Commercial Banks

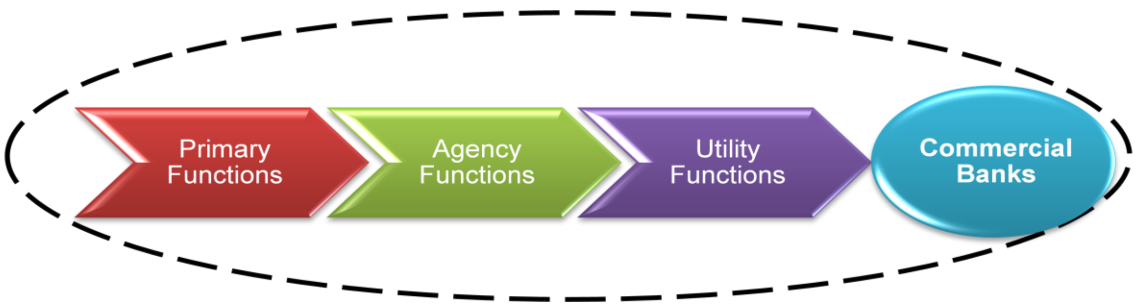
Meaning of Commercial Banks

A commercial bank is a financial institution which provides services such as accepting deposits, giving business loans, mortgage lending and basic investment products such as savings account and certificates of deposit.

The commercial bank is also called a joint stock bank because it is organised on the lines of joint stock companies. Features of commercial banks:

- A commercial bank deals with money, accepts deposits and advances short-term loans to traders.
- Its main aim is to earn profit and create demand deposits which serve as a medium of exchange.

Functions of Commercial Banks



Primary Functions

- Accepting Deposits: Accepting deposits from the public is the primary function of a commercial bank. A bank accepts deposits from individuals in society. To attract savings, banks accept three types of deposits—demand deposits, savings deposits and fixed deposits.

  Demand Deposits and Fixed Deposits
  - The interest rate on demand deposits is very low, whereas fixed deposits carry higher interest rate.
  - Demand deposits can be withdrawn at any time, whereas fixed deposits can be withdrawn only after the expiry of a specific period.
  - Demand deposits are chequable which can be withdrawn through cheques, whereas fixed deposits are not chequable.

- Advancing Loans: A commercial bank advances loans to business people, farmers and consumers against approved securities. Cash credit, overdraft, short-term loans, discounting of bill of exchange and money at call are loans advanced by commercial banks.

Credit facilities provided by a commercial bank:

- Cash credit: Banks sanction cash credit according to the requirement of the borrower on the basis of the bank credit limit. Interest will be paid by the borrower only on the actual amount withdrawn from the bank.
- Overdraft facilities: For overdraft facilities, an account holder can withdraw money in excess of the amount deposited with the bank. However, the borrower will pay interest on excess amount withdrawn from the bank.

Agency Functions

- Commercial banks provide services such as collection and making payments on behalf of their customers such as insurance premium and dividends.
- They also help in transferring funds from one place to another in the form of cheques and drafts.

Utility Functions

- To safeguard valuable items, a commercial bank provides a safety locker to its customers.
- Commercial banks involve in foreign exchange business. They finance foreign trading by accepting foreign bills of exchange.

Importance of Banks

The role of commercial banks in industrial and commercial life of a country:

- A commercial bank helps traders and industrialists by providing financial assistance. Its cheques and drafts are useful for large-scale trading.
- It accepts deposits from people who have a surplus amount and provides loans to investors who are in need for productive activity. Thus, they encourage savings and promote production activities by investing them.
- It helps in the distribution of surplus capital from regions where it is abundant and transfers it to a scarce region.
- It provides concessional loans to the priority sectors such as agriculture, small-scale industry, retail trade and export.

Credit Creation

Bank deposits form the basis for credit creation. Banks accept deposits from the public by opening a deposit account known as the primary deposit. Banks do not hold the money in the account itself and the entire amount is not withdrawn from the account at the same time. So, they advance loans to business people and retain only a small portion of the total deposits in the bank. The Central Bank decides the amount to be held in the form of cash. This is called the cash reserve ratio.

These banks advance loans to business people only against collateral securities. The bank will not give cash but open a derivative account in the name of the individual or institution. Here, the loans create a derivative deposit which is called a secondary deposit or derivative deposit. Thus, the secondary deposit is called the creation of credit.

Limitations of a Commercial Bank to Create Credit

- Credit creation by a commercial bank is based on the primary deposit. Hence, there should be a large amount of cash, but the Central Bank has full control over the cash deposited by the individual. They decide the amount of cash to hold as reserve and the amount for advancing loans.
- Business people can avail loans from the bank only when they have good securities to submit against a loan. If the approved securities are not available to them, then the bank will not be able to create credit as loans.

Nationalisation of Banks

- Arguments in Favour of Nationalisation of Banks
  - Branch expansion: To balance the banking system, nationalised banks set an objective to initiate branch expansion programmes. The number of bank branches was about 8260 in 1969 and it increased to about 80,514 in 2009.
  - Deposit mobilisation: Expansion of bank deposit is important for the development of an economy. Banks played an important role for the development of banking habits among the people in the nation.
  - Priority sector lending: To provide more credit to the priority sectors such as agriculture and small-scale industries.
  - Involvement in development efforts: After nationalisation, these public sector commercial banks have shifted their motive from profitability to development efforts.

- Arguments against Nationalisation of Banks
  - Political pressure: Political influence would start interfering in routine banking activities. Usually, political and administrative intervention in credit decision-making led to a deterioration in the quality of loan portfolios, resulting in poor rates of recovery.
  - Possibility of losses: Commercial banks extend credit facilities to the priority sector at concessional rates of interest which adversely affects the profitability of these banks.
  - Lack of competition: Despite a large number of banks, there was little scope of competition among them because of regulated interest rates. Customer services also deteriorated because there was no competition among these banks to capture business.
  - Trade unions of bank employees: Trade unions of bank employees are the strongest supporters of nationalisation of banks. Hence, bank strikes may lead to an economic crisis.

Privatisation of Banks

- Arguments in Favour of Privatisation of Commercial Banks
  - Commercial banks have the freedom to take decisions regarding loan advancement and are able to choose sectors with higher returns and recoverability.
  - They are free to design various innovative deposit schemes to attract depositors.
  - A competitive environment will be created in the banking sector because these banks will face many other private foreign banks in the banking sector. Hence, each commercial bank will try to survive and evolve new methods to improve their efficiency.

- Arguments against Privatisation of Commercial Banks
  - These banks would reduce the employment opportunities as private bank functions would be directed by profit motives.
  - It may lead to concentration of monopoly power in the hands of private sector banks and increase in unequal distribution of income and wealth of the economy.
  - If some of these banks are also merged with foreign banks and if restrictions on the movements of financial capital from one country to another country are withdrawn, then there will be no guarantee that the savings mobilised from the Indian economy would be recycled within India or abroad.

Classification of Commercial Banks in India

Commercial banks in India are classified on the basis of two aspects. They are

- On the basis of statute—scheduled banks and non-scheduled banks
  Scheduled banks are included in the second schedule of the Reserve Bank of India Act, 1934.
  Non-scheduled banks are not included in the second schedule of the Reserve Bank of India Act, 1934.
- On the basis of ownership—public sector and private sector commercial banks
  A public sector bank is a Government of India undertaking, while a private sector bank is owned by shareholders. In the private sector, both Indian banks and foreign banks are operating in the country.