CGPSC - MAINS

PAPER - 5

शर्मा एकेडमी®

An Institute for IAS/IPS, MPPSC

ECONOMICS OF INDIA & CHHATTISGARH
GEOGRAPHY OF INDIA
GEOGRAPHY OF CHHATTISGARH

PAPER – 5

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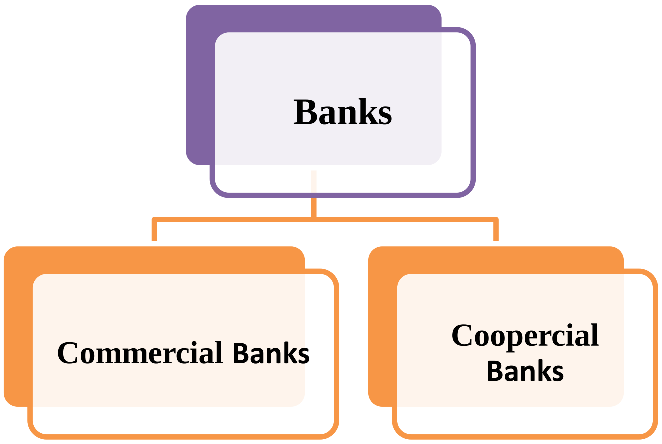
Banking

