ST. MARY'S UNIVERSITY
SCHOOL OF GRADUATE STUDIES

# PRACTICE AND CHALLENGES OF INTERNATIONAL BANKING SERVICE ON SELECTED PRIVATE COMMERCIAL BANKS IN ETHIOPIA


BY

ABEBA TADESSE

ID NO. SGS/0207/2005B


JUNE, 2016
ADDIS ABABA, ETHIOPIA

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**THESIS SUBMITTED TO ST. MARY'S UNIVERSITY, SCHOOL OF GRADUATE STUDIES IN PARTIAL FULFILMENT OF THE REQUIREMENTS FOR THE DEGREE OF MASTER OF BUSINESS ADMINISTRATION**

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**APPROVED BY BOARD OF EXAMINERS**

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**LIST OF ACRONYMS /ABBREVATIONS**

| | |
|---|---|
| NBE | National Bank of Ethiopia |
| ISBP | International Standard Banking Practice |
| IBSD | International Banking Service Department |
| ICC | International Chamber of Commerce |
| UCP | Uniform Custom Practice |
| URC | Uniform Rule for Collection |
| URR | Uniform Rule for Bank to Bank Reimbursement |
| LC | Letter of Credit |
| CAD | Cash Against Document |
| AIB | Awash International Bank |
| INCOTERM | International Commercial Terms |
| FCA | Free Carrier |
| FAS | Free Alongside ship |
| FOB | Free On Board |
| CFR | Cost & Freight |
| CIF | Cost, Insurance & Fright |
| CPT | Carriage Paid To |
| CIP | Carriage and Insurance Paid To |
| DAF | Delivered at |
| DES | Delivered Ex-Ship |
| DDU | Deliver Duty |
| DDP | Delivered Duty Paid |

## ABSTRACT

*International trade exposes the trading partners to various difficulties and risks due to the physical distance between parties, different time zones and currencies different legal rules applicable to the transaction as well as the fact that the parties may not generally know each other. Banks facilitate international commerce through a variety of products which include managing their international payments, mitigating the risks, and providing working capital. The research, a descriptive study using the survey method, makes an assessment of the trade service practices of selected Ethiopian private commercial banks in order to identify problems, expose any malpractices, indicate instances of non-compliance with international standard banking practices, shed light on risk areas, and identify knowledge gaps among the bank staff. From the research it has been found out that, most of the banks do not automatically effect payment to the remitting bank after releasing the shipping documents sent on documentary collection basis. Secondly, banks are having difficulty managing the level of approved purchase orders due to the fact that outstanding purchase orders are not considered as liabilities of banks under the Open Position directive of the National Bank of Ethiopia. On the other hand, most banks are not examining documents and notifying negotiating banks of discrepancies related to documents presented under letters of credits within the allowed period of five banking days. In addition, it can be concluded that most banks do not make a rigorous assessment of the creditworthiness of the importer and the marketability of the consignment when issuing letters of credit against a less-than 100% margin. In the study, it is recommended that banks should encourage importers to enter into a formal sales contract with sellers. Secondly, the National Bank of Ethiopia should revise its Open Position directive in such a way that banks would be allowed to account for at least 50-60% of their outstanding approved purchase orders as liabilities. Thirdly, banks should properly manage their commitments in foreign exchange so that they will not face liquidity problems when processing settlement of letters of credit and documentary collections.*

# CHAPTER ONE

# INTRODUCTION

## 1.1 BACKGROUND OF THE STUDY

Banking services involves mobilization of fund in the form of saving, deposits, checking accounts and time deposit that are payable on demand and lending service to the business organization and individual traders.  The funds should be employed to produce the maximum benefit to the bank in the form of service charge or interest income for the economic benefit to the community at large. (CGFS, 2014)

International banking services include all private and government commercial transaction between two or more countries including

- Correspondent banking service,
- International money transfer,
- Foreign currency accounts and
- Forex services.

Cross border trade or transaction entails additional and greater risk than domestic business transaction. International business comprises large and growth portion of the world total business, today, global events and completion affect almost all companies because most sell out put to and secure supplier from foreign countries.

International Financial Conference at Brussels in 1920 passed a resolution to the effect that all countries should establish central banks of their own. In our country National Bank of Ethiopia (NBE) have control over private and governmental banks. The handling of documents financial and/or commercial by banks in accordance with instruction received to obtain payment or acceptance with recognized rules Uniform Rules for collection International Chamber of Commerce (ICC) publication 522 subject to Uniform Custom Practice (UCP 600 version 2007.)

Ethiopian commercial banks, provide full-fledged international banking service in their branches including facilitation of import and export transaction, handling inward and outward money transfer services, purchase and sell of foreign currencies, and providing deposit services in hard currencies.

However, International banking services products have their own risk and challenges. According to the researcher/student work experience at some selected private banks foreign currency demand is more than supply. Therefore, most of the time banks are operating under scarce foreign exchange conditions. Such situation creates competition for this scarce resource among customers and causes dissatisfaction because of unfair treatment and to the worst may result in corrupt practice.

At the same time, some banks have faced foreign currency liquidity problem when handling the settlement of documentary collection because too much purchase order have been approved in excess of the foreign exchange earning capacity of the banks. Delaying of payments for these international transactions may affect correspondent banks relationship.

Therefore, the main concern of this study is to assess the practice and challenges of international banking service on selected private commercial banks in Ethiopian and compare its performance against International standard banking practice set out by the International Chamber of Commerce (ICC) and the regulation of National Bank of Ethiopia (NBE) and to identify major challenges of international trade service particularly import export transaction services.

## 1.2 **STATEMENT OF THE PROBLEM**

International banking service products like facilitation of import and export transaction or trade service, handling inward and outward money transfer services have long been practiced by Ethiopian commercial banks. And the income generated from these products in the form of service charge, commissions and other income is the lion share of banks total income.

Nevertheless, these products may pose some risks and challenges to the banks as well as trade partners. International trade service requires complete understanding of how international trade works, the channels, source identifications, contract terms, risk minimization, logistics, credit insurance and mode of payment. It is a complicated process due to the extended import –export regulation and various tax laws. This calls for carefully building clear vision of foreign trade process. Requirements may vary from country to country. (CGFS, 2014)

According to the observation of the student-researcher during her working experiences and according to pilot interviews made with professionals in the area, local banks are being exposed to unnecessary financial risks, encountering operational problems getting involved in some malpractices and failing to comply with international and local standards due to various factors.

During 12 years of international banking experience in different banks the student-researcher has observed a number of cases whereby bank managers involving of financial lose or malpractice regard to foreign currency request, unfair treatment and corrupt practice. Awash International Bank s.c. (AIB) the pioneer private commercial bank in Ethiopia is faced with these problem because of top manager, some first-class international banks terminated their correspondent relationships with local banks, while some Chinese banks have lost faith on letters of credits and documentary collection (purchase orders) issued by some Ethiopian private banks. Such incidents might have some considerable repercussions on the international trade performance of the country at large.(researcher working experience)

Thus, it implies the need for a research on the trade service practice of Ethiopian commercial banks.

- Lack of planned utilization of foreign currency which causes foreign currency liquidity problem when handling the settlement of documentary collection
- Bank manager's malpractice regard to foreign currency request, unfair treatment and corrupt practice, particularly handling of import & export process.
- Knowledge gap among some of the trade service staff in these local banks with regards to the international standard banking practice and trade service products. finally,
- How to mitigate banks solve these problem i.e trained International Banking Department staffs regards to mechanism of trade payment method, Uniform Rules for Collection, Uniform Customs Practice for Documentary Credits, and the directive of the NBE

Therefore, this study will address the following research questions.

**RESEARCH QUESTIONS**

- What is the existing practice of International Banking Service in relation to Import export transaction on selected private banks?
- What types of malpractices are observed for foreign currency utilization in these banks with respect to international banking services?
- What are the methods used to manage these instances of noncompliance with international and domestic standard and directives?

- What are the risk areas with respect to trade service products payments like documentary credit, documentary collections, and advance payments?
- What are the possible ways of mitigating risks associated with international banking service?
- What are the knowledge gaps among international banking department staff of these banks that require an immediate attention?

## 1.3 OBJECTIVE OF THE STUDY

### 1.3.1 GENERAL OBJECTIVES OF THE STUDY

The general objective of this study is to critically assess the practice and challenges of international banking service particularly import export practice at some selected private commercial banks in Ethiopia.

### 1.3.2 SPECIFIC OBJECTIVES OF THE STUDY

The specific objectives of this study are to:-

1. Assess the existing practice of International Banking Service particularly import export transaction service in the selected private banks.
2. Identify compliance issues with international and domestic standards and directives.
3. Identify major challenges that encounter international banking service foreign currency utilization in the selected sample banks.
4. Study major risk areas with respect to trade service products and payments of letters of credit, documentary collections, advance payment and find ways to mitigate the risks.
5. Assess employee commitment and knowledge gaps among trade service staff and develop an alternative mechanism to these private banks for staff development

## 1.4 **SIGNIFICANCE OF THE STUDY**

International banking services specially trade service have become one of the most important products that private commercial banks offer owing to the significant amount of revenue derived from these products and the attraction of customers and depositors looking for these services.

The outcome of this research paper will hopefully have close relevance to the day-to-day trade service practice of banks and helps improve such practices. The significance of the research outcome is also expected to be high in terms of revised their working procedures. Lastly, the research attempts to fill some of the knowledge gap among the practitioners articulate the significance more from the side of any beneficiary import export managers of those banks and other researchers.

## 1.5 **DEFINITION OF TERMS**

### 1.5.1 CONCEPTUAL DEFINITION OF TERMS

- International trade (Foreign Trade): - is the exchange of capital, goods, and service across international borders or territories. (CGFS, 2014)
- International Banking service : - banks product which are specially tailored to facilitate international trade transaction i.e. export and imports. (Committee on the Global Financial System 2014).
- International Standard Banking Practice (ISBP):- International standard banking practice for examination of documents under documentary credits, like commerical invoice, packing list, certificate of origin and bill of lading/air way bill/ truck way bill. ICC(2006)

- UCP600: - The Uniform Custom Practice for documentary credits 2007 Revision. ICC Publication no. 600 is rules that apply to any documentary credit when the text of the credit expressively indicates that it is subject to these rules.
- URC 522: The URC 522 are the Uniform Rules for Collections. URC 522 came into effect on 01 January 1996. The URC 522 were first published by the ICC in 1956. Revised versions were issued in 1967 and 1978. (International Chamber of Commerce, 1996)
- URR 525: The Uniform Rules for Bank-to-Bank Reimbursements under Documentary Credits (URR 525) come into effect on the 1st of July 1996. The seventeen articles of the URR525 deal with the situation covered by Article 19 of the UCP 500, where banks (an issuing bank, a claiming bank and a reimbursing bank) are involved. (Zsuzsanna, 2006)

### 1.5.2 OPERATIONAL DEFINITON OF TERMS

- Letter of Credit (LCs): - It is the most secure instruments available to international traders. Credit means any arrangement, however named or described, that is irrevocable and thereby constitutes a definite undertaking of the issuing bank to honor a complying presentation. (ICC, 2007).
- Export Letter of Credit: - An export letter of credit refers to a foreign bank undertaking issued on behalf of foreign importer. The issuing bank specifies all the requirements of its customer in the letter of credit and undertakes to honor all drafts drawn in conformity to the credit terms and conditions.
- Import Letter of Credit: -A letter of credit is a commitment by the bank to pay the seller of goods or services of a certain sum provided the seller presents the documents specified in the terms of the credit.
- Import Documentary Collection: - the handling by banks of draft and documents in accordance with the instruction of the principal in order to obtain payment or acceptance from draw. (Uniform Rules for Collections, ICC Publication 522.).

