

# Banking Theory and Practice -Study Material

## (II B.Com – General)

### UNIT – I

#### **1. Functions of Commercial Banks**

Commercial banks are financial institutions that accept deposits from the public and provide loans to individuals, businesses, and other entities, acting as intermediaries in the financial system. They play a pivotal role in mobilizing savings, facilitating payments, and supporting economic growth. Below is a detailed description of their primary and secondary functions.

##### **Primary Functions**

###### **1. Accepting-Deposit:**

Commercial banks accept various types of deposits to cater to different customer needs:

- **Demand Deposits:** These include current accounts and savings accounts. Current accounts are used by businesses for frequent transactions with no interest, while savings accounts offer nominal interest and allow limited withdrawals.
- **Fixed Deposits:** Also known as term deposits, these are funds deposited for a fixed period (e.g., 1 year, 5 years) at a higher interest rate, encouraging long-term savings.
- **Recurring Deposits:** Customers deposit a fixed amount regularly, earning interest over a specified period, ideal for small savers.

###### **2. Advancing-Loans:**

Banks lend money to individuals, businesses, and governments, generating revenue through interest. Types of loans include:

- **Personal Loans:** For individual needs like education, medical expenses, or purchasing consumer goods.
- **Business Loans:** To support working capital, expansion, or purchasing assets for businesses.
- **Overdrafts and Cash Credits:** Short-term credit facilities allowing account holders to withdraw more than their balance, subject to a limit.
- **Home and Vehicle Loans:** Secured loans for purchasing property or vehicles, with the asset as collateral.
- **Agricultural Loans:** Tailored for farmers to buy seeds, fertilizers, or equipment.

###### **3. Credit**

###### **Creation:**

Commercial banks create credit by lending out a portion of their deposits while maintaining a reserve ratio as mandated by the central bank (e.g., RBI). This process, known as the money multiplier effect, expands the money supply in the economy, facilitating economic activities.

## Secondary Functions

### 1. Agency

#### Functions:

Banks act as agents for their customers by:

- **Collecting Payments:** Handling cheques, bills, dividends, or other payments on behalf of clients.
- **Making Payments:** Paying bills, insurance premiums, or subscriptions as per customer instructions.
- **Acting as Trustees or Executors:** Managing trusts or estates as per client directives.

### 2. Utility

#### Functions:

Banks provide services that enhance customer convenience and support economic transactions:

- **Safe Deposit Lockers:** Offering secure storage for valuables like jewellery or important documents.
- **Foreign Exchange Services:** Facilitating currency exchange and international transactions for trade or travel.
- **Issuing Letters of Credit and Guarantees:** Supporting trade by guaranteeing payments or creditworthiness.
- **Internet and Mobile Banking:** Providing digital platforms for account management, fund transfers, and bill payments.

### 3. Investment

and

#### Advisory

#### Services:

Many banks offer wealth management services, including investment in mutual funds, insurance products, or government securities, and provide financial advice to clients.

## Role in Economic Development

Commercial banks contribute to economic growth by:

- Mobilizing savings for productive investments.
- Financing industries, agriculture, and small businesses.
- Supporting infrastructure development through loans.
- Facilitating international trade via foreign exchange and credit facilities.

## Challenges and Regulations

Commercial banks operate under strict regulations by the central bank (e.g., RBI in India) to ensure stability and protect depositors. They face challenges like non-performing assets (NPAs), cyber threats, and competition from fintech companies, requiring them to innovate and maintain trust.

## 2. Functions of the Reserve Bank of India (RBI)

The Reserve Bank of India (RBI), established in 1935 under the Reserve Bank of India Act, 1934, is India's central bank and monetary authority. It regulates the financial system, controls the money supply, and ensures economic stability. Its functions can be categorized into monetary, regulatory, developmental, and other roles.

