CHAPTER THREE
Commercial Banking
Functions of commercial banking

Commercial banks have to perform a variety of functions which are common to both developed and developing countries. These are known as **'General Banking'** functions of the commercial banks. The modern banks perform a variety of functions. These can be broadly divided into two categories: (a) Primary functions and (b) Secondary functions.

A. Primary Functions

Primary banking functions of the commercial banks include:

1. Acceptance of deposits
2. Advancing loans
3. Creation of credit
4. Clearing of cheques
5. Financing foreign trade
6. Remittance of funds

1. **Acceptance of Deposits:** Accepting deposits is the primary function of a commercial bank mobilise savings of the household sector. Banks generally accept three types of deposits viz., (a) Current Deposits (b) Savings Deposits, and (c) Fixed Deposits.

(a) ***Current Deposits:*** These deposits are also known as demand deposits. These deposits can be withdrawn at any time. Generally, no interest is allowed on current deposits, and in case, the customer is required to leave a minimum balance undrawn with the bank. Cheques are used to withdraw the amount. These deposits are kept by businessmen and industrialists who receive and make large payments through banks. The bank levies certain incidental charges on the customer for the services rendered by it.

(b) ***Savings Deposits:*** This is meant mainly for professional men and middle class people to help them deposit their small savings. It can be opened without any introduction. Money can be deposited at any time but the maximum cannot go beyond a certain limit.

There is a restriction on the amount that can be withdrawn at a particular time or during a week. If the customer wishes to withdraw more than the specified amount at any one time, he has to give prior notice. Interest is allowed on the credit balance of this account. This system greatly encourages the habit of thrift or savings.

(c) *Fixed Deposits:* These deposits are also known as time deposits. These deposits cannot be withdrawn before the expiry of the period for which they are deposited or without giving a prior notice for withdrawal. If the depositor is in need of money, he has to borrow on the security of this account and pay a slightly higher rate of interest to the bank. They are attracted by the payment of interest which is usually higher for longer period. Fixed deposits are liked by depositors both for their safety and as well as for their interest.

2. Advancing Loans: The second primary function of a commercial bank is to make loans and advances to all types of persons, particularly to businessmen and entrepreneurs. Loans are made against personal security, gold and silver, stocks of goods and other assets. The most common way of lending is by:

(a) ***Overdraft Facilities:*** In this case, the depositor in a current account is allowed to draw over and above his account up to a previously agreed limit. The bank allows the customer to overdraw his account through cheques. The bank, however, charges interest only on the amount overdrawn from the account.

(b) ***Cash Credit:*** Under this account, the bank gives loans to the borrowers against certain security. But the entire loan is not given at one particular time, instead the amount is credited into his account in the bank; but under emergency cash will be given. The borrower is required to pay interest only on the amount of credit availed to him. He will be allowed to withdraw small sums of money according to his requirements through cheques, but he cannot exceed the credit limit allowed to him. Besides, the bank can also give specified loan to a person, for a firm against some collateral security. The bank can recall such loans at its option.

(c) ***Discounting Bills of Exchange:*** This is another type of lending which is very popular

After deducting its commission, the bank pays the present price of the bill to the holder. Such bills form good investment for a bank. They provide a very liquid asset which can be quickly turned into cash. The commercial banks can rediscount the discounted bills with the central banks when they are in need of money. These bills are safe and secured bills. When the bill matures the bank can secure its payment from the party which had accepted the bill.

(d) ***Money at Call:*** Bank also grant loans for a very short period, generally not exceeding 7 days to the borrowers, usually dealers or brokers in stock exchange markets against collateral securities like stock or equity shares, debentures, etc., offered by them. Such advances are repayable immediately at short notice hence; they are described as money at call or call money..

(e) ***Term Loans:*** Banks give term loans to traders, industrialists and now to agriculturists also against some collateral securities. Term loans are so-called because their maturity period varies between 1 to 10 years. Term loans;as such provide intermediate or working capital funds to the borrowers. Sometimes, two or more banks may jointly provide large term loans to the borrower against a common security. Such loans are called ***participation loans or consortium finance.***

(f) ***Consumer Credit:*** Banks also grant credit to households in a limited amount to buy some durable consumer goods such as television sets, refrigerators, etc., or to meet some personal needs like payment of hospital bills etc. Such consumer credit is made in a lump sum and is repayable in instalments in a short time.

(g) ***Miscellaneous Advances****:* Among other forms of bank advances there are packing credits given to exporters for a short duration, export bills purchased/discounted, import finance-advances against import bills, finance to the self-employed, credit to the public sector, and credit to the cooperative sector and above all, credit to the weaker sections of the community at concessional rates.

3. **Creation of Credit:** A unique function of the bank is to create credit. Banks supply money to traders and manufacturers. They also create or manufacture money. Bank deposits are regarded as money. They are as good as cash. The reason is they can be used for the purchase of goods and services and also in payment of debts. When a bank grants a loan to its customer, it does not pay cash. It simply credits the account of the borrower. He can withdraw the amount whenever he wants by a cheque. In this case, bank has created a deposit without receiving cash. That is, banks are said to have created credit. Sayers says “banks are not merely purveyors of money, but also in an important sense, manufacturers of money.”

