UNIT - 2

BANKING INSTITUTIONS

Introduction

The word bank is derived from the Italian word 'banco' refers to desk/ bench used during the Renaissance era. Some of the evidences say that it is derived from the Greek word Banque which also means a bench or desk.

The first bank established was Casa De San Giorgio in 1148.

Bank of Venice was the first Public sector bank to be set up in 1157.

The first Central bank was established in 1668 in Sweden, followed by Bank of England 1694.

Meaning & Definition of Bank:

It is a financial institution which accepts the deposits from the public & lends the money to the required individuals & institutions.

Prof. Kinely has defined a bank as "An establishment which makes to individuals such advances of money or other means of payments as may be required & safely made; & to which individuals entrust money or means of payment when not required by them for use". (Another definition in classwork)

<u>Operations of Banks:</u>

1. **Conventional Operations**
    - Accepting of various types of deposits.
    - Lending the money to the needy customers.
    - A financial institution which transacts with money & money oriented transactions.
    - An intermediary between depositors & needy group.
    - Channelizing the deposits into lending, directly or through capital markets.
2. **Modern Operations:**
    - Act as a payment agents by conducting checking or current account customers.

- Paying cheques drawn by customers on the bank & collecting cheques deposited to customers current account.
- It enable customer payments via automated clearance house, wire transfers or telegraphic transfers etc.

Classification of Bank:

Bank

1. Retail Bank | **2. Investment Bank** | **3. Combined** | **4. Other Bank**

1. Retail Bank:

Commercial Bank

Community Banks

Community Development Banks

Credit Union Banks

Postal Saving Bank

Private Banks

Offshore Banks

Savings Banks

Building Associate & Land Banks

Ethical Banks

4. Other Bank:

Islamic Banks

Central Banks

Commercial Banks:

Commercial banks are commercial concerns who collects money from those who have it to spare or who are saving it out of their income, & lend to those who require it.

A commercial bank is also called as Business Bank, is a type of financial institution & intermediary, that lends money & provides transactional, saving & money market accounts & accepts time deposits.

<u>Classification or Structure of Commercial Banks in India</u>

<u>Commercial Banks</u>

Scheduled Banks **Non Scheduled Banks**

Indian Banks **Foreign Banks**

Public Sector Banks **Private Sector Banks**

SBI & Group **Nationalized Banks** **RRB's**

Scheduled Banks:

A Scheduled bank is so called because it has been included in the second schedule of the Reserve Bank of India Act 1934. To be included in the schedule, a bank must satisfy the following 3 conditions:

1. It must have a paid up capital & reserves of an aggregate value of minimum 5 lakhs;
2. It must satisfy the Reserve Bank that its affairs are not a partnership in any manner and harmful to the interest of it's depositors;
3. It must be a corporation or co-operative society & not a partnership or a single owner firm.

The commercial banking system in India consists of 297 Scheduled banks.

Non-scheduled Banks:

Banks whose name not included in the Second schedule of the RBI Act are considered as non-scheduled banks. These banks are also subject to the statutory cash reserve requirements.

Scheduled banks can be further categorized into

Foreign Banks:

These are the banks with head office outside the country in which they are located.

Example: Citi Bank, Standard Chartered Bank etc.

Indian Banks:

Indian banks are those banks which are registered or incorporated in the country.

Example: Karnataka Bank, Canara Bank etc.

Indian banks can be categorized into:

Private Sector Banks:

These are the banks in which majority of the stake is held by private individuals.

Example: ICICI, HDFC, AXIS etc.

Public Sector Banks:

These are those banks in which majority of the stake is held by the government.

Example: SBI, PNB, Bank of Baroda etc.

Public Sector Banks are further classified into:

State Bank of India group:

The public sector commercial banking in India started up of state Bank of India, in 1955, by taking over the Imperial Bank of India.

The State Bank of India was the first to make a public issue in 1993-94. At present the bank has authorized capital of 100 crores and the issued subscribed & paid-up capital of the bank is more than 474 crores.

Nationalized Banks:

Another important step towards public sector banking was taken in July 1969, when 14 banks with a **deposit base of 50 crores** or more were nationalized. Again in 1980, six more private sector banks were nationalized bringing up the total number of banks nationalized to twenty.

