

CHAPTER - III

COMMERCIAL BANKING:

Introduction:

Today banks have become a part and parcel of our life. There was a time when dwellers of city alone could enjoy their services. Now banks offer access to even a common man and their activities extend to areas neither touched. Banks cater to needs of agriculturists, industrialists, traders and to all the other sections of the society.

Commercial banks are very important segment of the money market. They play a very important role in the economy by mobilizing savings from various sectors which is the foundation for the growth and development of the economy. In turn the growth and development of economy determines the growth of banks as well.

Definition:

According to banking regulation Act, 1949 sec. 5 (b) defines the term Banking company as a company which transacts the business of banking in India and the term Banking has been defined as 'Accepting for the purpose of lending and investment of deposits of money from the public, repayable on demand, order or otherwise and withdraw able by cheque, draft order or otherwise'.

Functions of Commercial Banks:

I. Primary Functions:

1. Accepting of deposits : The following are the types of deposits:

A. Current deposits account: They are, generally opened by trading and industrial concerns, public authorities, etc. Current accounts are active or running accounts which are continuously in operation. Customers can deposit any amount of money and any number of times and their no restriction on number of withdrawals. Current deposits are repayable on demand. It is for this reason, they are also called demand deposits or demand liabilities. So, banks are required to keep the major portion of the current deposits in liquid form. Generally **no interest is allowed on current deposits.**

B. Fixed deposit account: They are opened by small investors who do not want to invest their money in risky industrial securities, but wish to deposit their money in banks and earn good and steady income. No introduction is necessary for opening the fixed deposit accounts, as they are not operated by cheques. **Fixed amounts are deposited by customers for fixed periods at fixed rate of interest.** The fixed deposits can be withdrawn, not on demand, but only after the expiry of fixed periods. It is for this reason known as time deposits.

C. Savings deposit account: They are opened by middle and low income groups who wish to save a part of their current incomes for their future needs and earn fair interest

on their deposits. Customers can deposit any amount of money and any number of times. There are restrictions on the number as well as the amount of withdrawals from these accounts.

2.Forms of advances Loans: The banker advances a lump sum for a certain period at an agreed rate of interest. The entire amount is credited to loan a/c, interest is charged on entire amount whether the borrower withdraws in full or part. The loan may be repaid in installments or at the expiry of a certain period. The loan may be made with or without security. Loan may be a demand loan or a terms loan. Demand loan is payable on demand, it is for meeting the working capital needs of the borrower. Term loans may be medium term or long term loan. **Medium term loans are granted for a period of one year to 5 years for the purchase of vehicles, tools and equipments.** Long term loans are granted for a period of more than 5 years for capital expenditure such as purchase of land, building, new machinery etc.

3.Cash credit: This a permanent arrangement by which the customer is allowed to borrow money upto a certain limit, here the borrower withdraws the money as and which he requires and interest is charged only on the amount actually withdrawn. Cash credit arrangements are usually against pledge or hypothecation of goods. Cash credits are the most favorite mode of borrowing by large commercial and industrial concerns.

4.Overdrafts: **Overdraft is an arrangement between a banker and his customer** by which the latter is allowed to withdraw over and above his credit balance in the current account upto on agreed limit. This is only a temporary accommodation/arrangements usually granted against securities. Interest is charged on the amount overdrawn.

5.Bills discounted and purchased: While the traders opt for credit transaction the debtors accepts the bill drawn upon him to pay certain sum money on certain specified date by the credit-BOE. **The banker discounts the BOE and credits the customer a/c,** here the banker receives the interest in advance. Sometimes banks purchase the bill instead discounting them. But in almost all cases the bank holds the bill only as a security for the advance.

6.Creation of credit: Credit creation is an important function of commercial banks. When a commercial bank advances a loan to its customers, liquid cash will not be lent. Instead it opens an account in the borrower's name and credits his account with the amount of loan. Such a deposit is indeed credit creation and this deposit is called secondary or derivative deposit. Thus **credit creation helps to increase the money supply so as to promote economic development in the country.**

7.Use of cheque system: Commercial banks perform the unique function of issuing and collecting cheques. Deposits can be withdrawn with the help of a cheque as it is a negotiable instrument. It can be transferred easily from one person to another. It becomes the most developed credit instrument. In modem business world the use of cheques to settle debts is found to be more convenient form than the use of liquid cash.