- Advance Payment: - where that buyer parts with money firms and waits for the seller to forward the goods/service at a later date. The amount transferred is limited for imports using this payment method.

## 1.6 SCOPE OF THE STUDY

The scope of the research is limited to trade service practices (i.e. those related to import and export transactions) of selected private commercial banks at head office.

## 1.7 ORGANIZATION OF THE RESEARCH REPORT

The research report is expected to have five chapters, which are explained as below.

Chapter One of the report shall contain background of the study, statement of the problem, basic research questions, objectives of the study, definition of terms, significance of the study and delimitation/scope of the study.

Chapter Two of the research report shall deal with the review of literature relevant to the study. While Chapter Three shall describe the type and design of the research; the participants in the study, the sources of data, the data collection tools, the procedure for data collection and the methods of data analysis to be used.

Chapter Four of the report shall summarize the results or findings of the study, and provide interpretation of the findings. On the other hand, the final chapter shall comprise of summary of findings, conclusions, limitations of the study and recommendations.

# CHAPTER TWO

# REVIEW OF THE RELATED LITERATURE

## 2.1 THEORETICAL FRAMEWORK

Early theories of International trade hold that countries trade for the same reason industrial trade. Countries, like individuals, are not equally capable of producing every good or service they want and need to consume. All countries, like individuals can benefit if each countries specializes in producing those goods it can produce best and satisfy their other wants and needs by trading from them. Specialization and trade makes total world output of goods and service larger than it would be without trade (Sawyer and Sprinkle 2005)

Adam Smith, a classical economist, was a leading advocate of free trade on the grounds that it promoted the international division of labour with free trade; nations could concentrate their production on good they could make most cheaply with all the consequents benefits of the division of labour. According to smith's principle of absolute advantage, each nation benefits by specialization in the production of the good that it produces at a lower cost than the other nation, while importing the good that it produce at a higher cost (Carbaugh, 2004)

Expanding upon Adam Smith's work based on absolute advantage, David Ricardo formulated the theory of comparative advantage the country's ability to produce a good at a lower opportunity cost than another country (Sawyer and Sprinkle 2005).

Later, John Stuart Mill was able to formulate the theory of reciprocal demand which suggests that the actual price at which trade takes place depends on the trading partner's interacting demands Modern trade theory contends that the pattern of world trade is governed by international differences in supply & demand conditions (Carbaugh, 2004)

International trade brings about difficulties and risks due to the physical distance between parties different time zone an currencies that need for additional conciliators, the relevance of multiple jurisdictional transaction and possibility of different legal rules applicable to the transaction as well as the fact that the parties do not generally know each other.

In a modern society banks have major role of the economic development depends on industrial growth and modernization of agriculture. Banks promote both these activities they mobilize small deposits from the public and provide financial resource to big industries. Indeed, banks perform the major task of capital formation.Buckova, M.(2011 )

### 2.1.1 THE ROLE OF BANKS IN INTERNATIONALTRADE

According to (Heffernan, 2005), banks distinguish themselves from other types of financial firms mainly by the provision of deposits and loan products. Banks must manage these deposits, which are liabilities for them, in order to maximize profit. Thus, banks' core activity is to act as financial intermediaries between savers and borrowers.

Banks also conduct other types of services like the trade finance which facilitate international trade. (Niepmann and Eisenlohr, 2014) explains that when exporters and importers engage in an international trade, they have to agree and decide on who finances the transaction and who bears which risk; and banks come in to the picture by way of providing finance and mitigating the risk involved.

In the case of open account method of payment, the exporter ships the consignment to the buyer and the latter makes payment only after receiving the goods; thus, the exporter pre-finances the transaction. On the other hand, the importer effects payment in advance of shipment of the goods by the exporter in the case of cash-in-advance payment method. In both cases, however, banks are usually involved by providing working capital finance to the exporter in the first case and to the importer in the second. (Ibid.)

### 2.1.2. INTERNATIONAL BANKING SERVICE

According to (Committee on the Global Financial System, 2014), banks facilitate international commerce through a variety of products which include managing their international payments, mitigating the risks, and providing working capital. The term “trade finance” is used to denote bank products which are specially tailored to facilitate international trade transactions i.e. exports and imports. (CGFS, 2014)

In addition, (Cherunilam, 2006) emphasizes that the international market is characterized by stiff competition and sensitivity; and thus, the credit facilities that banks provide to the buyers are among the most important factors for the success of export business.

Further, (Niepmann and Eisenlohr, 2014) put forward that international trade exposes both buyers and sellers to substantial risks, since the trading partner resides in a foreign land and enforcing of contracts is very hard. Trade finance products are designed and offered by banks with the aim of mitigating such risk associated with international trade.

Banks also play a crucial role in international commerce by offering trade finance products that can mitigate risks associated with the business of export. Further, (CGFS, 2014) point out that banks also help meet working capital needs of buyers and sellers by providing trade finance loans linked either to a letter of credit or other forms of documentation related to the underlying transaction.

In fact, (Niepmann and Eisenlohr, 2014) argue that trade finance can constrain exports, especially to the poorer countries during crisis times. Owing to the reductions in the supply of LCs associated with a contraction in bank lending, the lack of trade finance can explain the collapse in exports to the smaller and poorer countries in 2008/2009.

### 2.1.3 INCOTERMS - INTERNATIONAL COMMERICAL TERMS

The most complex & important tool of international trade is language. Small changes in wording can have a major impact on all the aspects of business agreement, especially in

International trade. For business terminology to be effective, phrase must mean the same thing throughout the industry. This is where “Incoterms” comes into existence.
Incoterms are internationally accepted commercial terms defining the respective roles of the buyer(Importer) and seller (Exporter) in the arrangement of transportation and other responsibilities and clarify when the ownership of the merchandise takes place. These terms are incorporated into export-import sales agreement and contracts worldwide and are a necessary part of foreign trade. (International Chamber of Commerce, 1996)

The main objectives of Incoterms defines the responsibilities and the obligation of a seller(Exporter) and a buyer (Importer) within the framework of international contracts of trade concerning loading, transport, type of transport, insurance and delivery. Its firs function is about a distribution of Transport Charge. The second role is to define the place of transfer and the transport risks involved in order to justify the ownership for support and damage of goods by shipments sent by the seller(Exporter) or the buyer(Importer) in an event of execution of transport.
Incoterms safeguard the following issues in Foreign Trade contract

a) To determine the critical point of the transfer of the risks of the seller to the buyer in the process forwarding of the goods (risk of loss, deterioration, robbery of the goods) all the person who supports these risks to make arrangement in particularly in terms of insurance.
b) To specify is going to subscribe the contract of carriage that is to say the seller or the buyer.
c) To distribute between the seller and the buyer the logistic and administrative expenses at the various stages of the process.
d) To define who is responsible for packaging, marking, operation of handling, loading and unloading of the goods or the potting and the discharge of the containers as well as the operations of inspections.

e) To fix respective obligations for the achievement of the formalities of exportation and/or importation as well as the supply of the documents.

INCOTERMS are most frequently listed by category. Below are the 11 international incoterms adopted by the international chamber of Commerce.

1. FCA - Free Carrier (…..named place): Free Carrier means that the seller (exporter) delivers the goods, cleared for export, to the carrier nominated by the buyer (importer) at the named place.
2. FAS - Free Alongside ship(.....named port of shipment): Free alongside ship means that the seller(exporter) delivers when the goods are placed alongside the vessel at the named port of shipment. This means that the buyer (importer) has to bear all costs and risks of los of or damage to the goods from that moment.
3. FOB - Free On Board (.....named port of shipment): Free on Board means that the seller (exporter) delivers when the goods pass the ship's rail at the named port of shipment. This means that the buyer (importer) has to bear all costs and risks of loss of or damage to the goods from that point.
4. CFR - Cost & Freight (…… named port of destination): Cost and Freight means that the seller (exporter) delivers when the goods pass the ships rail in the port of shipment. The seller(exporter) must pay costs and freight necessary to bring the goods to the named port of destination but the risk of loss of or damage to the goods, as well as any additional costs due to event occurring after the time of delivery are transferred from the seller (exporter) to the buyer (importer).
5. CIF - Cost, Insurance & Fright(…...named port of destination): Cost Insurance and Freight means that the seller(exporter) deliver when the goods pass the ship's rail in the port of shipment. The seller(exporter) must pay the cost and freight necessary to bring the goods to the named port of destination but he risk of loss of or damage to the goods, as well as any additional cost due to events occurring

after the time of delivery, are transferred from the seller (exporter) the buyer (importer).

6. CPT – Carrage Paid To(…. named place of destination): “Carriage paid to…” means that the seller(exporter) delivers the goods to the carrier nominated by him but the seller(exporter)must in additional pay the cost of carriage necessary to bring the goods to the named destination. This means that the buyer (importer)bears all risks and any other cost occurring after the goods have been so delivered.
7. CIP - Carriage and Insurance Paid To(….named place of destination) carriage and insurance paid to that the seller(exporter)delivers the goods to the carrier nominated by him but the seller(exporter)must in addition pay the cost of carriage necessary to bring the goods to the named destination. This means that the buyer (importer)bears all risks and any addition costs occurring after the goods have been so delivered. However, in CIP the seller (exporter) also has to procure insurance against the buyer’s risk of loss of or damage to the goods during the carriage.
8. DAF - Delivered at Frontier (……named place): Delivered at frontier means that the seller (exporter) deliver when the goods are placed at the disposal of the buyer (importer) on arriving means of transport not unloaded cleared for export, but not cleared for import at the named point and place at the frontier, but before the customs border of the adjoining country. The term” frontier” may be used for any frontier including that of the country of export.
9. DES - Delivered Ex-Ship(……named port of destination): Delivered Ex ship means that the seller (exporter) delivers when the goods are placed at the disposal of the buyer(importer) on board the ship not cleared for import at the named port of destination. The seller(exporter) has to bear all the costs and risks involved in bringing the goods to the named port of destination before discharging.