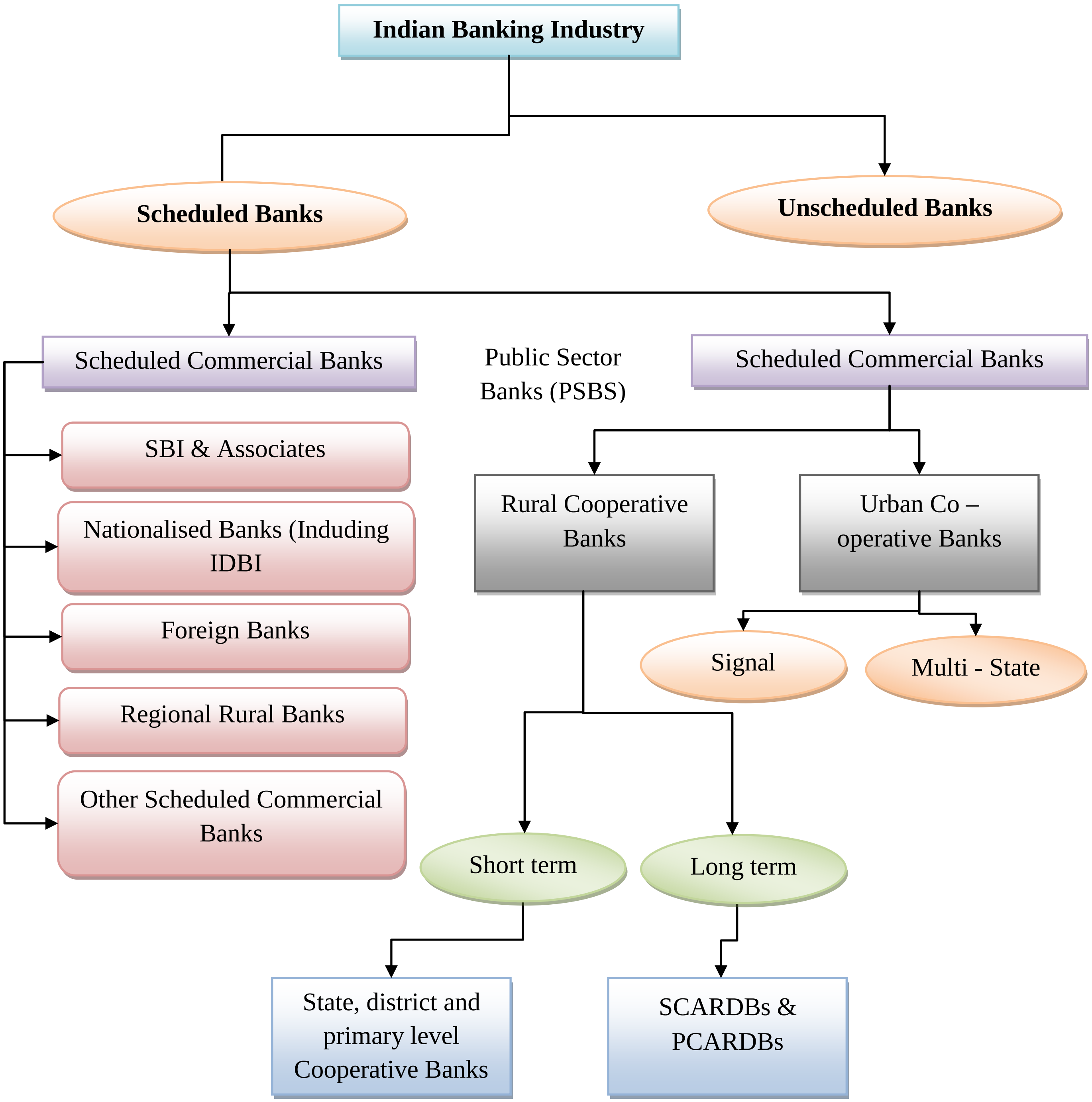


Definition of a Bank

Bank means an insititution which **receives funds from the public and gives loans and advances** to those who need them. Banking is the life blood of modern commerce and trade. The **Banking Companies Act, 1949** defines a **banking company** as one which **transacts the business of banking** in any state of India, and in the world.

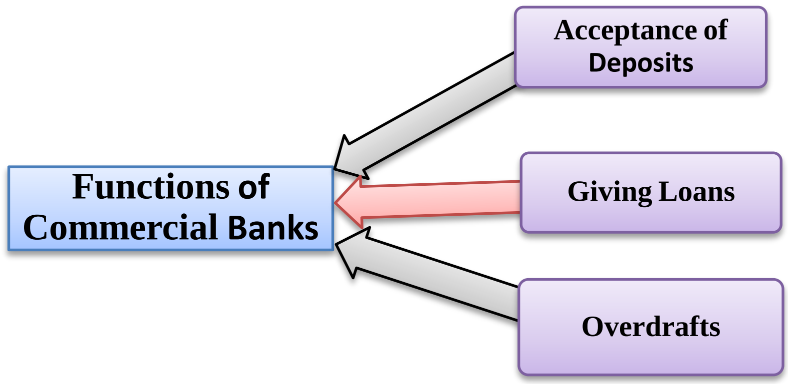
Banking has been defined as **accepting, for the purpose of lending or investment, deposits of money from the public** which are payable on demand or withdrawable by cheque draft, order or otherwise. Thus, banks act as a bridge between the **users of capital (investors) and those who save (savers)**. They activate the idle resources of the community and use them for productive purposes. Thus, two essential functions of banks that make them Financial Institutions (FIs) are:

- Accepting chequable deposits from the public, and
- Lending



Meaning of Commercial Bank

A commercial Bank is that financial institution which accepts deposits from the people, gives loan for various purpose and performs various other functions.



The main functions that commercial banks perform are:

1. Acceptance of Deposits

The bank accepts three types of deposits from the public:

(a) **Current Account Deposits**: Deposits in current accounts are payable on demand. They can be drawn upon by cheque without any restriction. These accounts are usually maintained by businesses and are used for making business payments. No interest is paid on these deposits. However, the banks offer various services to the account holder for a nominal charge, the most important being the cheque facility. Banks keep regular accounts of all transactions made in a particular account and submit statements of the same to the account-holder at regular intervals.

(b) **Fixed Term Deposits**: These are deposits for a fixed term (period of time) varying from a few days to a few years. They are not payable on demand and do not enjoy chequing facilities. The money deposited in such accounts become payable only on the maturity of the fixed period for which the deposit was initially made.

