr equally. For example if Ato Ahmed owns a bond priced 1000 birr, Ato Ahmed can take his money back at the time of maturity or can convert share of the bond issuing company so that he can become the share holder of the company. This provision makes bonds more attractive to many investors.

Governments also issue bonds. Governments use bonds for funds to build schools, libraries, electricity generation's plants and etc. The federal government issues bonds to finance its operation. The most popular is the government treasury bill. Such bonds will mature within specified period of time. Usually it has a short time of maturity.

? Distinguish between the different types of bonds?

3.3.2 Treasury Bill/T-Bill (Yegemjabet Sened)

A short-term debt obligation backed by the government with a maturity of less than one year. T-bills are sold in denominations such as in 1,000 birr up to a maximum purchase of billion birr and commonly have maturities 28 days, 91 days 182 days.

T-bills are issued through a competitive bidding process at a discount from par, which means that rather than paying fixed interest payments like conventional bonds, the appreciation of the bond provides the return to the holder.

3.3.3 Stocks or Shares

Stock or shares are units of ownership by which the amount invested by each owner in a corporation are stated. The certificate that the corporation issues when the investors contribute money or other assets in the corporation is called stocks or shares certificate. The stock or share certificate is an evidence of the investors' ownership equity. The people and organizations that own corporate stock usually own shares of the assets of the corporation. This is different from bondholders who have only lent money to the company. Bondholders, as lenders, do not have an ownership right.

Many stocks have a stated value assigned to them when they are issued. This stated value is called the par value of a share. When investors buy shares of a corporation, they are required to deposit money equal to the par value of the number of shares they buy. For example, the stated value of one share of Awash bank is 500 birr. If an investor invests birr 1,000,000 in Awash bank, he/she will have 2000 shares.

There are two types of stocks, namely *common stocks and preferred stocks*. The basic type of capital stock issued by every corporation often is called common stock. Common stocks possess the rights of ownership-voting rights, participation in dividends and a residual claim to assets in the event of liquidation. Corporations can also issue preferred stocks. The term preferred stems from the fact that these stocks almost have "preference" or priority over the common stock in receiving dividends and in the event of liquidation. However, preferred shares usually lack significant advantages found in common stock. For example, the dividends paid to preferred stocks normally do not increase if the company prospers. Also preferred stockholders usually do not have voting rights and therefore, have little say in management.

A corporation originally issues stock to raise capital needed to begin and to carry on operations. It sells stock to individual inventors or to other companies of financial institutors in return for cash to use in its operations. The first time the stock is sold is the only time the issuing company receives money from the stock.

Initial issues of stock are often sold in very large blocks to only a few buyers. These original buyers may then resell shares in smaller lots to other investors. Even though a single share of stock may be sold and resold hundreds of times during the life of a corporation, the issuing company does not normally take part in these transactions. Stock or shares are bought and sold through stockbrokers who simply inform the

issuing corporation of the transaction and of the present owner. A stockbroker is a person or company that represents investors in the buying and selling of shares If an investor wishes to buy 100 share of stock, he or she will instruct a broker to make the purchase. In return for their services, brokers receive a commission on the size of the order.

Activity:2

1. **Form a group and select two business organizations in your locality. Interview the owners and write the advantage and disadvantage of financing through loan or equity.**
2. **Organize educational visit to finance offices and report on the concept of treasury bills.**

3.4 The Banking System

A bank is a business enterprise that deals with money and credit. A bank is a service enterprise. These services range from simple things like maintaining an information desk to complex things like financing the importing and exporting goods. The some number and kinds of services may not be available at every bank. Almost all banks offer the following three important services.

1. They accept and safeguard money deposit with them.
2. They transfer money payment made by cheque.
3. They make loans to individuals, businesses and governments.

3.4.1 Banks Accept Deposits and Safeguard Money

How often have you heard or read about people whose money has been lost, stolen or destroyed by fire? Keeping money in a bank can prevent individual and companies from such kind of tragedies. Banks provide guaranty for the safety of money kept in them. Money that is kept in a bank for safekeeping is called a deposit. When you put your money in a bank, you are a depositor. This does not mean that somewhere in the bank a package of money is stored away with your name on it. It simply means that the bank owes you a sum of money equal to the amount you deposited. In other words, your deposit is a debt of the bank. As depositor, you can also withdraw money whenever you want from the bank. This is called withdrawal. A withdrawal is the opposite of a deposit.

In order to know how much money each customer has on deposit, a bank keeps a careful record of deposits and withdrawals. A bank's record of a customer's deposit

and withdrawals is an account. If you are a depositor at a bank, you have an account with the bank.

Sometimes a depositor wishes to deposit cash and leave it for a period of time to earn interest. An account with a bank on which the bank pays interest to the depositor is called a saving account. In this case, the money is not only safe, but also it earns interest. For example if Shegitu aims to deposit 1000 birr for two years in a saving account that earns simple interest at 3%, the interest would the computed as follows.

$$\textbf{Interest} = \textbf{Principal} \times \textbf{Rate} \times \textbf{Time}$$

$$60 = 1000 \times 3\% \times 2$$

Thus, Shegitu would earn an interest of 60 birr after two years. The sum of the money in the bank would be 1060. (1000 + 60 birr) at the end of two years. Rules and Regulation governing saving accounts of commercial Banks are as follows.

- Saving account may be opened on personal application and identification with initial deposit of birr fifty. A deposit should be made on the bank's official form provided for the purpose (deposit slip) and duly signed by the account holder. A deposit book (bank pass book) will be issued to the depositor after making the initial deposit. Subsequent deposits of birr one and up to any amount will be accepted.
- When deposits and withdrawals are made, the deposit book must be presented to the bank. Withdrawals should be made on the bank's official form provided for the purpose and duly signed by the account holder.
- Any amount in a savings account will attract interest at the rate of 3% but no interest will be paid on balances under birr 50. Only a fifty (50) birr deposits will earn interest. (Note that the rate of interest changes from time to time. It was 6% in the past but now the current interest rate in Ethiopia is 4 %)
- Interest will be calculated on the minimum balance standing to the credit of the deposit between the first days to the last of each Gregorian calendar month.

