

LESSON 18

COMMERCIAL BANK – MEANING AND FUNCTIONS

In the present times, 'bank' is most popular and most widely used word, the meaning of which is well known to all. Etymologically, however the bank is derived from the Italian word 'Banco' referring to a bench at which money changer used to display their coins. Later from 'Banke' in French it came to be known as Bank in English.

Another conception is that the word 'bank' is derived from German language 'Banck' which means joint stock fund. Thus, nothing can be definitely said about the origin of the word 'Bank'.

The development of modern banking was in Europe, which later on spread in the whole world.

Definition of Bank:

On basis of meaning and multifarious activities of bank, economists have given many definitions which are as follows-

According to Findlay Shirras:- "A banker or bank is a person, firm or company having a place of business where credits are opened by deposit or collection of money or currency or where money is advanced or loaned."

According to Crowther:- "The banker's business is to take the debts of other people to offer his own in exchange, and thereby create money."

Banking companies Act, 1949- Defines banking company in India as one "which transacts the business of banking which means the accepting for purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise and withdrawable by cheque, draft, order or otherwise".

From the above definitions, it is clear that bank is an institution which provides all the transactions related to money its customers.

Functions of Commercial Banks:

In present times, the functional area of commercial banks has become very vast. These banks

provide multifarious facilities to its customers. Besides financial clearance it provides insurance, lockers and investment facilities to the customers. The crucial functions traditionally performed by the banks are:-

1. Acceptance of deposits
2. Granting loans
3. Credit creation
4. Agency services
5. Other services

Acceptance of deposits:- The primary function of a commercial bank is accepting deposits from its customers. The customer deposits his small savings in current or saving accounts. The bank mobilizes such small savings of customers in funds and give interest on them.

Saving account: Such accounts are opened by small savers and service class people. On such accounts bank pays interest at fixed rate. The rate of interest is low.

Current account : Such accounts are maintained by industrialist and businessman whose daily cash transaction is more.

Time deposits:- The banks accept some deposits, for a fixed time which are called Fixed Deposits. The banks pay higher rate of interest on these deposits.

Demand deposits: Demand deposits are such deposits which are withdrawable by the depositor at any time and banks have to pay them.

In present times, to provide banking facility to the public in 'Pradhan Mantri Jan-dhan Yojna' under bank accounts are opened at zero balance also. There is provision of overdraft facility worth Rs. 5000 for the customers who regularly make transactions on such an account.

Granting loans:- Another major function of commercial banks is to extend loans. Bank provides facility of loan to its customers. Banks provide loan for home, education, marriage, and vehicles. Banks give a fixed time period for repayment of loans to its customers. Generally, the loans granted for purpose of assets are for long-term. Banks also provide simple loans to weaker section, under various government schemes.

Overdraft - A commercial bank grants overdraft facility to its customers on their current account. A customer can draw an amount in excess of the balance held in the account for a small period. This facility is provided by the banks to its prestigious borrowers of business class.

3. Credit creation :

Credit creation is the major function of commercial banks, like other banks their objective is also to earn profits. A bank accepts the deposits from depositors collect them and then grant loan to its customers on a certain rate of interest. This is called credit creation process by banks which we will study further.

4. Agency services :

Banks also provide agency services to its customers. Banks accept cheques, exchange bills, drafts etc and provide financial facilities in form of an agent. It acts as executor, trustee and attorney for customer's will.

Bearer Cheque:- It is encashable immediately at the bank by its possessor.

Crossed Cheque:- This cheque is crossed by parallel lines on its face. It is deposited only in the payee's account.

5. Other Functions :-

(i) Internet Banking : Commercial banks also provide its customers 24 hours service through Internet Banking. The customers with internet access can conveniently make the payment of fees for various services from their account sitting at home. Payment for online shopping is also possible through internet banking. For this, it issues login ID and password to

its customers which has to be kept secret.

