

UNIT III SERVICE BUSINESS - I

CHAPTER

12

FUNCTIONS OF COMMERCIAL BANKS



Learning Objectives

To enable the students to

- i. understand the primary and secondary functions of commercial banks
- ii. explain the diversified banking services
- iii. describe the uses of debit, credit and smart cards

Functions of Commercial Banks

They render many valuable services. The important functions of the Commercial banks can be explained with the help of the following chart

12.01 Primary Functions

The primary functions of a commercial bank are of three types. They are:

- I. Accepting Deposits
- II. Granting Loans and Advances.
- III. Creation of Credit

I. Accepting Deposits

The basic deposit accounts offered by commercial banks are listed below. In these days banks compete with each other to attract customers by adding facilities to these deposit accounts. Broadly deposit accounts can be classified into demand deposits and time deposits.

A. Demand Deposits

These deposits are repayable on demand on any day. This consists of savings deposits and current deposits.

1. Savings Deposits

General public deposit their savings into this account. This account can be opened in one individual's name or more than one name. Section 25 companies also can open savings accounts. Business firms are not permitted to open savings account. The rate of interest allowed on this deposit is lower than fixed deposits. Interest is paid on the basis of the amount and number of days the amount remains credited in the account. The bank provides facilities like cheque book, ATM (Automated Teller Machine) card etc. There is limit on number of ATM card withdrawals from other bank ATMs only. A minimum balance should be maintained in this deposit account. Otherwise penal interest is charged. Beyond a number (20 or 60 leaves) cheque book is available for a fee. Nomination can be registered. Salary account is a type of savings account offered to salaried employees in which zero balance is permitted. Some banks offer overdraft facility. An account inactive for a long period will become dormant account.

2. Current Deposits

This account is suitable for business institutions. Individuals too can open this account. A higher minimum balance should be kept in this account. If not penal interest is charged. No interest is paid for the balance in this account. Some banks have started offering interest on these account balances. Banks may collect bank charges on this account. Overdraft (short term unsecured loan) facility is available to current account customers. There is no limitation on deposit of cheques or withdrawals from this account. Credit worthiness of current account business customers are shared among banks.

B. Time Deposits

They include fixed deposits and recurring deposits which are repayable after a period.

1. Fixed Deposits (FD)

Certain amount is deposited for a fixed period for a fixed rate of interest. FDR (fixed deposit receipt) is given to the depositor. Rate

of interest is higher than savings account. On the date of maturity the principal along with interest for the fixed period is paid. A customer can obtain loan by depositing FDR. Pre-mature withdrawal of cash is also allowed for payment of penal charges and it carries no interest. Partial withdrawal also allowed. Fixed deposit period can be 1 month to 10 years. FD is also called term deposit

2. Recurring Deposits (RD)

Certain sum is deposited into the account every month for one year or five years or the agreed period. Interest rate is more than savings deposits and almost equal to fixed deposits. At the end of the period the deposited amounts along with interest are returned to the customer. Premature closing is allowed with a charge or deduction. It is ideal for persons having regular income to save and receive a lump sum. Any institution can open RD account. Minors or students also can open this account. Loan against this deposit is also provided by some banks.

Know Your Customer (KYC) Norms

KYC means “Know Your Customer”. It is the general rule to be followed by banks to get information regarding the identity and address of the customers. This rule helps to ensure that banks’ services are not misused. The KYC process is to be completed while opening accounts. These details should be updated periodically. A person willing to open a bank account, should submit a ‘proof of identity and proof of address’ together with a recent photograph.

Six documents have been notified by the Government of India as ‘Officially Valid Documents’ (OVDs) for the proof of identity. They are Passport, Driving Licence, Voters’ Identity Card, PAN Card, Aadhar Card issued by UIDAI and NREGA Job Card. The person should submit any one of these documents as proof of identity. If such documents also contain his/her address details, then it will be accepted as ‘proof of address’. If not, then another officially valid document which contains address details need to be submitted.



II. Granting Loans and Advances

The second primary function of commercial banks is lending money in order to earn interest income. Banks provide specific sums as loans which are repayable along with interest. Demand loans should be repaid whenever demanded. Term loans can be repaid after the agreed period. Advances are credit facilities provided for short period (within a year) to business community. But both terms are used interchangeably.

A. Advances

1. Overdraft

It is a credit facility extended mostly to current account holding business community customers. It is an arrangement reached between the banker and the credit worthy customers. Such customers are allowed to overdraw (when there is no balance money in the account) up to a certain amount usually for 3 months period. It may be extended for further periods. Only on the withdrawn amount of credit interest is charged and not on the maximum limit allowed. It is an unsecured credit. Secured overdraft against the security of financial instruments is also provided by some banks. It is repayable on demand.