Advantages of keeping money in the saving accounts:

1. ***Safety:*** Money kept in a bank is safer than in any place.
2. ***Saving account earns interest:*** When money is deposited in a saving account it earns interest. Thus an individual with a saving account will get extra money by just keeping his/her money at the bank.

Activity:3

1. **List the possible services that may be rendered by banks for the community**
2. **Calculate the interest based on the following information**
   a) **Principal 20,000 Rate 5% Time 3½ Years**
   b) **Principal 13200 Rate 6% Time 5 Years**
   c) **Principal 5000 Rate 5½ % Time 3½ Years**
3. **Form a group consisting of 10 members and make an educational visit to nearby banks around your locality and report to the class the procedures required to save money in the saving accounts.**

3.4.2 Banks Transfer Money Payments Made by Cheque

Like the saving account, a checking account also provides protection against the loss or theft of money. The checking account is an agreement by which a customer deposits money in an account and is given a book of cheques so that money can be drawn against that account. Cheque is an order to a bank to release the amount of money specified.

The person who signs the cheque ordering the bank to pay cash from that person's account or the account of a business is called the *drawer*. The person or business to whom the bank is ordered to pay the cash is called the *payee*. The bank on which the cheque is drawn is called the *drawee.* Checking account offers the convenience of paying by cheque. Because money deposited in a checking account may be withdrawn any time wanted, checking accounts are called demand deposits. Banks are not allowed to pay interest on demand deposits. For that reason people deposit money in checking accounts that they plan to spend in the near future.

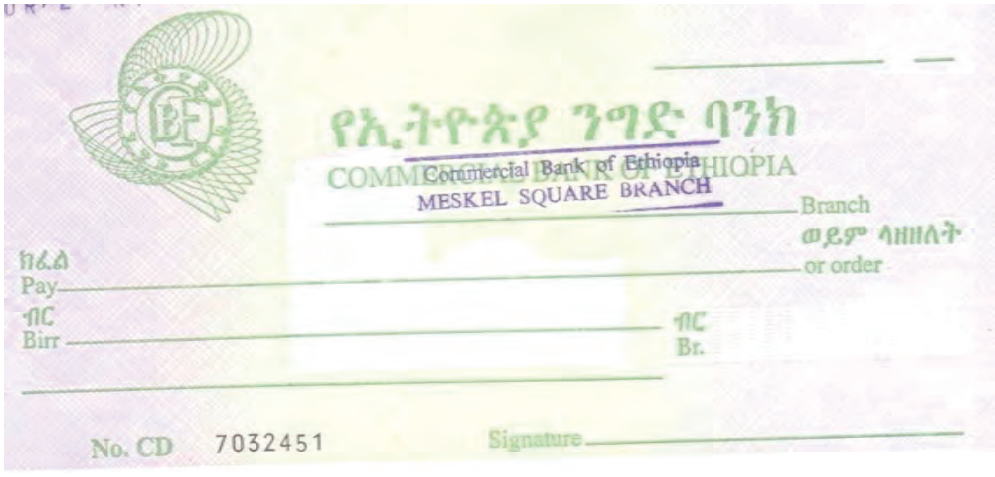

Figure 3.8 Sample of a Cheque

Like currency (cents and paper money), demand deposits also circulate. Ownership of these deposits is transferred from one person to another by means of cheques. A single bank may handle thousands of cheques that its depositors have written or received. Each bank must make payment for cheques drawn on funds deposited.

The use of checking account has the following advantages:

1. Checking accounts eliminate the need for keeping large amount of currency on hand. Thus the risk of misappropriation and exposure for damages and theft are minimized.
2. The owner of the business must notify the bank of the name of person/persons authorized to sign cheques. Thus, access to cash is limited to those individuals designated by the business owner or owners.
3. The signature of the cheque can easily be checked and readily identifies the person responsible for each cash disbursement.
4. The bank returns to the depositor all cheques that it has paid from the account. Thus, the depositor has documentary evidence showing the date and amount of each cash payment, the identity of the person receiving the money and the remaining balance.

? Write the difference between saving account and checking accounts.

3.4.3 Banks Make Credit to Individuals, Businesses and Government

Banks provide a variety of financial services to customers. They maintain saving accounts and pay interest on them. They facilitate safe payments through cheques. In addition to the above, banks also provide loans for financing business operations and satisfy financial needs of individuals and groups and in the process earn income in terms of interest. Most of the profits of commercial banks come from the interest earned by making loans to businesses and individuals. The nature of bank credit and related policies will be discussed in the succeeding paragraphs.

Credit refers to the act of obtaining something of value in return for re-payment at a definite or determinable future time. Credit policy is the action taken by the government through its central bank to regulate and control the supply of institutional credit.

Credit provision is a major function of banking. Commercial banks play an important

role in credit provision and fasten the overall economic activity through the following functions.

- Mobilization of resources and unused deposits
- Rendering banking services to the public
- Advancing credit facilities to various economic sectors

3.4.3.1 Credit Management

Credit management refers to a system developed to provide, monitor, investigate and implement and follow up the supply of money loans including procedures and ways by which the loan is repaid. It makes use of credit investigation as a preliminary step in providing credit. Credit investigation is used to provide and verify vital information desirable in making a decision. It is also important to know when sufficient credit information is available relative to credit line.

Granting credit to a large extent depends upon the faith and trust which the banker places in a borrower. But, the borrower's ability to pay involves impersonal as well as personal factors. The personal factors may be described as the capacity of the borrower. The impersonal factor is the marketability of the customer's product. The primary factor of credit granting are based on five essential elements, called the 5 C's: They are:

a) Character
b) Capacity
c) Capital
d) Collateral
e) Confidence

a) Character: Character chiefly applies to groups of traits that have social significance and moral quality. It is thus the sum of mental and moral qualities in a person. Therefore, of all the elements of credit, character is the most dominant factor, because without it no person can be trusted regardless of the ability or property that may be possessed. Character is thus the basic element that needs an expert appraisal in granting credit.

In judging the moral risk involved in the application for credit, several elements must be investigated. The applicant's character can be judged based on the applicants background, associated life style, records for honesty, reputation for paying bills i.e. willingness and promptness in discharging obligation in unfair competition, trustfulness in advertising, civil court record, record of past performance and sufficient business and/or personality information.