A variant of fixed deposits are recurring deposits. In these accounts, a depositor makes a regular deposit of an agreed sum over an agreed period, e.g., Rs. 100 per month for 5 years. Interest is paid on the deposits in these accounts.

(c) **Savings Account Deposits**: These deposits combine the features of both current account deposits and fixed deposits. They are payable on demand and also withdrawable by cheque, but with certain restrictions on the number of cheques issued in a period of time. Interest is paid on the deposits in these accounts but the interest paid on savings account deposits in these account but the interest paid on savings account deposits is less than that of the fixed deposits.

In monetary analysis, deposits are classified into two types: **demand deposits and time deposits**. Demand **deposits are payable on demand** either through cheque or otherwise. Only demand deposits many serve as a medium of exchange, because their ownership can be transferred from person to person through cheques. All other deposits that are **not payable on demand** are called **time deposits**.

All current account deposits are demand deposits and all terms deposits are time deposits. The classification of saving deposits is not as straightforward because they combine the features of both demand and time deposits. The Reserve Bank of India distinguishes between the demand liability portion of deposits (which are included under demand deposits) and the time liability portion of saving deposits. The rule to decide which part of the savings deposits came under which category was: the average of the monthly minimum balances in the saving accounts on which interest is being paid shall be regarded as a time liability and the excess over the said amount shall be regarded as demand liability.

2. Giving Loans

The deposits received by the banks are not allowed to lie idle by the bank. After keeping a certain portion of the deposits as reserves, the bank gives the balance to borrowers in the form of loans and advances. The different types of loans and advances made by banks are as follows:

(a) **Cash Credit**: In this arrangement an eligible borrower first sanctions a **credit limit** upto which he many borrow from the bank. This credit limit is determined by bank's estimation of the borrower's creditworthiness. However, actual utilisation of credit by the customer depends upon his withdrawing power. The withdrawing power depends on the value of the borrower's current assets, which comprise mainly of stocks of goods, raw materials, semi-manufactured or finished goods, and bills receivable (dues) from others. The borrower has to submit a stock statement of his assets to the bank showing evidence of on-going trade and production activity and acting as a legal documents in possession of the bank, to be used in case of default. The borrower has to pay interest on the 'drawn' or utilised portion of the credit only.

(b) **Demand Loans**: A demand loan is one that can be **recalled on demand**. It has no stated maturity. The entire loan amount is paid in lump sum by crediting it to the loan account of the borrower. Thus, the entire loan amount becomes chargeable to interest. Security brokers and others whose credit needs fluctuate day-to-day usually take these loans. The security against these loans may be personal, financial assets or goods.

(c) **Short-term Loans**: Short-term loans may be given as **personal loans, loans to finance working capital** or as priority sector advances. These loans are **secured loans**, i.e., they are loans made against some security. The whole amount of the short-term loan sanctioned is paid in lump sum by crediting it is to the loan account of the borrower. Thus, the entire loan amount become chargeable to interest. The repayment is made as scheduled, either in one installment at the end of the period, or in number of installments over the period of the loan.

In addition, commercial banks extend the following facilities when they are demanded by their customers.

3. Overdrafts

An overdraft is an advance given by **allowing a customer to overdraw his current account upto an agreed limit**. The security for overdrafts is usually financial assets of the account holder such as shares, debentures, life insurance policies, etc. Overdraft is a temporary facility and the rate of interest charged on the amount of credit used is lower than that on cash credit because the risk involved and services cost of such credit is less. It its easier to liquify financial assets than physical assets.

4. Discounting Bills of Exchange

A bill of exchange is a **document acknowledging an amount of money owed in consideration for goods received**. For example, if A buys goods from B, he may not pay B immediately. He may give B a bill of exchange, stating the amount of money owed and the time when the debt has to be settled. If B wants money immediately, he will present the bill of exchange to the banks for discounting. The bank will deduct a commission and pay the present value of the bill to B. Upon maturity of the bill, the bank will secure payment from A.

