M.A. (ECONOMICS) PART-II
SEMESTER-III

PAPER - ECO-304-305
(OPTION - III)

MONEY AND BANKING

Department of Distance Education
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SECTION-B

2.1. Commerical Banks-I

2.2. Commercial banks-II (Theories of Commercial Banking)

2.3. Innovations in Commerical Banking Services in India.

2.4. Demonetisation: Concept, Logic, Impact **(will be sent later)**

2.5. Non-Bank Financial Intermediaries **(will be sent later)**

M.A. (ECONOMICS) PART II **OPTION : MONEY & BANKING**
Semester-III

LESSON NO. 2.1

COMMERCIAL BANKS

WHAT IS A BANK:

Banking as an independent business originated during the 14th century in England. The business of banking in those days was conducted mainly by a class of people called "Jews" of Lombardy. These people viz. the Jews became popular in the course of time as 'Lombards' since they conducted their business in the Lombard street of England. The term bank is supposed to be derived from the Greek word 'Bancun' or 'Bancherium', both of which mean 'table' or 'bench'. The money lenders, who transacted their business on the benches in the market place, displayed their coins across benches and when a banker was unable to meet his obligations, his Bancun was broken to pieces. According to J.W. Gilbert, the term bank is synonymous to the Italian word "monte", meaning a mound or heap. Banking is, accordingly, a business which requires a heap of money. The Concise Oxford Dictionary defines a commercial bank as "an establishment for custody of money which it pays out on customer's order." This definition, though short and simple, is not fully comprehensive as it emphasizes only one aspect of banking namely, the acceptance of money for safe custody and transfer under orders from the customer. It ignores many other important functions which modern banks perform. Since a modern bank performs a number of functions, different economists have defined the term differently.

Professor R..S. Sayers in his book "Modern Banking" opines that: Banks are institutions-whose debts - usually referred to as "bank deposits" - are commonly accepted in the final settlement of the peoples' "debts", According to Geoffrey Crowther a banker is to take the debts of other people, to offer his own in exchange, and thereby to "create" money. He may be a dealer in debts, but indebtedness is an obverse of wealth, and it would be equally permissible to describe the banker as a liquifier of wealth". Professor L. Hart in his book, "Law of Banking" defines the banker as "one who, in the ordinary course of business, honours cheques drawn upon the person from whom he receives money on current account." In his book "Money & Banking", Prof. Raymond P. Kent defines the bank" "as an organisation whose principal operations are concerned with accumulation of the temporarily idle money of the general public for the purpose of advancing it to others for expenditure."

Crowther observes “the present day banker has three ancestors - merchant, money-lender and goldsmith. A modern bank is something of each of these. It is said money

has two properties. It is flat so that it can be piled up, and it is round, so that it can circulate. The progeny of the money-lender is concerned with flat money, piled up money i.e. savings. The progeny of the goldsmith is concerned with round money, circulating money i.e. cash."

After all is said and done, just as it has been chosen to define 'money is what money does', so too perhaps the best definition of a bank, or banking company or a banker is by way of reference to the functions it or he performs.

In this context, it would be best to use the definition put forward by Banking Companies Act, 1949 (now termed as Banking Regulation Act, since 1965) which defines 'banking' and 'banking company' in Section 5(b) as:

Banking means the accepting, for the purpose of lending or investment of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheques, draft order or otherwise.

It is important to note some points in this definition. These are –

(i) A bank will accept deposits of money, not goods or non-money financial assets.

(ii) The acceptance of deposits by companies for the purpose of financing their own business is not regarded as banking.

(iii) A foreign company incorporated outside India and having a place of business within India will be a banking company if it performs the functions of banking.

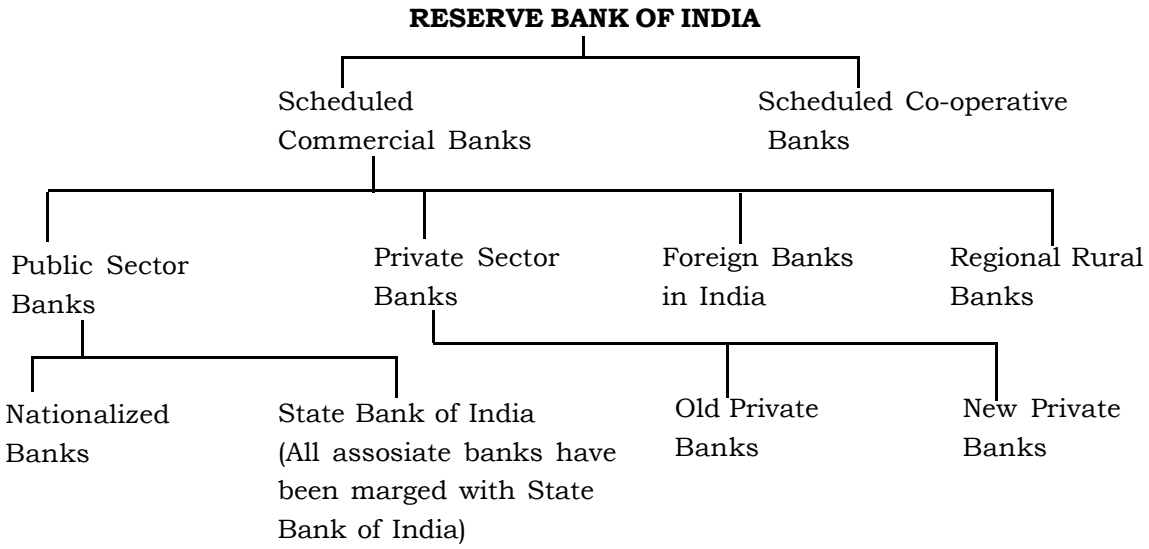
(iv) The deposits are to be accepted from the public at large, not merely from shareholders.

(v) The deposits are repayable/withdrawable.

Classification/Structure of Commercial Banks

Although banking system in India is organised as well as unorganized, we shall be focusing only on the organised system, i.e. we will not be including the indigenous banks and other private lenders in the structure of commercial banks here .

The organised banking system in India can be broadly divided into the Reserve Bank of India (which is the central bank of the country), the commercial banks, and the co-operative banks. Once again, we will leave out the co-operative banks, and concentrate only on commercial banks (as per the title of our lesson). The classification or structure of commercial banks can best be understood with the help of a chart :



Source : Adapted form Gaurav Datt and Ashwani Mahajan : Datt and Sundharam Indian Economy 63rd Revised Edition (2016) p.890.

Under the RBI Act, 1934, banks are classified as scheduled banks and non-scheduled banks.

The scheduled banks are those which are entered in the second schedule of RBI Act, 1934. These banks had to fulfill the following conditions to be classified as scheduled banks –

(i) The banker concerned must be in the business of banking in India.

(ii) It must have paid up capital and reserves of value not less than Rs. 5 lakhs.

(iii) It must satisfy the RBI that its affairs are not conducted in a manner detrimental to the interests of its depositors.

These banks come under the purview of various credit control measures of RBI. They have to maintain a minimum balance with the RBI. They are entitled to borrowing and rediscounting facilities of RBI.

The non-scheduled banks are not entitled to facilities from RBI except in abnormal conditions.

After 1969, commercial banks were broadly divided into nationalized/public sector banks and private sector banks. The State Bank of India and its seven associate banks, along with 19 other banks are public sector banks. The private sector banks include

the old as well as new banks (which came up mainly after 1991). Foreign banks in India are those banks which have their headquarters in other countries, but do banking business in India either by setting up branches, or through subsidiaries.

The main difference between State Bank of India (SBI) and nationalized banks is that while ownership of nationalized banks vests in the govt. of India, SBI is largely owned by RBI.

ECONOMIC FUNCTIONS OF COMMERCIAL BANKS

There are many kinds of banks: commercial banks, saving banks, industrial banks, agricultural banks, cooperative banks, exchange banks, central banks etc. But when we use the term bank without any prefix or qualification, it refers to commercial bank. 'The term commercial bank is a holdover from an earlier period when banks were predominantly short term financiers of lenders and merchants for goods in transit & inventories. Now when their lendings are no longer confined to short term "commercial" loans only, their name is not accurately descriptive of their nature and functions. It may rather be misleading. Today, these so-called commercial banks have diversified their activities to a point where these may be referred to as "Department Stores of Finance". They perform not just one but many types of functions, some of which are duplicated by other financial institutions.* The functions and services rendered by banks can be broadly classified under two heads:

(a) Banking functions; and

(b) Subsidiary Services

Under the former come such functions as the attraction of deposits, advancing of loans etc. Banks usually lend what is lent to them. Sometimes it so happens that they lend more than what is lent to them. Under such circumstances banks are said to "create credit." Creation of credit is another cardinal function which banks perform. They also undertake the transfer of funds from one account to another under written instances from their clients. So the modern banks are more concerned with the receipt, creation and transfer of deposits in addition to other miscellaneous services which they render to the industrial, trading and business communities.

Let us take each function and discuss it in some detail :

(a) Banking Functions :

1. Accepting of Deposits (or Bank as Borrower i.e. as collector and custodian of public savings): Banks attract deposits by mobilizing the savings of the community. The bank, to throw its net as wide as possible in order to have a rich game, has to maintain a variety of accounts that suits the needs and tastes of a large body of depositors. Generally speaking, deposits are of three types: fixed deposits, current

* We will study more about it in L. No. 11.

deposits & saving bank deposits. Fixed deposits are those deposits which are withdrawable only after a specific period. The bank allows a depositor to borrow funds against his fixed deposit as security. The longer the period of deposit, the more attractive the rate of interest. Fixed deposits are also known as time liability of the bank. Deposits accepted on current account, on the other hand, are withdrawable any time by the depositor by means of cheques. These are demand liabilities of the bank. As a rule the banks do not pay any interest on these deposits. Saving bank deposits are subject to certain restrictions on the amount so receivable or withdrawable. These deposits carry a lower rate of interest. A bank collects its funds mainly through its deposits. It pools the scattered savings of the community and thus, serves as the reservoir of the community's savings.