10. DDU - Deliver Duty Unpaid(…..named port of destination): Delivered duty unpaid means that the seller(exporter) delivers the goods to the buyer(importer), not cleared for import, and not unloaded from any arriving means of transport at the named place of destination. The seller (exporter) has to bear the costs and risks involved in bringing the goods thereto, other than, were applicable, any "duty" (which term includes the responsibility for and the risks of the carrying out of customs formalities, and the payment of formalities, customs duties, taxes and other charges) for import in the country of destination. Such " duty" has to be borne by the buyer (importer) as well as any costs and risks caused by his failure to clear the goods for import in time.
11. DDP - Delivered Duty Paid(….named Port of Destination): Deliver duty paid means that the seller(exporter) deliver the goods the buyer(importer), cleared for import, and not unloaded from any arriving means of transport at the named place of destination. The seller (exporter) has to bear all the costs and risks involved in bringing the goods thereto, other than, were applicable, any "duty" (which term includes the responsibility for and the risks of the carrying out of customs formalities, and the payment of formalities, customs duties, taxes and other charges) for import in the country of destination.

## 2.2. TRADE SERVICE PRODUCTS

The credit needs of the exporter depend to a very large extent on the type of sales terms. The sales contract must clearly specify the terms and conditions of the payment. The five most common trade payment methods are discussed below.

### 2.2.1 CASH IN ADVANCE

The most beneficial payment terms for the seller, according to Cherunilam (2006)is when payment is received in advance of the shipment of goods, i.e. the cash-in-advance payment term. It is not common for an importer to be willing to make advance payments. However when the consignment is to be manufactured to the order of and according to the specifications outlined by the importer, advance payment is usually required by the seller.

By the same token, under the cash-in-advance terms, the importer is actually pre-financing the transaction and the exporter receives the payment before incurring the production costs. This exposes the buyer to a risk, because the seller may fail to deliver the goods after receiving payment. (Niepmann, 2014)

The other case which gives rise to advance payment, according to Cherunilam (2006) is when the seller has a monopolistic position in the market. Here the buyer's bargaining power is lesser and as a result he has to make payment in advance of the shipment of the goods by the seller.

### 2.2.2 OPEN ACCOUNT

In contrast to the cash-in-advance method, the supplier first ships the goods and then the buyer effects payment under the open account method of payment. Since the exporter incurs production and distribution costs before receiving the payment, he is actually pre-financing the transaction. The risk to the exporter materializes when the importer fails to make payment for the goods after receiving them.(Niepmann, 2014)

In a similar manner, Cherunilam(2006) also demonstrates that under the open account scheme, the exporter delivers the goods with no financial documents to his advantage except the commercial invoice. Thus, the seller carries the entire financial burden with no documentary evidence. Since high risk is associated with the open account method, it is usually exercised between affiliated companies or when the buyer and seller have had a long standing business relationship.

### 2.2.3 CONSIGNMENT SALE

Under the consignment method of payment, the seller delivers the goods to his agent in the foreign land, who arranges for the sale of the goods and remits the payment to the supplier. Title to the goods remains with the exporter until the goods is sold to the ultimate buyer.

Under this method, the exporter is not protected against loss that could arise if the agent or consignee fails to repatriate the proceeds to the exporter from the sale of goods. (Cherunilam, 2006)

### 2.2.4 DOCUMENTARY COLLECTION (D/C)

Niepmann(2014) discusses that in a documentary collection method of payment, banks handle shipping documents based on the instructions of the seller. In this method of payment the buyer can get hold of the documents only after effecting payment for the document value without which he cannot receive the goods from the customs; thus a documentary collection provides better reliability of payment as compared to an open account basis.

Under this scheme, the importer benefits from not having to pay for the goods in advance, while the exporter can essentially withhold the relevant documents that allow the importer to take possession of the shipped goods until payment has been made. A documentary collection is a transaction whereby the exporter entrust the collection of payment to the remitting bank which in turn sends documents to a collecting bank along with the instructions for payment. Funds are received from the importer and remitted to the exporter through the banks involved in the collection in exchange for those documents. The banks' liability is limited to the forwarding and release of documents against payment and acceptance or promise of payment by the importer. (Committee on the Global Financial System, 2014)

Even with a DC arrangement, however, Niepmann (2014) explain that the buyer may still refuse to take up the documents and the exporter may be at risk.

Documentary collection carries the risk that the buyer will not or cannot pay for the goods upon receipt of the draft and documents. If this occurs it is the burden of the seller to locate a new buyer or pay for return shipment. (Giovannucci, 1996)

Documentary collections are of two types: documents against payment and documents against acceptance. Under the document against payment terms, also known as cash against documents the seller effects shipment of goods to the overseas buyer, but the shipping documents are handled through the banking channel and delivered to the buyer only against payment. (Niepmann, 2014)

In a similar manner, Cherunilam (2006) explains that under this method of payment, title to the goods remains with the seller until such time that the buyer pays for the value of the goods.

Documentary collections are governed by the URC 522. The URC 522 are the Uniform Rules for Collections. URC 522 came into effect on 01 January 1996. The URC 522 were first published by the ICC in 1956. Revised versions were issued in 1967 and 1978. (International Chamber of Commerce, 1996)

The Uniform Rules for Collections, 1996 Revision, ICC Publication No. 522, shall apply to all collections, where such rules are incorporated into the text of the collections instruction and are binding on all parties thereto unless otherwise expressly agreed or contrary to the provisions of a national, state or local law and/or regulation which cannot be departed from. (International Chamber of Commerce, 1996)

The URC 522 defines collection as:

> "Collection means the handling by banks of documents in accordance with instructions received, in order to:
>
> 1. Obtain payment and or acceptance,
> 2. Deliver documents against payment and/or against acceptance,
> 3. Deliver documents on other terms and conditions." (International Chamber of Commerce, 1996, p. 5)

The URC 522 distinguishes between two types of documents:

> Financial documents means bills of exchange, promissory notes, cheques, or other similar instrument used for obtaining the payment of money. Commercial documents means invoices, transport documents, documents of title or other similar documents, or any other documents whatsoever, not being financial documents. Clean collection means collection of financial documents not accompanied by commercial documents. Documentary collection means collection of:
>
> 1. Financial documents accompanied by commercial documents;
> 2. Commercial documents not accompanied by financial documents. (International Chamber of Commerce, 1996, p. 6)

In addition, Article 3 of the URC 522 further identified parties to a collection:

1. The principal who is the party entrusting the handling of a collection to a bank;

2. The remitting bank which is the bank to which the principal has entrusted the handling of the collection;
3. The collecting bank which is any bank, other than the remitting bank, involved in processing the collection
4. The presenting bank which is the collecting bank making presentation to the drawee;
5. The drawee is the one to whom presentation is to be made in accordance with the collection instruction. (International Chamber of Commerce, 1996, p. 8)

### 2.2.5 DOCUMENTARY LETTERS OF CREDIT (L/C)

DEFINITION OF AN L/C

Cherunilam (2006)states that a letter of credit is an instrument containing the undertaking of a bank to honor on it a draft drawn by a seller or beneficiary, under certain terms and conditions and up to a fixed amount.

A documentary letter of credit ensures that the exporter will be definitely paid for the value of goods shipped, provided that he fulfills the terms and conditions of the credit. In addition, under this payment method, the exporter can obtain payment from a bank at his own locality by presenting the shipping documents to the bank immediately after the shipment of goods. Thus, the letter of credit covers the major part of the export and import business in the world.

The letter of credit is a tripartite transaction. The buyer is the customer of the issuing bank at whose request the credit is issued. The beneficiary, on the other hand, is the seller of the goods to the buyer who receives the benefit of that credit. The letter of credit substitutes the bank's credit for that of the buyer. These transactions are considered to be three separate contract transactions. (Alphonse, 2010)

One significant reason for the popularity of commercial credits is the ability to substitute the established and reliable credit rating of one or more banks for the often unknown credit rating of the buyer. (Lipton, 1998)

Even more, the letter of credit allows the buyer and seller to contract a trusted intermediary (a bank) that will guarantee full payment to the seller provided that he has shipped the goods and complied with the terms of the agreed-upon letter. The L/C serves to evenly distribute risk between buyer and seller since the seller is assured of payment when the conditions of the L/C are met and the buyer is reasonably assured of receiving the goods ordered. (Giovannucci, 1996)

Thus, use of documentary credits keeps commercial activity flowing efficiently without the need for lengthy gaps between shipment of goods and payment, and the possible consequential need for provisional finance for the seller. (Lipton, 1998)

## TYPE AND CLASSIFICATION OF L/C

Letters of credit are classified in many ways and into many different types. However, in a general sense they fall into two main categories, namely the commercial letter of credit, which is a payment mechanism and a standby letter of credit which is basically a guarantee. Despite the similar nature of commercial and standby letter of credit, there are major differences between the two as regards the commercial purpose, the honoring of the credit and the risk involved. The risk of fraudulent calls is much higher in standby letter of credit transaction than in a commercial letter of credit. That is because in a commercial letter of credit, the beneficiary must provide a whole set of documents, which in general produced and issued by third parties, unlike a standby letter of credit where in general the beneficiary produces the documents. (Mueller, 2013)

The standby credit may be paid against a written demand as the stipulated document or against a written demand as the stipulated document or against a demand with some other documents specified, such as a certificate form a third party that there has been non-performance under the underlying contract. (Lipton, 1998)

Even though the irrevocable letter of credit is used most frequently in international trade, letters of credit may also be revocable allowing the exporter to obtain payment unless previously revoked by the importer. Documentary credits may be drawn at sight or at a fixed maturity date. Most letters of credit allow the beneficiary to transfer its rights to another (Folsom et al., 2005)

A confirmed L/C is one when a banker other than the issuing bank, adds its own confirmation to the credit. In case of confirmed L/C, the beneficiary's bank would submit the documents to the confirming banker. (ICSI, 1999 )

In a back to back credit, the exporter (the beneficiary) requests his banker to issue an L/C in favor of his supplier to procure raw materials, goods on the basis of the export L/C received by him.