? **Discuss some of the characters that should be possessed by the businessperson.**

b) ***Capacity:*** Capacity refers to income generating or earning power. It is important that adequacy of the applicant's income and present debt paying commitment as well as the applicants expenditure pattern be determined. Capacity is the test of the business risk. The business risk is an element, which depends upon the ability of the managers' of the concern. A person may be honest in everything, but if he/she is deficient in ability to pay; the banker may not grant the credit. The chief test of business risk is the capacity to generate profits over a period of time, which can be seen from the cash flow reported in a period of time.

Furthermore, the following must be observed in judging the customer's capacity.

Management ability: It refers to the ability of the managers to operate the day-today activities of the business. Such factors like one man business versus group management, modernization of systems and methods, know-how of handling financial matters, the existing applications of credit principles, degree of team work of official personnel, degree of human and employees relation are included in the management ability.

Business location: This refers to the place the business is located with reference to raw material and markets, modernization of equipment cost utilization system and the research system applied.

Demand stability: refers to the business's ability to attract customers on a regular basis.

Sales and net profits stability: refers to the business's ability to constantly generate profits as compared to the total sales on a constant basis without fluctuations on the activities.

c) ***Capital:*** In the sense of credit granting, capital measures the borrower's financial soundness or his/her financial strength. That means, the applicant must have enough money in his/her business to "turn around on". The owner's net investment in the firm must be considered when establishing credit limits. The main reason for having adequate capital is that receipts and expenditures are not synchronized and the enterprise has often to make payments before its claims are settled. Thus, the banker has to go for valuing the borrower's assets, which if converted into cash, would be sufficient to liquidate the requested loan.

The banker's first concern is thus to make sure that the borrower is able to repay the requested amount of money. Such ability depends upon elements such as:

a) The sufficiency of owner's equity funds in the business
b) The burden of repayments of existing debt
c) The cash inflow for the servicing needs of business and the ability to repay debt
d) The competence and reliability of management

The property risk can be determined by an examination of the borrower's financial statements. The lending bank should always determine whether the prospective customer had already borrowed from other financial institutions and how much. Capital adequacy could most rigorously be measured in the short term by contrasting shareholders fund. The property is always regarded as less important than the normal or business risk.

? Discuss the difference between capacity and capital?

d) Collateral: Collateral is anything of value (property or any other pledged deposits) pledged as additional security to secure the performance of a contract or the discharge of an obligation. Collateral security is returned to the customer when the obligation is fulfilled. For example, buildings or movable property like automobiles can be used as collateral to secure loan from the bank. Debtors may default on a debt either through fraud or negligence or due to the failure of the debtor's assets. To guard against such contingency, the creditor (the bank) may, as condition of the loan, require the borrower to assign legal rights over some specified asset of sufficient value to cover the amount of the debt.

e) Confidence: A bank lends to its client only if the bank has total confidence in the customer's intent and ability to repay the loan- the principal with interest. Confidence in the literal sense is an assurance of mind or firm belief in the trustworthiness of another person. Therefore, credit granting depends upon the level of confidence, which the bank places in the borrower. Such confidence results from the interplay of the four essential factors: Character, Capacity, Capital and Collateral.

? Describe the 5'Cs with examples from banks in your localities.

Brief History of Banking in Ethiopia

Modern banking in Ethiopia began in 1905, when the Bank of Abyssinia was first established in Addis Ababa under a 50-year franchise agreement with the then British owned National Bank of Egypt.

The agreement made between Emperor Menelik II and the representative of the National Bank of Egypt regarding the opening of the bank included:

1. A sum of pound sterling 500,000 was fixed to be the capital of the bank of which one-fifth was subscribed and the rest was to be obtained by selling shares in some important cities such as London, Paris and New York.
2. The bank was given the sole right of issuing bank notes and minting coins which were to be legal tender and freely exchangeable against gold and silver cover by the bank as well as to establish silver coins and abolish the Maria Theresa dollar.
3. The government agreed to give the bank a free grant of land and permit for building offices and warehouses.

Figure 3.9 Bank of Abyssinia

The building of Bank of Abyssinia is currently occupied by the Arada Post Office

4. All government and public funds were to be deposited with the bank and all payment to be made by cheques.
5. It was agreed not to allow any other bank to be established in Ethiopia during the 50-year concession period given to the institution.

After operating for about 25 years, the Imperial Government of Ethiopia nationalized the bank of Abyssinia. The new national institution, which bought the properties of the bank and took-over its operations was legally established on August 31, 1931 under the name of the "Bank of Ethiopia." Most of the board members of this new

institution were Ethiopians. The Bank of Ethiopia, which was a purely Ethiopian institution or the first indigenous bank in Africa took over the commercial activities of the Bank of Abyssinia and was authorized to issue Ethiopian dollar notes and coins. Later, the bank opened branches in Dire Dawa, Gore, Dessie, Debre Tabor and Harar as well as an agency in Gambella and a transit office in Djibouti. The Bank of Ethiopia operated until 1935 and ceased to function during the Fascist invasion. The Italians closed it in 1936. During the 5 years of enemy occupation, many branches of the Italian banks were opened and operated in the main towns of Ethiopia, but were closed soon after liberation.

The State Bank of Ethiopia was established on August 1942 and acted as the Central Bank of Ethiopia with the vested power to issue bank notes and coins as the agent of the Ministry of Finance.

Figure 3.10 State Bank of Ethiopia established in 1942

In July 1963, the new Ethiopian Monetary and Banking Law came into force and the State Bank was finally dissolved and split into the National Bank of Ethiopia and the Commercial Bank of Ethiopia. Share Company, thereby separating the functions of central and commercial banking. The central banking functions were transferred to the National Bank and the commercial activities to Commercial Bank for the purpose of encouraging the expansion and smooth running of banking and monetary operations in the country.

The National Bank of Ethiopia was assigned with the following responsibilities:

- Determining the amount of currency in circulation and the amount of loans to be advanced to the public

- Administering the country's foreign reserve currency.
- Licensing other banks within the country and controlling their activates.
- Issuing the national currency and seeing to it that it is circulated.
- Acting as an Agent of the Government, it deposits and pays Government money.
- Keeping the account of other government Agencies and Ministries.
- Preparing and selling Government bonds and documents.

To ensure the general economic stability of the nation, the National Bank controls other Banks in the following manner.