4. **Promote the Use of Cheques:** The commercial banks render an important service by providing to their customers a cheap medium of exchange like cheques. It is found much more convenient to settle debts through cheques rather than through the use of cash.

   The cheque is the most developed type of credit instrument in the money market.

5. **Financing Internal and Foreign Trade:** The bank finances internal and foreign trade through discounting of exchange bills. Sometimes, the bank gives short-term loans to traders on the security of commercial papers. This discounting business greatly facilitates the movement of internal and external trade.

6. **Remittance of Funds:** Commercial banks, on account of their network of branches throughout the country, also provide facilities to remit funds from one place to another for their customers by issuing bank drafts, mail transfers or telegraphic transfers on nominal commission charges. As compared to the postal money orders or other instruments, bank drafts have proved to be a much cheaper mode of transferring money and have helped the business community considerably.

B. Secondary Functions

Secondary banking functions of the commercial banks include:

1. Agency Services
2. General Utility Services

These are discussed below.

1. **Agency Services:** Banks also perform certain agency functions for and on behalf of their customers. The agency services are of immense value to the people at large.

   The various agency services rendered by banks are as follows:

(a) ***Collection and Payment of Credit Instruments:*** Banks collect and pay various credit instruments like cheques, bills of exchange, promissory notes etc., on behalf of their customers.

(b) ***Purchase and Sale of Securities:*** Banks purchase and sell various securities like shares, stocks, bonds, debentures on behalf of their customers.

(c) ***Collection of Dividends on Shares:*** Banks collect dividends and interest on shares and debentures of their customers and credit them to their accounts.

d) ***Acts as Correspondent****:* Sometimes banks act as representative and correspondents of their customers.

They get passports, traveller's tickets and even secure air and sea passages for their customers.

(e) ***Income-tax Consultancy:*** Banks may also employ income tax experts to prepare income tax returns for their customers and to help them to get refund of income tax.

(f) ***Execution of Standing Orders:*** Banks execute the standing instructions of their customers for making various periodic payments. They pay subscriptions, rents, insurance premium etc., on behalf of their customers.

(g) ***Acts as Trustee and Executor:*** Banks preserve the 'Wills' of their customers and execute them after their death.

2. **General Utility Services:** In addition to agency services, the modern banks provide many general

(a) Safe custody boxes: Bank provides locker facility to their customers. The customers can keep their valuables, such as gold and silver ornaments, important documents; shares and debentures in these lockers for safe custody.

(b) *Traveller's Cheques and Credit Cards:* Banks issue traveller's cheques to help their customers to travel without the fear of theft or loss of money. With this facility, the customers need not take the risk of carrying cash with them during their travels.

(c) *Letter of Credit:* Letters of credit are issued by the banks to their customers certifying their credit worthiness. Letters of credit are very useful in foreign trade.

(d) *Collection of Statistics:* Banks collect

(g) ***Gift Cheques:*** Some banks issue cheques of various denominations to be used on auspicious occasions.

(h) ***Accepting Bills of Exchange on Behalf of Customers:*** Sometimes, banks accept bills of exchange, internal as well as foreign, on behalf of their customers. It enables customers to import goods.

(i) ***Merchant Banking:*** Some commercial banks have opened merchant banking divisions to provide merchant banking services.

Balance Sheet of a Bank

The balance sheet of a commercial bank is a statement of its **assets and liabilities**. Assets are what others owe the bank, and what the bank owes others constitutes its liabilities. The business of a bank is reflected in its

balance sheet and hence its financial position as well. The balance sheet is issued usually at the end of every financial year of the bank.

The balance sheet of the bank comprises of two sides; the assets side and the liabilities side. It is customary to record liabilities on the left side and assets on the right side. The following is the proforma of a balance sheet of the bank.

Balance Sheet of the Bank

ASSETS	LIABILITIES
1. Cash a. Cash on hand b. Cash with central bank and other banks 3. Money at call and short notice 4. Bills discounted 5. Bills for collection 6. Investments 7. Loans and advances 8. Acceptances and endorsement 9. Fixed assets	1. Capital a. Authorized capital b. Issued capital c. Subscribed capital d. Paid-up-capital 2. Reserve fund 3. Deposits 4. Borrowings from other banks 5. Bills payable 6. Acceptances and endorsements 7. Contingent liabilities 8. Profit and loss account 9.Bills for collection

Liabilities

Liabilities are those items on account of which the bank is liable to pay others. They denote other's claims on the bank. Now we have to analyze the various items on the liabilities side.

1. **Capital:** The bank has to raise capital before commencing its business. Authorized capital is the maximum capital up to which the bank is empowered to raise capital by the Memorandum of Association. Generally, the entire authorized capital is not raised from the public. That part of authorized capital which is issued in the form of shares for public subscription is called the **issued capital**. Subscribed capital represents that part of issued capital which is actually subscribed by the public. Finally, paid-up capital is that part of the subscribed capital which the subscribers are actually called upon to pay.