(ii) ATM facility : The commercial banks, enable a customer to withdraw cash for 24 hours by providing ATM machines at public places (bus stand, railway station, hospitals, airport etc). Any customer can withdraw cash to a certain limit per day with his ATM card. It also provides facility of money transfers and account, balance information can also be obtained. ATM refers to automated teller machine. It is fully computerised and connected to bank server.

(iii) Mobile banking :- In present times, with the increased prevalence of smartphone the bank by means of mobile app provides banking facility to the customers. The customer can download the related bank app from play store to get the benefit of the facility. The customer with his user id and password with internet banking can make the payments with his mobile at any place and at any time.

(iv) Locker facility - Banks provide lockers facility at certain fees, so that customers can keep their valuable jewellery, property papers and legal papers with them for safe custody.

(v) Credit card facility - Commercial banks provide banking facility to its customers by means of credit card. The bank uses the payment card on its account of certain credit limit which enables the card holder to make payments by means of credit-card at any time anywhere. In very short period, online payments can be made.

Credit creation by commercial banks

In modern banking system, credit creation occupies an important place. Banks play a vital role in economic development of a country. Bank accepts small savings of the public in form of deposits. It performs the function of credit creation on basis of the deposits of small savings by granting loans for productive works. Now, we attempt to understand the process of credit creation by the commercial bank-

Credit creation-

Credit creation by derivative deposits - The small savings in form of deposits with the bank referred as

bank money or credit money, can be withdrawn by cheques from the banks. This money is payable on demand, thus is called as Demand Deposits. With increase in demand deposits, Banks grant loans multiple times to create credit money. This way the more the bank grants loans, the more will be credit deposit created. Thus, it is said every loan creates a deposit and deposits give birth to loans

According to Halm- “The creation of derivative deposits is the creation of credit”. In this way, there is manifold increase by credit creation with respect to the money accepted in forms of deposits by commercial banks.

According to Prof. Halm, there are two types of deposits - primary deposit and derivative deposit

Primary deposits :- Arises from the actual deposit in cash form in a bank made by its customer.

Derivative deposits :- Which arises from granting of loans, by opening accounts on basis of primary deposits.

Thus, primary deposits create derived deposits. These derivative deposits are also called credit deposits.

Process of credit creation -

A simplified hypothetical example is given here to illustrate the process of credit creation by the banks.

I Stage – Assume that the primary deposit with commercial bank is worth ` 10,000. The cash reserve ratio is 20 % the banks has to keep ` 2000 as cash reserve (20% of primary deposit) and the rest of the fund worth ` 8000 can be used for granting loan. This credit is given by opening an account in name of customer. Thus, every loan creates a deposits.

II Stage - Now again bank will keep 20% of 8000 rupees (1600) in form of cash reserve and will grant loan of a balance amount of ` 6400 , thus another person is granted loan of ` 6400 and amount is deposited in his account.

III Stage - Now, again 20 % of 6400` (1280) is kept as cash reserve and balance of ` 5120 is given

as loan. Thus, in this way in name of third person account loan worth 5120 is deposited.

It follows that a bank starts the process of credit creation with a primary deposit worth Rs.10,000. This process will continue to operate till the banks create credit five times (20%) of its primary deposits.

The process of credit creation can be more clear by illustrating the above example in given table.

Total Derived demand = Total Deposit - Total Cash Ratio

In Formula :- $\Sigma Dd = \Sigma Td - \Sigma Rra$

Table 18.1

Credit Creation Process By Bank			
Assets			Liabilities (Rs.)
Stage	Deposites	CRR (20 %)	Loan/ Derived Demand
I	10000	2000	10000-2000 = 8000
II	8000	1600	8000-1600 = 6400
III	6400	1280	6400-1280 = 5120
IV	5120	1024	5120-1024 = 4096
V	4096	819.2	4096-819.2 = 3276.8