2. Cash Credit

It is a secured credit facility given mostly to business institutions. Stock in hand, raw materials, other tangible assets, etc. are provided as collateral. A certain sum is allowed as credit for a short period. Interest is payable on the actual amount withdrawn and not on the entire credit facility. It is repayable on demand.

3. Discounting of Bills

Business customers approach banks to discount the commercial bills of exchanges and provide money. It is a short term credit instrument. Banks deduct the discount (interest) for the period mentioned in the bill and release the balance amount to the traders. If the bill is dishonoured, the bank can recover the amount from the customer. It is a form of unsecured credit.

B. Loans

Short term and medium term loans are provided by commercial banks against eligible collaterals to business concerns. It is a definite sum of money lent for a definite period. It is repayable in one lump sum or in instalments. Interest is payable on the entire loan amount. Every bank in these days design new methods of advancing loans to find more ways of learning income. Generally commercial banks provide the following loans.

1. Housing Loan

Taking the title deeds of the house as collateral security, based on the monthly income of the borrowing customer, banks advance medium and long term loans. The customer repay the loan in equated monthly instalments (EMI consists of principal and interest). This is a boon to the middle class salaried employees who cannot afford to pay the full price of a house in a lump sum.

2. Consumer Loan

Consumer durables like refrigerator, air conditioner, laptop, washing machine, television, etc. can be purchased by customers with consumer loans from banks. The product purchased is hypothecated



(secured loan arrangement where the movable asset remains with the borrower) as security for the consumer loan amount. The customer pays in equated monthly instalments for a specified period.

3. Vehicle Loan

Two wheelers, cars, buses and other vehicles can be purchased by individuals as well as institutions obtaining vehicle loans from the banks. Vehicles are hypothecated to the bank until the entire loan amount is repaid. Vehicle registration book is deposited with the bank and on full payment of loan amount it will be handed over to the customer.

4. Educational Loan

Loan is provided by banks to students for studying undergraduate, post graduate or professional courses. Loan may be received in instalments to pay the educational fees every year. After completion of the course one year is allowed for the student to get employed. Afterwards, the student should repay the loan with interest for the entire period. Interest is charged from the date of first instalment of loan amount payment.

5. Jewel Loan

Customers pledge their gold jewels and obtain loans from banks. The margin (percentage of value per gram that can be given as credit) requirement is fixed by the RBI. Interest should be paid every month. Otherwise interest on interest is charged. Within 12 months the customer can redeem or else can re-pledge. Jewels not redeemed even after reminders are sold in auction by banks to recover their dues.

III. Creation of Credit

Apart from the currency money issued by the RBI, the credit money in circulation created by commercial banks influence economic activities of a country to a large extent. Credit money of commercial banks is far greater in volume than the currency money. The volume, the purposes and the sector to which this credit money is to be channelised - all these are implemented by commercial banks under the guidance of the RBI.

According to 2011 data, the credit created by all Indian commercial banks was 75.1% of GDP. It was 233.3 % in the USA, 145.5% in China, and 340.9% in Japan.

12.02 Secondary Functions

Apart from the basic or primary functions commercial banks render various other services which are known as secondary functions. These services can be broadly classified into agency services and general utility services.

I. Agency Functions

Banks act as agents of customers and provide certain services. They are called Agency Functions which are as follows:

1. Transfer of Funds

Banks issue demand drafts, bankers' cheques, travelers' cheques, etc. and help in transfer of funds from one place to another. Customers need not carry cash. They can just forward the draft issued by the bank to the receiving institution. A small commission is collected by banks for this service.



2. Periodic Payment of Premiums, Rent, etc.

After instruction from the customers, banks undertake the monthly payment of insurance premium, rent, telephone bill, etc. from the accounts of customers. Now a days these payments are made through electronic clearing system facility offered by the banks.

3. Collection and Payment of Cheques

On behalf of customers bank collect the cheques deposited into the accounts of customers from other banks and deposit cash in the customers' accounts. Similarly cheques issued by a customer is honoured and the amount paid as directed by the customer.

Definition of Cheque: According to Negotiable Instruments Act 1881, "cheque is a bill of exchange drawn on a specified banker payable on demand".

Crossing of Cheque: Drawing two parallel transverse lines on the left top of the cheque. It implies that the money will not be paid over the counter but through bank account only.