8.Remittance of funds: Banks help their customers in transferring funds from one place to another by issuing bank drafts, mail transfers, telegraphic transfers and electronics transfers on nominal commission charges.

II. Secondary functions : (Miscellaneous / General utility)

The banker acts as an agent to his customers.

1.Payment and collection of dividends, salaries, pensions, telephone bills, insurance premium etc... : Customers can leave standing instructions with the banker for various periodic payments ensuring the regular payments and avoiding the trouble of performing it themselves.

2.Purchase and sales of securities: They simply perform the function of a broker and undertake the purchase and sale of various securities like shares, stocks, debentures etc., on behalf of their customers.

3.Acting as executor, administrator and trustee: An executor is a person appointed by a testator by a will to execute his will. When no will is prepared by the testator or when no executor is named in the will or when the executor named in the will is not available or willing to act as such, the court appoints a person called as administrator A trustee is a person who is entrusted with some property by the settler of the trust for the benefit of another person called the beneficiary. A modern bank serves as a trustee of its customer.

4.Acting as attorney: An attorney is a person appointed by another person by a power of attorney to act on his behalf. As an attorney of a customer, the banker is empowered to sign transfer forms in respect of sales and purchases of securities made by him on behalf of his customers.

5.Safe custody of valuables: There are 2 ways through which a banker ensures safety of its customer's valuables. By accepting valuable for safe custody, By hiring out safe deposit lockers to the customers.

6.Letter of credit: Letter of credit assumes great importance in international trade. Letter of credit assures payment to an exporter soon after he parts with the goods and enables the importer to make payment only after he receives the goods or the document title to goods. Thus, letters of credit facilitate foreign trade.

7.Traveler's Cheques: A traveler's cheque can be purchased by anyone, are issued indifferent denominations. No commission is charged on the sale of traveler's cheque, the purchaser has to deposit the money in the issuing bank equivalent to the amount of traveler's cheque, at the time of purchase as well as at the time of encashment he has to sign in the cheque. There is no expiry period, refundable, issued in single name only and not in joint names, clubs, Societies etc.

8.Merchant Banking: It covers a wide range of activities such as management of customers services, portfolio management, credit syndication, counseling, assisting companies in matters relating to restructuring, amalgamations, mergers and take over etc., preparation of project reports, project counseling, corporate counseling, issue management, pre-investment and feasibility.

9.Dealing in foreign exchange business: It includes, export finance, forward contract, issue of solvency certificates, banks get trade information and disseminate.

10.Leasing Finance: The banking laws (Amendment) act, enables commercial banks to carry on equipment leasing business and set up subsidiaries for carrying on such business.

11.Factoring: Factoring is a 'continuing arrangement between a financial institution say, a commercial bank (called the factor) and the business concern (called the customer) selling goods and services to trade customers in which the factor purchases the book debts of his client and immediately pay the client either the full value or a substantial part of the book debts, and thereafter collects the book debts from the debtors of the client on the due dates.

12.Tax Consultancy: Banks advices on income tax and other taxes, preparing customers annual statements, claiming allowances file appeals etc.,

13.Underwriting of securities: Every modern banker underwrite the shares and debentures of trading companies. He also underwrites the securities of government and semi government institutions.

14.Credit cards: Credit cards are issued to customers having current / saving stock. It enables a customer to purchase the goods and services upto a certain limit without making immediate payment.

15.Gift cheques: The purchaser of the cheque need not be an account holder, it has no negotiability and its payment is made only to the payee, gifted on occasions such as wedding, birthday etc.,

16.Consultancy Function: The consultancy service covers technical, financial, managerial and economic aspects. This service is provided small scale industries.

17.Teller System: Under this system, the teller is authorized to receive cash and make payments up to limited amounts without reference to the ledger balance or the specimen signature. Now it is automated teller system.

CREDIT CREATION:

Commercial banks always try to maintain their holdings of idle cash to the lowest extent possible. In their attempt to achieve this end, they unwittingly increase the total amount of money in circulation in the community. It, however, does not mean that they increase the total amount of legal tender currency which is an exclusive prerogative of the central bank.

When it is said that a banker is lending money, he is actually lending money in the deposit credit with a right to the borrower to draw cheques against it. For instance, let us take the case of a loan granted to a customer. Instead of paying away the whole loan in the form of liquid cash, the bank will place the amount to the credit of the borrower. Thus, the borrower acquires a claim against the bank, just as a sum of money deposited by him with the bank creates a claim against the bank. Assuming the borrower draws cheques in favour of other people, they pay these cheques into their own banks for collection, and their deposits go up. Here one may agree with Hartley Withers in that 'every loan creates a deposit'. Again, by purchasing securities or any other banking assets also a bank is adding to the total supply of money.