Thus, from the point of view of banking policy, deposits fall into two categories (i) Demand Deposits i.e. deposits repayable on demand. These include current deposits and saving deposits and (ii) Time Deposits: These have fixed maturity period and include fixed deposits, recurring deposits, deposits accepted under various schemes etc.

Banks owe the deposit amount to the depositing public. Deposits are bank's liabilities. To the extent these liabilities are demand liabilities, provision has to be made by banks to keep liquid assets with them to meet these liabilities on demand. Larger the proportion of demand liabilities, higher would be the ratio of liquid assets. Liquid assets, however, give a low return and hence bank's efforts would be to have maximum time deposits.

2. Grant of credit to all sectors of the economy (or banks as lender i.e. a dispenser of resources to the needy) : Money accumulated by the banks by accepting the deposits from the public is utilised for making advances to those who require it for productive purposes. The profit earning capacity of the bank mainly depends upon the performance of this function. This function is also important in the context of the economic development in general and the development of trade, industry and commerce in particular. Banks grant credit in the form of advances as Cash Credits, Overdrafts and Loans. While making advances, generally, no cash is given to the borrower. An account is opened in the name of the borrower and he is authorised to withdraw money through cheques until the amount of the loan agreed to by the bank, gets exhausted.

(i) Cash Credit : Cash credit is a type of advance wherein a banker permits its customer to borrow money upto a particular limit by bond of credit with one or more sureties. The advantage associated with this system is that a customer can withdraw money as and when required. The bank will charge interest only on the amount withdrawn by the customer. He is also free to repay into the account as frequently as he likes. Most industrial houses and business firms borrow money in this form. In the recent years, banks have started charging a minimum interest of around one percent for the amount

of account not used. However, the bank has no effective control on the end use of credit. This type of advance favours big and established borrowers.

(ii) Overdrafts : This facility is granted by the bank only to those persons who have their current accounts in the bank. To meet the temporary needs of the customers the bank may permit the customer to overdraw his current· account. The interest is charged only on the actual amount used. The difference between cash credit and overdraft is that an overdraft is not granted regularly, whereas the cash credit is sanctioned regularly to the business houses to meet their working capital needs. Secondly, to get the overdraft facility, a customer should be an account-holder of the bank; while cash credit requires no previous account in the bank. Also, for overdrafts the security is financial assets, while for cash credit it is mainly physical assets.

(iii) Loans : Loans are lump-sum advances made by banks to the customers. Interest is charged on the entire amount sanctioned irrespective of whether the complete amount is withdrawn or not by the customer. Loans are of various types. These may be term loans, participation loans, personal loans, call loans or collateral loans. Term loans are granted for a fixed period exceeding one year. They are granted to meet capital requirements of the business houses. These loans are to be repaid strictly according to the schedule of repayment. Utmost care is exercised while granting these loans. When loans are sanctioned by more than one financing agency to share the risk; we call them as the participation loans. These loans are more popular in the U.S.A. Such loans are granted only when the risk involved in lending is too large.

Personal loans are granted to the individuals to meet their personal requirements, mostly concerning their standard of living. The loans are repayable in monthly instalments. Personal loans are normally sanctioned for a period not exceeding two years. These loans are popular in the U.S.A. and U.K. Call loans are usually granted to the dealers on the stock-exchange. These loans are granted only for a few days - normally one to fifteen days. The banks reserve the right to call back the payment of these loans any time. When loans are granted against certain collateral securities, such as promissory notes supported by bank, securities of pledging etc., they are called collateral loans.

Thus, a bank acts as an intermediary in mobilising savings of the people and diverting them to the producers and businessmen to drive the wheels of industry and float the vessels of commerce.

3. Discounting of Bills : Discounting of bills is, practically speaking, lending for short periods. A trader, for instance, who does not want to lock up large funds in trade credits, may draw a bill of exchange on his debtor and after it has been accepted by, or on behalf of the debtor, he may get it discounted by his bankers. This gives the trader immediate possession of money to him less (i) a deduction for the loss of interest and (ii) cost of collection by the bank. The bills are usually for three months and when they

mature, the bank realises the face value of the bills from the debtor. This type of business is very common in advanced countries. In India efforts are being made to develop a regular bill market.

4. Creation of money i.e. bank as a creator of credit : The most distinctive deposits i.e. demand deposits serve as money in the community. Demand deposits are created in two ways. Firstly, by converting cash into a demand deposit with the bank and secondly, by borrowing from the bank and lodging the same amount with the bank as demand deposit. The latter form of deposit is most popular and provides the main channel through which banks create credit. The commercial banks create and destroy the community's money supply in the form of demand deposits through variations in their earning assets or their debt-instruments. The banks advance a loan to its customer and allows him to operate his loan in return for promise to repay the same together with interest thereon at some future date. A loan of Rs. 1000 sanctioned to a customer has the effect of not only increasing the total deposits of the bank, but has enabled the banker to put thousand more rupees into circulation. Every loan sanctioned by the banker creates a deposit. Thus, the bankers lend not only what is lent to them but sometimes more than what is lent to them. The mechanism of credit creation is explained in detail towards the end of this lesson. It is sufficient to say at this stage that banks are generally responsible for most of the fluctuations in the money supply in the country.

5. Clearing Cheques: The depositor has the right to withdraw his deposits with or without notice, depending on the nature of the deposits. He has also the right to ask his banker to transfer the funds into the account of someone else by means of a cheque. These cheques are frequently deposited in a bank other than the one on which they are drawn. This requires the transfer of credit, not only from one depositor to another but also from one bank to another. This process, called clearing, has become highly complicated but exceedingly efficient part of banking operations. Let us see how the process is carried on.

Whenever the payees or the receivers of bank cheques deposit in the same bank on which the cheques are drawn, it is just a case of book adjustment in the same bank. But normally, cheques are deposited in other banks. Consequently, the bank receiving the cheque deposit must collect the proceeds from the drawee bank. When it happens in the same city, the cheques are collected through local clearing house. But when they are drawn on other cities, agents located in those cities must be used to affect the collection. In such cases, the local bank carries a deposit with a city bank that agrees to act as its collecting agent. At the time of clearing, the messengers from each bank go to the clearing house and exchange the package of cheques so that each messenger comes into the possession of the cheques drawn on his bank. On a specially prepared statement sheet containing the names of all other clearing banks the total of cheques is brought to record

from the clearing house. If the amount received exceeds the amount brought to the clearing house, the bank has an unfavourable balance, or is a net debtor and must pay the difference to the clearing house. In some cities, cheque clearing is formally carried out more than once a day. Innovations like computers has made the task of cheque clearing considerably easier and time saving.

6. Financing foreign trade and as a dealer in foreign exchange : Modern banks finance foreign trade. They issue and accept instruments of credit like bills etc. for discounting purposes. They often accommodate businessmen and traders for purchasing and selling of goods.

Modern commercial banks, many of whom have branches or offices or correspondent banks in other countries trade in foreign currencies also. Although the central banks may intervene in times of difficulties, banks engage in currency exchange as a normal function without intermediary. This function has increased the security of commercial bank, as the foreign exchange reserves in other overseas office swelled, and gave rise to increase in their liquidity. Banks finance multi-national corporations and other industrial houses as well as exchange house, conserve foreign currency and accept foreign remittances for conversion into local currencies. Since the central banks are the custodian of foreign exchange and are also banker's bank, "reserve" information is sent by commercial banks to the central banks periodically.

7. Financing Industries : Banks provide the necessary finance for industrial development. This function is also of great importance to a country which is planning the use of its resources. The attitude of commercial banks towards industrial finance varies from country to country. England followed a natural policy towards industrial finance, while in Germany there was a complete collaboration between banks and industrial finance. In certain other countries, industries continue to develop on account of the finance provided by the banking system.

(b) Subsidiary Functions:

The subsidiary functions of modern commercial banks can be classified under two heads :

(i) Agency Functions and

(ii) General Utility Services

(ii) Agency Functions : A commercial bank performs certain functions as acting as an agent for and on behalf of its customers. Some of these functions relate to (a) collection and payment of cheques, bills, promissory notes and other commercial instruments, interest, dividend, subscriptions, rents or other periodical receipts and payments like insurance premium, (b) buying and selling of shares, bonds, securities etc. on behalf of the customer, (c) remitting of funds on behalf of the customers by drafts of mail or telegraphic transfer; (d) action as executor trustee and attorney for its customers,

and (e) acting as correspondent agent, representative of its client etc.

(ii) General Utility Services : A commercial bank performs certain general utility services such as (a) issuing of letters of credit to customers (b) issuing of bank drafts and' traveller's cheques, transfer of funds from one place to· another, (c) serving as referee to the financial standing and credit worthiness of the customers ; (d) underwriting loans to be raised by public bodies and corporations; (el provide safety vaults or lockers for the safe custody of valuables; (f) acting as trustees and executing the wills of the deceased, and (g) compiling statistics and information relating to trade, commerce and industry.

Thus commercial banks render valuable services to the community. A country with a well-developed banking system has a secure foundation of industrial and economic progress. It constitutes the very life blood of an advanced economic society. The following chart facilitates in understanding the functions of commercial banks.

