UNIT IV

Commercial Banks: Functions - Credit Creation - Central Banking: Functions - Methods of Credit control

COMMERCIAL BANKS:

FUNCTIONS

What is Commercial Bank?

A commercial bank is a kind of financial institution which carries all the operations related to deposit and withdrawal of money for the general public, providing loans for investment, etc. These banks are profit-making institutions and do business only to make a profit.

The two primary characteristics of a commercial bank are lending and borrowing. The bank receives the deposits and gives money to various projects to earn interest (profit). The rate of interest that a bank offers to the depositors are known as the borrowing rate, while the rate at which banks lends the money is called the lending rate.

Function of Commercial Bank:

The functions of commercial banks are classified into two main divisions.

(a) Primary functions –

- **Accepts deposit –** The bank takes deposits in the form of saving, current and fixed deposits. The surplus balances collected from the firm and individuals are lent to the temporary required of commercial transactions.
- **Provides Loan and Advances –** Another critical function of this bank is to offer loans and advances to the entrepreneurs and businesspeople and collect interest. For every bank, it is the primary source of making profits. In this process, a bank retains a small number of deposits as a reserve and offers (lends) the remaining amount to the borrowers in demand loans, overdraft, cash credit and short-run loans, etc.

- **Credit Cash-** When a customer is provided with credit or loan, they are not provided with liquid cash. First, a bank account is opened for the customer and then the money is transferred to the account. This process allows a bank to create money.

(b) Secondary functions –

- **Discounting bills of exchange –** It is a written agreement acknowledging the amount of money to be paid against the goods purchased at a given point of time in the future. The amount can also be cleared before the quoted time through a discounting method of a commercial bank.
- **Overdraft Facility –** It is an advance given to a customer by keeping the current account to overdraw up to the given limit.
- **Purchasing and Selling of the Securities –** The bank offers you with the facility of selling and buying the securities.
- **Locker Facilities –** Bank provides lockers facility to the customers to keep their valuable belonging or documents safely. Banks charge a minimum of an annual fee for this service.
- **Paying and Gather the Credit** – It uses different instruments like a promissory note, cheques and bill of exchange.

Types of Commercial Banks:

There are three different types of commercial banks.

- **Private Bank –** It is one type of commercial banks where private individuals and businesses own a majority of the share capital. All private banks are recorded as companies with limited liability. Such as Housing Development Finance Corporation (HDFC) Bank, Industrial Credit and Investment Corporation of India (ICICI) Bank and Yes Bank, etc.
- **Public Bank –** It is that type of bank that is nationalised, and the government holds a significant stake. For example, Bank of Baroda, State Bank of India (SBI), Dena Bank, Corporation Bank and Punjab National Bank.
- **Foreign Bank –** These banks are established in foreign countries and have branches in other countries. For instance, American Express Bank, Hong

Kong and Shanghai Banking Corporation (HSBC), Standard & Chartered Bank and Citibank, etc.

Examples of Commercial Banks

Few examples of commercial banks in India are.

- State Bank of India (SBI)
- Housing Development Finance Corporation (HDFC) Bank
- Industrial Credit and Investment Corporation of India (ICICI) Bank
- Dena Bank
- Corporation Bank

CREDIT CREATION

The process of credit creation is said to be one of the most important of the functions that are performed by a commercial bank.

The central bank of a country is responsible for ensuring money supply in the economy by currency circulation. It also ensures that for fulfilling all the transactions, there should be appropriate currency in the system.

This process cannot be implemented by the central bank alone, for this they require the help of commercial banks and their reserves. The commercial banks perform the function of credit creation in an economy.

Therefore, the money that is created by the commercial banks is known as credit money. This is achieved by the commercial banks in the form of purchasing of securities and providing loans. Commercial banks facilitate the loans by utilising the deposits that are obtained from the public.

There are restrictions on the amount of money that can be provided as credit from the total deposits that a bank obtains from the public. As per the rule, commercial banks need to maintain a certain portion of the public deposits as reserves with the central bank which will be used for meeting the immediate cash requirements of the depositors.

Only after keeping aside the required amount of those reserves, the commercial banks are permitted to lend to individuals or businesses.