Total	Td = 50000	Rr = 10000	Dd = 40000

The above table 18.1 clarifies how commercial bank create derived deposit from primary deposit and create credit manifold. The creation of derived deposits will depend upon credit multiplier coefficient. In the above example, when CRR in 20 % ie 1/5. The total credit creation will be 50,000. Because the credit

multiplies coefficient = $\frac{1}{RR}$

Where RR= cash reserve ratio

This determines the credit expansion by the banks. In above example, the primary deposits in the banks is 10,000 and CRR is 20% the credit multiplier coefficient will be-

$$\frac{1}{RR} = \frac{1}{20\%}$$

$$= \frac{1}{20}$$

$$\frac{100}{20} = 5$$

Then credit creation will be-

$$\frac{1}{RR} \times D = 5 \times 10,000$$
$$= ₹ 50,000$$

Similarly, the derivative deposits will be obtained by subtracting total amount of reserves from total deposits.

Derivative deposit = total deposits – total cash reserves

$$50000 - 10000 = ₹ 40000$$

Limitations of credit creations:-

Bank cannot create credit in unlimited amount. Many economic conditions have direct influence on it. A few limitations in the creation of credit are as follows-

1. Level of development of bank- In countries where banking services are not sufficiently developed, the credit capacity of banks are limited.
2. Banking habits among public - The banking habits among the people in a country has direct effect on credit creation capacity of the banks.
3. Business and industrial development. Countries which have achieved high industrial development, there the bank transactions are also highly developed. Hence, the credit creation capacity is more.
4. The monetary policy of central bank - Easy monetary policy of a country encourages credit creation.

Important points

- “Indian banking companies act 1949.” which transacts the business of banking which means the accepting for purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise and withdrawable by cheque, draft, order or otherwise.”
- The deposits accepted by the banks for certain period is called Fixed Deposit where the rate of interest is high.
- Demand deposits are withdrawable by the depositors at any time. The banks is liable to pay

on demand, the bank interest is low.

- The commercial bank to provide 24 hour service to its customers grants internet banking services. Customers can make payment for various services very conveniently from their account from their homes.
- ATM is automated teller machine, it is fully computerised which is connected with bank server.
- In present times, with the increases use of smartphone by means of mobile app banks provide its customers banking facilities.
- A commercial bank grants overdraft facility to its customer by which he is allowed to draw an amount in excess of the balance held in the account up to the stipulated limit.
- A commercial bank provides banking facilities to its customers by means of a credit card. It grants a limit of the card holder from which he can borrow the money for payment.

Exercise Questions

Objective Type Questions :-

1. The main function of commercial bank is-
(A) Accepting deposits and granting loans
(B) Issue of notes
(C) Function as banker of the government
(D) Grant economic help to the banks
2. Which of the following deposit account gets highest rate of interest-
(A) Current account
(B) Recurring deposit account
(C) Saving account
(D) Fixed deposit account
3. What is ATM facility-
(A) Counter open for 24 hour
(B) Immediate loan facility by bank
(C) 24 hours banking facility by computerised automatic machine
(D) General teller counter of bank

4. For mobile banking, it is necessary-
 - (A) Smart phone
 - (B) Internet
 - (C) Bank account
 - (D) All of the above
5. Under which scheme people can open an account in bank at free of cost-
 - (A) Pradhan Mantri Rojgar Yojna
 - (B) Pradhan Mantri Jan Dhan Yojna
 - (C) Pradhan Mantri Rahat Kosh Yojana
 - (D) Rashtriya Bachat Yojna

Very Short Answer Type Questions :-

1. Define commercial banks.
2. Write any two functions of commercial banks.
3. Explain overdraft facility.
4. What is internet banking?
5. Write full form of ATM?

Short Answer Type Questions :-

1. Write difference between saving account and current account.
2. Write the main function of commercial banks.
3. What is mobile banking? Explain.
4. Explain any two services provided by the banks in modern times.
5. Write two limitations of credit creation by the commercial banks.

Essay Type Question:-

1. Define commercial banks. Explain the functions of commercial bank in detail.
2. What is credit creation? Explain in detail the process of credit creation by commercial banks.

Answer Table

1	2	3	4	5
A	D	C	D	B