While an L/C is not a negotiable instrument, the bills of exchange drawn under it are negotiable. A transferable credit is one in which a beneficiary can transfer his rights to third parties.(Ibid)

In a Red Clause & Green Clause L/C a special clause allows the beneficiary to avail of a pre-shipment advance ( a type of export finance granted to an exporter, prior to the export of goods). In case of Green Clause credit, the exporter is entitled for an advance for storage (warehouse) facilities of goods. The advance would be granted only when the goods to be shipped have been warehoused, and against an undertaking by the exporter that the transportation documents would be delivered by an agreed date.(ICSI, 1999)

Revolving credit, on the other hand, is a type of credit used commonly where the buyer is a regular customer of the seller. It is a credit for a certain sum at any one time outstanding, which is automatically renewed by putting on at the bottom what you have taken off at the top. Therefore it is automatic in its operation and does not need any renewal. (Mallaya, 2007)

PRINCIPLES OF LETTER OF CREDIT

The fundamental principle of letters of credit, also known as the autonomy principle, is that the responsibility of the opening bank to pay against drafts drawn under a credit accompanied by documents which conform to the conditions of the credit is independent of performance of any party under the underlying contract. (Folsomet al., 2005)

The key element of any letter of credit, regardless of the set of rules applicable, and the reason for its widely spread use is the autonomy of the bank's obligation from the underlying contract and other related contracts. (Mueller, 2013)

The principle of strict compliance is contained in Articles 7,8, and 15 of UCP 600 and accords with the autonomy principle. It provides that the beneficiary must conform with documentary requirements specified in the letter of credit. The autonomy principle takes a significant role within a letter of credit. The justification behind it is to obtain a particular warranty that the issuing bank's undertaking will not in any way be influenced by or interfered with any irregularity with regard to the underlying contract. (Mueller, 2013)

Whilst the autonomy principle gives advantage to the beneficiary ( "pay first, argue later") the strict compliance doctrine benefits the applicant in so far as he will have to reimburse the issuing bank only against presentation of a complying set of documents. (Mueller, 2013)

## ISSUING BANK'S OBLIGATION UNDER AN L/C

The issuing bank's main obligations are to issue the letter of credit at the request of the applicant, to make the credit available to the beneficiary, via an advising bank; to examine the presented documents; to either accept or reject the documents; to honor or dishonor the credit and to reimburse the negotiating bank that has honored a complying presentation. (Mueller, 2013)

According to the Uniform Customs and Practice for Documentary Credits, 2007 Revision, as long as the stipulated documents are presented to the issuing bank and as long as they conform to the terms and conditions of the letter of credit, the issuing bank must effect payment to the presenter.

Once the letter of credit is issued by the issuing bank, the bank's liability is absolute given that the seller performs as required by the terms of the letter of credit. (Alphonse, 2010)

## PARTIES TO A LETTER OF CREDIT

There are four parties to a letter of credit: namely the beneficiary, applicant, the issuing bank and the advising bank. The beneficiary under a letter of credit is the exporter of the goods in whose favor the letter of credit is issued. The applicant, on the other hand, is the party who intends to import the goods and instructs the bank to establish the letter of credit. (Jain, 2012) The applicant is the party on whose request the credit is issued. He is obliged to lodge security as demanded by the issuing bank and to reimburse and pay the issuing bank fees for payments made under the letter of credit. (Mueller, 2013)

The bank in the importer's country that issues the letter of credit at the request of the importer is termed as the issuing bank. While, the bank in the exporter's country who is authorized by the issuing bank to advise the letter of credit to the beneficiary is referred to as the advising bank. (Jain, 2012)

A confirming bank is usually the bank in the exporter's country, who adds confirmation to the letter of credit at the request of the beneficiary, so that the latter gets payment without recourse from the confirming bank. (Alphonse, 2010)

## FOUR AUTONOMOUS CONTRACTS PERTAINING TO AN L/C

The letter of credit consists of at least three different autonomous contracts. First, the underlying sale contract under which the seller agrees to sell the goods to the buyer and the buyer agrees to pay the seller the purchase price. Secondly, a contract between the buyer and the issuing bank under which the issuing bank agrees to issue the letter of credit for the benefit of the seller and the buyer agrees to reimburse the bank for the payment made under the letter of credit and commissions. Thirdly, the issuing bank's undertaking towards the seller under which the issuing bank undertakes to honor the beneficiary's drafts provided it is accompanied by a complying set of documents. (Mueller, 2013)

In addition there is a contract between the issuing bank and a confirming bank authorizing the latter to make payments on presentation of documents by the seller and to remit the documents to the issuing bank on reimbursement for amounts paid out by the confirming bank. A confirming bank will often be used in situations in which there is no accessible branch of the issuing bank available to deal in credits in the jurisdiction in which the seller is physically situated. (Lipton, 1998)

## THE MECHANISM OF L/C

Because banks effectively screen out buyers who are not dependable or creditworthy, most buyers who are letter of credit applicants are trustworthy companies which want to do business, and are not going to object to minor discrepancies in a seller's documents. By waiving discrepancies, they permit the letter of credit to be honored. (Moses, 2005)

The seller's control of the bill of lading works to create an incentive for letters of credit to be paid even in the absence of a duty to pay. Sellers who use letters of credit should understand that if they do not control the goods by maintaining control of the bill of lading, they face the possibility that the letter of credit will not protect them from the risk of non-payment. A buyer who gains possession of the goods, and then learn that there are discrepancies in the documents, can take advantage of the seller simply by delaying any waiver of discrepancies or by trying to negotiate a lower price. (Moses, 2005)

## AMENDMENT TO AN L/C

A change made to a letter of credit after it has been issued is called an amendment. For the seller to change the terms of an irrevocable letter of credit, it must request an amendment from the buyer. The amendment process is as follows:

1. The seller requests a modification or amendment of questionable terms in the letter of credit;
2. If the buyer and issuing bank agree to the changes, the issuing bank will change the letter of credit;
3. The buyer's issuing bank notifies the seller's advising bank of the amendment; and
4. The seller's advising bank notifies the seller of the amendment. (Vaidya, 1990)

UCP 600

The UCP 600 states that an issuing bank is irrevocably bound by an amendment as of the time it issues the amendment. A confirming bank may extend its confirmation to an amendment and will be irrevocably bound as of the time it advises the amendment. (International Chamber of Commerce, 2007)

The Uniform Customs and Practice for Documentary Credits, 2007 Revision, ICC Publication no. 600 (UCP) are rules that apply to any documentary credit when the text of the credit expressly indicates that it is subject to these rules. (International Chamber of Commerce, 2007)

The UCP 600 defines a complying presentation as:

> Complying presentation means a presentation that is in accordance with the terms and conditions of the credit, the applicable provisions of these rules and international standard banking practice. (International Chamber of Commerce, 2007, p.11)

Article 2 of the UCP600 provides a definition of a letter of credit as:

> Credit means any arrangement, however named or described, that is irrevocable and thereby constitutes a definite undertaking of the issuing bank to honor a complying presentation. Honor means:
>
> a) To pay at sight if the credit is available by sight payment
> b) To incur a deferred payment undertaking and pay at maturity if the credit is available by deferred payment.

c) To accept a bill of exchange drawn by the beneficiary and pay at maturity if the credit is available by acceptance. (International Chamber of Commerce, 2007, p. 7)

ISBP 2006

In 1996 the US Council on International Banking published a paper titled “Standard Banking Practice for the Examination of Letters of Credit Documents” which provided a checklist for banks on what must be considered when inspecting the documents. The goal was to try to reduce the number of presentations rejected by the banks by providing a standard for documentary checkers. The International Standard Banking Practice for the Examination of Documents under Documentary Letters of Credit, commonly called ISBP, was approved by the Commission at its meeting in Rome in October 2002. (Zsuzsanna, 2006)

Article 1 of the ISBP states that:

> The terms of a credit are independent of the underlying transaction even if a credit expressly refers to that transaction. To avoid unnecessary costs, delays, and disputes in the examination of documents, however, the applicant and beneficiary should carefully consider which documents should be required, by whom they should be produced and the time frame for presentation. (International Chamber of Commerce, 2006, p.5)

With regards the commercial invoice Article 58 of the ISBP holds that:

> The description of the goods, services or performance in the invoice must correspond with the description in the credit. There is no requirement for a mirror image. The description must reflect what has actually been shipped or provided. (International Chamber of Commerce, 2006, p.9)

URR 525

The Uniform Rules for Bank-to-Bank Reimbursements under Documentary Credits (URR 525) come into effect on the 1st of July 1996. The seventeen articles of the URR525 deal with the state of affairs covered by Article 19 of the UCP 500, where banks (an issuing bank, a claiming bank and a reimbursing bank) are involved. It does not alter the provisions of the UCP but sets out a detailed code for the reimbursing process. (Zsuzsanna , 2006)

The URR defines reimbursement authorization as:

> Reimbursement authorization means an instruction or authorization, independent of the credit, issued by an issuing bank to a reimbursing bank to reimburse a claiming bank or if so requested by the issuing bank, to accept and pay a time draft drawn on the reimbursing bank. (International Chamber of Commerce, 1996, p.2)

**2.2.6 GUARANTEE**

Jain(2012) defines guarantee as a contract between the issuing bank and a named beneficiary in whose favor the guarantee has been furnished; and it is an act of trust to facilitate the smooth flow of trade and commerce in both domestic and international trade. Although the initiation of a bank guarantee begins with the primary or underlying contract between the parties, it is nevertheless, independent and autonomous.

In a bank guarantee, the issuing bank binds itself to pay unconditionally to the beneficiary upon receipt of first claim. A letter of credit ensures that a transaction proceeds as planned; bank guarantee, on the other hand, are meant to reduce the loss if the transaction fails to go as planned. A guarantee is a responsibility of a bank to answer for the debt, default or non-performance of its client. (Jain, 2012)

A bank guarantee can be used in relation to an open account transaction under which goods are delivered to the buyer before receipt of payment by the exporter in order to warranty against default by the buyer. In a similar way, the bank guarantees the buyer when he has made an advance payment to an exporter prior to the shipment of goods. Under a bank guarantee, the bank or the guarantor is secondarily obligated to the obligee should the primary obligor or the applicant fail in his obligation to perform. (Jain, 2012)

## 2.3 INTERNATIONAL STANDARD BANKING PRACTICE (ISBP) DOCUMENT

International trade transactions, especially those involving documentary collection and letters of credit, usually call for presentation of the four most common shipping documents which are discussed briefly as below.

### 2.3.1 COMMERCIAL INVOICE

A commercial document that itemizes a transaction between a buyer and a seller. An invoice will usually include the quantity of purchase, price of goods and/or services, date, parties involved, unique invoice number, and tax information. If goods or services were purchased on credit, the invoice will usually specify the terms of the deal, and provide information on the available methods of payment. (Alphonse, 2010) Article 18 of the UCP 600 states that a commercial invoice must appear to have been issued by the beneficiary; must be made out in the name of the applicant; must be made out in the same currency as the credit and; need not be signed.

