CHAPTER FIVE

COMMERCIAL BANK

Introduction

Historically, commercial bank came into being for its commercial purpose. The inception of modern banking is the outcome of commercial bank.

In the words of Professor Roger, "the bank which deals with money and money's worth with a view to earning profit is known as **``Commercial bank."**

Professor Hart says, "A banker is one who, in the ordinary course of business, honours cheques drawn upon him by persons for and for whom he receives money on current account."

The objectives of a commercial bank

A. To establish as an institution for maximizing profits and to conduct overall economic activities.
B. To collect savings or idle money from the public at a lower rate of interests and lend these public money at a higher rate of interests.
C. To create propensity of savings amongst the people.
D. To motivate people for investing money with a view to bringing solvency in them.
E. To create money against money as an alternative for enhancing supply of money.
F. To build up capital through savings.
G. To expedite investments.
H. To extend services to the customers.
I. To maintain economic stability by means of controlling money market.
J. To extend co-operation and advices to the Govt. on economic issues.

To assist the Govt. for trade& business and socio-economic development

Functions of Commercial Bank

The functions of commercial bank are given below:

A. General Functions:

1. Receiving Deposits:

The first and foremost function of commercial bank is to receive or collect deposits from the public in different forms of accounts e.g. current, savings, term deposits.

No interest is charged in the current account, lower rate of interest is charged in the savings account and comparatively higher interest rates charged in fixed deposits. Thus, commercial bank builds up customer network.

2. **Accommodation of loans and advances:**

Commercial Bank attaches much importance to providing loans and advances at higher rates than the deposit rates and thus earns profits on it. Working capital is accommodated to the borrower for expansion and smooth running of business. In the similar manner, commercial bank extends financial accommodation for the development of agriculture and industry. Credit accommodation is provided to the entrepreneurs for reviving sick and old industries as per Govt. directives. Thus, commercial bank also extends welfare services to the people at large.

3. **Creation of Loan Deposits:**

Commercial Bank not only receives deposits from public and accommodates loans to public but also creates loan deposits. For example: while disbursing loans as per sanction stipulation, the amount of loan is credited to the borrower's account. The borrower may not withdraw the full amount at a time. The residual amount i.e. balance left in the account creates loan deposits.

4. **Creation of medium of exchange:**

Central Bank has got exclusive right to issue notes. On the other hand, Commercial Bank creates medium of exchange by issuing cheques. Like notes, cheque is transferrable being popularly used in the banking transactions.

5. **Contribution in foreign trade:**

Commercial Bank plays a vital role in expediting foreign exchange and foreign trade business e.g. import, export etc. It contributes greatly in the economy through import finance and export finance and thus, earns foreign exchange for the country.

6. **Formation of capital:**

Commercial Bank extends financial assistance for the formation of capital in the trade, commerce and industry in the country which expedites its economic development.

7. **Creation of Investment Environment:**

Commercial Bank plays a significant role in creating investment environments in the country.

B. **Public Utility Functions:**

In modern banking, commercial bank executes public utility services:

1. **Remittance of Money:**

Remittance of money to the public from one place to another is one of the functions of commercial bank. Remittance is effected in the form of demand draft ,telegraphic transfer etc. through different branches and correspondents home and abroad.

2. **Help in trade and commerce:**

Commercial Bank helps expand trade and commerce. In inland and foreign trade customers are allowed credit accommodation in the form of letter of credit , bill purchased and discounted etc.

3. **Safe custody of valuables:**

Commercial Bank introduces locker‟ services to the customers for safe custody of valuables e.g. documents, shares, securities etc.

4. **Help in Foreign Exchange business:**

While opening letter of credit, commercial bank obtains credit report of the suppliers and thus help expedite import and export business.

5. **Act as a Referee:**

Commercial Bank acts as a referee for and on behalf of the customers.

6. **Act as an Adviser:**

Commercial Bank provides valuable advice to the customers on different products, business growth and development, feasibility of business and industry.

7. **Collect utility service bills:**

As a social commitment, Commercial Bank collects utility service bills e.g. water, electricity, gas, telephone etc. from the public.

8. **Purchase and sale of prize bonds, shares etc.**

Commercial Bank undertakes to purchase and sale of prize bonds, shares etc. as a part of social commitment.

9. **Help people travel abroad:**

Commercial Bank helps customers in traveling abroad through issuance of travellers cheques, drafts, cash etc. in favour of the customers.

C. Agency Functions:

Besides above stated functions, commercial bank acts as a representative of the customers.

1. **Collection and payment:**

Commercial Bank is engaged in collection and payment of cheque, bill of exchange, promissory notes, pension, dividends, subscription, insurance premium, interest etc. on behalf of the clients.

