

Economics-1
BALLB-207

Unit 4:
Commercial banks

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The initiation of the banking system: Goldsmiths

- The earliest banks were run by goldsmiths who used to offer receipts equal to the value of the gold in return for actual gold deposits. People deposited the gold with the goldsmith to keep it safe.
- Gradually they realized that most people don’t withdraw their gold under normal circumstances, so they could lend additional gold receipts to people who require a loan.
- For example, if a goldsmith has 100 pounds of gold deposited with him, he has already issued receipts worth 100 pounds. Since most of the gold is not withdrawn, the goldsmith may issue loan receipts worth another 20 pounds of gold.
- However, in extreme circumstances, many depositors may withdraw the gold, in which case the goldsmith may not have enough gold to pay back everyone. This is similar to banks runs occurring these days.

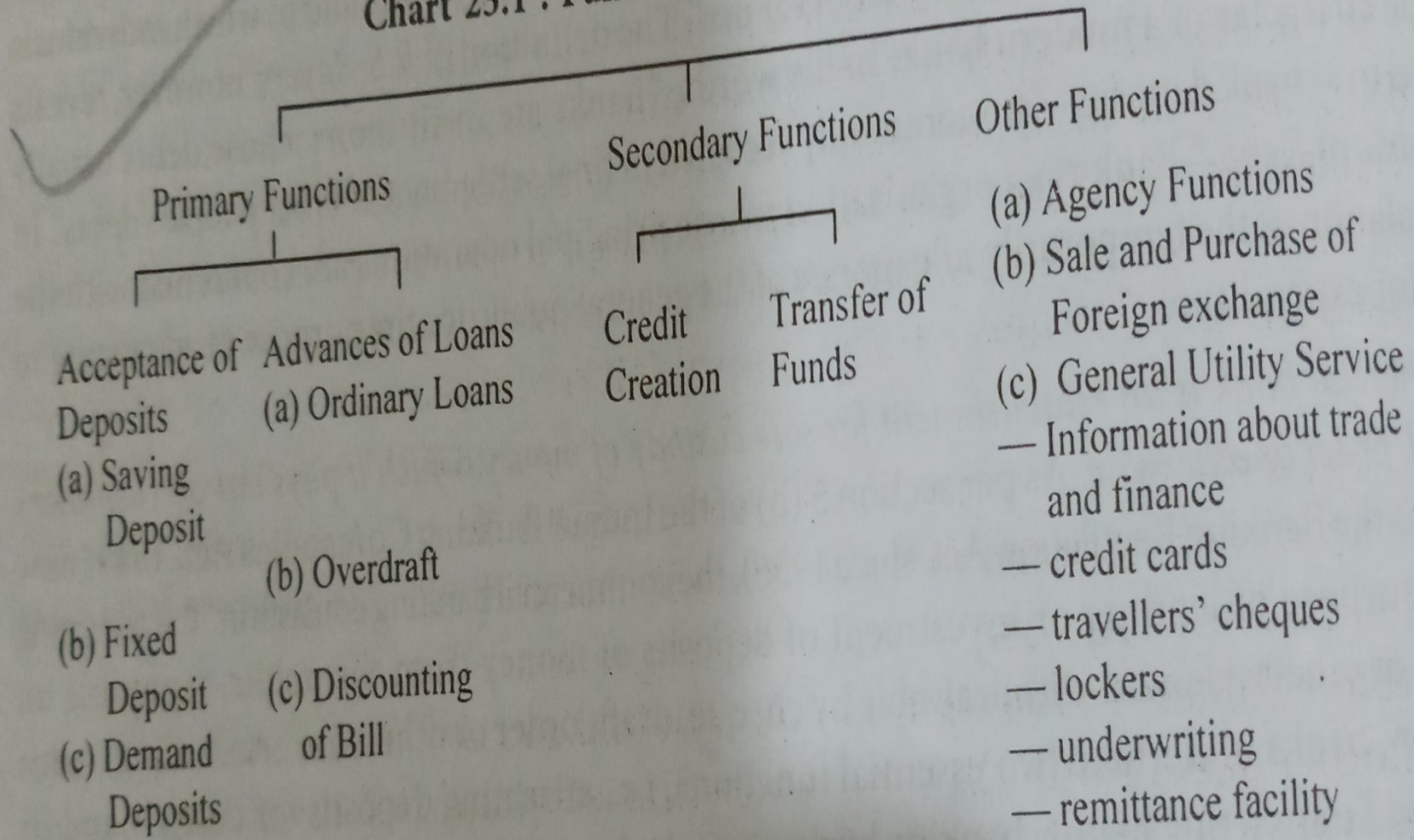
Commercial banks and other financial institutions

