UNIT – IV

BANKING

What is Commercial Bank?

A commercial bank is a kind of financial institution which carries all the operations related to deposit and withdrawal of money for the general public, providing loans for investment, etc. These banks are profit-making institutions and do business only to make a profit.

The two primary characteristics of a commercial bank are lending and borrowing. The bank receives the deposits and gives money to various projects to earn interest (profit). The rate of interest that a bank offers to the depositors are known as the borrowing rate, while the rate at which banks lends the money is called the lending rate.

Function of Commercial Bank:

The functions of commercial banks are classified into two main divisions.

(a) Primary functions –

- **Accepts deposit –** The bank takes deposits in the form of saving, current and fixed deposits. The surplus balances collected from the firm and individuals are lent to the temporary required of commercial transactions.
- **Provides Loan and Advances –** Another critical function of this bank is to offer loans and advances to the entrepreneurs and businesspeople and collect interest. For every bank, it is the primary source of making profits. In this process, a bank retains a small number of deposits as a reserve and offers (lends) the remaining amount to the borrowers in demand loans, overdraft, cash credit and short-run loans, etc.
- **Credit Cash-** When a customer is provided with credit or loan, they are not provided with liquid cash. First, a bank account is opened for the customer and then the money is transferred to the account. This process allows a bank to create money.

(b) Secondary functions –

- **Discounting bills of exchange –** It is a written agreement acknowledging the amount of money to be paid against the goods purchased at a given point of time in the future. The amount can also be cleared before the quoted time through a discounting method of a commercial bank.
- **Overdraft Facility –** It is an advance given to a customer by keeping the current account to overdraw up to the given limit.
- **Purchasing and Selling of the Securities –** The bank offers you with the facility of selling and buying the securities.
- **Locker Facilities –** Bank provides lockers facility to the customers to keep their valuable belonging or documents safely. Banks charge a minimum of an annual fee for this service.
- **Paying and Gather the Credit –** It uses different instruments like a promissory note, cheques and bill of exchange.

Types of Commercial Banks:

There are three different types of commercial banks.

- **Private Bank –** It is one type of commercial banks where private individuals and businesses own a majority of the share capital. All private banks are recorded as companies with limited liability. Such as Housing Development Finance Corporation (HDFC) Bank, Industrial Credit and Investment Corporation of India (ICICI) Bank and Yes Bank, etc.
- **Public Bank –** It is that type of bank that is nationalised, and the government holds a significant stake. For example, Bank of Baroda, State Bank of India (SBI), Dena Bank, Corporation Bank and Punjab National Bank.
- **Foreign Bank –** These banks are established in foreign countries and have branches in other countries. For instance, American Express Bank, Hong Kong and Shanghai Banking Corporation (HSBC), Standard & Chartered Bank and Citibank, etc.

Examples of Commercial Banks

Few examples of commercial banks in India are.

- State Bank of India (SBI)
- Housing Development Finance Corporation (HDFC) Bank
- Industrial Credit and Investment Corporation of India (ICICI) Bank
- Dena Bank
- Corporation Bank

Eight major functions of central bank in an economy are as follows:
(1) Bank of Issue, (2) Banker, Agent and Advisor to Government, (3) Custodian of Cash Reserves, (4) Custodian of Foreign Balances,

(5) Lender of Last Resort, (6) Clearing House, (7) Controller of Credit, and (8) Protection of Depositor's Interest.

Functions of Central Bank

Function 1Bank of Issue:

Central bank now-a-days has the monopoly of note-issue in every country. The currency notes printed and issued by the central bank are declared unlimited legal tender throughout the country.

The main objects of the system of currency regulation in general are to see that:

(i) People's confidence in the currency is maintained,

(ii) Its supply is adjusted to demand in the economy.

Thus, keeping in view the aims of uniformity, elasticity, safety and security, the system of note-issue has been varying from time to time.

Function 2 Banker, Agent and Adviser to the Government:

Central bank, everywhere, performs the functions of banker, agent and adviser to the government.

Function 3 # Custodian of Cash Reserves:

All commercial banks in a country keep a part of their cash balances as deposits with the central bank, may be on account of convention or legal compulsion. They draw during busy seasons and pay back during slack seasons. Part of these balances is used for clearing purposes. Other member banks look to it for guidance, help and direction in time of need.

It affects centralisation of cash reserves of the member banks. "The centralisation of cash reserves in the central bank is a source of great strength to the banking system of any country. Centralised cash reserves can at least serve as the basis of a large and more elastic credit structure than if the same amount were scattered amongst the individual banks.

It is obvious, when bank reserves are pooled in one institution which is, moreover, charged with the responsibility of safeguarding the national economic interest, such reserves can be employed to the fullest extent possible and in the most effective manner during periods of seasonal strain and in financial crises or general emergencies...the centralisation of cash reserves is conducive to economy in their use and to increased elasticity and liquidity of the banking system and of the credit structure as a whole."