### Monetary Functions

- Monetary Policy Formulation:**  
The RBI formulates and implements monetary policy to control inflation, stabilize the currency, and promote economic growth. Tools include:
  - **Repo Rate:** The rate at which RBI lends to commercial banks, influencing liquidity and credit availability.
  - **Reverse Repo Rate:** The rate at which RBI borrows from banks, controlling excess money supply.
  - **Cash Reserve Ratio (CRR):** The percentage of deposits banks must keep with the RBI, regulating lending capacity.
  - **Statutory Liquidity Ratio (SLR):** The portion of deposits banks must invest in government securities, ensuring liquidity.
- Currency Issuance:**  
The RBI has the sole authority to issue currency notes (except coins, issued by the Government of India). It ensures adequate supply, maintains currency quality, and combats counterfeiting.
- Control of Credit:**  
The RBI uses qualitative and quantitative measures to regulate credit:
  - **Quantitative Measures:** Adjusting interest rates or reserve ratios to control money supply.
  - **Qualitative Measures:** Setting lending priorities (e.g., for agriculture or MSMEs) to direct credit to productive sectors.

### Regulatory and Supervisory Functions

- Regulation of Banks:**  
The RBI licenses, supervises, and regulates commercial banks, cooperative banks, and non-banking financial companies (NBFCs) to ensure financial stability.
  - Issues guidelines on capital adequacy, risk management, and corporate governance.
  - Conducts inspections to monitor compliance and financial health.
- Foreign Exchange Management:**  
Under the Foreign Exchange Management Act (FEMA), 1999, the RBI regulates foreign exchange transactions, stabilizes the rupee's external value, and manages India's foreign exchange reserves.

- 3. Consumer Protection:**  
The RBI ensures fair banking practices, resolves customer grievances through the Banking Ombudsman, and promotes financial literacy.

### Developmental Functions

- 1. Promotion of Financial Inclusion:**  
The RBI encourages banks to open branches in rural areas, promote schemes like Jan Dhan Yojana, and support microfinance to include underserved populations in the financial system.
- 2. Development of Financial Markets:**  
The RBI develops money, government securities, and forex markets to ensure liquidity and efficiency. It regulates payment and settlement systems like NEFT, RTGS, and UPI.
- 3. Support for Economic Policies:**  
The RBI aligns its policies with government objectives, such as promoting exports, supporting MSMEs, or financing infrastructure projects.

### Other Functions

- 1. Banker to the Government:**  
The RBI manages the government's banking needs, including maintaining accounts, raising loans, and managing public debt.
- 2. Banker to Banks:**  
It acts as a lender of last resort, providing funds to banks facing liquidity crises, and operates the clearing house for interbank transactions.
- 3. Economic Research and Data Collection:**  
The RBI conducts research, publishes reports (e.g., Annual Report, Financial Stability Report), and collects data to guide policy decisions.

### Significance

The RBI's multifaceted role ensures monetary stability, financial system resilience, and economic growth. Its policies balance inflation and growth, protect depositors, and foster trust in the banking system.

## **3. Distinction Between Central Bank and Commercial Banks**

The central bank (e.g., RBI in India) and commercial banks serve distinct roles in the financial system. While both are integral to economic stability, their objectives, functions, and operations differ significantly. Below is a detailed comparison.

### 1. Definition and Ownership

- **Central Bank:** A government-established institution (e.g., RBI, established under the RBI Act, 1934) responsible for monetary policy and financial regulation. It is typically publicly owned or operates under government control.

- **Commercial Banks:** Financial institutions (e.g., SBI, HDFC Bank) that accept deposits and provide loans to the public. They can be public (e.g., SBI), private (e.g., ICICI), or foreign-owned, operating for profit.

## 2. Objectives

- **Central Bank:** Aims to ensure monetary stability, control inflation, promote economic growth, and maintain financial system stability. Its focus is on public welfare and national economic goals.
- **Commercial Banks:** Focus on profit maximization by providing banking services, earning interest on loans, and charging fees for services.

## 3. Functions

- **Central Bank:**
  - Issues currency and controls money supply.
  - Formulates monetary policy (e.g., repo rate, CRR).
  - Regulates and supervises banks and NBFCs.
  - Acts as banker to the government and banks.
  - Manages foreign exchange reserves and stabilizes the currency.
- **Commercial Banks:**
  - Accept deposits (savings, fixed, current).
  - Provide loans and credit facilities (personal, business, home loans).
  - Offer agency services (e.g., bill payments) and utility services (e.g., lockers, internet banking).
  - Facilitate credit creation through lending.

## 4. Customers

- **Central Bank:** Primarily serves the government, commercial banks, and other financial institutions. It does not deal directly with the public for banking services.
- **Commercial Banks:** Serve individuals, businesses, and organizations, offering a wide range of retail and corporate banking services.