TABLE

Economic Functions of a Commercial Bank

Banking Functions	**Subsidiary Functions**	
	Agency Functions	**General Utility Services**
1. Accepting Deposits	1. Collection of cheques and bills	1. Issuing Letters of Credit
2. Advancing Loans	2. Buying & Selling of Shares	2. Issuing of Bank Drafts
3. Discounting of bills	3. Remittance of funds	3. Serving as referee
4. Creation of money	4. Acting as executor	4. Underwriting loans
5. Clearing cheques	5. Acting as agent of clients	5. Acting as trustees
6. Financing Foreign Trade		6. Safe custody of valuables
		7. Compiling Statistics
7. Financing Industries		

IMPORTANCE OF BANKS :

Banks are essential institutions for mobilizing savings for the purpose of lending. The banks, while lending, choose their debtors properly. As one authority has put it : "They discover the industrious, the prudent, the punctual, the honest, while they discount the spendthrift, the gambler, the liar and knave. There is, many a men who would be

deterred from dishonesty by the frown of a banker though he might but care to the admonition of a bishop." In short, banks are public conservators of commercial virtues. A well knit banking system, therefore, secures- a good foundation for nation's industrial and economic progress in the following ways :

1. In the first place; a banking system **accelerates the rate of capital formation** in the country. The basic malady that effects a developing economy is the tardy rate of capital formation. The essence of capital formation, according to Nurkse, is the diversion of a part of society in currently available resources for the purpose of increasing the stock of capital goods so as to make possible an expansion of consumable output in the future. Now the mere existence of a sound banking organization tends to encourage savings, thrift, economy and investment, facilitates the interchange of goods and creates a general feeling of security and prosperity which, besides accelerating the formation of capital, also pushes up the national dividend.
2. Secondly, it acts as an **engine of balanced regional development** in the country.. The banks help in the proper allocation of funds and they aid in the transfer of the surplus of one district to another where it can be more gainfully and efficiently employed. In this way production is stimulated by the more rapid circulation of money and by the facility of obtaining the necessary capital to ride over difficult times. Bank loans as the manufacturers enable them to increase productive capacity and to adopt new method & machinery.
3. Thirdly, the banking system helps in the **extension of size of market**. The commercial banks act as intermediary between the seller and buyer. Goods are supplied on bank guarantees which makes it viable for commerce and industry to cultivate and locate markets even in those areas which may be physically too distant otherwise to prove an economic proposition.
4. Fourthly, bankers render great service in **controlling credit** & co- operating with the central bank.
5. Fifthly, the banks help in **developing entrepreneurship**. This role is being effectively played by underwriting new scrips by granting assistance for promoting new ventures of financial promotion under the joint guarantee system. In Germany, for example, scarcely a single important company has been founded without the collaboration of a bank.
6. Lastly, banks provide a **convenient and safe deposit** for valuables and securities in transacting foreign exchange business and in placing their established reputation at the service of merchants and travellers by issue of various forms of letters of credit.

Hence there is no need, whatever, to overemphasize the importance of banking as part and parcel of modern industrial and commercial culture. The role of banks in promoting development & growth specially in the context of planning and breaking the trap of underdevelopment is an issue of topical interest to the students of any economy. To sum up "commercial banks have been rightly crowned as," nucleus of all economic activities."

ROLE OF COMMERCIAL BANKS IN ECONOMIC DEVELOPMENT :

Besides performing the usual in commercial banking functions, banks in developing countries play an effective role in their economic development. The majority of people in such countries are poor, unemployed and engaged in traditional agriculture. There is also an acute shortage of capital. Commercial banks help in overcoming these activities. In India, the key feature of the post-nationalisation period in the field of allocation of credit has been growing functional diversification with increasing emphasis on credit to priority sectors. The concept of priority sector for the allocation of commercial bank credit took definite shape during the brief period of the Social Control of Banks (1968). Initially, three sectors - agriculture, small industries and exports were officially recognised as priority sectors. Later, a few more categories came to be added to the list, namely, road and water transport operators, professional and self-employed persons, retail trade and small business and education. The banks were directed to provide 40 percent of total credit to priority sector, of which at least 15 percent of total credit was to be by way of direct finance to agriculture and at least 25 percent of priority sector advances (or 10% of total credit) was to go to the 'weaker sections.'

Banks provide term loans to identified poor families under the IRDP (Integrated Rural Development Programme) scheme, which was launched in 1978-79 as a major poverty alleviation programme. Its main objective has been to take above the poverty line the families in the identified target groups by creating substantial employment opportunities in rural areas and by enabling them to acquire productive assets with the help of govt. subsidy and term loans from banks. The target groups are scheduled castes/tribes, agricultural labourers, rural artisans, marginal and small farmers, etc.

Commercial banks have also been lending extensively to the farmers both directly and indirectly. The latest thrust was the introduction of service area approach in 1989. Under this, all the villages have been allocated to different branches of banks in such a way that each branch has a cluster of 15 to 25 villages. The branches have to survey the villages allocated to them and prepare financial plans for each of them. However, on the demand of the Panel of Bankers of the Indian Bankers' Association (in 1998), the SAA was given up.

Another notable feature has been the shift of banking from the big customers to small ones. In the field of bank advance too, small scale industries have come to occupy

a prominent place.

Thus, commercial banks have come in a big way to help agriculture and other hitherto neglected priority sectors and making the task of economic development easier.

CREATION (AND DESTRUCTION) OF CREDIT

All banks are engaged in the creation of credit. Creation of credit is one of the most important functions of a modern bank. Commercial banks are defined as "purveyors of money" (Sayers). A bank has sometimes been called a factory for the manufacture of credit, or what Harry G. Johnson calls as "producers of money". Money can be created or destroyed in the sense that its supply is increased or decreased by the Government or by the commercial banks. In this section, we are mainly concerned to show the process and mechanism involved in the creation & destruction of money in the above sense.

Creation of Bank Credit: Demand deposits are by far the most important constituents of total money supply in modern times. Demand deposits arise principally from (a) cash deposits (h) bank loans and investments. The former are called "**Primary Deposits**" and the latter "**Derivative Deposits".** In the case of primary deposits there is no net increase in the money supply, since there is merely a shift from cash to demand deposits. Primary deposits, however, are capable of serving as basis for credit expansion and, therefore, for increased money supply. It is derivative deposits which result in a new increase in money supply, since bank credit is thereby created, to use Crowther's terminology, out of thin air. Thus, banks create credit in two ways: (i) by advancing loans, (ii) by purchasing securities. The process involved in creation of bank credit can be illustrated as follows :

The Single Bank : When a bank lends, the borrowers do not ordinarily take the proceeds in cash; instead he takes on an account in the bank. On the bank's balance sheet, loans (as asset) and demand deposits (as liability) both arise. A bank creates a demand deposit when it lends. In effect, since demand deposits are money; bank creates money. To begin with, since the only limit on creation of demand deposits appears to be the requirement of legal reserves (say 10%), a superficial answer to the problem of how much a bank can lend, would be that it can lend (i.e. create demand deposits) upto a limit of 10 times (in our example 10% of reserves) its excess reserves. But this will happen only if there are no cash transactions. The reality is that borrowers don't take out loans, and pay interest on them, just to leave the funds sitting there. They want to spend the money. They will probably write cheques on their new demand deposits, which will probably be deposited in other banks by their recipients.

Thus, a single commercial bank can lend up to the amount of its excess reserves, and no more.* But it can lend or buy securities upto the amount of its excess reserves without endangering its legal reserve position.

An individual bank can therefore create money, but only if it has excess reserves to begin with. As soon as it has created this money, it loses it to another bank when the money is spent. This is the key difference between the ability of a single bank to create money as compared with the banking system as a whole.

Banking System as a whole : The commercial banking system as a whole can expand credit many times the initial excess reserves. The process is called multiple credit expansion.

To understand the basic economic process underlying creation of deposits, we make certain simplifying assumptions. We suppose that there are many banks, and each is required by law to hold 10 percent cash reserves against its transactions deposits. We also assume that the public does not change its currency holding throughout the process. Thus, there is no currency drain. It is also assumed that each bank will put all the money that is possible into earning assets (loans) so that there are no excess reserves.

Suppose that there is an initial deposit of Rs. 1000 in a bank, (name it as Bank I). This increases both the demand deposits and cash reserves of bank I. By our assumptions, the bank will hold 10% (i.e. Rs. 100) of this deposit in its cash reserves, and put the rest 90% (i.e. Rs. 900) into loans. By our second assumption, the person who takes this loan will not keep the amount with himself, but deposit it with some other bank, say bank II. Now bank II has cash reserves of Rs. 900. By our assumptions, bank II will keep 10% (i.e. Rs. 90) of this deposit with itself, and loan out the rest of 90% (Rs. 810).

Once again, the person who took this loan of Rs. 810, will deposit it in a third bank III, which will keep 10% of it (Rs. 81) in reserves, and loan out the rest 90%.

We see that total transactions deposits in these three institutions increased to Rs. 2710, whereas we had started with a Rs. 1000 deposit. Transactions deposits have thus been created by the banks; and since transactions deposits are money, it is equally accurate to say that the banks have created money.

Now the question is, where does this process stop? One way is to keep going through the arithmetic of successive rounds. But since this is a cumbersome process, we can find the solution by 'setting up' the problem in mathematical terms, as follows :

Now, Rs 1000 = 1000

and $900 = \frac{9}{10} \times 1000$ (because 900 = 90% of $1000 = \frac{9}{10} \times 1000$)

*A single bank here does NOT amount to a monopoly bank in the economy. If there is a monopoly bank in the economy, then the amount of demand deposits created will be the same as that created when the banking system as a whole is considered, provided we consider the same set of assumptions.