- Determines the loan relationships between other banks and financial institutions and itself
- Makes the necessary loan regulations of other banks and financial institutions.
- Determines the maximum and minimum interest rates to be imposed by other banks and financial institutions.

The National Bank is both a government bank and bankers' bank because this bank serves the banks themselves in almost the same way as the public. The National Bank of Ethiopia was established with a capital of ten million Ethiopian Dollars and is government owned led by a Management board. To protect the interest of depositors, banks are required to follow the rules and regulations of the National Bank of Ethiopia as a supervising authority of all banks and insurance companies in Ethiopia.

Figure 3.11 Head Office National Bank of Ethiopia

The Commercial Bank of Ethiopia was incorporated as a share company on December 16, 1963 to take over the commercial banking activities of the former State Bank of Ethiopia. The bank is wholly owned by the state and operated as an autonomous institution under the commercial code of Ethiopia. The following are some of the important responsibilities of the Commercial Bank of Ethiopia:

- Performing all commercial banking activities
- Encouraging the public to open up different accounts with banks.

- Encouraging the development of business activities through banks and familiarizing the public with the activities of commercial banking.

According to the general directives issued to it by the National Bank of Ethiopia, the Commercial Banks are responsible to perform the following duties.

- Receive savings, demand and time deposits
- Make loans and advances.
- Draw, accept, discount, buy and sell bill of exchange, drafts and promissory notes payable within or outside Ethiopia.
- Issue letter of credits.
- Buy, sell, hold or otherwise deal in foreign exchange.
- Hold, acquire and sell negotiable instruments and securities by the government or private sectors.
- Keep in safes or otherwise, securities, jewels, precious metal and other valuables.
- Negotiate, underwrite or issue bond.
- Act as an agent for persons and, in this capacity, engage in the sell of money and shares.
- Control the end use of credits, loans and other facilities that it provides to its customers.
- Acquire, possess, own, mortgage, sell, exchange and dispose of property for the purpose of attaining its objectives and the proper functioning of its operations.
- Perform other banking activities customarily carried but by commercial bank.

Figure 3.12 Head Office, Commercial Bank of Ethiopia

After the fall of the Military Government in 1991, the Transitional Government of Ethiopia issued market economic policy. Proclamation number 84/94 allowed the Ethiopian private sector to establish privately owned banks. Awash International Bank was established as the first private bank. Dashen Bank, Abysinia, Wegagen Bank and other private banks were established since then.

Activity: 4

1. **Write a short note on the development of banking in Ethiopia**
2. **Discus the role of National Bank of Ethiopia.**

3.5 Risk and Insurace

3.5.1 Risk

A risk may be defined as the possibility of an unfortunate occurrence or exposure to losses. A human being has always encountered risks, some inconsequential and some with serious impact. Risks with insignificant consequences usually do not lead us to trouble. However, it is desirable to escape from serious risks as much as possible. But if the risk cannot be avoided the next best thing is to try to minimize the consequences.

Many people accept the risk of losing an umbrella without much concern. But if an individual's home is destroyed by fire, the risk entails consequences that cannot be ignored. The owner may avail himself/herself of some means to reduce his/her financial loss.

Risks are encountered in business activities. For example, the proprietor of a store may be sued for having defective stairs that resulted injury to a customer, and may be fined 10,000 birr. We also know that businesspersons have their store fixtures damaged by fire, may suffer depreciation in the value of goods, incur loss, or have their cash stolen. The occurrence of such uncertainties that may cause damages leads to the desire for more security. The desire for security is the basis of insurance.

There are two types of risks:

a) Speculative risk
b) Pure risk

a) Speculative risk: is one whose consequences may be either favorable or unfavorable. Thus, the purchaser of wheat may have to sell the wheat at a loss. On the other hand, if the price rises he/she will have a profit. The proprietor of a business may lose his/her investment due to competition, a change in the import tariff, new invention, governmental policies and the like, but he/she may also make a small fortune in favorable conditions. The buyer of a house may have to sell it later at a loss, but he/she may make money on the transaction.

Most risks of this nature are unfortunate only to some individuals and not necessarily to society as a whole. Thus the loss for one person from the sale of a house is the gain of another; the decline in the wheat price enriches some persons at the expense of others; the decline of one business establishment may mean larger profits to others. The other feature of these risks is that they are often non

measurable, that is, we lack the information about their occurrence that would permit reliable estimation of their probable frequency and severity.

Protection against these risks is available or utilized only to a limited extent and in isolated instances because 1) elimination of unfavorable consequences may cost too much relative to the potential gain or even eliminate the possibility of gain. 2) many persons prefer to accept such risks 3) there is little information upon which to base an insurance payment and 4) Insurance against these contingencies involves too much moral risk.

b) ***Pure risks:*** as distinguished from speculative risks always entail serious and harmful consequences. Some of the examples of pure risks are fire that destroys property, the breakage of a window, the loss of employment, etc. All of these consequences are unfortunate, not only for the individual sufferer but also for society as a whole. There is no possibility of gain. Consequently it is extremely important that the person seeks ways to compensate these risks.

Accidental destruction of business property is a good example of an insurable risk. It is a pure risk because it is not a basic risk of business investment. The value of the property can be determined accurately. An individual business is not likely to be destroyed by fire if precautions are observed. There is, however, enough risk to all businesses that large number of them are willing to pay premiums for protection.

Though some of these risks are non-measurable, many of them are measurable. For example, the consequences of a premature death can be predicted; total loss that will be incurred through fire can be approximated in advance. As a result, many of these risks are insurable with life insurance, property insurance, etc. Insurance, however, is not the only method of meeting risk.

? Describe the difference between speculative risk and pure risk with examples that really occurred in your locality.