- A commercial bank is an establishment for safe custody of money, which pays it out on customer’s demand, order or otherwise.
- While commercial banks keep demand deposits, other financial institutions allow withdrawal at maturity only.
- Commercial banks lend for a variety of purposes while financial institutions have specific purposes of lending. E.g. NABARD lends for agricultural operations, IFCI focuses on

bank earns pro

of other functions. All these functions (Chart

Chart 23.1 : Functions of Commercial Bank



Primary functions

- **Acceptance of deposits:** The commercial banks accept deposits from individuals, firms, and other institutions, which mobilizes funds for production. The forms in which commercial banks accept deposits are as follows:
  - **Savings deposits:** These are the most liquid form of deposits made by individuals with excess cash who are reluctant to take any risks. Money in savings deposits may withdrawn through checks or transfers. Any amount may be deposited, but there are limits imposed on the amount withdrawn, except under exceptional circumstances.
  - **Fixed/term/time deposits:** Money in fixed deposits is locked in for a period of time, and may be withdrawn upon maturity. In case of an emergency, money may be withdrawn before maturity, after foregoing the interest for that time period. Fixed deposits are more attractive as they pay a higher interest rates, but are less liquid than savings deposits.
  - **Demand deposits:** Deposits in the current account are called demand deposits as they are repayable on demand, and any amount can be withdrawn without any limit on the amount withdrawn. These deposits are mostly used by firms which cannot afford to keep their money locked in for a certain period.

Primary functions

- **Advancing of loans:** Banks give loans to those who need money for consumption or investment purposes. Earlier, bank lending was restricted to short durations, but eventually banks realized that they could lend in excess of their deposits to long term investment purposes. The mains ways of lending are:
  - **Ordinary loans**: These are loans given against easily marketable tangible securities, and the loan amount is deposited in the accounts of the borrowers. The interest is charged on the full amount of the loan.
  - **Overdraft:** These are the loans given to customers who hold a current account with the bank. They may issue cheques in excess of their balance in accounts, and this facility is given to some reliable depositors. The interest is charged on the excess amount overdrawn.
  - **Discounting bills**: Banks may also lend by discounting bills prior to maturity of exchange after charging the interest for the period and the cost of collection.

Secondary and other functions

- **Secondary functions:**
  - **Credit creation:** Since banks lend more than their deposits, they can create credit in the economy, which enables the money market to function.
  - **Transfer of funds**: Banks enable transfer of funds through cheques, demand drafts, pay order etc. This helps in trade and commerce.
- **Other functions**:
  - **Agency functions**: Banks make and receive payments of insurance, drafts, bills, etc. they also gold, silver, and other securities on behalf of their customers.
  - **Sale and purchase of foreign exchange**
  - **General utility services:** These include provision of information on trade and finance, issue of credit cards,

Role and importance of commercial banks

- Promotion of capital formation
- Provision of finance and credit
- Developing entrepreneurship
- Providing elasticity of supply of money
- Distribution of funds between regions

Balance sheet of a commercial bank

- The balance sheet/position statement of a bank is a statement of its assets and liabilities at any point of time.
- All banks in India are supposed to prepare their balance sheets in accordance with the Indian Banking Regulation Act, 1949.
- The balance sheet comprises of two columns:
  - **Assets**: It includes different types of possessions of the bank and imply debt incurred by the bank to its customers.
  - **Liabilities**: Claims against different types of assets of the bank. These represent amounts due from the banks to the shareholders, depositors, and others.

Assets of a commercial bank

- Cash
- Money at call and short notice
- Bills discounted
- Loans and advances
- Investments
- Bills receivable
- Acceptance, endorsements, etc.
- Premises, furniture, and other assets
- Non banking assets

Liabilities of a commercial bank

- Capital
- Reserve funds
- Deposits
- Borrowings from other sources
- Bills payable
- Bills for collection, acceptance, endorsements etc.
- Contingent liabilities
- Profit or loss

Liquidity of a commercial bank

- Liquidity of the bank refers to its ability to convert its assets into cash upon requirement.
- The presence of a high cash reserve means that the bank has high liquidity, but it is an unprofitable asset.
- The rate at which the bank can borrow also determines its liquidity position.
- A bank faces market risk (increase in interest rate) as well as default risk.
- When the cost of borrowing is high or there is high risk, the bank will keep greater liquidity.
- Banks should be careful about the availability of liquid assets and

Profitability of a commercial bank

- Banks lend to borrowers at an interest rate much higher than that required to pay back its depositors. This difference between the value of deposits and loans of banks comprises of its profits.
- Banks are guided by profit motive while distributing its funds in various assets.
- If the bank invests in safest assets, it will lose the high interests on other assets.
- However, assets that give high interest to banks may be

Investment of funds

- Banks have to make a trade off between liquidity and profitability while making investment decisions. The different types of assets for investment include:
  - **Cash (primary reserves):** It is the most liquid asset but it does not bring any profits to the bank to pay its shareholders. Usually banks only keep about 10% of their assets in cash reserves, but it varies depending on the following factors:
    - Nature of business and business conditions
    - Nature of banking structure of the country
    - Banking habits of people
    - Number and magnitude of transactions
    - Nature of deposits

Investment of funds

- **Money at call and short notice:** High liquidity and low profitability. Also called secondary reserves.
- **Discounting of bill:** Sufficient liquidity and profitability. They acquired for a short period (90 days) and are easily marketable, also called self liquidating bills. The bills of exchange include treasury bills and promissory notes issued by government, and are quite safe.
- **Loans and advances:** They are less liquid and risky, but are profitable due to high interest rates charged.
- **Investments:** These are least liquid but highly profitable. Banks don’t prefer highly risky shares of