Regional Rural Banks:

Regional Rural Banks were set up on the recommendations of a working group headed by Narasimhan in 1975. The objective is to provide credit & other facilities to small & marginal farmers, agricultural laborers & artisans. The capital of RRB's comes in the proportion of 50:15:35 between government of India, State Govt. & sponsoring commercial banks.

Functions of Commercial Bank:

Commercial Banks have emerged as the single most important source of institutional credit. They are performing multifarious functions in various fields.

Primary Functions	Agency/ Secondary Functions	General Utility Functions	Other function

Primary Functions:

1. **Accepting Deposits:**
   The first major function of a commercial bank is acceptance of deposits from the public. Public deposits are classified as follows:
   - Time/ Term deposits
   - Fixed deposits
   - Recurring deposits
   - Cash Certificates(Scheme of savings)

2. **Lending or Advancing Loans:**
   Lending or advancing loan is another acid test function of a commercial bank. A commercial bank must lend the deposits or make advances to the public directly or indirectly. The usual methods adopted by commercial banks to give loan are discussed below:

(a) **Money at call**: It is the money lent for very short period, generally varying from 1-14 days. Such advances are usually made to other banks or financial institutions only. Money at call ensures liquidity.

(b) **Overdraft:** As the name suggests, an overdraft is an advance given by allowing a customer to overdraw his current account upto an agreed amount. An overdraft account is operated the same way as the current account. In overdraft facility the interest is charged only on the credit actually utilized i.e to the extent account is overdrawn.

(c) **Cash credit:** Advancing credit as cash credit is also very popular. Under this system, the bank advances loans to the customer on the basis of his current assets, receivables or fixed assets by hypothecating them in favour of the banker. Basically cash credit differs from overdraft in two respects 1) Security & Duration.

(d) **Discounting of Bills**: this is another very important method of advancing loans/ credit. It is not only the banker who extends credit but the traders also in the normal course of business allow credit. This invariably is done with the help of negotiable instruments, the most important of them being a bill of exchange.

(e) **Term loans:** This is a lump sum loan advanced with a fixed maturity period of more than one year. Term loans are usually secured & provide medium to long term funds to the borrowers. The entire loan sanctioned is paid or credited to the account of the customer.

(f) **Credit to Government:** The commercial banks provide indirect credit to the central & state governments by investing in their securities. Investments in securities form an important of the portfolio of a bank.

It is once again emphasized that only when an institution performs both these functions can it be called a commercial bank.

3. **Credit Creation:**
   As a monetary institution credit creation is another distinct function performed by the commercial banks. In fact this function is automatically performed while advancing credit or loans or by accepting deposits. Banks are able to create credit because the demand deposits i.e a claim against the bank is accepted by the public in settlement of their debts.

4. **Cheque System of Payment of funds:**
   A cheque is a negotiable instrument, it is the most popular credit instrument used by the client to make payments. The cheque system was evolved in very early stages of banking & now it has become the main credit instrument in the banking world.

<u>Agency Functions or Services</u>

Banks, apart from performing the primary or acid test functions of acceptance of deposits & lending, render a number of useful services to the customers.

a. **Collection & payment of credit & other instruments:** the commercial banks collect & pay the various negotiable instruments like cheque, bills of exchange, promissory notes, hundies, coupons, dividend warrants etc. customers can leave standing instructions with the banker for various periodic payments ensuring the regular payments & avoiding the trouble of performing it themselves.
b. **Sale & purchase of stock exchange securities:** The modern commercial banks also undertake the purchase & sale of various securities like shares, stocks, bonds & debentures etc on behalf of the customers.
c. **Acting as trustee**: Through expert staff & specialized departments banks also undertake administration & trusteeship functions.
d. **Remittance of funds:** The commercial banks remit funds on behalf of clients from one place to another through cheques, drafts, mail transfers etc.
e. **Representation & Correspondence:** Sometimes commercial banks act as representatives of the clients especially in handling various applications.
f. **Bullion trading:** In many countries, the commercial banks trade in bullions like gold & silver. In October 1997, eight banks including SBI, IOB, Canara Bank & Allahabad Bank have been allowed import of gold which has been put under open general license category.