2. **Purchase and sale of shares and securities:**

Commercial Bank is entrusted with the responsibility of purchase and sale of shares and securities on behalf of the customers.

3. **Maintenance of secrecy:**

Maintenance of secrecy is one of the most important functions of commercial bank.

4. **Act as a trustee:**

Commercial Bank acts as a trustee on behalf of the customer.

5. **Economic Development and Welfare activities**:

Commercial Bank contributes much for the welfare and economic development of the country

Distinguish between Central Bank and Commercial Bank:

Central Bank and Commercial Bank are both financial institutions. But they have got distinguishing features. Central Bank is meant for national welfare and Commercial Bank is meant for earning profits. The following points of distinction between central bank and commercial bank:

NO.	. Points of distinction	Central bank	Commercial bank
	Formation	Central Bank is the sole banking Institution which is established through ordinance or special law of the Government	Commercial Bank is formed on the basis of Banking Company Laws.
	Ownership	Commercial Bank is formed on the basis of Banking Company Laws.	Commercial Bank is established under both govt. and private Ownership.
	Purpose	To earn profit is not the main purpose of central bank. Its main purpose is to control credit system and money market	The main purpose of commercial bank is to earn profit. Recovery of loan is the main stay for generation of profit
	Number	In a country there is only one Central Bank	In a country there may be more number of commercial banks.
	Control	Central bank is conducted exclusively under Government control	Commercial Bank is conducted under central bank‟s control.
	Gov't influence	Government has direct influence on Central Bank	Government has indirect influence On Commercial Bank through Central Bank
	Currency market	Central Bank organizes, controls and administers currency market	Commercial Banks are the members of the currency market
	Competition	Central Bank does not compete with other banks	Commercial Bank has to face to face lot of competition
	Representative	Central Bank represents the country or state	Commercial Bank represents the Customers
	Foreign Branch	Central Bank has no branch abroad.	Commercial Bank may have many Branches abroad

	Note issue	Note issue is the primary function of central bank.	Commercial bank cannot issue the note
	Credit control	Central Bank controls credit.	Commercial Bank assists central bank In controlling credit.
	Clearing House	Central Bank acts as a clearing house for settlement of inter-bank transactions	Commercial banks are the members of the clearing house. They settle transactions through clearing house
	Nature Of work	Central bank is not engaged in general banking activities i.e. to receive deposits, to lend, to create loan etc.	Commercial bank is engaged in receiving deposits, paying money, creating loan etc.
	Foreign Exchange	Central Bank controls foreign exchange.	Commercial bank helps central bank in controlling foreign exchange
	Investments	Central bank does not Make any investment for profitability purpose	Commercial bank makes investments in various sectors for the purpose of profitability.
	Refinance Facility	Central bank refinances commercial bank against first class securities, bill of exchange	Commercial bank takes refinance facility from the central bank
	Development work	Central Bank formulates policy on development Work	Commercial bank participates in the development program Initiated by the central bank

Credit Creation

It is an open secret that the banks do not keep cent per cent reserve against deposits in order to meet the demands of depositors. The bank is not a cloak room where you can keep your currency notes or coins and claim those very notes or coins back when you desire. It is generally understood that money received by the bank is meant to be advanced to others. A depositor has to be content simply with the bank's promise or undertaking to pay him back whenever he makes a demand.

This bank is able to do with a very small reserve, because all the depositors do not come to withdraw money simultaneously; some withdraw, while others deposit at the same time. The bank is thus enabled to erect a vast superstructure of credit on the basis of a small cash reserve. The bank is able to lend money and charge interest without parting with cash. The bank loan creates a deposit or, as we have seen above, it creates a credit for the borrower.

Similarly, the bank buys securities and pays the seller with its own cheque which again is no cash; it is just a promise to pay cash. The cheque is deposited in some bank and a deposit is created or credit is created for the seller of the securities. This is credit creation.

Thus, term 'credit creation' implies a situation, to use Benham's words, when "a bank may receive interest simply by permitting customers to overdraw their accounts or by purchasing securities and paying for them with its own cheques, thus increasing the total bank deposits."

Limitations on Credit Creation:

From the account of credit creation given above, it would seem that the banks 'reap where they have not sown'. They advance loans or buy securities without actually paying cash. But they earn interest on the loans they give, or earn dividends on the securities they purchase, all the same. This is very tempting. They make profits without investing cash. They would, of course, like to make as much profit, like this, as they can.

But they cannot go on expanding credit indefinitely. In their own interest, they have to apply the brake and they do actually apply it, for it is well known that the profits made by the banks are not very high. The overriding limitation arises from the obligation-of the banks to meet the demands of their depositors.