And 810= $\frac{9}{10} \times 900 = \frac{9}{10} \times \frac{9}{10} \times 1000 = \left(\frac{9}{10}\right)^2 1000$

and so on

Now let ΔB = amount by which primary deposits increased, (i.e. Rs. 1000 in our example)

R_d = reserve requirement (10% or $\frac{1}{10}$ in our example)

$\therefore$ Let $r = 1 - R_d$ (90% = $\frac{9}{10}$ in our example)

Thus, the preceding sequence of numbers can be stated symbolically as

$\Delta B + \Delta Br + \Delta Br^2 + \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots$

Let us suppose the process ends in n rounds, so that

$S = \Delta B + \Delta Br + \Delta Br^2 + \ldots\ldots\ldots\ldots\ldots\ldots\ldots + \Delta Br^{n-1} = \Delta B\,(1 + r + r^2 + \ldots\ldots\ldots + r^{n-1})$

Where S stands for sum.

Since the above is a geometric progression

$$S = \Delta B \frac{1 - r^n}{1 - r}$$

If n is very large i.e. $n \to \alpha$, then $r^n \to O$.

$$\therefore\ S = \Delta B \frac{1}{1 - r}$$

But $1 - r = R_d$ (because $r = 1 - R_d$)

Hence S = $\Delta B \frac{1}{R_d}$

This gives us the total deposits created by the banking system.

In our example,

ΔB = Rs. 1000

$$R_d = 10\% = \frac{1}{10}$$

$$\therefore S = 1000 \times \frac{1}{\frac{1}{10}} = 10{,}000$$

i.e. Deposits worth Rs. 10,000 were created (in our example) out of an initial deposit of Rs. 1000.

Thus, the total money/credit created by all banks together is the reciprocal of reserve ratio (R_d) multiplied by initial deposit inflow (ΔB).

The Destruction of Bank Credit by Banking System : Bank credit can be destroyed through a reduction in bank loans and investments; the extent of destruction depending on the prevailing reserve ratio. A reduction of each legally required reserve to support demand deposits leads to multiple contraction of bank credit throughout the banking system and therefore, to a decline in the total supply of money.

Suppose that a depositor permanently withdraws Rs. 100 from his checking account that is not spent but the money is kept in hoarding. The bank in question loses Rs. 100 of cash and Rs. 100 of demand deposits. Suppose that the reserve ratio is 10 percent. The bank presumably had Rs. 10 against the 100 rupees of demand deposit withdrawn, but has to pay Rs. 100 (and not Rs. 10). The bank has to use Rs. 90 of its legal reserves held against other demand deposits in order to meet the original depositor's demand for Rs. 100. This means that the bank's legal reserves have fallen below the required minimum and the bank will have to take some action to improve its cash-reserve position. This is where a 10 : 1 contraction of banking system begins. For the bank must call in loans for selling securities to the amount of Rs. 90 thus involving other banks in the process of the 10 : 1 contraction of credit. If, however, the bank could acquire additional cash by borrowing from the central bank, it would not take deflationary action. Thus, a reduction of cash reserves below the legal minimum leads to magnified decline in total demand deposits and, therefore, to a sharp decline in total supply of money. The table below indicates the effect.

TABLE

Multiple Credit Contraction

Reserve deposits	Initial of cash	Magnified Contraction in total
10%	10 : 1	1000
25%	4 : 1	400
50%	2 : 1	200
100%	1 : 1	100

It is not difficult to understand why some economists favour a 100 per cent reserve ratio. A system of 100 percent reserve, it is believed would stabilize the price system since it would prevent an otherwise inevitable multiple credit contraction or expansion of bank money. But it is still a moot point.

Practical Limits to deposit expansion :

1. Cash Drain : The extent of credit creation depends on the amount of cash which commercial banks hold. The larger the amount of cash with the banking system, the greater will be the excess reserves and larger will be the credit creation power of the

banks. It has been assumed that in the chain process of multiple credit creation all the reserves lost by a bank are gained by another bank and no payments are made in cash. In practice this may not be the case, for some reserves may be drained away from the banking system. It is quite apparent from this that presence of and cash drain amounts to an- increase in the reserve requirement, and thus, reduces the expansion potential of any given volume of excess reserves.

2. Excess Reserves : We have assumed that banks keep only as much reserves as they are legally required to do. In actual practice, banks usually maintain some "excess" reserve in addition to the statutory requirement. All banks need some cash to meet reserve requirement with the central bank. Higher the reserve ratio to be maintained, smaller will be the relative excess funds- and smaller wi11 be the volume of credit creation and vice versa.

3. General Policy of Banks : Any single bank cannot follow an expansionist or a contractionist policy for a long time; others also want to do so. They must march like a regiment in a parade. For example, if one bank expands credit enormously, only a fraction of the additional bank deposits thereby created will remain with it. As a result this bank will have permanent debit balances at the clearing house and its reserves with the central bank will dwindle. In other words, cash reserves will come down and it will find itself in a precarious situation.

4. Different Types of Deposits: We assumed that all the deposits are in the form of demand deposits only, while actually a large part of total deposits is in the form of time deposits. Since time deposits are not withdrawable by cheques and do not serve as money, the result of an increase in time deposits is to reduce the money supply. A shift from demand to time deposits limits the potential expansion of demand deposits.

5. Control by the Central Bank : The central bank has the duty of maintaining the value of money and is empowered to control commercial banks, for commercial banks also create money. Hence the restrictions imposed by the central bank (both quantitative and qualitative controls) would also affect the capacity of a bank to create credit.

6. Availability of Securities : Bank cannot create money out of their own. If we examine the balance sheets, we will find that against each deposit created by them they hold assets in various forms as shown in the asset column of the balance sheet. Availability of such assets like government securities, collateral securities, bills etc. is another important limitation. Total securities which can be offered at a point of time are restricted to a fixed amount.

7. Demand for Loans: In order to make loans, the banks must find customers who wish to borrow. If there is no or low demand for loans by businessmen and traders, banks will obviously not be able to create much of additional deposits. Thus, the amount

of borrowing by the customers sets a limit to the amount of expansion of credit. This is specially so in times of depression.

8. Cash & Banking Habits : The total cash in the banking industry would depend upon the total cash deposited by the people, which in turn depends on their banking habits. If for any reason, the people decided to hold more cash, the flow of cash into the banking industry and consequently its power to create credit will decline. How much cash the people will hold and how much of it they will deposit in banks depends upon the total cash supplied by the government and the central bank, as well as the banking habits of people.

Thus, we find that there is nothing mechanical and completely accurate about using a 5: 1 or any other fixed ratio for multiple expansion. The process of multiple credit creation described above should, therefore, be taken to indicate that an individual bank would be able to expand its lending safely by an amount equal to its excess resources. If each bank adopts the safe rule of thumb of expanding by the amount of its excess reserves, a part of the additional reserves will pass over the other banks until, in the end, the increased reserves are spread over the system as a whole supporting large volumes of loans and deposits.

SIGNIFICANCE OF CREDIT CREATION

Credit creation vitally affects the level of economic activity in the country. Left to itself, the credit expansion or contraction may "boom the booms" and "depress the depression". Thus, credit control has a lot to do with the cyclical fluctuation in the economy. In the case of underdeveloped countries, credit creation has to be controlled to ensure economic growth stability. It can be easily understood that if the credit is allowed to be unduly created, prices rise and wages will rise alongwith. Inflationary situation is inimical to economic growth because entrepreneurs are deprived of necessary funds. Hence the monetary authorities pursue a policy of controlled expansion of credit to ensure economic growth with stability. Since money supply in a country depends on the volume of' credit created, credit expansion plays a very vital role in determining the level of national income and the volume of employment in the country.

Check on Credit Creation : In any country, central bank is vested with the sole responsibility of controlling the credit in the economy. The various objects for which a Central Bank controls the credit are (i) to safeguard its gold against internal and external drains (ii) to ensure stability to internal prices ; (iii) to achieve stability of foreign exchange; (iv) to eliminate fluctuations in output and employment; and (v) to assist in economic growth. The assistance is required not only in underdeveloped countries desirous of accelerating economic development but also in developed countries desirous of maintaining and improving their living standards.

The central bank can control credit by the following methods

(a) **Quantitative or General Controls which include :** (i) Manipulation of bank rate or discount rate; (ii) Open Market operations; (iii) Varying cash reserve requirements etc.

(b) **Other Methods of Credit Control include** (i) varying margin requirement; (il) Secondary reserve requirement (iii) Rationing of credit; (iv) Direct action; (v) Moral suasion and (vi) Publicity.

All or a combination of these methods is employed by the central bank to tide over credit expansion with a view of bringing; an equanimity in the economic situation. These methods will be dealt with in detail in a subsequent lesson.

SUMMARY

A bank is an institution which deals in money. Modern banks perform several functions like accepting deposits, advancing loans, discounting bills, creation of money, clearing cheques, financing foreign trade, financing industries and agency and general utility functions. However, creation of credit is one of the cardinal functions.

Commercial banks, defined as 'purveyors' of money, play an important role in the creation of credit money. A particular bank can create credit only to the extent of excess reserves while the banking system as a whole can create multiple credit. The total credit creation of the banking system as a whole is equal to initial deposits multiplied by the inverse of cash reserve ratio.