<u>General utility functions:</u>

a. Receiving of valuables for safe custody.
b. Acting as a referee.
c. Issuing letter of credit.
d. Acting as underwriters.
e. Issuing of traveller's cheques & credit cards.
f. Issuing of gift cheques
g. Dealing in foreign exchange.
h. Merchant banking services.

Resultative/Other Functions:

a. Mobilization of savings of the people.
b. Channelizing savings into productive channels.
c. Extension of financial services to rural areas.
d. Making credit to weaker sections of society.

Management of Commercial banks:

a. One or two whole time directors.
b. A directors represent workmen (Staff) of the bank.
c. A director to represent non-workmen (Officers) of the bank.
d. One director to represent the deposits of the bank.
e. Three directors to represent the interests of farmers, workers & artisans
f. Five directors having special knowledge in banking, accounting, industry, agriculture etc.
g. One director who will be an official of RBI.
h. One director, who will be an official of the Government of India.

Role of Commercial Banks:

1. **Banks promote capital formation:**
   Commercial banks accept deposits from individuals & businesses, these deposits are then made available to the businesses which make use of them for productive purposes in the country.
2. **Investment in new enterprises:**
   Businessmen normally hesitate to invest their money in risky enterprises. The commercial banks generally provide short & medium term loans to entrepreneurs to invest in new enterprises & adopt new methods of production.
3. **Promotion of trade & industry:**
   With the growth of commercial banking, there is vast expansion in trade & industry. The use of bank draft, cheque, bill of exchange, credit cards & letters of credit etc. have revolutionized both national & international trade.
4. **Development of agriculture:**
   The commercial banks particularly in developing countries are now providing credit for development of agriculture & small scale industries in rural areas.
5. **Balanced development of different regions:**

The commercial banks play a very important role in achieving balanced development in different regions of the country. They help in transferring surplus capital from developed regions to the less developed regions.

6. **Influencing economic activity:**
   The banks can also influence the economic activity of the country through its influence on availability of credit & the rate of interest. can also influence the economic activity of the country through its influence on availability of credit & the rate of interest. The credit creation activity can raise aggregate demand which leads to more production in the economy.
7. **Implementation of Monetary policy:**
   The central bank of the country controls & regulates volume of credit through the active cooperation of the banking system in the country.
8. **Monetization of the economy:**
   The commercial banks by opening branches in the rural & backward areas are reducing the exchange of goods through barter. The use of money has greatly increased the volume of production of goods.
9. **Export promotion cells:**
   In order to increase the exports of the country, the commercial banks have established export promotion cells. They provide information about general trade & economic conditions both inside & outside the country to its customers.

<u>Investment Norms/ Investment Policy of Commercial Bank:</u>

The following principles underline the investment policy of the bank. They are

1. **Liquidity:**
   Liquidity means the ability of the bank to convert its non cash assets into cash easily & without loss. It is a well known fact that a bank deals in funds belonging to the public. Hence, the bank should always be on its guard in handling these funds. The bank cannot have all its assets in the form of cash because it is an idle asset which does not fetch any return to the bank.
2. **Profitability:**
   A commercial bank by definition, is a profit hunting institution. Bank has to earn profit to earn income to pay salaries to the staff, interest to the depositors, dividend to the shareholders & to meet the day to day expenditure.
3. **Safety or Security:**
   Apart from liquidity & profitability, the bank should look to the principle of safety of its funds also for its smooth working. While advancing loans, it is necessary that the bank should consider the 3 C's (Character, Capacity & Collateral) of the borrower.

4. **Diversity:**
   The bank should invest its funds in such a way as to secure for itself an adequate & permanent return. And while investing its funds, the bank should not keep all its eggs in the same basket. Diversification of investment is necessary to avoid the dangerous consequences of investing in one or two channels.
5. **Salability of Securities:**
   Further, the bank should invest its funds in such types of securities as can be easily marketed at a time of emergency. The bank cannot afford to invest its funds in very long term securities or those securities which are unsalable.
6. **Stability in the value of investments:**
   The bank should invest its funds in those stocks & securities the prices of which are more or less stable. The bank cannot afford to invest its funds in securities, the prices of which are subjected to frequent variation.
7. **Principles of Tax- Exemption of Investments:**
   Finally, the investment policy of a bank should be based on the principle of Tax-Exemption of investments. The bank should invest in those government securities which are exempted from income & other taxes. This will help the bank to increase its profits.
8. **Productivity:**
   Banks must consider the volume of profit generated by the document pledged by the loan taker whether it gives normal rate of profit or not.