Function 4 # Custodian of Foreign Balances:

Under the gold standard or when the country is on the gold standard, the management of that standard, with a view to securing stability of exchange rate, is left to the central bank.

After World War I, central banks have been keeping gold and foreign currencies as reserve note-issue and also to meet adverse balance of payment, if any, with other countries. It is the function of the central bank to maintain the exchange rate fixed by the government and manage exchange control and other restrictions imposed by the state. Thus, it becomes a custodian of nation's reserves of international currency or foreign balances.

Function 5 # Lender of Last Resort:

Central bank is the lender of last resort, for it can give cash to the member banks to strengthen their cash reserves position by rediscounting first class bills in case there is a crisis or panic which develops into 'run' on banks or when there is a seasonal strain. Member banks can also take advances on approved short-term securities from the central bank to add to their cash resources at the shortest time.

This facility of turning their assets into cash at short notice is of great use to them and promotes in the banking and credit system economy, elasticity and liquidity.

Thus, the central bank by acting as the lender of the last resort assumes the responsibility of meeting all reasonable demands for accommodation by commercial banks in times of difficulties and strains.

De Kock expresses the opinion that the lending of last resort function of the central bank imparts greater liquidity and elasticity to the entire credit structure of the country. According to Hawtrey, the essential duty of the central bank as the lender of last resort is to make good a shortage of cash among the competitive banks.

Function 6 # Clearing House:

Central bank also acts as a clearing house for the settlement of accounts of commercial banks. A clearing house is an organisation where mutual claims of banks on one another are offset, and a settlement is made by the payment of the difference. Central bank being a bankers' bank keeps the cash balances of commercial banks and as such it becomes easier for the member banks to adjust or settle their claims against one another through the central bank.

Suppose there are two banks, they draw cheques on each other. Suppose bank A has due to it Rs. 3,000 from bank B and has to pay Rs. 4,000 to B. At the clearing house, mutual claims are offset and bank A pays the balance of Rs. 1,000 to B and the account is settled. Clearing house function of the central bank leads to a good deal of economy in the use of cash and much of labour and inconvenience are avoided.

Function 7 # Controller of Credit:

The control or adjustment of credit of commercial banks by the central bank is accepted as its most important function. Commercial banks create lot of credit which sometimes results in inflation.

The expansion or contraction of currency and credit may be said to be the most important causes of business fluctuations. The need for credit control is obvious. It mainly arises from the fact that money and credit play an important role in determining the level of incomes, output and employment.

According to Dr. De Kock, "the control and adjustment of credit is accepted by most economists and bankers as the main function of a central bank. It is the function which embraces the most important questions of central banking policy and the one through which practically all other functions are united and made to serve a common purpose."

Thus, the control which the central bank exercises over commercial banks as regards their deposits, is called controller of credit.

Function 8 # Protection of Depositors Interests:

The central bank has to supervise the functioning of commercial banks so as to protect the interest of the depositors and ensure development of banking on sound lines.

The business of banking has, therefore, been recognized as a public service necessitating legislative safeguards to prevent bank failures.

Legislation is enacted to enable the central bank to inspect commercial banks in order to maintain a sound banking system, comprising strong individual units with adequate financial resources operating under proper management in conformity with the banking laws and regulations and public and national interests.

Functions of Reserve Bank

1. Issue of Notes —The Reserve Bank has a monopoly for printing the currency notes in the country. It has the sole right to issue currency notes of various denominations except one rupee note (which is issued by the Ministry of Finance).

The Reserve Bank has adopted the Minimum Reserve System for issuing/printing the currency notes. *Since 1957, it maintains gold and foreign exchange reserves of Rs. 200 Cr. of which at least Rs. 115 cr. should be in gold and remaining in the foreign currencies.*

2. Banker to the Government–The second important function of the Reserve Bank is to act as the Banker, Agent and Adviser to the Government of India and states. It performs

all the banking functions of the State and Central Government and it also tenders useful advice to the government on matters related to economic and monetary policy. It also manages the public debt of the government.

3. Banker's Bank:- The Reserve Bank performs the same functions for the other commercial banks as the other banks ordinarily perform for their customers. RBI lends money to all the commercial banks of the country.

Structure of Banking Sector in India

4. Controller of the Credit:- The RBI undertakes the responsibility of controlling credit created by commercial banks. RBI uses two methods to control the extra flow of money in the economy. These methods are quantitative and qualitative techniques to control and regulate the credit flow in the country. When RBI observes that the economy has sufficient money supply and it may cause an inflationary situation in the country then it squeezes the money supply through its tight monetary policy and vice versa.

Where do Printing of Security Papers, Notes and Minting take Place in India?