When the bank buys securities, it pays for them by its own cheque. This cheque, like a currency note issued by the central bank, is an IOU ('I Owe You') of the bank issuing it. And this is accepted by the seller of the securities because of his faith in the ability of the bank to produce cash on demand. The seller deposits this cheque in the very same bank or with any other bank where he has an account, thereby creating additional deposit money. Thus, the commercial banks as a system can and do increase the total amount of money in circulation by increasing the purchasing power of the people through the deposit money created by them.

A close analytical study of the mechanism of banking will simplify matters more. Let us take the case of a community where there is only one bank and where the people are highly banking minded so that all transactions are settled by means of cheques. Further, let us assume that total amount of legal tender currency in circulation is Rs.10,000 and the bank knows by experience that 10 per cent of its deposits as cash reserves is sufficient to meet the demands of its customers.

Since there is only one bank in the community, people will deposit all their money in this particular bank. The balance sheet of the bank would then be:

Liabilities	Rs.	Assets	Rs.
Deposits	10,000	Cash in hand	10,000

According to our assumption , the bank need maintain a cash reserve of only 10 per cent of the deposits and can safely lend the balance amount of Rs9,000 to those who are in need of funds. The bank will place this amount to the credit of the norrowers, giving them the right to operate their accountrs with cheques. Their deposits will consequently go up by this amount. The balance sheet of the bank, then, would be :

Liabilities	Rs.	Assets	Rs.
Deposits (original)	10,000	Cash in hand	10,000
Deposits (i.e. credit Balance of borrowers)	9,000	Loans to clients	9,000
	19,000		19,000

These depositions, now standing to the credit of the norrowers are, as we know, claims against the bank. As such they command a purchasing power and hence they may be considered as good as money. Suppose the norrowers draw cheques in fav our of their creditors. The payees of these cheques will not require liquid cash over the counter since they are highly banking minded, according to our supposed single bank for collection. Here what happens is merely a transfer of the credit balance of the norrowers to the credit of the accounts of the payees of their cheques. In short, although the total amount of legal tender currency in circulation is only to the order of Rs.10,000, our bank, through the process of creating additional deposit money, has brought into effective circulation an additional amount of Rs.9,000, thereby raising the total supply of money from Rs.10,000 to Rs.19,000. The power of the bank to increase the amount of money in circulation does not come to an end here. It can further increase the supply of money.

As shown in the above balance sheet, the amount of the deposits of the bank is now Rs.19000. The assumption is that the bank should maintain a cash reserve ratio of only 10 percent. To maintain this, the bank only needs to provide an additional amount of Rs.900 over and above Rs.8,100 in the vaults of the bank which it can lend without undergoing any risk. Now the balance sheet position would be.

Liabilities	Rs.	Assets	Rs.
Deposits (original)	10,000	Cash in hand	10,000
Deposits (i.e. credit Balance of borrowers)	9,000	Loans to clients	9,000
Deposits (credit balance of subsequent borrowers)	8,100		8,100
	27,100		27,100

Here the bank has to keep an additional cash reserve of Rs.810. The total cash reserves increase to Rs.2,710. Still there is a balance of loanable funds with the bank, amounting to Rs.7,290.

Thus, the bank can go on increasing the creation of additional money. However, there are questions crop up. Is it possible for the bank to increase credit without any limit? Is the power of the bank to increase the supply of deposit money unlimited? The answer is definitely in the negative.

Limitations on the Creation of Credit:

The power of commercial banks to create credit is limited mainly by the cash reserves which they have to hold against their deposits and the total amount of legal tender currency issued by the central bank. Every bank has to meet the demands of its customers to pay cash over the counter. So a working reserve of liquid cash is always necessary for a bank. Of course, if the people are highly banking minded, a lower cash reserve will be sufficient. But in the case of a community where the habits are not well developed, a higher cash reserve will be essential. In either case, a cash reserve is necessary. This acts as a brake on the power of the banks to create credit.

Commercial banks can increase the total amount of money in circulation through the process of credit creation. In the words of Sayers, 'Bankers are not merely purveyors of money, but also, in an important sense, manufacturers of money.'