5. Investment of funds

The banks invest their surplus funds in three types of securities – **Government securities, other approved securities, and other, securities**. Government securities are securities of both the central and state governments such as treasury bills, national savings certificates, etc.

Other approved securities are securities under the provisions of the Banking Regulation Act, 1949. These include securities of state associated bodies like electricity boards, housing boards, debentures of Land Development Banks, units of UTI, shares of Regional Rural Banks, etc.

Part of the banks investment in government securities and other approved securities are mandatory under the provisions of the Statutory Liquidity Ratio requirement of the RBI. However, banks hold excess investments in these securities because banks can borrow against these securities from RBI and others, or sell these securities in the open market to meet their need for cash. Banks hold them even though the return from them is lower than that on loans and advances because they are more liquid.

6. Agency Functions of the Bank

The bank performs certain agency functions for his customers in return for a commission. The agency services provided by the banks are:

(i) Transfer of funds – the bank provides facility for cheap and easy remittance of funds from place to place via instruments such as the demand drafts, mail transfers, telegraphic transfers, etc.

(ii) Collection of funds- the bank undertakes to collect on behalf of its customers through instruments such as cheques, demand drafts, bills, hundies, etc.

(iii) Purchase and sale of shares and securities on behalf of customers.

(iv) Collection of dividends and interest on share and debentures on behalf of customers.

(v) Payment of bills and insurance premium as per customer's directions.

(vi) Acting as executors and trustees of wills.

(vii) Provision of income tax consultancy and acceptance of income tax payments of customers.

(viii) Acting as correspondent, agent or representative of customers as well as securing documentation for air and sea passage.

7. **Credit Creation**

   Credit creation is one of the most significant functions performed by commercial banks. Credit is defined as finance made available by one party to another party on a certain rate of interest. Credit plays a crucial role in the monetary and business system.

8. **Miscellaneous Function**

(i) Purchase and sale of foreign exchange.

(ii) Issuance of travellers' cheques and gift cheques.

(iii) Safe custody of valuable goods in lockers.

(iv) Underwriting activities (agreeing to partly or fully purchase the whole or the unsold portion respectively of new issue of securities) and private placement of securities (selling securities not through the open market, but privately to selected entities).

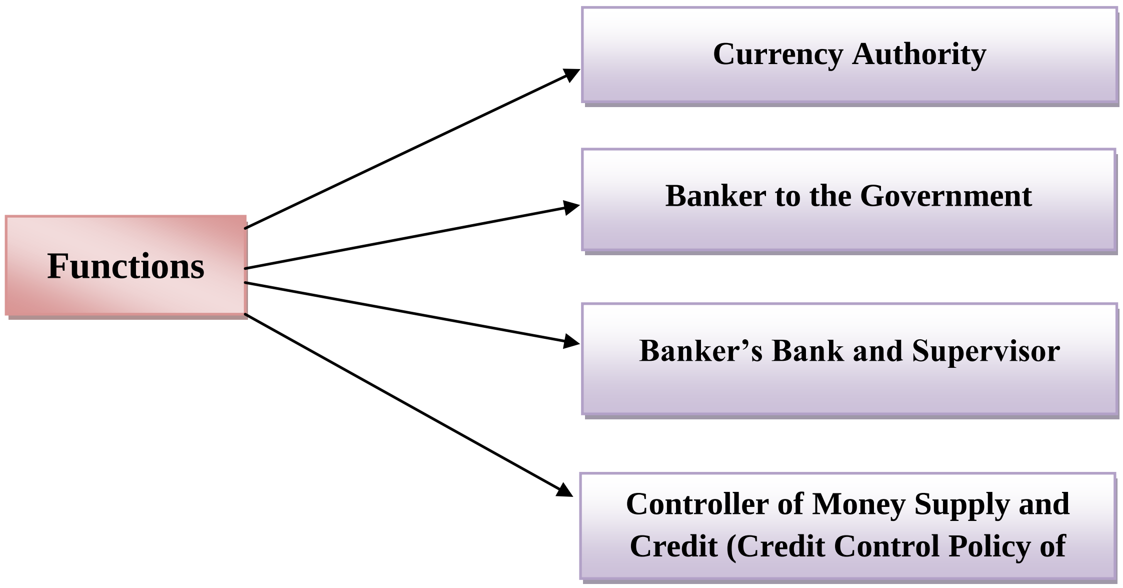
Reserve Bank of India & its Functions

The Reserve Bank of India (RBI) was set up in 1935 **(by the RBI Act, 1934)** as a private bank