Though, in theory, the banking system as a whole can create multiple credit given by the above formula, in practice, there are certain restrictions like the cash drain, amount of excess reserves, general policy of the banks, different types of deposits, availability of securities, demand for loans, banking habits of the people and the control by the central bank. In order to ensure economic growth, the stability under expansion of credit must be checked. The responsibility of controlling the credit in the country is vested with the central bank. The central bank employs both quantitative and qualitative methods to achieve the desired results.

Note: Suggested Readings and Questions are given at the end of the unit.

M.A. (ECONOMICS) PART II **OPTION : MONEY & BANKING**
Semester-III

LESSON NO. 2.2 **AUTHOR : DR. ANITA GILL**

COMMERCIAL BANKS - II
(Theories of Commercial Banking)

INTRODUCTION

In the previous lesson, we had an introduction with commercial banks. We studied about the evolution and functions of commercial banks, its most important function being the creation of credit. This creation of credit function is the one that separates commercial banks from other financial institutions.

The functions of commercial banks made clear two things - one, that banks lend other people's money, and two, most of the liabilities of banks are payable on demand (i.e. to say, the 'other' people may, and do, ask for their money back at any time!). These two aspects of banking lead to what is generally called the central problem of bank management i.e. reconciling the conflicting banking goals of solvency, liquidity and profitability. Let us see what these terms mean.

1. LIQUIDITY :

Liquidity is the ability of a commercial bank to meet claims of cash on demand. R.S. Sayers defined it as, "Liquidity is the word that the banker uses to describe the ability to satisfy demands for cash in exchange for deposits." People deposit their money with the bank for safe custody and convenience and they can demand money back at any time. For this, a bank must keep sufficient amount in the form of liquid cash or nearly so. Assets for this purpose are known as liquid assets and they are cash in hand, money at call and short notice, bills of exchange and treasury bills etc. In the words of Chandler, "By the liquidity of an asset we mean its capacity to convert into money easily and quickly and without loss of value in terms of money." Obviously, money is the most liquid asset.

If a bank does not keep liquidity or is not able to meet the demand for cash by the depositors, it loses confidence of the public. Again, a bank cannot afford to keep all his money in liquid form.

Requirement of liquidity in portfolio management is conditioned by various factors such as :

(a) Liquid Reserves :

Commercial banks have to keep certain amount as liquid reserve because of the bindings of the banking law or by convention.

(b) Banking Habits of the People

If people have developed banking habits, i.e., they use cheques then the use of cash shall be less and there will be less need for liquid assets.

(c) Structure of Banking System:

In case of branch banking the cash reserves can be centralised in the head office and branches can be managed with less cash reserves.

(d) Nature of Economy:

In a developed economy, most of the transactions are through cheques.

But in an underdeveloped economy, most of the transactions are through cash, therefore, banks require more liquid assets.

(e) Money Market:

If there is a developed money market then it is quite easy to buy or sell securities. This will mean less liquid cash and vice-versa.

2. SOLVENCY:

Commercial banks have to create maximum confidence in the public. Such a confidence can be created only by meeting their demand for withdrawals at any time. Therefore, a sound bank must be ready to meet all the liabilities with the assets. According to Prof. Sayers, "A bank is solvent if the amount of its assets exceeds the amount of its liabilities to all claimants."

The problem of solvency arises because of the fixed nature of liabilities and the assets are liable to change in terms of value because of changes in rates of interest.

3. PROFITABILITY:

Commercial banks have to earn income to meet the cost of running the bank, payment of interest on deposits, accumulation of reserves and dividend of the shareholders. For this purpose, they make use of some of their assets in profitable investments and try to earn maximum income with minimum of variable cost. Use of assets for 'loans and advances' is the most profitable. Confidence on the part of a bank and public is the determining factor. Profitability is possible only when people are confident that the bank will pay them back their money whenever they demand it. These deposits of the people form an asset and enable the bank to operate and earn more income. According to R.S. Sayers, "The profit which is the ultimate object of a commercial bank, is derived from the income attached to the assets it is able to hold and by the public being willing to hold by the banks debts (deposits) as money balances. The profits are greater, the higher the yields of assets it holds."

J. Harvey and M. Johnson maintain that "liquidity and profitability pull in opposite directions. The shorter the period of loan, the greater the bank's liquidity, but the less it will earn by way of interest."

BANKING THEORY

Banking theories are nothing but abstract arguments dealing with the focal point

as to how banks should behave in order to reconcile its conflicting goals. But it is also important to note that banking theory is not simply a sort of abstract description of what bankers do. There is an intimate relationship between banking theory and banking practice - the decisions of bankers are as much influenced by the prevailing theory of banking as the theory is influenced by prevailing banking practices.

We normally discuss four theories of banking. While the first three theories-commonly known as historical theories of banking - deal exclusively with the asset side of a bank's balance sheet, the fourth theory mainly deals with the liability side of a bank's balance sheet. This is because, historically, it was thought that banks do not have any control over the size of its liabilities. But several significant developments in banking' practices during the 1960s changed this view, and there emerged a new (fourth) theory of banking - the liability management theory.

Let us consider the historical theories first, and then the contemporary theory.

1. The Commercial Loan Theory of Banking

This is the oldest theory of banking and is also called the Real Bills Doctrine. A discussion of this theory can be found in Adam Smith's Wealth of Nations (1779).

The commercial loan theory holds that commercial banks should make only short-term, self-liquidating and productive loans.

Here, a short-term loan would mean a loan maturing in less than one year from when it is first made (the ideal period being about three months). Self-liquidating means that the loan contains within itself' its own means of payments. This is to say that the funds for a borrower to repay a loan were supposed to arise out of the very transaction being financed by the particular loan. Productive loans means that the loan is solidly based on 'real' goods as opposed to loans for speculative or purely financial purposes.

In short, the commercial loan theory states that banks should not make long term loans. For example it should not make real estate loans or loans for the purpose of financing the purchase of plant and equipment. Moreover, even short-term loans should not be made unless and until they are backed up by real, physical, tangible goods.

The primary objective of the commercial loan theory was to maintain the stabilization of the banking, system. This is because at that time there were no central banks or deposit insurance corporations. A bank had to remain liquid, solvent, as well as earn a profit on its own; there was no government agency charged with the responsibility of bailing a bank out of trouble.

An example that is commonly cited to illustrate the commercial loan theory is that of a retail toy store that did its peak volume of business in the three months before Christmas. Such a store can borrow from a bank to purchase inventory (toys) in the month of September. And during October, November and December (festival time), the toys can be sold and the bank loan can be repaid out of proceeds of this sale. Thus, a

productive loan was taken for a short period, which repaid itself.

However, the commercial loan theory had several shortcomings. The basic weakness of the theory was that it misconceived the nature of what is and what is not 'real'. Taking the above example once again, it is true that toys are tangible (i.e. real), but the fact is that a bank does not make loans on the goods themselves, but on the value of goods. Thus, if the value (i.e. price) of toys goes down, or if they are not sold (for whatever reason), the bank's loan will not be repayable. Speaking genernally, there is an element of speculation in any loan.

In addition, the commercial loan theory fails to distinguish between an individual bank and the banking system as a whole. For the individual bank, many loans might be liquid, but these may not be liquid from the point of view of the banking system as a whole. This is because the repayment of one loan often requires the extension of another. So for the banking system as a whole, no net liquidation takes place.

Not only was the commercial loan theory theoretically unsound, it was out of touch with historical reality. We cite the particular case of USA. Around 1850, the industrial revolution had started in the United States. The economic development of the country created heavy demands for capital. As a result, banks were pressurized to make long-term loans. But for the banks, it was a threat to their stability. So many banks tried to compromise by writing what were essentially long-term loans under the guise of a series of short term loans that were automatically renewed at maturity. This resulted in even greater instability in the banking industry, which was resolved only with the setting up of Federal Deposit Insurance Corporation (FDIC) in 1933.

The shortcomings of the commercial loan theory, in both theory and practice, led to the development of more realistic views regarding management of bank assets.

II. The Shiftability Theory

The shiftability theory emerged in the American banking scene towards the end of the 19th century. This theory, however, did not replace the commercial loan theory completely, but only took a more general view, and widened the list of assets that a bank might hold. This is to say that the shiftability theory did not say that commercial loans were inappropriate, but , only held that there were other, better assets that a bank can hold.

This theory provides the idea of liquidity through shiftability, i.e. through the ability to sell off (or shift) assets to others. Thus, a bank can hold short term open market investments (such as treasury bills) and sell all these investments whenever it needs liquidity (money) to payoff its depositors.

The shiftability theory slowly gained ground, as it was realized that commercial loans were not really liquid, and consisted only of shifting of loans from one bank to another. But if, instead, of commercial loans, a bank is holding short-term assets like

treasury bills, it is in a better position, as these can be promptly sold as and when the need arises.

With this theory, the liquidity position of a bank consequently came to be closely associated with the amount of money market instruments that the bank was holding - the so - called secondary reserves.

Historically speaking the early 1900s saw only a few banks making use of this shiftability theory. But the growth of treasury bills in the 1930s, which also coincides with a dearth of opportunities to make good business loans, gave wide sanction to the concept of providing for liquidity by holding short-term securities. And by World War II, money market securities gained considerable ground over loan portfolio, both in practice and in theory.

However, the shiftability theory was not without flaws. It contained the same defect that had plagued the commercial loan theory - reliance on the actions of a third party. Thus, although one bank, or even a few banks, could obtain needed liquidity by shifting its assets the same cannot be true for all the banks taken together. This is because all banks cannot gain additional cash reserves by shifting their earning assets (treasury bills) to each other. Citing the case of the U.S. economy once again, during 1929-33, all the banks wanted to be sellers - and none of them wanted to buy. There was need for some agency outside the banking system which could provide all banks with liquidity they needed. In fact, this was the role for which the Federal Reserve System (of U.S.) was designed, but this agency did not play its role during this period. The result was' the failure of thousands of banks.