3.5.1.1 Risk Management

Business management can respond to risk in a number of ways. They can respond in the following principal ways:

A) Sound management
B) Risk reduction
C) Self-insurance
D) Purchased insurance

a) Sound Management: Sound management is clearly the best way to reduce speculative risk. Careful control of financing, product development and production, marketing and distribution, and other management concerns help to insure that the result of speculative risk will be profits rather than loss and failure. Good credit management will reduce losses from bad debts and delayed payments. Good human relations management can reduce losses from strikes or other labor problems. Good general management policies also reduce pure risk. Well-trained personnel with good morale, using modern equipment with proper maintenance eliminate or minimize many accidents.

b) Risk reduction: Good managers take steps to reduce insurable risks. Many company specifically train employees in safe working procedures. Buildings may be built with fireproof materials. Plant and office security systems reduce theft and danger to employees. Machine designs and building layouts can also be made safer.

c) Self-Insurance: One sound way to deal with insurable risk is to remain financially prepared to accept a loss without damaging a business's strength. Small losses must be accepted as daily occurrences. Some materials and inventory will be damaged or lost. Machinery will break down. Windows will be broken. For most companies, these small losses are normal business expenses. Some companies also establish reserve funds to be used if a major loss occurs.

This practice is called self-insurance. The advantage of self-insurance is that the money in the reserve can earn interest for the company. Self-insurance, however, is usually practical only for large companies and for a limited range of risks. It is very difficult to keep large reserve to cover all possible risks which will tie up so much money that harms normal business operations. Large companies with numerous stores or plants in different locations, however, may be able to use self-insurance against fire since it is unlikely that more than one facility will burn at a time.

? Discuss risk management by relating to business activities that you observe around your locality.

d) Purchased insurance: Nearly most companies rely on purchased insurance to protect them against pure risk. Despite good management, risk reduction efforts, and the ability to accept some losses, there will always be risks that threaten the company's strength Insurance is usually the answer.

Insurance as a risk management tool can be defined as follows.

Insurance can be defined from two points of view. First, insurance is the protections against financial loss provided by an insurer. Second, insurance is a device by means of which the risks of two or more persons or firms are combined through actual or promised contributions.

Insurance can be bought as protection against pure risk. Insurance companies make contracts with businesses agree to pay these businesses for losses resulting from pure risk. The insured business makes regular payments, called *premiums*, to the insurance company. When the insured business or individual enter into a written agreement with the insurance company, the agreement is called *a policy*. The person who buys insurance is called the *policyholder*. The insurance company can afford to pay for losses at any one time.

From the functional standpoint, insurance is a social device whereby many individuals may make small periodic contributions and those who suffer losses may be reimbursed. As such, it is a social device where by many share the losses of a few. *By the underwriting process, an insurance company contracts to reimburse an insured for certain described losses*. In its legal aspect insurance is a contract where the insurer agrees to reimburse any financial loss the insured may suffer within the scope of the contract, and the insured agreeing to pay a contribution. The insurer may be a corporation, an association, or an individual. The varying forms of organizations that assume risk may be conveniently referred to as the insurance carrier (insurer). The individual who is relieved of the risk is known as the insured.

? Describe the relations and difference between insurance premium and insurance policy.

3.5.1.2 Essential Requirements for Insurance

In order to make insurance contracts operate equitably and produce the desired benefits, and be practical from a business point of view, the following conditions are necessary.

1. The insured must be subject to a real risk. This risk may be loss of goods or benefits that he/she has already possessed or of prospective benefits or profits. It is important that the contract be based upon someone's actual possibility of loss and not upon the mere desire of the insured to be against the happening of some event. It is preferable that *the risk be such that the insured cannot produce the event or increase the probability of its happening*. At least he/she should have no incentive for doing so.

2. The cost of insurance must not be prohibitive. In order for insurance to be of any great benefit to a large portion of the business community, the premium paid must be within the reach of nearly everyone. Otherwise the risks undertaken will be confined to a small and selected group of persons, which is insufficient in number and thus harming the insurer.
3. The extent of the potential loss from the risk must be measurable in some fairly accurate way. It is necessary that the extent of the hazard involved be capable of approximate mathematical calculation. An insurance company could not sell guarantees of future protection without some estimate of future losses. This is the basis to determine the amount to be insured.
4. The likelihood of any individual business suffering an immediate loss from a given risk must be slight. For example, a person caught by a deadly disease might be refrained to enter into a life insurance policy.
5. There must be very large number of companies subject to the risk. Many companies must contribute to the pool to provide enough money to pay for the losses.
6. One of the fundamental requirements among those enumerated above is that the insured person must possess some real interest in the subject matter insured a doctrine known as the necessity of an insurable interest.

? **Form a group consisting of five to ten members and discuss the requirements of insurance by taking specific business enterprise.**

3.5.1.3 Principle of Insurance

Insurance contracts are based on the following fundamental principles:

a) Good faith
b) Insurable Interest
c) Indemnity
d) Subrogation

a) Good faith: The parties that are concerned in insurance contract are obliged to have utmost good faith. In this way, insurance contracts are different from the ordinary business contracts, which are based on the rule of "let the buyer take care." For example, in an ordinary contract of sale of goods, the buyer is expected to take all care necessary to ensure the quality of the goods he/she wants to buy. If the goods turn out to be unsatisfactory, the buyer will have no solution against the seller and will have to bear the consequence. But in insurance contract of any kind, each of the parties is under an obligation to open or tell all the facts as they may have some influence on the decision of the other party to enter into such a contract. The responsibility to tell all facts mainly rests with the insured, which has all-important information about the subject matter of insurance.

b) Insurable Interests: According to this principle, no person can enter into a legal contract of insurance unless he/she has an insurable interest in the object or life insured. Insurable interest means an interest in an object or life, which brings the insured financial benefit in the case of its safety, and financial loss in the case of its loss or damage.

c) Indemnity: The main purpose of insurance is to transfer the loss suffered by a person to the insurance company. The insurance company can easily spread the loss over a large number of policyholders. It is, therefore, necessary that the person that lost his/her property cannot be allowed to get more than the amount that lost by certain incident. For practical reasons, the insured cannot be permitted to make a profit out of his/her loss.

d) Subrogation: According to this principle, the insurer becomes entitled to all the rights of the property of the insured once claim of the insured has been fully and finally paid. In other words, after the insurance company pays the claims of the insured against his/her loss, the scrap or whatever is left of the damaged or destroyed property will automatically belong to the insurance company.

? Discuss each of the insurance principles identified above.

3.6 Classifications of Insurance

The various types of insurance coverage have been grouped into several classes. These classifications have come about by practice within insurance company offices, and by the influence of legislation controlling the financial aspects of transaction.

Providers of insurance have originated hundreds of different kinds of policies covering insurable risks in various combinations. The following can be taken as the classifications of insurance.