with two extra functions-regulation and control of the bank in India and being the banker of the government.

After nationalization in 1949, it emerged as the **central banking body of India**

and it did not remain a 'bank' in the technical sense. Since then, the governments have been handing over different **functions** to the RBI, which stand today as given below:



1. Currency Authority

The Central Bank is the sole authority for the issue of currency in the country. All the currency issued by the central bank is its monetary liability. This means that the Central Bank is obliged to back the currency with assets of equal value. These assets usually consist of gold coin, gold bullion, foreign securities, and the domestic government's local currency securities.

The country's Central Governments is usually authorized to borrow money from the central bank. Government does this, by selling local currency securities to the central bank. The effect of this is to increase the supply of money in the economy. When the central bank acquires these securities, it issues currency. This authority of the government gives its flexibility to monetize its debt. Monetising the **government's debt (called public debt)** is the process of converting its debt (whether existing or new), which is a non-monetary liability, into central bank currency, which is a monetary liability.

Putting and withdrawing currency into and from circulation is also the job of its banking department. For example, when the government incurs a deficit in its budget, it borrows from the central bank. This is done by selling treasury bills to the central bank, the latter paying for the bills by drawing down its stock of currency or printing currency against equal transfer of the said securities. The government spends the new currency and puts it into circulation.

2. Banker to the Government

The central bank acts as a **banker to the government** – both Central as well as State governments. It carries our all the banking business of the government and the government keeps its cash balances on current account with the central bank.

As the banker to the government, the central bank accepts receipts and makes payments for the government, and carries out exchange, remittance and other banking operations. The

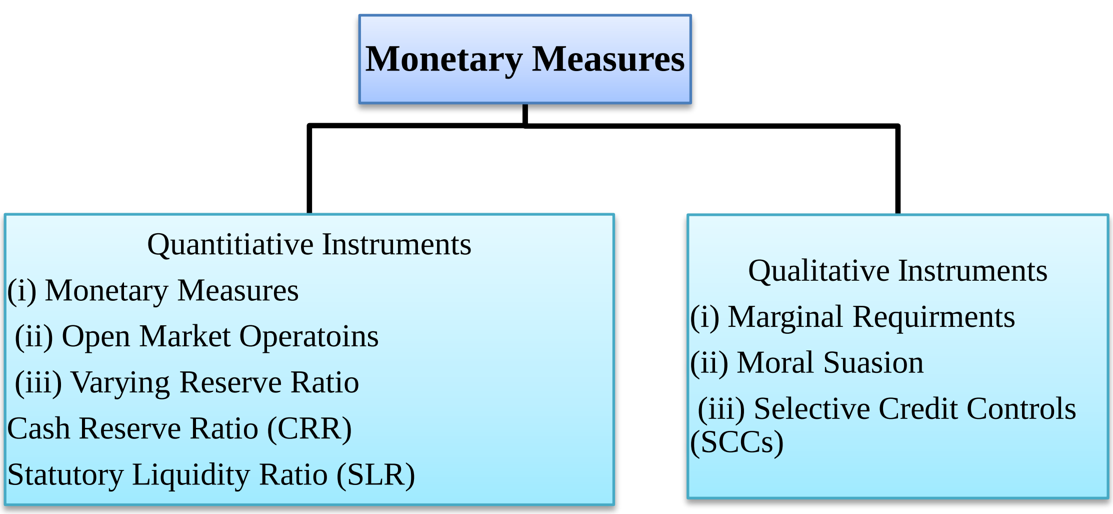
central bank also provides short-term credit to the government, so that the government can meet any shortfalls in receipts over disbursements. The government borrows money by selling treasury bills to the central bank. The government carries on short-term borrowing by selling adhoc treasury bills to the central bank.
As the Government's Banker's the central bank also has the responsibility of managing the public debt. This means that the central bank has to manage all new issues of government loans.
The central bank also advises the government on banking and financial matters.