However, the shiftability theory, when applied practically, taught the bankers that the problem of liquidity of the whole banking system cannot be solved by commercial banks alone, and the central bank must necessarily play the role of lender of last resort.

III. The Anticipated Income Theory

A third view of how to provide for bank liquidity developed in 1940s. This is known as the doctrine of anticipated income. Althought it did not challenge the theory of shiftability, but it focused greater attention on the types of loans appropriate for a bank to make. However, its conclusions were different from that of commercial loan theory in that the anticipated income theory holds that banks could make long-term and non-business loans. This is because the theory held that there is no such thing as a self-liquidating loan. Instead, all loans are repaid out of the future earnings of the borrower, that is, out of anticipated income. So, it is the borrower's ability to repay the loan out of future earning which is of prime importance.

Thus, under the anticipated income theory, it became acceptable for banks to engage in a much broader range of lending.

It may be mentioned here that the doctrine of anticipated income is a method

for analysing borrower's creditworthiness. It gives the lender a criteria for evaluating the potential of a borrower to repay a loan in time. However, bank liquidity also means that a bank is capable of raising cash quickly as and when needed. And if the doctrine of anticipated income is looked upon as a method of evaluating borrower creditworthiness, then it is best to see it as complementary to (and not competitive with) other theories of bank liquidity.

IV. The Liability Management Theory

The 1960s witnessed a change in bank liquidity practices. Until then, banks relied exclusively on asset management for providing liquidity. This is because it was thought that a bank had no control over the size or mix of its liabilities. This is why the previous theories of banking (discussed above) all relied on asset management to supply liquidity.

Starting with the early 1960s, however, banks began increasingly to draw their liquidity from the liability side of the balance sheet. Banks began to adjust their liabilities to suit their needs. Liability management became the most important banking development of the 1960s. But it does not mean that the bank managed only its liabilities and was passive with respect to its assets. The theory continued to recognize that the asset structure of the bank has a prominent role to play in providing the bank with liquidity. The only change was that now banks recognised that they could use its liabilities for liquidity.

Simply speaking, liability management means that when a bank needs money, it "just goes out and buys it." This is to say that the bank borrows the funds it needs. For example, the bank might borrow from central bank (or even other banks), it might issue new CDs (Certificates of Deposit) etc. The money so borrowed can then be used to accommodate the loan demands of customers. It, thus, literally "borrows from Peter to lend to Paul". And as long as "Paul" is willing to pay a higher rate of interest than "Peter" is charging, it is good banking practice.

In the U.S. economy, liability management began with the rapid growth of the federal funds market. In the 1950s and 1960s, banks were put under heavy pressure to meet the credit demands of customers, and hence borrowed reserves from each other. Negotiable Certificates of Deposit (CDs) were the next liability instrument developed by the banking system. The development of the CD market gave banks ready access to non-bank funds because CDs could be sold to corporations, state and local governments, and private individuals.

However, there have been misgivings regarding the liability management theory also. It is said to be suffering from the same flaws as the shiftability theory. Thus, while any individual bank can acquire funds through selling liabilities, the entire banking system cannot-there must be banks that are willing to lend their excess reserves.

Later Developments

These days, banks are increasingly making use of financial models to help and guide them in their decision-making process. Use of financial models implies that the relationship; between and among the bank's assets and liabilities are specified in mathematical terms, with the objective of making more profits. After the development of the basic model, statistical analysis is used. The model may also be programmed onto a high speed computer and then the consequence of various choices may be observed. The bank can then use the choice whose consequence suits its objectives the best.

It may seem, at first instance, that bank models do not constitute a theory of banking as the other theories discussed e·arlier. However, it must be remembered that all banking theories try to establish rules of behaviour for banks under various possible circumstances. And the only difference between these theories and banking models is that the latter try to consider the bank as a whole, that is; as a multidimensional unit with a wide variety of choices open to it. But the traditional concerns of bankers for liquidity, solvency, and profits are not ignored. These are built into the models. The models are used to help the banker choose the best path for attaining and reconciling these goals.

Note: Suggested Readings and Questions for Practice are given at the end of the unit.

M.A. (ECONOMICS) PART II **OPTION : MONEY & BANKING**
Semester-III

LESSON NO. 2.3 **AUTHOR: DR. ANITA GILL**

INNOVATIONS IN COMMERCIAL BANKING SERVICES

INTRODUCTION

Looking back at the banking scenario of the past about three decades, we can observe a vast change in the quality and content of services offered by banks. Diversification of banking services has become the order of the day. Commercial banks are no longer the mobiliser of short-term deposits and suppliers of short-term funds to traditional sectors. New services, both credit and non-credit ones, have been introduced and existing services developed by banks throughout the world as they meet increasing competition for business from within the banking industry and from without, and fill gaps in their range of services in an attempt to satisfy the needs of their present and potential customers. In other words, banks the world over .are becoming financial supermarkets in which a wide variety of services can be purchased, and often conduct business that does not always resemble banking.

In India also, the changes that have been taking place have necessitated banking· companies to give up their conservative and traditional system of banking and take to new and progressive functions. The Government of India issued guidelines in 1983 to the banks under section 6 of the Banking Regulation Act, 1949 permitting and encouraging them to diversify their functions. Banks in India now also provide a growing range of innovative services, apart from their essential function of promoting saving and directing them to the most productive investment and economic growth.

In India, following the UK model, banks are allowed to undertake para banking (i.e. non-bank) activities (such as leasing, merchant banking, mutual funds, capital market activities, factoring, housing-finance, etc.) through subsidiaries and in-house in services such as money market mutual funds, credit cards, etc. The reasons for banks diversifying their business and entering para-banking activities include the need for a profit centre, diversification of earnings, maximisation of economies of scale, the desire to have leading market positions in all financial services etc.

Let us discuss these activities now.

LEASING

Leasing is a financial service under which an enterprise acquires the right to make use of an asset without holding title to it. It is-based on the theory that an enterprise makes a profit by using an asset instead of merely owning it. In simple terms, a lease is the use

of an asset which belongs to somebody else. The possession and the use of the asset vests with the user called the 'Lessee', whereas the ownership remains with the provider called the 'Lessor.' Generally, the lessee has not to make an initial deposit and has, thus, no stake in the asset he uses. Under this method a business can obtain many kinds of assets including plant, machinery, equipment and vehicles, without the need for capital outlay.

Broadly speaking, lease financing may be classified into two categories :

1. Sale and Lease Back
2. Direct Leasing

1. Sale and Lease Back: In this type of lease arrangement, a company owning an asset sells it to someone else and leases it back simultaneously. For example, a company X, already owning an asset, sells it to Y and simultaneously leases it for continuous use. The new· lessee X, then has in his possession the use of an asset as well as cash received as its sale proceeds. Thus, the seller has given up the title to the asset but retains its use. The underlying advantage is that the company receives cash from the sale of the asset for profitable investment in the business while still making economic use of the asset during the lease period.

This type of lease is mostly found in the real estate financing, when financial institutions play the role of lessors, buy a property from a business concern and then lease it back to the same concern.

2. Direct Leasing: In this, the company acquires the use of the property that it did not previously own. It may be arranged through a financial institution or the manufacturer. Finance companies usually enter into the business of acquiring property for their clients who are in need of certain assets for business purpose. Once property is acquired, a direct lease is arranged.

The sale and leaseback or direct leasing arrangements are of two kinds:

(i) Financial or fully pay-out lease, which can also be called a capital lease; and

(ii) Operating Lease

The distinction between them lies in ownership and service.

(i) Financial Lease: This is a source of medium to long-term finance because to all intent and purposes, the lessee assumes all the benefits of ownership over the asset and uses the financial lease as an alternative to borrowing the money and buying. Banks usually confine their activities to financial leases.

The lessor enters the transaction as the financier and buys the equipment from the supplier for the use of lessee. Even though it is the lessee who usually writes the specifications for the equipment to ensure that what is supplied meets that specification, he will not become the owner. The primary rental period is designed to correspond to the working life of the asset. After this period, the lessee has the option to enter a contract for

a second period for a nominal rent, or return the asset to the lessor to sell the asset as the lessor's agent. Since the lessor is separate from the supplier of the asset, the leasing agreement will invariably make the lessee responsible for maintaining and repairing the equipment.

(ii) Operating lease : This is a short-term lease lasting only a few weeks or months. It is usually granted when the lessor is himself a manufacturer or distributor of the asset which is demanded by the client. The asset (photocopier, wood processors, exhibition hall, or even consumer durables) is hired to the client, but it is never envisaged that true ownership would be passed on to the user. And since the lessor is, in most cases, himself the manufacturer or distributor of asset, the responsibility for servicing and repairing too lies with him. The lessor also bears the risk of obsolescence.

In India, equipment leasing was not very popular till the 80s. The main reason for this was easy availability of debt finance. However, by the middle of 80s, the leasing industry began flourishing, when the Banking Regulation Act was amended in 1984 to enable nationalised banks to form subsidiaries to undertake leasing business. Leasing was now classified as a major financial activity. The RBI has stipulated that the investment of a bank in the shares of other leasing companies together with investment in its own subsidiaries (to transact leasing business) should not exceed 10 percent of the paid up capital and reserve of the bank. It has advised the banks not to engage themselves directly in leasing business but to extend loans to companies engaged in such activities. However, banks have now been allowed to enter into the leasing business, instead of allowing only leasing subsidiaries sponsored by banks to conduct leasing business.