1) Fire Insurance
2) Marine Insurance
3) Motor Insurance
4) Theft Insurance
5) All risk insurance
6) Accident Insurance
7) Employer's liability Insurance (work men's compensation)
8) Life Insurance

3.6.1 Fire Insurance

As the name suggests, fire insurance covers damage to buildings and contents caused by fire, lightening and explosion of gas or boilers used for domestic purposes such as heating and cooking. These domestic uses can of course occur in factories and canteens. The standard fire policy covers the following:

i) Fire (including fire resulting from explosion)
ii) Lightening
iii) Explosion of boilers used for domestic purposes only
iv) Explosion of gas used for domestic purposes only or for lighting in a building or forming part of any gas works.

3.6.2 Marine Insurance

Originated for protection against the risk of shipping goods at sea, it has now been extended to cover other kinds of shipping. The two distinct marine insurances are:

1) Ocean Marine Insurance
2) Inland Marine Insurance

3.6.2.1 Ocean Marine Insurance

Marine insurance protects goods and ships while they are at sea and temporarily while they are in port. Ocean marine insurance provides cover for the whole machinery, materials and outfit stores and provisions for the officers and the crew. Although specific variations are possible, policies usually cover sinking, fire and water damage and vandalism as well as other kinds of damage.

3.6.2.2 Inland Marine Insurance

Inland marine insurance is related to an insurance coverage of goods in transit from one place to another by air, rail, road, or registered post. The inland marine insurance covers the risks of shipping goods in inland waterways. Such policies are issued to cover cargo transported over inland water and cargo in transit by railroad or registered post. Goods in transit are normally protected against loss or damage resulting from accidents such as train collisions, derailment and road accidents. Coverage also usually includes damage from fire, wind, earthquakes and other natural forces. Damage caused by people, such as theft or vandalism, may or may not be covered in a specific policy. Cargo insurance is related to export or import shipments.

? **Describe the difference between fire insurance and marine insurance.**

3.6.3 Motor Insurance

Policies are available for private cars, motorcycles, goods-carrying vehicles, public services such as buses and taxis, agricultural vehicles and special types which include road rollers, excavators and levelers. Motor Insurance has five major classes namely, Private Car Insurance, Commercial Vehicles, Motor Cycles, Motor Trade and special types.

Private Car Insurance is related to private cars that are used for social and domestic purposes. Comprehensive policies issued to individuals also include personal accident benefits for insured and the spouse, medical expenses and loss or damage of rugs, clothing and personal effects.

Commercial Vehicles Insurance policy covers all vehicles used for commercial purposes such as lorries, buses, vehicles used for taxi purposes and etc. Such vehicles are not insured under private car policies but under special contracts known as commercial vehicle policies.

Motor Cycles Insurance policy depends upon the machine whether it is a moped or a high-powered motorcycle, and it also depends on the age and experience of the cyclist. The cover is comparatively inexpensive relative to motorcar insurance.

Motor Trade Insurance policy is offered to garage owners and other people engaged in the motor trade to ensure that their liability is covered while using vehicles on the road. Damage to vehicles in garages and showrooms can also be included under such policies.

Special Types This classification of insurance refers to "land vehicles other than railway rolling stock" and many such vehicles fall under a category known to insurers as "special types". These will include forklift tracks, mobile cranes, bulldozers and excavators. Such vehicles may be on roads as well as building sites and other private grounds. Where special type vehicles are not used on roads, they are transported from site to site and it is more appropriate to insure the liability policy, as the vehicle is really being used as a tool or trade rather than a motor vehicle.

? Discuss the different types of policies available to protect motor vehicles.

3.6.4 Theft Insurance

This policy is designed to cover any act of stealing of the contents of offices, shops, warehouses and other business premises against loss or damage by theft following

visible and forcible entry into or exit from the premises. The theft must force the normal security fittings of the premises to gain entry or exit.

3.6.5 All Risks Insurance

The all risks policy covers the property specified against any loss or damage (including fire and theft) unless and otherwise specifically excluded or mentioned. Special policies of these types are available for:

- Office equipment
- Computers
- Special machinery
- Construction projects
- Money
- Goods-in-transit
- Holiday baggage
- Personal effects

3.6.6 Accident Insurance

Accident insurance policies usually provide one or more of the types of coverage: a) it may pay some or all of the expenses of hospitalization, surgery, and other medical care resulting from accidents or illness b) it may pay the insured some or all of the income lost when illness or injury prevents working or c) it may make lump sum payments for loss of sight or limbs or for death resulting from an accident.

? Discuss the different types of insurance policies described above.

3.6.7 Employer's Liability Insurance (Workmen's Compensation Insurance)

This form of insurance is designed to protect an employer against legal liability that he/she may incur as a result of death or bodily injury sustained by his/her employer's liability policy that will provide him/her exactly the same amount he/she has had to pay out. In addition, the policy also pays certain expenses such as lawyer's fees and medical expenses paid for the treatment of the injured employee. Worker's compensation insurance usually pays for medical expenses and for a portion of worker's salaries while they are unable to work. Worker's compensation also usually makes a payment to worker's family if death results from a job-related accident. However, willful or injury caused by intoxication are not covered.

3.6.8 Life Insurance

In return for premiums, life insurance pays a sum to survivors if the insured dies while the policy is in effect. Many policies include provision for the accumulation of savings and other special features. Its basic purpose, however, is to repay survivors for some of the financial losses that result when a person dies. Medical and funeral expenses must be paid. Outstanding debts may be a burden. Loss of income formerly provided by the insured may greatly lower the standard of living of survivors.

A premium of life insurance differs in an important way from other kinds of insurance. Premiums for fire insurance, for instance, are based on an estimation of the likelihood that a fire will occur. In contrast, death is certain. The only unknown factors are the time and the cause. Life insurance policies can be categorized as a) whole-life b) endowment and c) term life insurance.

Whole-life Insurance may be considered the standard life insurance policy. It is bought for its protective features. The insured makes equal payments periodically from the purchase date until his/her death. When the insured dies, the face value of the policy is paid to his or her survivors or to other specified people or organizations. This type of insurance automatically includes a saving plan.