## 5. Profit Motive

- **Central Bank:** Operates for public welfare, not profit. Any surplus is transferred to the government (e.g., RBI transfers dividends to the Government of India).
- **Commercial Banks:** Operate to earn profits through interest rate spreads, fees, and other financial services.

## 6. Regulatory Role

- **Central Bank:** Regulates and supervises commercial banks, setting guidelines on capital adequacy, lending practices, and risk management.

- **Commercial Banks:** Operate under the central bank's regulations, complying with policies like CRR, SLR, and priority sector lending norms.

## 7. Credit Creation

- **Central Bank:** Indirectly influences credit creation by setting reserve ratios and interest rates, controlling the money supply.
- **Commercial Banks:** Directly create credit by lending a portion of their deposits, contributing to the money multiplier effect.

## 8. Examples

- **Central Bank:** Reserve Bank of India (RBI), Federal Reserve (USA), European Central Bank (ECB).
- **Commercial Banks:** State Bank of India, HDFC Bank, ICICI Bank, Citibank.

## 9. Policy Instruments

- **Central Bank:** Uses monetary policy tools like repo rate, open market operations, and reserve ratios to regulate the economy.
- **Commercial Banks:** Follow central bank policies but focus on operational decisions like loan approvals, interest rates on deposits, and customer service.

## 10. Role in Crisis

- **Central Bank:** Acts as a lender of last resort, providing liquidity to banks during financial crises, and stabilizes the economy during downturns.
- **Commercial Banks:** May face liquidity issues during crises and rely on the central bank for support.

## Conclusion

The central bank and commercial banks complement each other in the financial system. The central bank sets the regulatory and monetary framework to ensure stability, while commercial banks execute retail and corporate banking functions to drive economic activity. Their distinct roles ensure a balanced and efficient financial ecosystem.

## 1. Credit Creation

Credit creation is the process by which commercial banks generate money in an economy by extending loans and advances beyond their physical cash reserves. This ability stems from the fractional reserve banking system, where banks are required to keep only a fraction of their deposits as reserves, lending out the remainder. The process significantly expands the money supply, facilitating economic growth.

### Process of Credit Creation

1. **Initial Deposit:** A bank receives a deposit, say Rs. 1000, from a customer. Assuming a reserve requirement of 10%, the bank keeps Rs. 100 as reserve and can lend Rs. 900.
2. **Loan Creation:** The Rs. 900 is lent to a borrower, who spends it, and the amount is deposited into another bank account, possibly in the same or a different bank.

3. **Secondary Deposit:** The second bank receives Rs. 900, keeps 10% (Rs. 90) as reserve, and lends out Rs. 810. This process continues, with each subsequent loan creating new deposits.
4. **Money Multiplier:** The total money created is calculated using the money multiplier formula: **Total Credit = Initial Deposit × (1/Reserve Ratio)**. For a 10% reserve ratio, the multiplier is 10, so a Rs. 1000 deposit can create up to Rs. 10,000 in the economy (Rs. 1000 + Rs. 900 + Rs. 810 + ...).

### Assumptions

- All transactions occur within the banking system.
- Banks lend out the maximum permissible amount.
- There is demand for loans, and borrowers utilize the full loan amount.
- No cash leakages occur (e.g., people holding cash outside banks).

### Limitations

- **Reserve Ratio:** A higher reserve requirement reduces the multiplier effect.
- **Cash Leakages:** If individuals hold cash, less money re-enters the banking system.
- **Loan Repayment:** If loans are repaid quickly, the money supply contracts.
- **Economic Conditions:** During recessions, demand for loans may decrease, limiting credit creation.

### Significance

Credit creation stimulates investment, production, and consumption, driving economic growth. However, excessive credit creation can lead to inflation, while inadequate creation may cause economic stagnation. Central banks regulate this process through monetary policy tools like reserve ratios, open market operations, and interest rates.

## 2. Kinds of Banks

Banks are financial institutions that accept deposits, provide loans, and offer financial services. They vary based on their functions, ownership, and target customers. Below is a detailed classification of the kinds of banks.

### 1. Commercial Banks

These are profit-oriented banks that cater to individuals, businesses, and industries. They accept deposits (savings, current, fixed) and provide loans (short-term and long-term). Services include overdrafts, bill discounting, and trade financing. Examples include State Bank of India, HSBC, and Citibank.