### 2.3.2 PACKING LIST

A credit requirement for a “Packing List” , which is a detailed list of items shipped, may be met by a document containing packing details whether titled “Packing Note”, “Packing and Weight List”, etc., or an untitled document. However, the content of a packing list or any document must appear to fulfill the purpose of the required document. (International Chamber of Commerce, 2006)

### 2.3.3. CERTIFICATE OF ORIGIN

A document declaring in which country a commodity or good was manufactured. The certificate of origin contains information regarding the product's destination and country of export and is required by many treaty agreements before being accepted into another nation. (Folsomet al., 2005)

A certificate of origin must be signed, dated and certify the origin of the goods. A certificate of origin should be issued by the party specified in the letter of credit. If a credit does not state party who issues the certificate, then a document issued by any party, including the beneficiary or the exporter himself, is accepted. (International Chamber of Commerce, 2006)

### 2.3.4 BILL OF LADING

A bill of lading is a transport document issued by a carrier as a receipt for the goods. Bill of lading, like bills of exchange, may be made out to any bearer, or to a particular person or his order. If made out to bearer, they can be transferred by delivery; while if made out to order, they can be transferred by endorsement and delivery of the bill of lading. In practice, however, bill of lading made out to bearer is seldom used, as the bill of lading serves as a document of title. The feature of the bill of lading as a document of title is in fact what makes the consignment negotiable as well. (Folsom et al., 2005)

In addition, the bill of lading retains its attribute of document of title until such time that the contract of carriage by sea is completed by delivery of the goods against the bill. If the carrier, however, delivers the consignment to a person who is not, actually, the holder of the bill of lading, the carrier bears the responsibility. (Folsomet al., 2005)

The negotiability quality of the order bill of lading implies that it functions as a document of title. The goods are merged with the document, and the legitimate holder of the bill of lading has title to the goods. The exporter thus, can retain control of the goods in transit by requiring the payment of the price of the goods before the bill of lading is delivered to the importer. An intermediary bank, usually referred to as the negotiating bank, that advances funds to the exporter, is protected by becoming a consignee or retaining ownership of the bill of lading. If the shipping company delivers the consignment without taking up or cancelling the bill of lading, it remains legally responsible to any party who has purchased the bill. (Folsomet al., 2005)

### 2.3.5 AIRWAY BILL

Air way bill delivered with goods shipped by an international courier to provide detailed information about the shipment and allow it to be tracked. The air waybill has multiple copies so that each party involved in the shipment can document it. (Giovannucci, 1996)

## 2.4 EMPIRICAL STUDIES ON LETTERS OF CREDIT

Jain(2012) observes that a bank is absolutely bound to effect payment under a letter of credit even if it is informed that the merchandise shipped is not of the quality contract for. Disputes as to the quality of the goods may arise and be litigated later between buyer and seller; but the issuing bank remains obligated to honor drafts drawn by the seller in conformity with the terms and conditions of the letter of credit. A documentary credit has an immediate legal effect. In contrast to a guaranty, which undertakes to answer for the debt, default or nonperformance of another, the issuing bank under a letter of credit is primarily liable upon it.

Though letters of credit are a widely used trade payment method, and considered to be a secure payment device, however Moses (2005) argues that there is an irony in the use of letters of credit, although they serve as effective payment mechanisms most of the time, in the majority of the cases the bank refuses to honor drafts due to discrepancies. The slightest discrepancy would relieve the issuing or confirming bank of its obligations to honor draft and documents.

Hashim(2000)argues that the principle of strict compliance is aimed at protecting the importer who has neither the opportunity to check the physical goods nor to supervise the process of loading the goods in the exporter's country due to the geographical distance. Hence, the documents are the only security available to the importer. The shipping documents evidence that the goods have been delivered in accordance with the terms and conditions in the sale contract.

Moses (2005)on the other hand discusses that banks only deal with documents, not with goods, and have no obligation to investigate or determine if the underlying transaction has actually occurred. Instead the bank's obligation is limited to determining whether the required documents have been presented in proper form.

In an empirical study of the letters of credit in 500 transactions, it is found that documents presented did not conform to the letter of credit requirements 73 percent of the time. It is also discovered that in almost every case, buyer promptly waived the discrepancies, thereby permitting payment under the letter of credit to occur. Since seller's right to be paid vanishes if the discrepancies cannot be cured, in the majority of documentary presentations, payment by the bank will occur if buyer decides to waive the defects in the seller's presentations. (Moses, 2005)

## 2.5 SUMMARY OF LITERATURE REVIEW

International trade exposes the trading partners to various difficulties and risks due to the physical distance between parties, different time zones and currencies, different legal rules applicable to the transaction as well as the fact that the parties may not generally know each other.

Banks facilitate international trade through a variety of trade service products like the letter of credit which are used to effect international payments and mitigate the risks, and also by providing the necessary working capital in the form of pre-shipment and post-shipment finance.

Each method of payment addresses certain level of risk for the buyer and seller.

Cash in Advance( TT): - The seller receives a payment in advance from the buyer prior to shipment of the goods.

Adv to the buyer: None

Risk to the buyer: No control over the goods
Seller may refuse to ship

Adv to the seller: Goods shipped when convenient
Use of buyer's funds

Risk to the seller: None

Open Account: - Goods are shipped to the buyer in advance and payment is made later through and arrangement negotiated in advance with the seller

Adv to the buyer: pays when convenient
Control over the goods

Risk to the buyer: None

Adv to the seller: None

Risk to the seller: Buyer may refuse to pay
No control over the goods

On Consignment:-The seller ships good to the buyer in advance, but retains ownership. Payment is received if and when the buyer sells the goods and a consignee acts like an agent.

Adv to the buyer: pays only as goods are sold

Risk to the buyer: None

Adv to the seller: Retains ownership of the goods

Risk to the seller: limited control of goods

Payment contingent upon sale of goods

The buyer may refuse to pay after sale of the goods.

CASH AGAINST DOCUMENT (CAD)Collection is a process governed by international rules by which the supplier is able to collect payment from an overseas buyer through an intermediary bank i.e. the handling of documents by banks in accordance with instruction received in order to:

- Obtain payment and/or acceptance,
- Deliver documents against payment and/or acceptance
- Deliver documents on other terms and conditions

Adv to the buyer: May refuse to pay or accept the draft or pay the value of document

Risk to the buyer: Goods may not be as represented in the documentation

Adv to the seller: Title documents controlled through the banking system

Risk to the seller: Buyer may refuse to accept the draft or to pay the value of the Document.

Documentary collections mean financial documents/instruments accompanied by commercial documents

Conditions under which the documents are released to the importer/buyer

- Document against payment (D/P) or Cash against document (CAD)
- Document against acceptance (D/A)
- Documents released without payment or free or payment (FOP)

Letter of Credit A Letter of Credit is an instrument issued by bank in favor of a beneficiary at the request of a buyer. By definition a letter of credit is an arrangement expressed in the form of a formal letter or tested telex/SWIFT, where by a bank, (the issuing bank) at the request and in accordance with the instruction of its customer (the applicant), undertakes irrevocably to re-imburse or cause to be re-imburse to a third party, ( the beneficiary), against presentation of documents and in compliance with the terms and conditions stipulated in the credit.

Adv to the buyer:

- The buyer is assured that the documents delivered meet all the terms and conditions laid down in the L/C.
- Through the use of bankers acceptances a buyer who has purchased goods under L/C may finance of the goods at sometimes at a future fixed date.
- Risk of not receiving goods ordered can be reduced through terms and conditions imposed under the letter of credit.
- Payment effected after shipment of goods and documents are presented to the advising bank.

Risk to the buyer:

- Banks deal with documents and not with goods, services or performance to which the documents may relate.

Adv to the seller:

- The seller can rely on bank's credit worthiness rather than the buyer. The seller is more confident when it has a bank's commitment upon presentation of conforming documents.
- Can assist in obtaining per and post shipment financing.

While cash-in-advance method of payment is the riskiest method from the buyer's point of view, open-account method, to the contrary, is the most disadvantageous from the seller's perspective. On the other hand, the letter of credit protects the interest of the seller through the principle of autonomy and the interest of the buyer through the principle of strict compliance.

## 2.6 CONCEPTUAL FRAMEWORK

International trade exposes the trading partners to various difficulties and risks due to the physical distance between parties, different time zones and currencies, different legal rules applicable to the transaction as well as the fact that the parties may not generally know each other.

Banks facilitate international trade through a variety of trade service products like the letter of credit which are used to effect international payments and mitigate the risks, and also by providing the necessary working capital in the form of pre-shipment and post-shipment finance.

While cash-in-advance method of payment is the riskiest method from the buyer's point of view, open-account method, to the contrary, is the most disadvantageous from the seller's perspective. On the other hand, the letter of credit protects the interest of the seller through the principle of autonomy and the interest of the buyer through the principle of strict compliance.

# CHAPTER THREE

## RESEARCH DESIGN AND METHODOLOGY

This section of the research paper presents the methodology that was employed by the researcher to conduct the study, to select the sample, to collect and analyze data used to assess the practice and challenges of international banking service on selected private commercial banks in Ethiopia.

### 3.1 RESEARCH DESIGN

According to Creswell(2009) research design are plans and the procedures for research that span the decision from broad assumption to detailed methods of data collection and analysis the selection of the research design based on the nature of the research problem or issue being addressed. The researcher‘s personal experience and the audiences of the study. Research designs simply the framework of the study based on the research techniques or methods.

In line with the objective of the research, which is to make an assessment of the existing practice and challenges of international banking service of private commercial banks, the research design shall employ descriptive type of study. According to Kothari (2004) the major purpose of descriptive type of research is description of the state of affairs as it exists at present; the main characteristic of this method is that the researcher has no control over the variables; he can only report what has the practice and challenges and how to mitigate such challenges.

### 3.2 RESEARCH APPROCH

In order to achieve the main objective of this research, the researcher were used mixed methods approach (both quantitative and qualitative).

### 3.3 DATA TYPE AND SOURCE

To obtain data concerning the practices and challenges of international banking service of private commercial banks, the researcher were used both primary and secondary data sources for the study. The primary data was collected from selected bank managers, senior bank officer through questionnaires by setting self-administered question in person and semi-structured interview. Questionnaires were administered to employees, officers and mangers of each bank. All questions are from the objective of the study. Interviews were conducted with the bank Managers and officers in order to grasp important information that may not be fully secured through structured questionnaire and interview. Secondary data will be gathering from various documents, brushers, articles, published and unpublished journals, and various books written on issues related to the topic.

### 3.4 RESEARCH METHOD

The survey method is considered as the most appropriate research strategy for any descriptive study. As noted by Kothari (2007), surveys are concerned with describing, recording, analyzing and interpreting conditions that either exist or existed; surveys are only concerned with conditions or relationships that exist, opinions that are held, processes that are going on.