Endowment Life Insurance policies emphasizes the savings possibilities more than does whole-life. Higher premiums are charged so that the cash surrender value increases rapidly. Premiums are set so that in a specified number of years the cash value will have added up a saving fund equal to the face value of the policy. At this time, the insured may collect the face value of the policy or elect to receive annual payments. Endowment life is the only type of life insurance that allows the insured rather than the beneficiary to collect the face value of the policy.

Term Life Insurance provides payment if the insured dies within a certain number of years stated in the policy. A 10-year term policy, for example, requires the regular payment of premiums for ten years and pays the face value of the policy if the insured dies within that period. If the insured does not die during the specified term, all premiums remain the property of the insurer.

Each kind of life insurance policy has advantages and disadvantages and is best suited to particular situations. Term policies provide inexpensive protection for temporary periods. Term policies are difficult and expensive for older people to buy. Whole life insurance is a compromise between term and endowment policies. It provides good protection at a reasonable cost. Whole life insurance is more expensive

than term life insurance and does not have the extensive saving capabilities that endowment policies have. Endowment policies stress saving more than protection. The premiums are the highest of the three types. The savings features of endowment policies can only be judged in comparison with other types of investment.

? Discuss the different types of life insurance policies and their advantages in relation to your community.

3.7 The Practice of Insurace In Ethiopia

Europeans have introduced modern forms of insurance services to Ethiopia. Indigenous self-help associations such as EKUB and IDIR had existed earlier and have been used for centuries. These traditional forms of social security due to their operational simplicity and their voluntary nature are still active, widespread and strong in various parts of urban and rural Ethiopia providing their members with financial and material assistance.

The practice of insurance services in its modern sense is a recent phenomenon, which is said only to have been started in the early 1920's. This was when the then Bank of Abyssinia began to underwrite fire and marine insurance as an agency to a foreign company. In Ethiopia, an Austrian named Muzinger, as an agent of a foreign Fire Insurance Company, established the first service rendering insurance company in 1923. For the first time this company gave compensation for a customer enterprise that has lost a warehouse as a result of fire damage in 1929. During the Italian invasion (1936-1941) no other insurance companies were allowed to operate except the Italian Insurance Companies. After the end of World War II different foreign insurance companies began to operate once again. Later on a number of British Insurance Agents were widely operating in the country.

Despite all the achievements in the expansion of insurance services in the country, all of them had their head offices abroad. An insurance company with its head office in Addis Ababa was established for the first time in 1951. This company of Ethiopia gradually continued to expand the insurance business from the capital city to the major towns of the country. Before the DERG came to power, there were 13 insurance companies operating in the country. On January 1975, DERG nationalized all banks and thirteen insurance companies. This paved the way to the operation of the insurance services in a centralized and consolidated manner and thereby led to the establishment of Ethiopian Insurance Corporation in January 1976 with the following major objectives.

a) To engage in all classes of insurance business in Ethiopia
b) To ensure that the insurance services reach the broad masses of the people
c) To promote efficient utilization of both material and finance insurance resources.

After the fall of the Military Government in 1991, the Transitional Government of Ethiopia issued an economic policy which laid the foundation for a transition from centrally planned economic system to market economy, a system in which the critical role of the private sector in development is fully recognized. In the insurance industry, a number of Ethiopian Entrepreneurs grabbed the opportunity and established insurance companies. Many private insurance companies were established since then.

3.7.1 Mahber, Eder and Ekub

Besides banks and other financial institutions in Ethiopia, there are various traditional associations that provide financial service. These associations encourage the residents of specific or given community or kebeles to save a certain amount of their earnings or income in order to meet different social needs for the purposes of self-help and mutual assistance. Such associations may be formed by any group of people who wish to get together in order to help themselves and to offer services to each other. Mahber and Idir are associations in society for mutual aid and burial. Ekub is thrifty or rotating credit society. These three associations are known and have been in use for many years in Ethiopia.

Activity: 5

Identify an insurance company in your locality and do the following.

1. **Report when it was established and what type of insurance coverage it provides and the number of insurance holders.**
2. **Identify its rates for insurance premiums and its insurance policy on various coverage and present to the class.**
3. **List the steps involved in buying insurance policy.**

3.8 Investment Policies In Ethiopia

Investment means expenditure of capital by an investor to establish a new enterprise or to upgrade that exists for profit. Currently, in an effort to contribute their share to the economic development of Ethiopia, many investors have established new enterprises or expanding existing ones with huge amount of capital.

There are two types of investors, namely: Domestic Investor and Foreign Investor.

3.8.1 Domestic Investor

According to the Ethiopian Investment Policy, a " Domestic Investor" includes

- An Ethiopian
- A foreign national permanently residing in Ethiopia
- Government and public enterprises
- Cooperative societies established in accordance with the relevant law
- A foreign national who is Ethiopian by birth and wishing to be considered as a domestic investor.

3.8.2 Foreign Investor

According to the Ethiopian Investment Policy, a "Foreign Investor" means:

- A foreign national who has invested foreign capital in Ethiopia.
- An existing enterprise owned by foreign investors.
- Ethiopian, permanently residing abroad and preferring to be treated as a foreign investor.
- A joint venture established between a foreign investor and a domestic investor.

3.8.3 Areas of Investment

The investor could choose the most feasible project from among the potential areas of investment. It is therefore important to identify in advance the areas of investment that are reserved for domestic investors by the investment proclamation.

3.8.3.1 Areas Reserved for the Government

The following investment areas are exclusively reserved for the government:

1. generation of hydroelectric power, generation and supply of electricity above an installed capacity of 25 Megawatts as well as transmission and supply of electrical energy through the integrated National Grid System.
2. Air transport services using aircraft with a seating capacity of more than 20 passengers or with a cargo capacity of more than 2,700 kg.
3. Rail transport service.
4. Postal services with the exception of courier services.

3.8.3.2 Areas Reserved for Join Venture with the Government

Investors shall be allowed to invest in defense industries and telecommunication services only in partnership with the government.

3.8.3.3 Areas Reserved for Ethiopian Nationals

The following investment areas are exclusively reserved for Ethiopian Nationals. Foreign nationals are not allowed to invest in these areas.

1. Banking and Insurance business.
2. Excluding generation of electricity from hydropower, generation and supply of electricity of up to 25 Megawatts.
3. Air transport services using air craft with a seating capacity of up to 20 passengers or with a cargo capacity of up to 2,700 kg.
4. Forwarding and shipping agency service.