Formula for determining the Credit creation

The following formulae can be used to determine the total credit creation

Total Credit Creation = Original Deposit $\times$ Credit Multiplier Coefficient

Where,

Credit multiplier coefficient= 1 / r

r = Cash reserve requirement also known as Cash Reserve Ratio (CRR)

Let’s understand this with an example

If the money deposited in bank is Rs.10000 and the bank has a CRR of 10%, then Credit multiplier coefficient will be

Credit multiplier coefficient = 1 / 10%

= 1/ 0.1

= 10

Total Credit Creation = 10000 $\times$ 10 = 100000

Similarly, if CRR = 20 %

Then

Credit multiplier coefficient = 1 / 20%

= 1/ 0.2

= 5

Therefore, Total Credit Creation = 10000 $\times$ 5 = 50000

From the above values we can understand that low CRR value results in high credit creation and high CRR results in less credit creation. Therefore, with the help of credit creation, money gets multiplied in the economy.

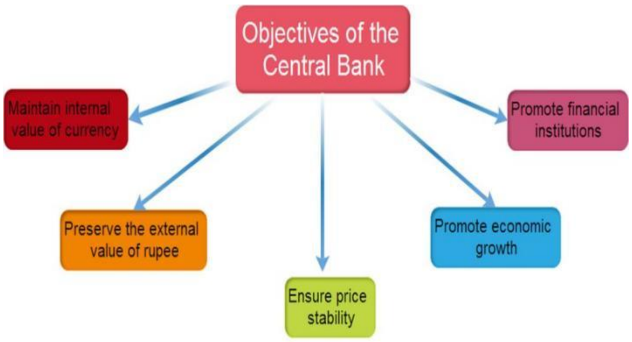
However, commercial banks face many challenges and limitations while performing the credit creation in an economy which is discussed below.

CENTRAL BANKING

Reserve Bank of India (RBI) is the Central Bank of India. RBI was established on 1 April 1935 by the RBI Act 1934. Key functions of RBI are, banker's bank, the custodian of foreign reserve, controller of credit and to manage printing and supply of currency notes in the country.

Reserve Bank of India (RBI) is the central bank of the country. RBI is a statutory body. It is responsible for the printing of currency notes and managing the supply of money in the Indian economy.

Initially, the ownership of almost all the share capital was in the hands of non-government shareholders. So in order to prevent the centralisation of the shares in few hands, the **RBI was nationalised on January 1, 1949.**



Functions of Reserve Bank

1. Issue of Notes —The Reserve Bank has a monopoly for printing the currency notes in the country. It has the sole right to issue currency notes of various denominations except one rupee note (which is issued by the Ministry of Finance).

The Reserve Bank has adopted the Minimum Reserve System for issuing/printing the currency notes. Since 1957, it maintains gold and foreign exchange reserves of Rs.

200 Cr. of which at least Rs. 115 cr. should be in gold and remaining in the foreign currencies.

2. Banker to the Government–The second important function of the Reserve Bank is to act as the Banker, Agent and Adviser to the Government of India and states. It performs all the banking functions of the State and Central Government and it also tenders useful advice to the government on matters related to economic and monetary policy. It also manages the public debt of the government.

3. Banker's Bank:- The Reserve Bank performs the same functions for the other commercial banks as the other banks ordinarily perform for their customers. RBI lends money to all the commercial banks of the country.

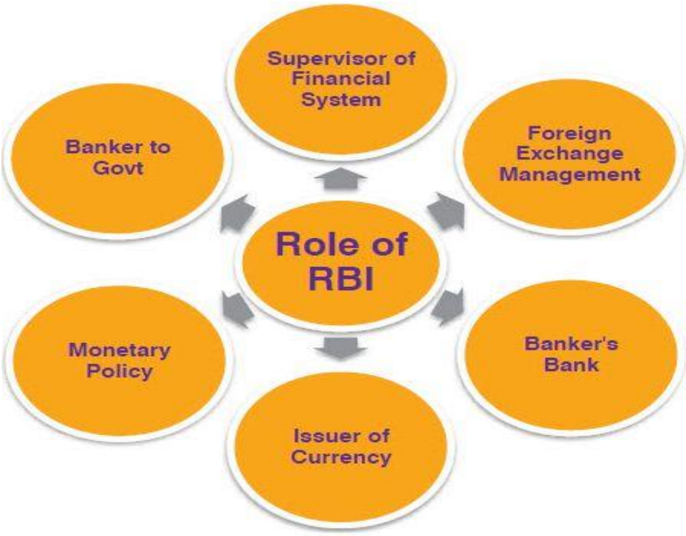
Structure of Banking Sector in India

4. Controller of the Credit:- The RBI undertakes the responsibility of controlling credit created by commercial banks. RBI uses two methods to control the extra flow of money in the economy. These methods are quantitative and qualitative techniques to control and regulate the credit flow in the country. **When RBI observes that the economy has sufficient money supply and it may cause an inflationary situation in the country then it squeezes the money supply through its tight** monetary policy **and vice versa.**

Where do Printing of Security Papers, Notes and Minting take Place in India?