Accordingly, the survey method has been employed in the study which comprises of questionnaires and interviews.

### 3.4 RESEARCH INSTRUMENT

The questionnaires is developed from the objective of the study it would measure to assess the international banking service practice in Ethiopian private commercial banks and compare its performance against International standard banking practice set out by the International Chamber of Commerce (ICC) and the regulation of National Bank of

Ethiopia (NBE) at the same time and measure the level of bank staff on international banking service knowledge. Questionnaires were used as the main instruments to collect data methods, hoping that it may provide an opportunity for obtaining reliable and valid information from large number of respondents. Semi-structured interview is important to obtain information with regard to issues that required clarification such as directives, annual reports, policies and records of various training programs and vital information that is not expected to access using questionnaires; and it was used concurrently with the design of the questionnaire.

## 3.5 POPULATION AND SAMPLING TECHNIQUES

The study was conducted on the basis of convenience to the researcher six selected private commercial banks in the country. A sample consisting of IBS department division managers, relationship manager, senior international banking officers, officers and an internal auditor selected from each of the four selected banks on the basis of purposive sampling technique. As a result, the total sample shall comprise 62 international banking professionals with varying levels of experience and responsibility.

**Table : 1 Population and sampling of respondent**

| No | Name of the banks | License date | No of Respondent |
|---|---|---|---|
| 1 | Awash International Bank S.C. | 1994 | 15 Respondents in different position |
| 2 | Nib International Bank S.C. | 1999 | 12 Respondents in different position |
| 3 | Oromia International Bank S.C. | 2008 | 10 Respondents in different position |
| 4 | Buna International Bank S.C. | 2009 | 8 Respondents in different position |
| 5 | Addis International Bank S.C | 2011 | 6 Respondents in different position |
| 6 | Wegagen Bank S.C | 1997 | 11 Respondents in different position |

As far as data collection procedure is concerned, first contact was made with the administrative affairs head of the banks. Then with the necessary permission, the researcher was contact list of employees including department manager and officers of the bank. In the second round activity, will be conducted to enhance the transparency of the questions for the study and lastly, Interview will be conducted with select sampled areas

## 3.5 METHODS OF DATA ANALYSIS

The researcher used descriptive statistics for data analysis. Thus, the questionnaires that were answered and retrieved were coded, analyzed and presented with the help of frequency tables.

To this end, the researcher employed the SPSS software (Version 20) in processing and analyzing the data.

# CHAPTER FOUR

## 4 . DATA PRESENTATION, ANALYSIS AND INTERPRETATION

This chapter presents the output of data analysis. The presentations are in the form of tables, graphs, percentage and statements. The presentation is according to the objectives of the study.

**Table 4.1**: Number of Questionnaires Distributed and Returned

| Position | Number of questionnaires distributed | Number of questionnaires returned | Approximate Percentage (%) |
|---|---|---|---|
| Division Managers | 12 | 12 | 100% |
| Relationship Manager –Trade Service | 6 | 6 | 100% |
| Senior International Banking Officers | 18 | 16 | 88.9% |
| International Banking Officers | 24 | 24 | 100% |
| Internal auditor | 2 | 2 | 100% |
| Total | 62 | 60 | 96.8% |

Source: Own survey (2016)

In addition, semi-structured interviews were conducted with 5 international banking division managers and the results have been consolidated with the data obtained from the questionnaires and presented in detail.

### 4.1 RESPONDENT'S DEMOGRAPHIC CHARACTERISTICS

The data was solicited from banking professionals with diverse demographic characteristics. The first part of the questionnaire consists of demographic information of the participants. The variables include: sex, educational background, working experience and office positions which are summarized and presented as below.

**Table 4.2**: General Information about Respondents

| | Frequency | Percentage |
|---|---|---|
| **1. Educational Background** | | |
| • Diploma | | |
| • 1st Degree | 47 | 78% |
| • Masters and above | 13 | 22% |
| Total | 60 | 100% |
| **2. Working Experience** | | |
| • 1-5 Years | 12 | 20% |
| • 5-10 Years | 29 | 48% |
| • More than 10 Years | 19 | 32% |
| Total | 60 | 100% |
| **3. Position** | | |
| • Division Managers | 10 | 16.7% |
| • Managerial | 6 | 10% |
| • Officers | 42 | 70% |
| • Auditors | 2 | 3.3% |
| Total | 60 | 100% |

Source: Own survey (2016)

As depicted on Table 4.1, out of the 60 respondents, the majority (78%) had attained 1st degrees while the balance (22%) had earned Master's degree. Looking into their working experience, 48% of the respondents had service years of 5 to 10 years, while 32% of them had working experience more than 10 years,. Only 20% of respondents had service years of less than 5 years.

In terms of their positions, 26.7% had managerial positions, namely division managers, and relationship managers in their respective banks, while 70% were still professional staff comprising of senior and intermediate international banking officers and 3.3% had contributed for this questioner is 2 Internal auditors.

## 4.2 GENERAL INTERNATIONAL BANKING SERVICE ISSUE

Under Part II, Section the questionnaires, issues related to general international banking service was raised and the responses are summarized as per their respective title as follows:

**Table 4.3:** General International banking service issues

Where: 1. All the time 2. Most of the time 3. Sometimes 4. Rarely 5. Never

N= number of respondents, %=approximate percentage

| Issues | 1 | | 2 | | 3 | | 4 | | 5 | | TOTAL |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | N | % | N | % | N | % | N | % | N | % | |
| International banking department provides foreign exchange service promptly | 0 | 0% | 3 | 5% | 34 | 57% | 17 | 28% | 6 | 10% | 60 |
| The bank foreign currency operation are well managed and efficient | 9 | 15% | 27 | 45% | 7 | 12% | 9 | 15% | 8 | 13% | 60 |
| The foreign exchange transaction made timely with highly secured technology | 1 | 2% | 35 | 58% | 21 | 35% | 3 | 5% | 0 | 0% | 60 |
| The customer satisfied with the foreign exchange service given by international bank department | 4 | 7% | 22 | 37% | 14 | 23% | 16 | 27% | 4 | 7% | 60 |
| The employees are highly responsible and accountable in foreign exchange service provision | 0 | 0% | 3 | 5% | 9 | 15% | 33 | 55% | 15 | 25% | 60 |
| The employees have skills and are committed in foreign banking service | 0 | 0% | 7 | 12% | 15 | 33% | 29 | 48% | 9 | 15% | 60 |
| Effective internal controls to monitor and control overall foreign exchange operation | 0 | 0% | 39 | 65% | 13 | 22% | 8 | 13% | 0 | 0% | 60 |
| The bank permit foreign currency for its customers on the basis of first come first served | 0 | 0% | 31 | 50% | 20 | 33% | 3 | 5% | 6 | 10% | 60 |

Source: Own survey (2016)

The result of the survey as reflected in table 4.1. Suggest that major respondents agree there is no well managed service and effective internal controls to monitor overall foreign exchange operation with regard to foreign exchange transaction made timely with highly secured technology and the banks permit foreign currency for its customer on the basis of bank interest only like depositor, exporter instead of satisfying customer of first come first served basis.

Similarly, interview responses also show that banks do not usually effective internal controls over international banking service operation. So, National bank of Ethiopia had created a database for centralized to manage customer foreign currency request for first come first served basis and also control customers do not use multiple request for all banks.

## 4.3. COMPLIANCE ISSUE WITH INTERNATIONAL, DOMESTIC STANDARDS AND DIRECTIVE

International Standard Banking Practice for the Examination of Documents under Documentary Credits (ISBP), ICC Publication 645 has evolved into a necessary companion to the UCP for determining compliance of documents with the terms of letters of credit. It explains how the practices articulated in UCP 600 are applied by documentary practitioners. (International Chamber of Commerce, 2006)

A total of 6 questions on most relevant to assess the international banking service practice in Ethiopian private commercial banks and compare its performance against International standard banking practice set out by the International Chamber of Commerce (ICC) and the regulation of National Bank of Ethiopia (NBE) .

**Table 4.4:** Compliance issue with international, domestic standards and directive

Where, 1- Never 2- rarely 3-sometimes 4- often 5- always

| Issues | 1 | | 2 | | 3 | | 4 | | 5 | | TOTAL |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | N | % | N | % | N | % | N | % | N | % | |
| The bank established line of authority, responsibility and limits to its employees for measuring , managing and report to compliance | 3 | 5% | 5 | 8% | 31 | 52% | 12 | 20% | 9 | 15% | 60 |
| Foreign exchange procedures meet the necessary standards of accuracy, promptness and completeness | 0 | 0% | 10 | 47% | 14 | 23% | 29 | 48% | 7 | 12% | 60 |
| International Standard Banking Practice for Examination of Documents (ISBP) guidelines when examining documents. | 0 | 0% | 15 | 25% | 12 | 20% | 27 | 45% | 6 | 10% | 60 |
| NBE is good enough in supervising foreign operation activities of the bank | 0 | 0% | 0 | 0% | 8 | 13% | 0 | 0% | 52 | 87% | 60 |
| Outstanding purchase orders approved are within manageable limit. ( to secure the bank's liquidity in foreign currency ) | 27 | 45% | 19 | 32% | 14 | 23% | 0 | 0% | 0 | 0% | 60 |
| The approved foreign currency payment made based on the modality of payment as per the international practice within acceptable time limit | 8 | 13% | 40 | 67% | 12 | 20% | 0 | 0% | 0 | 0% | 60 |

Source: Own survey (2016)

Out of the 60 respondents, majority of them the banks not frequently reported that managing and report to compliance, in most or all of the time, they take into account

Article No. 6-42 (General Principles) of the ISBP when examining documents and determining whether the documents have discrepancy or not.

Banks are not properly managing the level of approved purchase orders (which are prerequisites for documentary collections) since the National Bank of Ethiopia does not consider approved purchase order as liabilities to the banks. According to the directive on Open Position,(which is a daily report on the foreign currency assets and liabilities of the bank) only letters of credit are considered as liabilities of the bank. As a result, banks are having difficulty in allocating or reserving foreign currency needed for settlement of documentary collections.

On a related issue, the survey results show that in most of the cases the banks faced foreign currency liquidity problem when handling the settlement of documentary collection because too much purchase order have been approved in excess of the foreign exchange earning capacity of the banks. Delaying of payments for these international transactions may affect correspondent banks relationship.