? Discuss with your classmates why foreign nationals are not allowed to invest in banking service, air transport, etc in Ethiopia.

Nevertheless with the exception of areas exclusively reserved for the government or areas reserved for joint venture with the government, other investment areas are open for Ethiopian Nationals.

3.8.3.4 Areas of Investment Reserved for Domestic Investors

In accordance with the Regulation No. 35/1998, the following areas of investment are exclusively reserved for domestic investors:

1. Radio and television broadcasting services
2. Retail trade and brokerage
3. Wholesale trade (excluding supply or petroleum and its by products as well as wholesale by foreign investors of their products locally produced)
4. Import trade
5. Export trade or raw coffee, oil seeds, pulses, hides and skins and live sheep goats and cattle not raised or fattened on own farm
6. Construction companies excluding grade 1 contractors
7. Tanning of hides and skins up to crust level
8. Hotels other than star-designated, motels, pensions, tea rooms, coffee shops, bars, night clubs and restaurants excluding international and specialized restaurants
9. Tour operations, travel agency, commission agency and ticket offices.
10. Car, air and taxi-cabs transport
11. Commercial road transport and inland-water transport services
12. Bakery products and pastries exclusively for the domestic market

13. Grinding mills
14. Barber shops, beauty salons, gold smith and tailoring excluding garment factories
15. Building maintenance services, repair and maintenance of vehicles
16. Saw mills and manufacture of wood products exclusively for the domestic market
17. Customs clearance services
18. Museums, theaters and cinema hall operations
19. Printing industry
20. Artisans mining

Domestic investors could also invest, without any capital restrictions, in all the other areas that are not reserved for the Government.

3.8.3.5 Areas of Investment open for Foreign Investors

With the exception of areas reserved for the government, for Ethiopian Nationals, or for domestic investors as well as areas reserved for joint venture with the government, all other areas are open for foreign investors. Where the government permits under special provisions, forwarding and shipping agency services shall also be open for foreign investors.

In a joint venture between foreign and domestic investors, the equity share of the domestic investor in the registered investment capital shall not be less than 27%.

Activity: 6

Form a group and discuss on each of the investment areas reserved for domestic investors.

1. **Differentiate between domestic and foreign investors.**
2. **State investment opportunities in your locality.**
3. **List some of the investment areas allowed for foreign investors.**
4. **Discuss the advantages of attracting foreign investment in Ethiopia.**
5. **List profit oriented organizations established following the investment policy in your locality.**

Summary

1. Money is anything that people will accept in exchange for their goods and services in the belief that they may in turn exchange it for other goods and services.
2. Money serves as a) standard of value b) medium of exchange c) store of value d) standard of deferred payments.
3. The possible sources of capital for investment are a) owner's capital or equity financing 2) loan or debt financing.
4. Equity financing involves the use of funds contributed by or from owners to finance operations while debt financing is the use of borrowed money for the same purpose.
5. Equity financing can be done through the sale of stocks or shares (units of ownership) and debt financing is done through short-term bank loans, mortgage loans and bonds.
6. A bond is a written pledge to lenders stating the borrower's intention to repay a loan. Stockholders are the owner of the corporation assets unlike the bondholders who lent money for corporations.
7. A bank is a business enterprise that deals with money and credit. Almost all banks offer three important services: a) accept and safeguard money deposits b) transfer money payment made by cheque c) make loans to individuals, businesses and governments.
8. The National Bank is the government bank and at the same time the bankers' bank that supervises financial activities of commercial banks. Commercial banks provide saving and credit services to their clients.
9. The primary factors of credit granting are based on five essential elements called the 5C's. They are: Character, Capacity, Capital, Collateral and Confidence.
10. Modern banking in Ethiopia began in 1905, when the Bank of Abyssinia was first established in Addis Ababa.
11. A risk is defined as the possibility of an unfortunate occurrence. There are two types of risks: speculative risks and pure risks.
12. Business managers can respond to risk in a number of ways: Some of the ways are:
    1. sound management
    2. risk reduction
    3. self-insurance
    4. purchased insurance
13. Insurance can be defined as the protection against financial loss provided by an insurer and it is a device by means of which the risks of two or more persons or firms are covered through actual or promised contributions.
14. Investment refers to the expenditure of capital by an investor to establish for profit a new enterprise or to upgrade on that exists. There are two types investors in Ethiopia: Domestic Investors and Foreign Investors.

Review questions

Part I. Choose the best answer from the given alternatives.

1. Without money the price of every good has to be expressed in terms of exchange ratios with all other goods or services. This statement refers:
   a) Money serves as medium of exchange.
   b) Money serves as a store of values.
   c) Money serves as standard of values.
   d) Money serves as a means of deferred payments.
2. Identify a false statement
   a) The material used as money must be easily divided.
   b) The material used as money should be easily spoiled.
   c) Money must be easy to carry.
   d) The paper out of which the paper notes are printed should be of the same quality.
3. When funds are raised through the contribution of the owner, it is called _____
   a) Debit financing
   b) Equity financing
   c) Capital raising
   d) Bank deposit
4. What is the type of loan facility that provides the uses to withdraw more than the amount kept in checking account?
   a) Short-term loans
   b) Long-term loans
   c) Over-drafts
   d) Middle-term loans
5. What is the written pledge to lenders stating the borrower's intention to repay a loan?
   a) Principal
   b) Cheque
   c) Bond
   d) Trustee
6. Which of the following term applies to groups of traits that have social significance and moral quality?
   a) Capacity
   b) Confidence
   c) Capital
   d) Character
7. What is the possibility of an unfortunate occurrence of exposure to losses?
   a) Insurance
   b) Risk
   c) Loan
   d) Fund
8. Which of the following term signifies transferring the loss suffered by a person to the insurance company?
   a) Subrogation
   b) Interests
   c) Indemnity
   d) Assurance

Part II. Define the following terms.

1. **Money**
2. **Bonds**
3. **Stocks**
4. **Collateral**
5. **Risk**

Part III. Answer the following questions with examples from your locality.

1. **Describe money in terms of its functions and characteristics.**
2. **Discuss the importance of the banking system in economic development.**
3. **List and explain the different types of life insurance policies.**
4. **What are the possible means that you suggest to attract foreign investors?**