Sources & Application of Funds of CB:

Sources of Funds:

1. **Capital:**
   Nationalized banks – capital owned by the central government & the shareholders of the bank.
   Foreign Bank-the amount bought by bank by way of start up capital as prescribed by RBI & the amount of deposit kept with RBI as per the provisions of the Banking Regulation Act, 1949.
2. **Reserves & surplus :**
   Statutory Reserve- According to section 17 of the Banking Regulation Act, 1949, every banking company is required to transfer atleast 20% of its profits each year prior to declaration of dividend to the reserve fund. Such a reserve is termed as statutory reserve.
   Capital Reserve- the reserve created out of capital profits.

Share Premium- premium received by a banking company on issue of share capital. Revenue & other reserves this item includes all reserves other than those classified as capital reserve.

3. **Deposits :**
   Deposits are a major source for the funds of a banking company. They constitute more than 80% of a commercial banks funds.
4. **Borrowings :**
   A banking company may borrow from other sister institutions. Usually these borrowings are for short term & to meet the urgent requirements of funds.
5. **Other Liabilities :**
   These includes bills payable, inter office adjustments, interest accrued, balance of profits etc.

Application of Funds(Utilization)

1. **Cash in hand & with Reserve Bank :**
   Cash balance maintained by a bank with itself. This balance is maintained by the bank to meet any demand by its customers. Cash with Reserve Bank, this refers to the cash balance maintained by a commercial bank with the Reserve Bank of India.
2. **Balance with other Banks & money at call & Short notice :**
   The banks keep money deposited with other banks besides the central Bank of the country. This money can be drawn by the banks as when the need arises. This is therefore termed as "the first line of defence".
   Money at call & short notice represent the loans given by one bank to another for a short period. Call loans are repayable at any time the banker recalls them while short notice advances are repayable within short period say 24 hours.
3. **Investments :**
   These include securities of the central & state governments shares, debentures etc. this has been done to maintain SLR with the Reserve Bank of India,
4. **Advances :**
   A major portion of bank's funds is used for this purpose & this is also a major source of a bank's income. Advances can be of Loans, cash Credit, Overdrafts, Bills Discounted & purchased.
5. **Fixed Assets:**
   These comprise of premises, furniture & other assets which are meant for use in the business & not for conversion into cash.
6. **Other Assets :**

These comprises of inter office adjustments, tax paid in advance, stationary & stamps, non - banking assets in satisfaction of claims.

7. **Contingent Liabilities (Schedule 12):**
   These are the liabilities which may or may not happen. These are to be shown outside the balance sheet.

Profitability and Liquidity of Commercial Banks:

Profitability refers to generating additional income through various loans and advances, Investment schemes etc. It is important to earn profit to manage administration and management of banking activities.

Liquidity means having those assets which can be converted into cash quickly. To fulfill the requirement of depositor it is necessary to have sufficient liquid assets or cash. Bank can not undermine the interest of the depositors.

Factors to be considered to decide the liquidity of CB:

Liquidity of the bank is considered by the following factors:

1. **Profitability of bank** will directly influence the liquidity position, it says self - dependent of commercial bank to discharge immediate liabilities.
2. **Obtaining the support from lender of last resort (RBI),** which should lower the incentive for holding liquid assets.
3. **Interest margin** as a measure of opportunity costs of holding liquid assets.
4. **Loan growth,** where higher loan growth signals increase in illiquid assets. It affects negatively the liquidity position by employing all liquid assets in loan lending.
5. **Short term interest rate,** which influences increase or decrease of additional liquidity.
6. **Size of the bank,** which says about needed quantum of liquid assets to meet customer community.
7. **Rate of inflation,** which increases the vulnerability of banks to nominal values of loans provided to customers.
8. **Asset structure,** which represents percentage of liquid assets composition in total assets of the bank.
9. **CRR & statutory reserve,** any increase or decrease in Cash Reserve Ratio maintained with RBI & statutory reserve out of current year profit as statutory requirements determines the availability of liquid assets to show sound liquidity.
10. **Customer cash requirement,** the proper estimation of customer day to day cash requirements borrowed from the bank determines the liquidity position of commercial bank