3. Banker's Bank and Supervisor

As the banker to banks, the Central Bank holds a part of the cash reserves of banks, lends them short-term funds and provides them with **centralized clearing and remittance facilities**. The banks are required to deposit a stipulated ratio of their net total liabilities (the CRR) with the Central Bank. The purpose of this stipulation is to use these reserves as an instrument of monetary and credit control. In addition to this the bank holds excess reserves with the Central Bank to meet any clearing drains due to settlement with other banks or net withdrawals by their account holders. The pool of funds with the Central Bank serves as a source from which it can make advances to banks temporarily in need to funds, acting in its capacity as lender of last resort.
The Central Bank **supervises, regulates and controls** the commercial banks. The regulation of banks may be related to their licensing, branch expansion, liquidity of assets, management, amalgamation (merging of banks) and liquidation (the winding up of banks). The control is exercised by periodic inspection of banks and the returns filled by them.

4. Controller of Money Supply and Credit (Credit Control Policy of RBI)

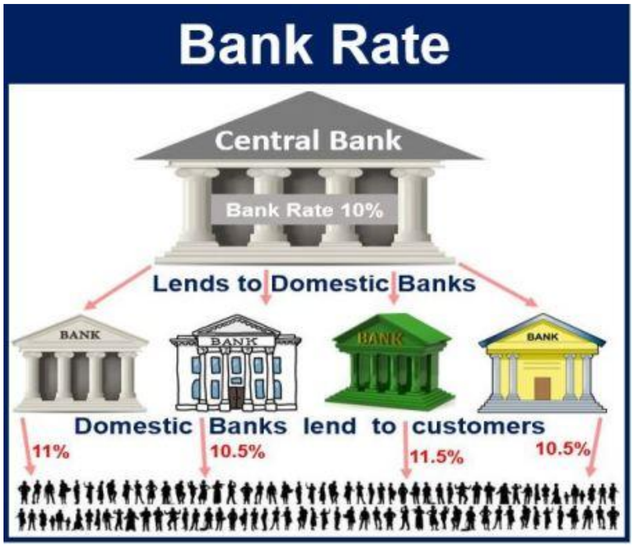
The various credit policy or monetary instruments used by the Central Bank or the country can be divided into two parts, as shown below:



Credit Control Policy of Central Bank

The Central bank controls the money supply and credit in the best interest of the economy. The bank does this by taking recourse to various instruments. Generally they are categorized as quantitative and qualitative instruments. Let us fist deal with the instruments of **quantitative control**, i.e., those that affect only the quantity of the particular variable.

(i) **Bank Rate Policy**:



The bank rate is the rate at which the **central bank lends funds a 'lender of last resort' to banks**, against approved securities or eligible bills of exchange.

The effect of a change in the bank rate is to change the cost of securing funds from the central bank. An increase in the bank rate increases the costs of borrowing from the central bank. This well reduces the ability of banks to create credit. A rise in the bank rate will then cause the banks to increase the rates at which they lend. This will then discourage businessmen and others from taking loans, thus reducing the volume of credit. A decrease in the bank rate will have the opposite effect. In actual practice, however, the effectiveness of bank rate policy will depend on (a) the degree of bank's dependence on borrower reserves (positive relationship), (b) the sensitivity of bank's demand for borrowed funds to the difference between the bank lending rate and their borrowing rate (positive relationship), (c) the extent to which other rates of interest in the market change and (d) the state of supply and demand of funds from other sources.