4. Acting as Executors, Trustees and Attorneys

Banks act as executors of will of the customers and implement their will after their death. As a trustee a bank takes care of the funds of the customers. Banker signs transfer deed of the properties of the customers in the capacity of attorney to customers.

5. Conduct Share Market Transactions

A Demat account should be opened with Depository Participant and that demat

account should be linked with savings bank account by the customer. Then the customer can ask the bank to conduct online purchase or sale of securities, on behalf him.

6. Preparation of Income Tax Return

Banks prepare the annual income tax return on behalf of the customers and provide income tax related advices to them.

7. Dealing in Foreign Exchange

Banks buy and sell foreign currencies on behalf o customers.

8. Acting as Correspondent

Banks act as correspondent of customers and receive travel ticket, passport, etc.

II. General utility functions

In addition to primary, secondary and agency functions, commercial banks offer some services for the general welfare of the customers. They are called general utility services. They are as follows.

1. Issue of demand drafts and bankers' cheques

Demand drafts and Bankers Cheques are issued to public and customers as well. Instead of sending money they can attach these instruments for payment of educational fees, etc.

2. Accepting Bills of Exchange on behalf of Customers

Banks accept bills on behalf of customers and make payments to the foreign exporter. Afterwards, the banks collect from the customers.



3. Safety lockers

Valuable documents, jewels, etc. can be kept safely in a vault provided by bank for a rent. These vaults room is called 'Strong Room'.

4. Letters of credit

This document is given by bank on behalf of importing customer to the exporter guaranteeing payment for the imported goods. It is a very important document in international trade.

5. Travellers cheques

Customers need not carry cash during travel in India or abroad. The denomination and words are printed in the cheque. It is accepted as money in shops, hotels, travel agencies, etc.

6. Gift cheques

These denomination printed cheques are available in attractive design so that it can be presented during wedding, birthday functions, etc.

7. Reference service

Business firms can give their bank's name as reference to the new business institution with which they want to establish commercial relationship. Banks willingly act as referees and provide information about the financial standing of their customers.

12.03 Diversified Banking Functions

Competition in the banking industry has reduced their profits. Therefore the commercial banks started identifying and offering new and diversified financial services. They are purely other than banking

services. Providing all such banking and other financial services is also called universal banking. Such services are as follows:

1. Bank Assurance

It refers to the offering of insurance policies or products by a bank in association with another insurance company. Banks should follow Insurance Regulatory and Development Authority of India (IRDA) regulations in addition to RBI regulations. Corporation Bank, Oriental Bank of Commerce and Vijaya Bank has tied up with Life Insurance Corporation of India. SBI has joined hands with BNP Paribas Cardif - a French company to sell insurance products.

2. Merchant Banking

Merchant banks do not provide regular banking services. A commercial bank or its subsidiary merchant bank may offer services like project counselling, underwriting, etc. required for starting a company. It is called merchant banking. They are mostly stock market related services. Merchant Banks are controlled by Stock Exchange Board of India (SEBI) regulations also.

3. Retail Banking (Personal Banking)

It refers to mass market banking which reaches out to large number of individual end customers. Apart from accepting deposits, their services include personal loans, vehicle loans, consumer durable loans, loans against equity shares, debit and credit cards, mortgages, etc.



4. Housing Finance

Housing finance is provided against the security of immovable property of land and buildings. Many banks such as SBI, Bank of India, etc, have set up housing finance subsidiaries.

5. Mutual Fund

It is a financial intermediary that pools the savings of investors for collective investment in diversified portfolio securities in the capital market and money market. Many banks like SBI, Indian Bank, etc, have set up mutual fund subsidiaries.

6. Venture Capital Fund

Venture capital fund provides start-up share capital to new ventures of little known, unregistered, risky, young and small private business, especially in technology oriented and knowledge intensive business. Many commercial banks like SBI, Canara Bank, etc. have set up venture capital fund subsidiaries.

7. Factoring

Factoring is a continuing arrangement between a financial intermediary (factor) and a business concern (client) whereby the factor purchase the clients' accounts receivable. Banks like SBI and Canara Bank have established subsidiaries to provide factoring services.

12.04 Electronic Banking Functions

This reduces cost and time and makes banking service convenient to the customers. It is operated through internet. This service is a substitute for drafts, cheques and other paper based transfer of funds.