Over the years, leasing has provided a popular financing method for acquiring plant and machinery, especially for small and medium-sized enterprises. This is because leasing offers a convenient means of diversifying and modernising existing activities without undertaking large investments on a long term basis. Lease finance is also an easier and quicker form of finance as compared to a loan to finance purchase of an asset, because it relieves the firm of restrictive terms and conditions. Leasing agreements do not normally require down payments and margins. Also, lease rentals can be fixed flexibly to suit the lessee's cash flow.

MERCHANT BANKING

This is another field which has become popular in India in recent years. The buoyancy in the investment climate as a result of liberalisation in industrial and licensing policies, combined with the amendment to the Banking Regulation act permitting commercial banks to go in for new financial services has opened up opportunities for banks in the merchant banking business.

The term merchant banking eludes any precise definition. In London, for example, merchant banking refers to those who are members of the Accepting Houses committee,

which is now known as British Merchant Banking and Securities Houses Associations. The American counterpart of merchant banking is called investment banking, and is concerned with garnering savings of thrifty people and directing the funds to business enterprises seeking capital for the acquisition of plant and equipment.

In India, merchant bank is more or less a merchant banking department, a department of a commercial bank or the satellite of such a bank. Indian merchant banking has, by and large, been synonymous with issue management. It was started by foreign banks in India-Grindlays Bank in 1967, and Citi Bank in 1970. Amongst the Indian Banks, State Bank of India was the first commercial bank which set up a Merchant Banking division in 1972. In the 80s, there were a number of financial institutions, brokers, and financial consultants taking up merchant banking, and offered stiff competition to the commercial banks. Thus, leading banks like SBI and Canara Bank set up separate merchant banking subsidiaries. At present around eight commercial banks have set up merchant banking subsidiaries.

Merchant banking business in our country is being performed by three categories of institutions-commercial banks, national and state level financial corporations like IDBI, ICICI, IFCI, and leading broker firms like H. L. Financial Consultancy and Management services, Champak Investments and Financial. Consultancy Company, Lloyds Finance, Kotak Mahindra, etc.

Functions: Merchant banks help the entrepreneur in conception of an idea, identification of projects*, obtaining sanctions and approvals from state and central government departments, licence and registeration.

As sponsors of issue, they obtain consent from the Securities and Exchange Board of India (SEBI) for the issue of capital, arrangements for underwriting, and for the appointment of brokers to the issues. They also undertake preparation of prospectus, press publicity and compliance with stock exchange requirements.

Merchant banks also undertake credit syndication, i. e. preparation of project files, loan applications for financial assistance on behalf of promoters from various financial institutions for term loans, working capital finance for new projects etc.

Merchant banks also render such services as corporate counseling and advice on mergers, acquisition and reorganisation.

In short merchant banks translate project ideas into industrial ventures.

The important difference between commercial banks and merchant banks is that while commercial banks basically deal in debt and debt related finance, the sphere of activity of merchant banks is equity and equity related finance. Commercial banks are

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* Identification of projects includes location of project, availability of raw material, skilled labour, tax incentives and concessions.

asset oriented while merchant banks are management oriented.

Since 1993, merchant banking has been statutorily brought under the regulatory framework of the SEBI. Accordingly, all merchant bankers will require authorisation by the SEBI to do business. SEBI will prescribe a code of conduct which will take into account professional competence, quality of personnel and infrastructure, capital adequacy, and past track record. Under the code of conduct, the merchant bankers will have to ensure transparency of operations. They will have to submit half yearly report to SEBI. SEBI has been empowered to suspend or cancel the authorisation in case of violation of the guidelines.

There is a tremendous demand for merchant banking services in the country. But the supply of such services is limited as compared to demand. Merchant banking operations have been largely confined to managing issues, but very little work has been done in investment counselling and project appraisals. Thus, existing merchant banks should broad base their present activities.

MUTUAL FUNDS*

Mutual funds (MFs) is essentially a mechanism of pooling together the savings of a large number of investors for collective investments with the objective of attractive yields and appreciation in their value. Mutual Funds come to the rescue of investors who have limited resources and lack of professional knowledge associated with investment business. An advantage of mutual funds over other investments is that there is always a market for its units/shares–close-ended schemes** can always be sold in the share market, whereas under open-ended scheme*** investors can always approach the fund for repurchase at Net Asset Value.

Mutual Funds came in India with the establishment of Unit Trust of India in 1964. The monopoly of UTI ended in 1987, when the government amended the Banking Regulation Act to permit commercial banks to launch mutual funds in India. The State Bank of India was the first bank to launch a mutual fund called SBI Mutual Fund in July 1987. Another scheme, known as 'Magnum Monthly Income Scheme was launched in

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*These are called Unit Trusts in UK

**, ***Operationally, MF schemes can be classified into open-ended schemes and close-ended schemes. In open-ended schemes, the size of scheme is 'open', or not specified. The investor can subscribe to the fund at any time. The shares or units are normally not traded on the stock exchange but are repurchased by the fund at periodically announced rates. Both the amount, and the period are flexible.

Close-ended schemes have a definite period after which their shares/units are redeemed. The opening and closing dates of subscription are clearly intimated to investors. These are traded in the secondary market as these have to be quoted on the stock exchange. A fixed number of shares/units are issued, represented by a certificate.

June 1989, while 'Magnum Tax Saving Scheme' was launched in 1990. The next major entrant was Canara Bank which established its 'Can bank Mutual Fund' in 1987. During 1989-90, three more banks, viz, Indian Bank, Bank of India, and Punjab National Bank set up mutual funds. In all, seven public sector banks have set up mutual funds. Since then, India has witnessed a rapid growth of schemes, investible funds, and investors in mutual funds. SEBI has approved 21 private sector sponsors to set up mutual funds and 10 mutual funds in the public sector.

A new instrument which has emerged in the MFs business in India since 1992 is the Money Market Mutual Fund (MMMF). The MMMF's are exclusively meant for the money market to undertake investments of exclusively short-term nature such as commercial paper, certificates of deposits, bill discounting, and treasury bills. State Bank of Hyderabad has been granted in principle approval to set up a MMMF.

Each MF is a pool of diversified securities and a form of collective investment that is useful in spreading risks and optimising returns. MF operations manage their portfolio of securities and earn income through dividend, interest, and capital gains. This income is transferred to mutual fund shareholders who are assured of a reasonable rate of return on their saving, irrespective of the' way the capital market behaves.

The Govt. of India has come out with comprehensive guidelines governing the formation and operations of all the mutual funds, and the SEBI (Securities and Exchange Board of India) has been vested with statutory powers to oversee the operations of MF's. SEBI has introduced a uniform set of regulations governing the mutual funds in the country, known as SEBI (Mutual Fund) Regulation, 1993. Besides, the RBI also issue guidelines from time to time.

Mutual funds are promoting, apart from a healthy capital market, much wanted equity culture and supplying the much needed financial capital to industries through direct subscription and promoters participation. But despite the fact that there has been a considerable growth in MF's in India, in the global perspective their number is still negligible. This is mainly because investor confidence in mutual funds has been low.

FACTORING

Factoring is a bank service which may or may not involve the grant of bank credit. It is a method by which a businessman can obtain cash for invoices* he sends to his customers in respect of supply of goods and services to them. It is also termed as 'invoice discounting'. It involves the sale of receivables to a financial institution a commercial financial company or a commercial bank.

Very often, suppliers of goods and services, particularly in the small-scale sector, face working capital constraints when they have to wait for a long time to recover

*Invoice : A list of items provided (or work done) together with their cost, for payment at a later date.

payments for goods and services they have provided. Such trade credit gets locked up in the form of receivables which takes a long time for realisation. Timely collection and efficient management of receivables is of utmost importance to them for efficient fund management. Such enterprises would be happy to sell such assets (receivables) for cash, even at a discount, which could be put to more productive use. A factor makes such a transaction possible.

Let us first understand the modus operandi of a factoring institution:

When a firm wants to factor its receivables, it submits particulars such as a list of customers, amount of the order, terms of sales, etc. to the factoring institution before despatching any merchandise to its customers. The factor scrutinises each customer's account of the client firm to make a decision whether to 'accept' or 'reject' the order. The factor returns to the client the list submitted with these orders. The client is free to supply to a customer, who has been rejected by the factor, at his own risk.

After the goods are despatched, the client firm prepares an assignment schedule and attaches a copy of invoice and delivery challan. In the assignment schedule, complete details about the sale viz. customer name, address, terms of sale, due dates, amount of invoices are recorded. The invoices are stamped before being sent to the buyer directing him to make the payment to the factor. All the parties involved should have records.

The factoring institution scrutinises the assignment schedule to segregate approved and unapproved buyers. The client company's account is then credited with the entire amount of the invoice less commission, in case of approved buyers, and 90% of invoice less commission, for 'unapproved buyers'.

The factor prepares an 'accounts current' at the end of the month to reveal the exact financial standing the client has with him. The interest charges and commissions are also recorded therein.

Types of Factoring Services :-

1. Full Service Factoring (without recourse) :- This includes all types of facilities including credit protection. The client sells the goods to the customer and invoices him in the usual way only inscribing a notification to the effect that the debt due on the invoice is assigned to and must be paid to the factor. The client offers the invoice to the factor along with other documents. The factor buys all debts and agrees to provide immediate prepayment upto 80-85 % of the value of the assigned invoices.