5. Custodian of Foreign Reserves:-For the purpose of keeping the foreign exchange rates stable, the Reserve Bank buys and sells foreign currencies and also protects the country's foreign exchange funds. RBI sells the foreign currency in the foreign exchange market when its supply decreases in the economy and vice-versa. Currently, India has a Foreign Exchange Reserve of around US$ 487 bn.

6. Other Functions:-The Reserve Bank performs a number of other developmental works. These works include the function of clearinghouse arranging credit for agriculture (which has been transferred to NABARD) collecting and publishing the economic data, buying and selling of Government securities (gilt edge, treasury bills etc)and trade bills, giving loans to the Government buying and selling of valuable commodities etc. It also acts as *the representative of the Government in the International Monetary Fund (I.M.F.) and represents the membership of India.*

Credit Control Instruments used by RBI

1. The Bank Rate Policy:

From the very inception of the Reserve Bank of India (1935) until November 1951, the bank rate was kept unchanged at 3 p.c.

However, since then, it has been raised from time to time. Bank rate remained virtually inoperative between 1981 and 1991 as the RBI pegged it at 10 p.c. for the period 1981-91.

It was raised to 11 p.c. on 3 July, 1991 and to 12 p.c. on October 1991 for curbing money supply and reducing liquidity, credit and hence aggregate demand.

Reliance on bank rate on the part of the RBI has been greatly reduced. In the early months of 1997, we found stringent monetary growth as well as some sort of 'recession' in industries. Seeing this, the RBI in June 1997 lowered down the bank rate from 12 p.c. to 10 p.c. in two stages. Again, in April 1998, bank rate was slashed to 9 p.c., 8 p.c. in March 1999 and 7 p.c. in April 2000. It was raised to 7.50 p.c. in February 2001.

As some sort of price stability was achieved, the RBI kept on reducing the bank rate from time to since 2001. Bank rate was lowered down to 6 p.c. in April 2003. However, from 2003 to the present time (i.e., January 2009), bank rate has been kept unchanged at 6 p.c.

In fact, the RBI has been emphasising less on the bank rate and putting greater reliance on repo rate and reverse repo rate. Repo rate is the rate at which commercial banks take loans from the RBI by depositing securities while reverse repo rate is the rate at which the RBI sells securities to the commercial banks. Increase in repo rate means control over the money supply.

In November 2006, repo rate was raised to 7.25 p.c. and to 7.75 p.c. in October 2007 which the aim of reducing liquidity of cash so that current inflationary tendencies can be curbed. In April 2008, both repo rate and reverse repo rate have been kept unchanged at 7.75 p.c. and 6 p.c., respectively.

The second quarter of the current fiscal year 2008-2009 saw an ugly head of high dose of inflation with the record rise in prices of crude oil ($ 147 per barrel), global rise in the prices of foodgrains. Indian economy witnessed an inflation rate of nearly 13 p.c. in September 2008. The RBI had to intervene in the money market to curb excess liquidity. It then raised repo rate to 8.5 p.c. in June 2008 and to 9 p.c. in September 2008. Reverse repo rate had, however, been kept at 6 p.c.

Against the backdrop of recessionary tendencies developed in the banking industry, share market, etc. in mid-October 2008, the RBI cut the repo rate to 8 p.c. on 20 October 2008. As these measures were considered to be inadequate against the growing economic meltdown in India, the RBI kept on lowering repo rate to 6.5 p.c. in December 2008 and again slashed to 5.5 p.c. on 2 January 2009. Likewise, reverse repo rate was reduced from 6 p.c. in October 2008 to 5 p.c. in December 2008 and again to 4 p.c. in 17 January 2009.

2. Open Market Operations (OMOs):

The RBI Act has empowered the Bank to buy and sell government securities, treasury bills, other approved securities and short-term commercial bills. But this provision has served very little purpose, largely due to the absence of a organised bill market in the country. Moreover, the bulk of government securities in India are held by institutional investors, notably commercial banks and insurance companies.

Consequently, dealings of the RBI in regard to open market operations are largely confined to them. However, the RBI has not been using it as an anti-inflationary weapon. After economic reforms the RBI has been widely undertaking switch operations purchase of one loan against sale of another.

This means this instrument has been reactivated by the RBI. Active use of OMO was made in 1993-95 to curb inflationary tendencies. The RBI has had to divest government securities from its portfolio through the OMO.

3. Cash Reserve Ratio (CRR):

This is a very important and effective instrument of credit control. The RBI used this instrument for the first time in 1960 when there was a sharp increase in commodity prices.

This technique of credit control has been used very frequently in recent years with a view to stabilising prices. It was raised to 5 p.c. in June 1970. Since this measure had failed to yield necessary results, the cash reserve ratio was raised again to 7 p.c. in September 1973.