2. **Reserve Fund:** Reserve fund is the accumulated undistributed profits of the bank. The bank maintains reserve fund to tide over any crisis. But, it belongs to the shareholders and hence a liability on the bank. In India, the commercial bank is required by law to transfer 20 per cent of its annual profits to the Reserve fund.
3. **Deposits:** The deposits of the public like demand deposits, savings deposits and fixed deposits constitute an important item on the liabilities side of the balance sheet. The success of any banking business depends to a large extent upon the degree of confidence it can instill in the minds of the depositors. The bank can never afford to forget the claims of the depositors. Hence, the bank should always have enough cash to honor the obligations of the depositors.
4. **Borrowings from Other Banks:** Under this head, the bank shows those loans it has taken from other banks. The bank takes loans from other banks, especially the central bank, in certain extraordinary circumstances.

5. **Bills Payable:** These include the unpaid bank drafts and telegraphic transfers issued by the bank. These drafts and telegraphic transfers are paid to the holders thereof by the bank's branches, agents and correspondents who are reimbursed by the bank.
6. **Acceptances and Endorsements:** This item appears as a contra item on both the sides of the balance sheet. It represents the liability of the bank in respect of bills accepted or endorsed on behalf of its customers and also letters of credit issued and guarantees given on their behalf. For rendering this service, a commission is charged and the customers to whom this service is extended are liable to the bank for full payment of the bills. Hence, this item is shown on both sides of the balance sheet.
7. **Contingent Liabilities:** Contingent liabilities comprise of those liabilities which are not known in advance and are unforeseeable. Every bank makes some provision for contingent liabilities.

8. **Profit and Loss Account:** The profit earned by the bank in the course of the year is shown under this head. Since the profit is payable to the shareholders it represents a liability on the bank.
9. **Bills for Collection:** This item also appears on both the sides of the balance sheet. It consists of drafts and hundies drawn by sellers of goods on their customers and are sent to the bank for collection, against delivery documents like railway receipt, bill of lading, etc., attached thereto. All such bills in hand at the date of the balance sheet are shown on both the sides of the balance sheet because they form an asset of the bank, since the bank will receive payment in due course, it is also a liability because the bank will have to account for them to its customers.

Assets

According to Crowther, the assets side of the balance sheet is more complicated and interesting. Assets are the claims of the bank on others. In the distribution of its assets, the bank is governed by certain well defined principles. These principles constitute the principles of the investment policy of the bank or the principles underlying the distribution of the assets of the bank. The most important guiding principles of the distribution of assets of the bank are liquidity, profitability and safety or security. In fact, the various items on the assets side are distributed according to the descending order of liquidity and the ascending order of profitability. Now, we have to analyze the various items on the assets side.

1. **Cash:** Here we can distinguish cash on hand from cash with central bank and other banks cash on hand refers to cash in the vaults of the bank. It constitutes the most liquid asset which can be immediately used to meet the obligations of the depositors. Cash on hand is called the first line of defense to the bank.

   In addition to cash on hand, the bank also keeps some money with the central bank or other commercial banks. This represents the second line of defense to the bank.

2. **Money at Call and Short Notice:** Money at call and short notice includes loans to the brokers in the stock market, dealers in the discount market and to other banks. These loans could be quickly converted into cash and without loss, as

income to the bank. The significance of money at call and short notice is that it is used by the banks to effect desirable adjustments in the balance sheet. This process is called 'Window Dressing'. This item constitutes the 'third line of defense' to the bank.

3. **Bills Discounted:** The commercial banks invest in short term bills consisting of bills of exchange and treasury bills which are self-liquidating in character. These short term bills are highly negotiable and they satisfy the twin objectives of liquidity and profitability. If a commercial bank requires additional funds, it can easily rediscount the bills in the bill market and it can also rediscount the bills with the central bank.
4. **Bills for Collection:** As mentioned earlier, this item appears on both sides of the balance sheet.

5. **Investments:** This item includes the total amount of the profit yielding assets of the bank. The bank invests a part of its funds in government and non-government securities.
6. **Loans and Advances:** Loans and advances constitute the most profitable asset to the bank. The very survival of the bank depends upon the extent of income it can earn by advancing loans. But, this item is the least liquid asset as well. The bank earns quite a sizeable interest from the loans and advances it gives to the private individuals and commercial firms.
7. **Acceptances and Endorsements:** As discussed earlier, this item appears as a contra item on both sides of the balance sheet.

8. **Fixed Assets:** Fixed assets include building, furniture and other property owned by the bank. This item includes the total volume of the movable and immovable property of the bank. Fixed assets are referred to as ‘dead stocks’. The bank generally undervalues this item deliberately in the balance sheet. The intention here is to build up secret reserves which can be used at times of crisis.

Balance sheet of a bank acts as a mirror of its policies, operations and achievements. The liabilities indicate the sources of its funds; the assets are the various kinds of debts incurred by a bank to its customers. Thus, the balance sheet is a complete picture of the size and nature of operations of a bank.