### 2. Central Bank

The central bank is the apex monetary authority, responsible for regulating the banking system and controlling money supply. It acts as a banker to the government and commercial banks, issues

currency, and formulates monetary policy. Examples include the Reserve Bank of India (RBI) and the Federal Reserve (USA).

### **3. Cooperative Banks**

These banks serve members of cooperative societies, primarily in rural and semi-urban areas. They provide affordable credit to farmers, small businesses, and low-income groups. They are divided into urban cooperative banks and rural cooperative banks (e.g., District Cooperative Banks).

### **4. Development Banks**

These banks provide long-term finance for industrial and infrastructure development. They support projects in agriculture, industry, and trade, often with government backing. Examples include the Industrial Development Bank of India (IDBI) and the National Bank for Agriculture and Rural Development (NABARD).

### **5. Investment Banks**

Investment banks assist corporations and governments in raising capital through underwriting securities (stocks, bonds) and providing advisory services for mergers and acquisitions. Examples include Goldman Sachs and Morgan Stanley.

### **6. Regional Rural Banks (RRBs)**

RRBs focus on rural development, providing credit to farmers, artisans, and small enterprises. They are sponsored by commercial banks, the central government, and state governments. Example: Gramin Banks in India.

### **7. Small Finance Banks**

These cater to underserved sections, offering basic banking services like savings accounts and small loans. They aim to promote financial inclusion. Examples include Ujjivan Small Finance Bank and AU Small Finance Bank.

### **8. Payment Banks**

These banks offer limited services like deposits, remittances, and bill payments but cannot provide loans or credit cards. They target unbanked populations using technology-driven platforms. Example: Airtel Payments Bank.

## **3. Commercial Bank**

A commercial bank is a financial institution that accepts deposits from the public and provides loans to individuals, businesses, and industries to earn profit. It acts as an intermediary between savers and borrowers, facilitating money circulation and economic activity. Commercial banks are regulated by the central bank (e.g., RBI in India).

### **Functions of Commercial Banks**

#### **1. Accepting Deposits:**

- **Savings Accounts:** Interest-bearing accounts for individuals.

- **Current Accounts:** Non-interest-bearing accounts for businesses with unlimited transactions.
  - **Fixed Deposits:** Term deposits with higher interest rates for a fixed periods.
2. **Providing Loans and Advances:**
    - Short-term and long-term loans for businesses, housing, education, and personal needs.
    - Overdrafts, cash credit, and bill discounting to meet working capital requirements.
  3. **Credit Creation:**
    - Through fractional reserve banking, commercial banks create money by lending multiple times their reserves (explained in Credit Creation section).
  4. **Agency Functions:**
    - Collecting cheques, dividends, and utility bill payments on behalf of customers.
    - Acting as executors, trustees, or financial advisors.
  5. **General Utility Services:**
    - Issuing letters of credit, traveler's cheques, and bank drafts.
    - Providing locker facilities, foreign exchange services, and digital banking (e.g., net banking, mobile apps).
  6. **Trade Financing:**
    - Facilitating international trade through export-import financing and guarantees.

### **Types of Commercial Banks**

- **Public Sector Banks:** Government-owned, e.g., State Bank of India.
- **Private Sector Banks:** Privately owned, e.g., HDFC Bank, ICICI Bank.
- **Foreign Banks:** Operate in host countries, e.g., Standard Chartered, Citibank.
- **Regional Rural Banks:** Focus on rural areas, sponsored by commercial banks.

### **Role in Economy**

- **Mobilizing Savings:** Channelizing idle funds into productive investments.
- **Promoting Entrepreneurship:** Providing credit for startups and businesses.
- **Facilitating Trade:** Supporting domestic and international trade through financing.
- **Financial Inclusion:** Expanding banking services to underserved populations via digital platforms.
- **Monetary Policy Transmission:** Implementing central bank policies by adjusting lending rates and credit supply.

### **Challenges**

- **Non-Performing Assets (NPAs):** Rising bad loans affect profitability.
- **Competition:** From fintech firms and non-banking financial companies.
- **Regulatory Compliance:** Adhering to strict central bank norms.
- **Cybersecurity:** Protecting against digital fraud and data breaches.