Due to huge growth of liquidity in the economy over time, this ratio was raised from time to time. Following the recommendations of the Narasimham Committee, the Government has decided to reduce CRR to a level below 10 p.c. over a four-year period. By January 1997, CRR had been lowered down to 10 p.c. as suggested by the Narasimham Committee. The CRR was reduced further from 10 p.c. to 9.5 p.c. in November 1997, and again raised to 11 p.c. in August 1998 to reduce liquidity.

Since then the RBI has been reducing it regularly as soon as stability in price level was reached. It was lowered down to 4.50 p.c. in 2002-03 and again raised to 5.50 p.c. in January 2007 with the increase in oil price and low rainfall.

Since then, we have been seeing a rise in the CRR almost regularly witnessing a high price rise. CRR had been raised to 8 p.c. in May 2008 and again to 8.25 p.c. in May 2008, with no sign of drop in inflationary situation. In order to control excess liquidity, the RBI raised CRR to 8.75 p.c. in July 2008 and to 9 p.c. in September 2008 so as to check a high inflation rate of almost 13 p.c.

Meanwhile, in September-end 2008, the US economy plunged into deep recession, although its signs were visible at least since March-April 2008. Its impacts were felt by the major economies of the world in late September and early October. Several drastic measures had been taken by the US Government and many other Governments of Europe, China, Japan, etc. for concerted action. Indian share market witnessed also such cataclysm. Share prices plummeted down to an abnormally low level, thereby threatening the morale of investors.

It had been estimated by the RBI that the banking industry was starving of liquidity to the tune of at least Rs. 90,000 crore. To prevent further erosion of confidence amongst investors and the banking industry, the RBI decided immediately and that too without hesitation to take immediate measures to come out of the crisis. It employed the most "directest" method of credit instrument to inject more liquidity in the banking industry and mutual funds.

First, it lowered down CRR from 9 p.c. to 8.50 p.c. on October 6 and to 7.50 p.c. on October 10 so as to infuse liquidity of Rs. 60,000 crore in banks. However, as the downhill in share market could not be prevented on desired direction, further cut in CRR to 7 p.c. was made on October 14 to provide additional money of Rs. 40,000 crore in the banking industry.

The RBI had injected Rs. 1,25,000 crore in the economy but it had failed to check the exit of foreign institutional investors from the stock market resulting in a drop in Sensex below 10,000 mark on 17 October 2008. Meanwhile, recessionaries tendencies deepened further.

To inject more liquidity, the RBI cut the CRR to 5.5 p.c. in November 2008 and to 5 p.c. in January 2009. We will have to wait to a future date to get the desired results. However, only one good thing that is visible is that the inflation rate has been showing some sort of decelerating trend. It came to down to less than 6 p.c. on end January 2009.

4. Statutory Liquidity Ratio (SLR):

Apart from cash reserve requirements (CRR) that all commercial banks have to meet with the RBI, the Banking Regulation Act of 1949 says that the banks are under obligation to invest a certain amount of gold and unencumbered government and other approved securities as secondary reserve. This is called the SLR.

However, since 1970, the RBI has been raising it gradually and banks are complying with it. It was raised to 38.5 p.c. in April 1990. The motive behind raising SLR over the past several years was the desire to mobilise even larger resources through the so-called market borrowings in support of Central and State budgets.

Following the recommendations of the Narasimham Committee, SLR had been lowered down to the floor of 25 p.c. (October 1997). Consequent upon the amendment of the Banking Regulation Act in 2007, the statutory floor of 25 p.c. has been removed and the RBI has been provided the discretion to prescribe the SLR at a lower level. Accordingly, since 1 November 2008, the SLR stands reduced to 24 p.c.

5. Selective Credit Control (SCC):

The RBI has used this method for regulating the flow of credit of specific branches of economic activity and thus check the misuse of borrowing facilities.

Commercial banks have been prohibited from extending credit for speculative hoarding of such commodities by traders. This is the main thrust of selective controls.

SCC was first introduced in early 1956 as part of the RBI's policy of 'controlled expansion'. Usually, the following commodities are covered by the SCC: foodgrains, major oil seeds and vegetable oils, cotton and kapas, sugar, gur and khandsari, cotton textiles, including cotton yarn, manmade fibres and yarn, and fabrics made out of manmade fibres (including stock-in-process)'.

There has been no change in the selective credit controls imposed by the RBI against price-sensitive essential commodities in 1994- 95. During April 1996, there was an across- the-board liberalisation of selective credit controls on bank advances against some price- sensitive essential goods.

One form of selective credit control introduced in 1965 was the Credit Authorisation Scheme. With the aim of liberating and deregulating the financial system, the RBI abolished this scheme in 1998. The RBI no longer relies on this technique of credit control.