### 4.4. PRACTICE & CHALLENGES OF FOREIGN CURRENCY UTILIZATION

**Table 4.5.** Practice & challenges of foreign currency utilization

Where, 1- Strong Disagree 2-Disagree 3-Neutral 4- Agree 5- Strong Agree

| Issues | 1 | | 2 | | 3 | | 4 | | 5 | | TOTAL |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | N | % | N | % | N | % | N | % | N | % | |
| Foreign currency generated through export, remittance and other source meets the bank expected plan | 9 | 15% | 38 | 63% | 13 | 22% | 0 | 28% | 0 | 10% | 60 |
| The bank generates sufficient foreign currency to meet the demand for customers(demand/supply) | 36 | 60% | 12 | 20% | 12 | 20% | 0 | 0% | 0 | 0% | 60 |
| The bank has a well organized foreign currency generation scheme | 14 | 23% | 32 | 53% | 9 | 15% | 5 | 8% | 0 | 0% | 60 |
| The bank has transparency in foreign currency allocation. | 6 | 10% | 15 | 25% | 27 | 45% | 8 | 13% | 4 | 7% | 60 |
| The bank has dedicated committee assigned to mobilize foreign currency | 0 | 0% | 0 | 0% | 32 | 53% | 19 | 32% | 9 | 15% | 60 |
| Banks foreign currency liquidity problem when handling the settlement of documentary collection | 0 | 0% | 0 | 12% | 0 | 33% | 47 | 48% | 13 | 15% | 60 |
| The bank has sufficient and well developed foreign currency manual so as to deal with all aspect of foreign currency management process | 0 | 0% | 11 | 18% | 23 | 38% | 9 | 15% | 17 | 28% | 60 |
| The banks, foreign currency polices and procedure has a hole for misusing of foreign currency | 4 | 7% | 34 | 57% | 12 | 20% | 8 | 13% | 2 | 3% | 60 |

Source: Own survey (2016)

From the information by table 4.5 banks is not generates sufficient foreign currency through export and remittance to meet there demand. The major challenges banks are operating under scare foreign exchange condition. Such situation create competition for this scare resource among customer and caused their dissatisfaction for unfair treatment best of result in corrupt practice at worse if the process is not guided by clearly define procedure and not enforced accordingly. This in turn result in loss of customer and reputation which ultimately culminate in significant financial loss to the bank

## 4.5: ISSUE RELATED TO RISK AREA OF INTERNATIONAL BANKING SERVICE

**Table 4.6: Percentage distribution: Risk area of International Banking Service Measurement**

| Risk area Measurements | Frequency | Relative Frequency (%) |
|---|---|---|
| Foreign currency demand is more than supply | 13 | 22% |
| Delay of payments International transaction | 12 | 20% |
| Malpractice regard to foreign currency request | 8 | 13.3% |
| Unfair treatment | 4 | 6.7% |
| Corrupt practice | 17 | 28% |
| Lack of trained manpower in the sector | 6 | 10% |
| **Total** | **60** | **100%** |

Source: Own survey (2016)

With regard to foreign currency demand is more than supply most of the respondents replied that this problem addressed all private banks. Similarly, (20%) of respondents admitted that only infrequent do banks effect payment to the remitting bank automatically once the buyer takes up the documents. Likewise, results of the interviews indicate that , in most of the cases, payment to the remitting bank under documentary collections are delayed up to two or three months after settlement by the importer.

One important issue raised, during the interview and under the open-end questions on the issue of documentary collections, is that banks are not properly managing the level of approved purchase orders ( which are prerequisites for documentary collections) since the National Bank of Ethiopia does not consider approved purchase order as liabilities to the banks. According to the directive on Open Position.(which is a daily report on the foreign currency assets and liabilities of the bank) only letters of credit are considered as liabilities of the bank. Banks are only allowed to hold excess foreign currency up to the equivalent of 15% of their paid capital; any excess holding above that limit shall be sold out to the NBE or other banks. As a result, banks are having difficulty in allocating or reserving foreign currency needed for settlement of documentary collections. In fact, one interviewee recommended that at least 20% of outstanding purchase orders should be included in the open position report so that banks may be able to allocate some foreign exchange for the settlement of related documentary collections.

On the other hand, 13.3% and 6.7% of the respondents responded positively to the question either malpractice foreign currency request or unfair treatment risky practice for the bank. In a similar manner, most of the respondents reported that corrupt practice is also major risk area of the banks due to the stiff competition between these banks for foreign exchange request that makes ensure transparency in handling customer request.

## 4.6. ISSUE RELATED TO EMPLOYEE COMMITMENT & KNOWLEDGE FACTOR

**Table 4.7: Rating:** Employee Commitment & Knowledge Factors

| Employee Commitment & Knowledge Factors | **Frequency** | **Relative Frequency (%)** |
|---|---|---|
| I committed to serving based on customer satisfaction | 15 | 25% |
| I clearly understand the objectives of our bank | 10 | 16% |
| Our bank knowledge transfer through formal procedures | 8 | 13.3% |
| I consider that employee knowledge as an organizational asset and not their own source of strength | 11 | 18% |
| I clearly understand NBE directives & International Standard Banking Practice (ISBP) | 12 | 20% |
| Our bank give training continually to fill knowledge gap of the staff | 4 | 16.7% |
| **Total** | **60** | **100%** |

Source: Own survey (2016)

The respondents were asked to assess the degree of bank employees' familiarity with the mechanism of trade service, Uniform Rules for Collection, Uniform Customs Practice for Documentary Credits and the directive of the National Bank of Ethiopia. On average, the level of familiarity is only moderate.

High staff turnover among the experienced professionals was cited, during the interview, as one of the reasons for the lack of international banking staff with sufficient job knowledge. The interviewees further indicated that training is not sufficiently provided to the international banking staff periodically.

# CHAPTER FIVE

## SUMMARY, CONCLUSION AND RECOMMENDATION

This chapter presents summaries of the study findings as per the study objectives, conclusions based on those findings and recommendations which are based on both the study findings and other relevant literature considered necessary and vital to be used in future to improve the study situation.

### 5.1 SUMMARY OF FINDINGS

The broad objective of the study was to make a critical assessment practice and challenges of international banking service selected Ethiopian private commercial banks in order to shed light on risk areas, identify problems, expose malpractices and indicate instances of non-compliance with international standard banking practices.

In line with the objective of the research, which is to make an assessment of the existing international banking service practice of private commercial banks the researcher have the above major findings:

- Banks do not generates sufficient foreign currency through export and remittance to meet there demand. The major challenges banks are operating under scare foreign exchange condition. Such situation create competition for this scare resource among customer and caused their dissatisfaction for unfair treatment best of result in corrupt practice at worse if the process is not guided by clearly define procedure and not enforced accordingly. These in turn result in loss of customer and reputation which ultimately culminate in significant financial loss to the bank.

- In the same manner, banks are not properly managing the level of approved purchase orders (which are prerequisites for documentary collections) since the

National Bank of Ethiopia does not consider approved purchase order as liabilities to the banks. According to the directive on Open Position, (which is a daily report on the foreign currency assets and liabilities of the bank) only letters of credit are considered as liabilities of the bank. As a result, banks are having difficulty in allocating or reserving foreign currency needed for settlement of documentary collections.

On the other hand, it is found that most banks do not comply with the directives of the National Bank of Ethiopia and the international standard practice in terms of: checking the delinquent status of the customer, creating awareness among the customers of the need to submit proof of entry of goods to the NBE, making sure that the final documents are in line with the import permit or the purchase order, checking for the validity of the pro-forma invoice, taking into account international standard banking practice ISBP guidelines when examining documents.

- The degree of employee commitment and knowledge issue international banking personnel with trade service area (according To respondents) is found to be only moderate owing to the relatively high staff turnover in the banks and due to the lack or insufficiency of training on trade service practices.

  Knowledge gaps in the following areas need urgent attention:

  1) The mechanism of trade payment methods,
  2) Uniform Rules for Collection,
  3) Uniform Customs Practice for Documentary Credits and
  4) The relevant directives of the National Bank of Ethiopia

## 5.2 CONCLUSION

The study, which was a descriptive type of research and which employed the survey method of data collection namely, interview and questionnaires, has enabled the researcher to come up with several findings discussed above.

Based on the results, the author concludes the following:

### 5.2.1. The Existing Practice comply with International and domestic standards and directives

Article 4 of the URC 522 states that banks are only permitted to act upon the instructions given in such collection instruction, and in accordance with these Rules. Banks will disregard any instructions from any party/bank other than the party/bank from whom they received the collection. Nevertheless, these finds suggest that, due to a lack of awareness of the uniform rules for collection, most bankers take action on the collection documents based on instruction received from the drawee and at times contrary to the collection instructions of the remitting bank. To illustrate, most collection instructions request the presenting bank to inform the remitting bank by SWIFT the reasons for non-acceptance of documents by the drawee before simply returning the collection documents at the instruction of the drawee. However, seldom do banks' inform the remitting bank of non-acceptance and request for further instruction.

Failure to seek instructions from the remitting bank in case of non-payment and failing to advise the remitting bank of the fate of documents can deteriorate correspondent banking relationships.

Article 26 of the URC 522, states that the presenting bank should endeavor to ascertain the reasons for non-payment and/or non-acceptance and advise accordingly, without delay, the bank from which it received the collection instruction. In contrast, the findings suggest that rarely do the banks send advice of non-payment or non-acceptance to the remitting bank in a timely manner. Such malpractice amounts to non-compliance with the international banking standard which eventually destroys banking relationships

### 5.2.2 The degree of challenges encountered is it to difficult to manage

Those banks there is no well managed service and effective internal controls to monitor overall foreign exchange operation with regard to foreign exchange transaction made timely with highly secured technology and the banks permit foreign currency for its customer on the basis of bank interest only like depositor, exporter instead of satisfying customer of first come first served basis.

Banks are not properly managing the level of approved purchase orders (which are prerequisites for documentary collections) since the National Bank of Ethiopia does not consider approved purchase order as liabilities to the banks. According to the directive on Open Position,(which is a daily report on the foreign currency assets and liabilities of the bank) only letters of credit are considered as liabilities of the bank. As a result, banks are having difficulty in allocating or reserving foreign currency needed for settlement of documentary collections.

### 5.2.3 Risk Areas with respect to trade service products

Trade payment methods like the documentary collection and the cash-in-advance expose the trade partners to different risks. For instance, the buyer may refuse to take up the documents sent under a documentary collection after shipment of goods has already been effected; thus, the seller might face the risk of non-payment. On the other hand, a buyer who has effected payment under the cash-in-advance method might end up losing his money if the seller turns out to be a dishonest one and fails to ship the goods as agreed. It is apparent that Ethiopian businessmen engaged in the import and export business are being exposed to risks of non-payment and non-performance by their trade counterpart due to a lack of awareness of the advantages and disadvantages of trade payment methods.