The factor takes upon himself to collect funds from the client's customer, absorbing any credit loss along the way. The remaining amounts are paid over on agreed dates, based on maturity dates of the invoices irrespective of whether the factor has received payment from the customer or not. He is not responsible for claims of defective goods or disputes covering despatches/ shipments.

Thus, the factor takes on itself the risk that payment may not be made. For this extra risk the factor will charge more from the client.

Since factor is assuming credit risk he takes the responsibility for credit control, assesses the credit risk and decides what amount of credit will be allowed to individual customers. The factor has to closely examine the financial viability of each debtor of his client before entering into any agreement.

The factor also undertakes sales ledger administration responsibilities of the client including maintenance of books, accounting etc.

The factor also offers consultancy services in areas of production, financing and marketing.

(2) Full Service Factoring with Recourse :- This includes all facilities except that of credit protection i.e. if any debt is not paid by debtor on maturity, the factor can recover his dues from the (seller) client and the debt is reassigned back to the (seller) client.

Beginners in factoring services begin with recourse factoring.

(3) Invoice Discounting/ Credit Factoring :- The factor purchases all or selected invoices of its clients at a discount. The factor does NOT maintain sales ledger for its clients, nor undertakes debt collection.

The customer is not aware that the client is availing any factoring facility. Hence it is also called Confidential Discounting.

(4) Maturity Factoring/Debt Administration:- Here, the service provided may be purely administrative. These services are -

- monitor and maintain sales ledger
- issue and despatch invoices
- collect debts on due date.

This is also known as Collection factoring.

(5) Bulk factoring :- A variation of invoice discounting, in which finance is provided by the factor to the seller / client only after notification to the debtors to make payment to the factor.

Protection against bad debts, sales ledger administration, collection of debts is NOT provided.

(6) Agency factoring :- Amounts to bulk factoring with additional facility of insurance against bad debts.

Sales ledger administration and collection of debts is NOT provided.

Difference Between Bill Discounting (B.D.) and Factoring (F)

B.D.	F.
(i) Provides only finance to clients	(i) Offers other services,
(ii) Drawee or acceptor is aware of bank's charge or receivables.	(ii) Sometimes confidential
(iii) Individual transaction-each bill is assessed.	(iii) Bulk financing concept is followed.

In view of the desirability and usefulness of factoring-services, the RBI appointed a study group in 1988 under the chairmanship of Mr. C.S. Kalyansunderam. The study group suggested that only select promoter institutions, groups or individuals with good track record in finance and management should be permitted into this new field at least in early years. The report of the Working Group on Money Market (Vaghul Committee) constituted by RBI also recommended that banks should be encouraged to set-up factoring divisions.

India's first factoring company was set up jointly by Canbank Financial Services Ltd. and Rashtriya Chemicals and Fertilisers Ltd. to act as a specialised agency to dealers in fertilizers. State Bank of India and Punjab and Sind Bank have been permitted to form subsidiary to provide factoring services in Northern region. With a view to catering -to the needs of eastern region, United Commercial Bank, United Bank of India and Allahabad Bank have been permitted to float subsidies.

Factoring is an activity which has not taken off in a big way in India. In the factoring segment, Canbank Factors, heads the banking subsidiaries in the market, followed by SBI Factors and Commercial Services. Hong Kong Bank has also been given permission to commence factoring operations. Since 1994, the RBI has permitted banks also to undertake factoring departmentally (in house). This is now being done by American Express Bank, Bank of America and Global Trust Bank.

FORFAITING :

Closely associated with the concept of factoring is the concept of forfaiting.

A form of financing of receivables arising from international trade is known as forfaiting. Within this arrangement a bank or financial institution undertakes the purchase of trade bills or promissory notes without recourse to the seller. Purchase is through discounting of the documents covering the entire risk of non-payment at the time of collection. All risks, thus, become the full responsibility of the forfaiter (purchaser).

Forfaiting is essentially aimed at protecting the exporter from any default risk. The bills of exchange accepted by the importer, and co-accepted by a bank in favour of the forfaiting agency, are exchanged for the discounted cash proceeds, without recourse by the exporter.

While factoring is for transactions with short-term maturity period, forfaiting is for transactions with medium term maturity period. Factoring can be either with or without recourse, but forfaiting can be without recourse only. A factor also provides other services, but forfaiting is a pure financing arrangement. In India, forfaiting has been permitted to exporters since 1992, essentially as a method of post shipment export finance.

VENTURE CAPITAL

Venture capital, also known as greenfield financing, seed capital or start up capital, refers to the commitment of capital for the formation of setting up of firms

particularly to those specialising in new ideas or new technologies. Venture capital financing involves financial engineering well beyond the conventional loan giving exercise and involves considerable risk. Hence it would not be fair to involve the general investing public initially in' such ventures. The scope of activities include seed capital for industrial start ups, additional capital to new businesses at various stages of their growth, capital to new enterprises for foreign operations, expansion, diversification etc.

Venture capital funds usually provide equity finance rather than debt finance. In India, venture capital fund was first started by Industrial Finance Corporation of India (IFCI), which started the Risk Capital Foundation in 1975 (now converted into a company Risk Capital and Technology Finance Corporation Ltd. (RCTFC) as a subsidiary of IFCI).

The ICICI also set up the Technology Development and Information Corporation of India Ltd. (TDICI)* for providing venture capital. In the private sector, the first venture capital company 'Credit Capital Venture Fund' was set up in April 1989. This was followed by 20th Century Venture Capital Corporations and Indus Venture Capital Fund.

Venture capital is a new area where banks have entered. The major player in this market is the Can bank Venture Capital fund which had a line of credit from World Bank for its 'first fund'. A number of banks such as State Bank of India, Andhra Bank, Union Bank of India have contributed towards equity of venture capital funds floated by TDICI, Gujarat Investment Corporation etc. Grindlays Bank has launched India Investment Fund which involves funds raised abroad from nonresident Indians to be used for projects which need venture financing.

HOUSING FINANCE

In tune with their conservative traditions in lending, commercial banks played a very limited role in providing housing finance till the early seventies. However, now housing finance is a part of lending schemes for banks.

The Central Government has adopted a comprehensive National Housing Policy (NHP) which envisages development of a viable and accountable institutional system for provisions of housing finance. An outcome of the NHP has been the setting up of an apex institution-the National Housing Bank (NHB) as a subsidiary of the RBI under the NHB Act, 1987. A number of specialised housing financing subsidiaries have been floated by scheduled commercial banks. Initially, there were only five banking subsidiaries in the field of housing finance-SBI Home Finance, BOB Housing Finance; PNB Housing Finance, Cent bank Home Finance, and Vibank Housing Finance.

HIRE-PURCHASE

Hire-purchase is a type of instalment credit which is the provision of finance to be repaid by instalments over a period in accordance with a contractual arrangement.

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* Now known as ICICI Venture Fund Management Co.

The Government of India has permitted banks to engage in hire-purchase business. Under the RBI guidelines, banks can undertake hire-purchase business, through a subsidiary and not directly, and an existing or new subsidiary shall not engage itself in the financing of other companies or concerns engaged in hire-purchase business. The subsidiary of a commercial bank may lend either to the dealer or to a finance intermediary who has already financed articles sold by the dealer to the hirer under a hire-purchase contract.

While considering proposals from dealers or hire-purchase financing companies, the bank subsidiary should take precautions and look to the particular nature of transaction under hire-purchase contract. It should make an assessment of the financial standing of the dealer hire-purchase company, and take into consideration the principles of good lending.

CONCLUSION

We have discussed above some of the innovations in Indian banking. But these, in no way, constitute a complete list of the activities that banks in our country have been undertaking since 1980s. Banks have also entered areas like securitisation, stock-broking, financial guarantees and of course, innovations in payments mechanism like credit cards, debit cards and Automated Teller Machines (ATMs). Another facility is that of Anywhere Banking (also known as core banking solutions) under which a customer having an account with any select branch can operate it from other designated branches of the bank throughout the country. State Bank of Patiala (now merged with State Bank of India)is one of the banks to provide this facility to its customers. New private sector banks, foreign banks and a few old private sector banks are also offering core banking solutions (CBS). Some of these activities (also known as parabanking activities) are carried through subsidiaries, for e.g. leasing, merchant banking, factoring, housing finance etc. while others are carried in-house (credit cards, money market mutual funds etc.)

However, it must be realised that para banking activities have not only the potential for higher profits, but also possess the drawback of greater volatility. Parent banks have been using banking subsidiaries to undertake prohibited transactions. In such a scenario,

SUGGESTED READINGS
(L.No. 9 to 11)

1. Suraj B. Gupta : Monetary Economics: Thoery, Institutions and Policy
2. Dudley G. Luckett : Money and Banking
3. Gaurav Datt and Ashwani Mahajan : Datt and Sundharam Indian Economy (Latest edition)
4. H.R. Suneja : Innovations in Banking Services
5. D. Ajit : Para Banking in India: Some Issues", in Economic and Political Weekly, Vol xxxi, No. 42, October 18-24, 1997.

QUESTIONS [FOR PRACTICE ONLY]
(L.No. 9-11)

Long Answer Type:-

1. Discuss the funtions of commerical banks.
2. Critically examine the theories of commerical banks.
3. Discuss the innovations in commerical banking services.
4. How do commerical banks create credit? What are the limitations to creation of credit?

Short Answer Type

Write brief notes on:

1. Destruction of credit
2. Definition of commerical bank.
3. Merchant Banks
4. Leasing
5 Factoring
6 Commerical Loan Theory of Banks.
7 Agency Funtions of Commerical banks.