Balance Sheet of Banks

A **balance sheet** (aka **statement of condition**, **statement of financial position**) is a financial report that shows the value of a company's assets, liabilities, and owner's equity on a specific date, usually at the end of an accounting period, such as a quarter or a year. An **asset** is anything that can be sold for value. A **liability** is an obligation that must eventually be paid, and, hence, it is a claim on assets. The owner's equity in a bank is often referred to as **bank capital**, which is what is left when all assets have been sold and all liabilities have been paid. The relationship of the assets, liabilities, and owner's equity of a bank is shown by the following equation:

Bank Assets = Bank Liabilities + Bank Capital

A bank uses liabilities to buy assets, which earns its income. By using liabilities, such as deposits or borrowings, to finance assets, such as loans to individuals or businesses, or to buy interest earning securities, the owners of the bank can leverage their bank capital to earn much more than would otherwise be possible using only the bank's capital. Assets and liabilities are further distinguished as being either current or long-term. **Current assets** are assets expected to be sold or otherwise converted to cash within 1 year; otherwise, the assets are long-term (aka **noncurrent assets**). **Current liabilities** are expected to be paid within 1 year; otherwise, the liabilities are long-term (aka **noncurrent liabilities**). Working capital is the excess of current assets over current liabilities, a measure of its **liquidity**, meaning its ability to meet short-term liabilities:

Working Capital = Current Assets – Current Liabilities

Generally, working capital should be sufficient to meet current liabilities. However, it should not be excessive, since capital in the form of long-term assets usually has a higher return. The excess of the bank's long-term assets over its long-term liabilities is an indication of its **solvency** its ability to continue as a going concern.

Asset: uses of funds

Assets earn revenue for the bank and includes cash, securities, loans, and property and equipment that allows it to operate

Cash and cash equivalent

One of the major services of a bank is to supply cash on demand, whether it is a depositor withdrawing money or writing a check, or a bank customer drawing on a credit line. A bank also needs funds to pay bills, but while bills are predictable in both amount and timing, cash withdrawals by customers are not.

Hence, a bank must maintain a certain level of cash compared to its liabilities to maintain solvency. A bank must hold some cash as **reserves**, which is the amount of money held in a bank's account at the Federal Reserve (Fed). The Federal Reserve determines the **legal reserves** which is the minimum amount of cash that banks must hold in their accounts to ensure the safety of banks and also allows the Fed to effect monetary policy by adjusting the reserve level. Often, banks will keep **excess reserves** for greater safety.

To do business at its branches and automated teller machines (ATMs), a bank also needs **vault cash**, which includes not only cash in its vaults, but also cash elsewhere on a bank's premises, such as in teller drawers, and the cash in its ATM machines.

Some banks, usually smaller banks, also have accounts at larger banks, called **correspondent banks**. Which are usually larger banks that often borrow from the smaller banks or perform services for them? This relationship makes lending expeditious because many of these smaller banks are rural and have excess reserves whereas the larger banks in the cities usually have a deficiency of reserves.

Another source of cash is **cash in the process of collection**. When a banks receives a check, it must present the check to the bank on which it is drawn for payment, and, previously, this has taken several days. Nowadays, checks are being processed electronically and many transfers of funds are being conducted electronically instead of using checks. So this category of cash is diminishing significantly, and will probably disappear when all financial transactions finally become electronic.

Cash equivalents are another short-term asset, so-called because they are nearly equivalent to cash: short-term investments that can either be used as cash or can be quickly converted to cash without loss of value, such as demand deposits, T-bills, and commercial paper.

A primary characteristic of financial instrument that are classified as cash equivalents is that they have a short-term maturity of 3 months or less, so interest rate risk is minimal, and they are the most highly rated securities or issued by a government that can print its own money, such as the T-bill issued by the US government, so there is little credit risk.

Securities

The primary securities that banks own are united state treasury and municipal bond. These bonds can be sold quickly in the secondary market when a bank needs more cash, so they are often referred to as **secondary reserves**.

The recent credit crisis has also underscored the fact that banks held many asset backed securities as well. United States banks are not permitted to own stocks, because of their risk, but, ironically, they can hold much riskier securities called derivatives

Loans are the major asset for most banks. They earn more interest than banks have to pay on deposits, and, thus, are a major source of revenue for a bank. Often banks will sell the loans, such as mortgages, credit card and auto loan receivables to be securitized into asset-backed securities which can be sold to investors. This allows banks to make more loans while also earning origination fees and/or servicing fees on the securitized loans.

Loans include the following major types:

- Business loans, usually called commercial and industrial (C&I) loans
- Real estate loans
    - residential mortgages
    - home equity loans
    - commercial mortgages
- Consumer loans
    - credit cards
    - auto loans
- Interbank loans