1. NEFT - National Electronic Funds Transfer

This was launched by the RBI in 2005. Under this electronic funds transfer system, bulk transfer of transactions are settled in batches during specific timings across India. Individuals and institutions which maintain accounts with a NEFT enabled bank branch are eligible for using NEFT. Transactions do not occur under real time basis. Once in every half hour from 8.00 am to 7.30 pm. 23 settlements are allowed in a day. NEFT transfers are not allowed on Sundays and bank holidays. Both NEFT and RTGS use IFSC (Indian Financial System Code) - a 11 digit alphanumeric code, to identify a bank branch. IFSC is provided by IDRBT (Institute for Development & Research on Banking Technology), Hyderabad.

2. RTGS - Real Time Gross Settlement Systems

It was launched by the RBI in 2013. The transactions are settled on real time basis. Gross settlement means the transaction is settled between one bank and another bank without adding any other transactions. RTGS facility is available between 9.00 am to 4.30 pm on weekdays and up to 2.00 pm on Saturdays. In one day the RTGS routes about 60,000 transactions worth about ₹2,700 billion and covers over 52,000 bank branches located in 10,000 cities and towns. RTGS transfers are not allowed on Sundays and bank holidays. Minimum limit for RTGS transaction is 2 lakhs.

3. Electronic Clearing Services (ECS)

ECS was launched by the RBI in 1995. It is an electronic method of fund transfer from a



bank to another bank. ECS credit can be used to credit salary, dividend, interest, pension etc. and ECS debit is used to debit monthly telephone bills, electricity bills, equated monthly installments (EMI) payments. For this purpose the account holding individuals and institutions concerned should fill up certain forms and submit to the banks. ECS transactions between banks are settled in the current account maintained in the clearing house.

4.CORE Banking Solutions

‘CORE’ stands for ‘Centralized Online Real time Exchange’. In the centralized server of the bank, all the details of all the accounts of all the branches of the bank are available. A customer can withdraw money through cheque at any branch of that bank throughout the world. Similarly anyone can deposit money into the account. Entry of the transactions is recorded in the centralized server of the bank in real time and can be seen in all the branches of the bank. This facility is called core banking solutions.

5. Internet Banking or Virtual Banking

Internet banking refers to performing banking operations through internet, using computers and mobile phone. This can be done by a customer from home or office or any part of the world and all 24 hours of 7 days.

6. Mobile Banking

Most of the commercial banks have designed computer programs called apps which can be downloaded in smartphones. With this app in the smartphone a customer can operate his account transactions from

anywhere. This service is known as mobile banking.

7. Automated Teller Machine (ATM) and CDM Facilities

A customer can withdraw money anytime, anywhere in India from the ATM machine using the ATM card given by his/her bank. The machine also shows the balance available in the customers’ account, provides statement print of the few past transactions, etc. Withdrawal of money in other bank ATMs is restricted and will be charged beyond the specified number of usage. Cash Deposit Machine Facility is useful to the public as well as customers to deposit cash into the account anytime. Similarly there are cheque deposit machines which receive cheques at any time.

8. IMPS - Immediate Payment Service

IMPS was launched by the National Payments Corporation of India in November 2010. IMPS allows funds transfer through mobile phone or internet banking by banking customers and approved non-banking partners. Its transactions are on real time basis. The current maximum limit is ₹ 2 lakhs. It made India a leading country in the world in real time payments in retail sector.

9. Funds Transfer Through SMS

*99# is the number for the funds transfer from any mobile phone. It was launched in 2014. Every common man in India can transact banking transactions from any corner of India.

NACH, BBPS, BHIM

National Automated Clearing House founded in 2008 is a web based solution to facilitate interbank high volume electronic transactions which are repetitive and periodic in nature. It will be helpful for banks, financial institutions, Corporates and Governments. It is a centralised system that aim at consolidating multiple ECS systems running across the country and removing local barriers.

Bharat Bill Payment System is a RBI guided system operated by National Payments Corporation of India from August 2016. It is a one stop payment platform for all bills providing anytime anywhere bill payment service to all customers across India with certainty, reliability and safety of transactions.

Bharat Interface for Money is an app that lets a bank customer make simple, easy and quick payment transactions using Unified Payments Interface (UPI). A bank customer can make instant bank to bank payments and pay and collect money using just mobile number or virtual payment address (VPA). It was launched in December 2016.

10. Debit Cards

ATM card is also called debit card. This card is more useful in purchase of goods and services anywhere in India, if the shop maintains a swiping machine facility. VISA card and Maestro card services are offered by Visa Corporation and Mastercard both from the USA. RuPay cards services were launched in March 2012 by the National Payments Corporation of India.