5. Custodian of Foreign Reserves:-For the purpose of keeping the foreign exchange rates stable, the Reserve Bank buys and sells foreign currencies and also protects the country's foreign exchange funds. RBI sells the foreign currency in the foreign exchange market when its supply decreases in the economy and vice-versa. **Currently, India has a Foreign Exchange Reserve of around US$ 487 bn.**

6. Other Functions:-The Reserve Bank performs a number of other developmental works. These works include the function of clearinghouse arranging credit for agriculture (which has been transferred to NABARD) collecting and publishing the economic data, buying and selling of Government securities (gilt edge, treasury bills etc)and trade bills, giving loans to the Government buying and selling of valuable commodities etc. It also acts as the representative of the Government in the International Monetary Fund (I.M.F.) and represents the membership of India.



The new department constituted in RBI:- On July 6, 2005, a new department, named financial market department in reserve bank of India was constituted for surveillance on financial markets.

This newly constituted dept. will separate the activities of debt management and monetary operations in the future. This department will also perform the duties of developing and monitoring the instruments of the money market and also monitoring the government securities and foreign money markets.

So it can be concluded that as soon as our country is growing the role of RBI is going to be very crucial in the upcoming years.

METHODS OF CREDIT CONTROL

CREDIT CONTROL METHODS OF RBI

It is one of the important function of RBI for controlling supply of money or credit. There are 2 types of methods employed by the RBI to control credit creation:

1. Quantitative method
2. Qualitative method

Quantitative method:

1. Bank rate: It is the rate of interest at which central bank lends funds to commercial banks. During excess demand or inflationary gap, central bank increases bank rate. Borrowings become costly and commercial banks borrow less from central bank. During deflationary gap central bank decreases the bank rate. It is cheap to borrow from the central bank or the part of the commercial banks which in turn the Commercial banks also decreases their lending rates.
2. Open market operations: The open market operations means buying and selling of bonds and shares by RBI is open market. It is also called buying and selling of government security by the central bank from the public and commercial banks.

Sale of securities

At the time of inflation the RBI starts selling of government securities in the market. The resources of commercial bank are reduced and they are not in a position to lend more to the business community. This reduces the investment and aggregate demand.

Purchase of securities

At the time of deflation the RBI starts buying securities from open market. The reserves of commercial banks are raised and they lend more investment, output income and aggregate demand starts rising.

Legal Reserve Requirement: It is another method of RBI for controlling credit or supply of money. It includes 2 types of methods such as:

1. Cash Reserve Ratio (CRR): It is the ratio of bank deposits that commercial bank has to keep with the central bank. At the time of inflation the RBI increases the rate of CRR, similarly at the time of deflation RBI decreases the rate of CRR.
2. Statutory Liquidity Ratio (SLR): Every bank required to maintain a fixed percentage of its assets in the form of cash or other liquid assets called SLR.

At the time of inflation the RBI increases the SLR, similarly at the time of deflation RBI decreases the rate of SLR.

Qualitative method:

1. Margin requirements: It is the difference between the market value of loan and the security value of loan. At the time of inflation the margin requirement value decreases by RBI for discouraging people and commercial banks for approaching more and more amount of loan. On the other hand at the time of deflation the RBI increases the value of margin just to encourage issuing of more amount of loan to the commercial banks and general public.
2. Moral suasion: It refers to written or oral advices given by central bank to commercial banks to restrict or expand credit.
3. Direct Action: Sometimes the RBI directly takes action against the commercial banks. It takes action to such type of commercial banks who are not following the rules regulation of RBI. It cancels their registration or nationalization of commercial banks.
4. Rationing of credit: It is the related to limiting the amount of credit, which is issued by all the commercial banks. RBI fixes the size of issuing the credit according to the requirement of the country.

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