### 5.2.4 Issue related to employee commitment & knowledge factor

From the research that has been carried out, due to a relatively high staff turnover among the bank staff and the insufficiency or in some cases the lack of periodic training, the level of the job knowledge of most international banking staff is below what is considered sufficient.

Most of the malpractices and instances of non-compliance of banks, however, result from the lack of sufficient job knowledge. More than sufficient job knowledge among the staff is required in order for the bank to avoid such malpractices and violation of local and international standards and regulations.

## 5.3 RECOMMENDATION

Based on the findings and conclusions, the following recommendations were forwarded to alleviate or at least minimize the operational problems, correct the malpractices, avoid instances of non-compliance with standards and regulations, mitigate some of the risks and fill the knowledge gaps.

Bank should carefully design and well managed to internal controls over international banking service operation with regard to foreign exchange transaction made timely with highly secured technology and the banks permit foreign currency for its customer on the basis satisfying customer of first come first served basis.

Banks also should properly manage their assets and liabilities in foreign exchange so that they will not face liquidity problems upon settlement of letters of credits and documentary collections.

Similarly, The National Bank of Ethiopia should revise its Open Position directive in such a way that banks would be allowed to account their outstanding approved purchase orders as liabilities (in addition to the tolerance up to 15% of paid up capital). In this way, banks can reserved the necessary foreign exchange necessary for the settlement of the related documentary collections.

Finally the researcher recommends periodic training should be provided to the international banking department personnel on the mechanism of trade payment methods, Uniform Rules for Collection, Uniform Customs Practice and on the relevant directives of the National Bank of Ethiopia.

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**Appendix I**

**St. Mary's University**

**School of Graduate Studies**

**Faculty of Business Administration**

Questionnaire

Dear respondent

The objective of this questionnaire is to secure the necessary and relevant first –hand information that may be useful to conduct research regarding on the assessment of Practice and Challenges of International Banking Service –a case study of selected private commercial banks of Ethiopia. The purpose of the study is for the partial fulfillment of requirement for the completion of Masters in Business Administration (MBA).

Therefore, for the successful accomplishment of the study, the response of the respondent will play important role for being used as valuable input for the study. So, you are kindly requested to genuinely fill the questionnaire.

**Thank you in advance for your cooperation**

- **Name of the bank……………………………………**

***Instruction: -***

- Please don't write your name
- Put " √ " mark as per the questions required in the box or answer in the space provided
- In case you have any question please, contact my cell phone and email address
  Tel: +251-911-892583
  Email: mike.kidus@yahoo.com

**Part one: personal profile**

1. Gender Male ☐ Female ☐

2. Educational Background Diploma ☐ Degree☐ Master and above☐

3. Work experience (Years)

   1-5 ☐ 5-10 ☐ More than 10 ☐

4. Position

   Division Manager ☐ Managerial ☐ Officer☐

**Part two:** this section is designed to collected relevant information regarding to **General International Banking Service and Compliance issue with international, domestic standards and directives**. Please, check "√" and rate yourself honestly based on what your actually do given the statement using the following scales:

1- Never 2- rarely 3-sometimes 4- often 5- always

**I. General International Banking Service questions**

| No | Description | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|---|
| 1 | International banking department provides foreign exchange service promptly | | | | | |
| 2 | The bank foreign currency operation are well managed and efficient | | | | | |
| 3 | The foreign exchange transaction made timely with highly secured technology | | | | | |
| 4 | The customer satisfied with the foreign exchange service given by international bank department | | | | | |
| 5 | The employees are highly responsible and accountable in foreign exchange service provision | | | | | |
| 6 | The employees have skills and are committed in foreign banking service | | | | | |
| 7 | Effective internal controls to monitor and control overall foreign exchange operation | | | | | |
| 8 | The bank permit foreign currency for its customers on the basis of first come first served | | | | | |

### II. Compliance issue with international, domestic standards and directives

| No | Description | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|---|
| 1 | The bank established line of authority, responsibility and limits to its employees for measuring , managing and report to compliance | | | | | |
| 2 | Foreign exchange procedures meet the necessary standards of accuracy, promptness and completeness | | | | | |
| 3 | International Standard Banking Practice for Examination of Documents (ISBP) guidelines when examining documents. | | | | | |
| 4 | NBE is good enough in supervising foreign operation activities of the bank | | | | | |
| 5 | Outstanding purchase orders approved are within manageable limit. ( to secure the bank's liquidity in foreign currency ) | | | | | |
| 6 | The approved foreign currency payment made based on the modality of payment as per the international practice within acceptable time limit | | | | | |

**Part three:** this section is designed to collected relevant information regarding to **Major challenges of foreign currency utilization issues, Risk area of International Banking Service**, Please, check " √ " and rate yourself honestly based on what your actually do given the statement using the following scales:

1- Strong Disagree 2-Disagree 3-Neutral 4- Agree 5- Strong Agree

### III. Challenges of foreign currency utilization

| No | Questions | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|---|
| 1 | Foreign currency generated through export, remittance and other source meets the bank expected plan | | | | | |
| 2 | The bank generates sufficient foreign currency to meet the demand for customers(demand/supply) | | | | | |
| 3 | The bank has a well organized foreign currency generation scheme | | | | | |
| 4 | The bank has transparency in foreign currency allocation. | | | | | |
| 5 | The bank has dedicated committee assigned to mobilize foreign currency | | | | | |
| 6 | Banks foreign currency liquidity problem when handling the settlement of documentary collection | | | | | |
| 7 | The bank has sufficient and well developed foreign currency manual so as to deal with all aspect of foreign currency management process | | | | | |

| | | | | | | |
|---|---|---|---|---|---|---|
| 8 | The banks, foreign currency polices and procedure has a hole for misusing of foreign currency | | | | | |

**IV. Risk area of International Banking Service**

| No | Questions | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|---|
| 1 | Foreign currency demand is more than supply | | | | | |
| 2 | Delay of payments International transaction | | | | | |
| 3 | Malpractice regard to foreign currency request | | | | | |
| 4 | Unfair treatment | | | | | |
| 5 | Corrupt practice | | | | | |
| 6 | Lack of trained manpower in the sector | | | | | |

**Part four :** this section is designed to collected relevant information regarding to **employee commitment and knowledge of trade service staffs** Please, check " √ " and rate yourself honestly based on what your actually do given the statement using the following scales:

1- Strong Disagree 2-Disagree 3-Neutral 4- Agree 5- Strong Agree

**V. Employee Commitment & Knowledge Factors**

| No | Questions | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|---|
| 1 | I committed to serving based on customer satisfaction | | | | | |
| 2 | Good quality service being a positive effect on perceived value in banking service | | | | | |
| 3 | I clearly understand the objectives of our bank | | | | | |
| 4 | Customer's feedback with regard to service motivate the job | | | | | |
| 5 | Our bank knowledge transfer through formal procedures | | | | | |
| 6 | I consider that employee knowledge as an organizational asset and not their own source of strength | | | | | |

| | | | | | | |
|---|---|---|---|---|---|---|
| 7 | I clearly understand NBE directives & International Standard Banking Practice (ISBP) | | | | | |
| 8 | Our bank give training continually to fill knowledge gap of the staff | | | | | |

**Finally please write your opinion to solve the above problem**

1 What possible remedial solutions do you propose in order to solve the above mentioned risk area of international banking service.

______________________________________________________________________
______________________________________________________________________
______________________________________________________________________
____________________________________________________________________.

2 Do your bank have foreign currency liquidity problem when handling settlement of letter of credit and documentary collection?

Yes ☐ No ☐

3 If your answer for Q. 2 yes what is your suggestion to solve delaying of payments for international transactions?

______________________________________________________________________
______________________________________________________________________
__________________________________________________ .

**Thank you very much**

**Appendix II**

**St. Mary's University**
**School of Graduate Studies**
**Faculty of Business Administration**

**Interview Questions for Managers**

**Part I**

1. Do you have the practice of effective internal controls to monitor foreign exchange operation?
2. Do you make a close follow up the bank foreign currency request, utilization at the same time settlement?
3. What challenges, problems, malpractices and instances of non-compliance with NBE directives and international standard practice do you observe with regards to international banking service?
4. What mechanism do you employ to see that the total outstanding purchase orders approved are within manageable limit in order to secure the bank's liquidity in foreign currency?
5. How do you assess the level of job knowledge of employees at the International Banking Department especially with regards the mechanism of trade payment methods, Uniform Rules for Collection, Uniform Customs Practice for Documentary Credits, and the directive of the NBE?

6. What possible remedial solutions do you propose in order to solve risk area of international banking service?

- Foreign currency demand is more than supply
- Delay of payments International transaction
- Malpractice regard to foreign currency request
- Unfair treatment
- Corrupt practice
- Lack of trained manpower in the sector

**Appendix III**

List of banks in Ethiopia

| S.No | Name of Banks | Years of Established |
|---|---|---|
| 1 | National Bank of Ethiopia | Feb,15/1906 |
| 2 | Development Bank of Ethiopia | 1909 |
| 3 | Commercial Bank of Ethiopia | 1963 |
| 4 | Construction and Business Bank | 1983 |
| 5 | Awash International Bank | November 10/1994 |
| 6 | Dashen Bank | September 20/1995 |
| 7 | Bank of Abyssinia | February 15/1996 |
| 8 | Wegagaen Bank | June 11/1997 |
| 9 | United Bank | September 10/1998 |
| 10 | Nib International Bank | October 28/1999 |
| 11 | Cooperative Bank of Oromia | March 8/2005 |
| 12 | Lion International Bank | October 2/2006 |
| 13 | Oromia International Bank | September 18/2008 |
| 14 | Bunna International Bank | November 21/2009 |
| 15 | Zemen Bank | October 20/2009 |
| 16 | Abay Bank S.C. | July 14/2010 |
| 17 | Berhan International Bank | April 6/2010 |
| 18 | Addis International Bank | 2011 |
| 19 | Debub Global Bank | April 20/2012 |
| 20 | Enat Bank | March 3/2013 |

## DECLARATION

I, the undersigned, declare that this thesis is my original work, prepared under the guidance of Solomon Markos(PhD). All sources of materials used for the thesis have been duly acknowledged. I further confirm that the thesis has not been submitted either in part or in full to any other higher learning institution for the purpose of earning any degree.

____________________________ ________________________

Name Signature

**St. Mary's University** **June ,2016**
**Addis Ababa**

## ENDORSEMENT

This thesis, titled "**Practice and challenges of international banking service selected Ethiopian private commercial banks**" has been submitted to St. Mary's University, School of Graduate Studies for MBA program with my approval as a university advisor.

| | |
|---|---|
| ________________________ | ________________________ |
| Advisor | Signature |

**St. Mary's University** **June, 2016**
**Addis Ababa**