11. Credit Cards

Banks issue credit cards to customers and other eligible persons. With this card, the holder can purchase goods and services on credit at any shop in India. If the dues are paid within the stipulated time no interest is charged. The credit limit is fixed by the issuing bank based on the income of the cardholder.

12.05 Functions of All Commercial Banks in Totality



All commercial banks put together perform certain functions to the development of the country's economy.

1. More production and economic growth

These banks supply the vitamin money to all sectors of the economy including manufacturing sector. As a result all the sectors produce more.

2. Capital formation

Banks encourage savings habit among people and accumulate their small dormant savings. These funds can be fruitfully channelized for productive purposes of the economy.



3. Consortium finance

Thousands of crores required to establish a mega factory is not available from a single source. Banks join together and provide consortium finance in such cases.

4. Service coverage to non-monetised sector

Branches of the banks are opened in rural and village areas so that the non-banking areas are provided banking services.

5. Balanced regional development

Banks transfer funds from surplus areas and make them available in scarce districts or areas for the formation and operation of business institutions. Even growth of different regions can be achieved through this function.

6. Smoothing of trade and commerce

For the efficient functioning of all traders and business institutions in a country, safe keeping of their funds, transfer of funds, payment and collection of funds when and where needed is very much necessary. Banks perform this function.

7. Development of industry, agriculture, MSMEs and SHGs

Banks design methods and instruments of financing each sector differently. They provide finance for small farmers, medium traders as well as industries. For example banks allow micro credit to SHGs, overdraft to traders and issue Certificate of Deposits to finance industries.

8. Implementation of monetary policy

Banks have established customer relationship with all public and business institutions

through the network of branches. Broad guidelines or rules of the Government for the monetary sector of a country cannot be applied without such banks.

9. Encourages export and international trade

Banks open foreign branches or establish correspondent relationship with banks in foreign countries to help exporters. Instruments like letters of credit and international factoring services are undertaken to help exporters and importers.

10. New entrepreneurs and employment opportunities

Entrepreneurs obtain project loans and establish new business houses. By providing the required credit banks generate more economic activities and new employment opportunities.

Key Terms

Deposits, Loans, Electronic, Debit card, Credit card, Smart card, Core banking



For Own Thinking

In all ATM Centers, there are one or two machines, sometime it may be four or five. All ATM machines have some amount of money inside the box. In this way lot of currency notes are locked day by day. Think about the alternate way for avoiding this locking of currency notes.

Debate about the security problem in E-Banking system of services.



For Future Learning

Field visit - nearest - collect information about rate of interest payable on Savings deposit, Fixed deposit, Current deposit and Recurring deposit.

Collect photo copies of the various cards used in our day- to-day life.

Nowadays debit card, credit card, smart cards and other cards are used for day to day purposes. In future how many cards we may use for our purposes.



Case Study

A person forgot his password of Debit card, How to get password? Give guidelines to him.



Exercise



I. Choose the Correct Answer

- Electronic banking can be done through
 - Computers
 - Mobile phones
 - ATM
 - All of the above
- Minimum how much amount can be transferred through RTGS?
 - Any amount
 - 50,000
 - 2 lakh
 - 5 lakh

- The largest commercial bank of India
 - ICICI
 - SBI
 - PNB
 - RBI
- In which kind of account, it is compulsory to deposit certain amount at certain time?
 - Saving deposit
 - Fixed deposit
 - Current deposit
 - Recurring deposit
- Which of the following is not a type of advance provided by commercial bank?
 - Collecting and supplying business information
 - Overdraft
 - Cash credit
 - Discounting of bills

Answers

1. d 2. c 3. b 4. d 5. a.

II. Very Short Answer Questions

- What is Mobile Banking?
- Write a short notes on Debit card.
- Write a short notes on Credit card.
- What do you mean by ATM?

III. Short Answer Questions

- What is E-Banking?
- Write a short note on – RTGS.
- Explain – NEFT.



IV. Long Answer Questions

1. Discuss the various primary functions performed by the Commercial Banks. (any 5)
2. Explain the various secondary functions of Commercial banks. (any 5)

Reference

1. Balaji. C.D. and Prasad. C. 2016, "Principles of Commerce", Margham Publications, Chennai
2. Natarajan. S and Parameshwaran. 2014, "3. Indian Banking", S. Chand & Company Ltd. Delhi
3. Dharmaraj. E, 2005, "Banking Theory - Law and Practice", Scitech Publications
4. Selvaraj. M. 2014, "Modern Banking" - Bavani Pulications.