CHAPTER 16

BANKING

16.1 INTRODUCTION

The word 'bank' is derived from the Italian word ' banco' which means a bench. The earliest bankers, the Jews of Lombardy in Italy transacted their business at benches in the market place. When a banker failed, his bank was broken up by the people. In the first half of the sixteenth century the word 'Banker' had came into general are in England to denote a money-lender engaged in international finance.

A bank is an institution which deals with money and credit. Prof. A. G. Hart writes, "a banker is one who, in the ordinary course of his business, receives money which he repays by honouring cheques of persons from whom or on whose account he receives it". Prof. G. N. Halm points out that "banks are institutions which extend credit out of funds which they own, borrow or create".

There are two important kinds of banks, viz, commercial banks and central banks. Commercial banks developed first. These are institutions having dealing with individuals and firms. Central banks are institutions which have close relations with governments and which do not work on the basis of getting maximum profit.

16.2 COMMERCIAL BANKS

A commercial bank is an institution which deals with money and credit. It accepts deposits from the public, makes the funds available to these who need them, and helps in the remittance of money from one place to another. According to *G. Crowther* a bank collects money from those who have it to spare or who are saving it out of their incomes, and it lends this money to those who require it. According to *Prof. R. S. Sayers* a bank is an institution whose debts (bank deposits) are widely accepted in settlement of other people's debts to each other.

A commercial bank is a commercial institution and thus, it aims at carrying profit. It is a unique financial institution that creates demand deposits which serve as a medium of exchange and as a result, the banks manage the payment system of the country.

16.3 FUNCTIONS OF COMMERCIAL BANKS

Some basic functions performed by modern commercial banks are discussed below :

A. Accepting Deposits :

This is the primary function of a bank. In order to attract savings from all sorts of individuals, the banks maintain following accounts :

(i) **Fixed Deposit Account :** Money in this account is deposited for a fixed period of time and can not be withdrawn before the maturity. The rate of interest on this account is relatively higher.

(ii) **Current Deposit Account :** Money from these accounts can be withdrawn in as many times and in as much amount as desired by the depositors. Normally, no interest is paid on there accounts.

(iii) **Savings Bank Deposit Account :** This account is to encourage and mobilise small savings of the public. Certain restrictions are imposed on the number of withdrawals and the amount to be withdrawn. Rate of interest on the account is relatively low.

(iv) **Recurring Deposit Account :** Money in these accounts is deposited in monthly instalments for a fixed period and is repaid to the depositors along with interest on maturity.

B. Advancing of Loans :

This is also a primary function of commercial banks. The banks lend their excess reserves (Total deposits minus cash reserves) to the needy borrowers for which they have following schemes:

(i) **Money at call and short notice :** These loans are granted to other banks and/or financial institutions. Such loans are very short period loans and can be called back by the bank at a very short notice of say, one to fourteen days.

(ii) **Cash Credit :** This loan is sanctioned against current assets like shares, stocks, bonds, etc. Interest is charged only on the amount actually withdrawn from the account.

(iii) **Over Draft :** It is a facility through which customers are allowed to withdraw more than their deposits. Interest is charged from the customers on the overdrawn amount.

(iv) **Term Loans :** The banks also advance medium term and long term loans, the maturity of which is more than one year. The interest is charged on the entire amount of the loan and the loan is repaid either on maturity or in instalments.

(v) **Discounting of Bills and Exchange :** Through this method, a holder of a bill of exchange can get it discounted by the bank. After making some marginal deductions, the bank pays the value of the bill to the holder.

C. **Credit Creation :**

This is a unique function of commercial banks. Whenever a bank grants a loan, it creates an equal amount of bank deposit. Creation of such deposits is called credit creation.

D. **Promoting Cheque System :**

Cheque is the most developed credit instrument in the money market. Commercial banks are the promoters of cheque system. They have the facilities of bearer cheques, crossed cheques, Banker's cheques, gift cheques etc.

E **Agency Functions :**

(i) Banks help their customers in transferring funds from one place to another through cheques, drafts, etc.

(ii) Banks pay subscriptions, rents insurance premia, etc. on behalf of their customers.

(iii) Banks undertake purchase and sale of various securities like shares, bonds, etc. on behalf of their customers.

(iv) Banks collect dividends, interest on bonds, etc. on behalf of their customers.

(v) Banks preserve the wills of their customers and execute them after their death.

F. **General Utility Functions :**

Banks provide locker facility to their customers. Banks issue traveller's cheques to help their customers to travel without the fear of theft or loss of money. Banks collect statistics giving important information relating to industry, trade and commerce, etc. Banks underwrite the securities issued by the govt. public or private bodies. Banks also deal in the business of foreign currencies.

Banks, therefore, help in increasing output, advancing business and in the proper use of surplus funds. Banks encourage trade and industry, provide the habit of thrift, create credit and capital, distribute the funds equitably, reduce cyclical fluctuations. Industrial development will not be possible without the existence of banks. The banks encourage trade and industries by providing loans to them with the help of banks, specialisation in trade and industries have been evolved. There have been some commercial or industrial institutions which provide adequate amount for short term and long term requirements of industries. These banks help in promoting new entrepreneurship. The industries are, now in a position to renovate their production - techniques, introduce machineries, improve working conditions etc. with the help of modern banks.

In underdeveloped countries, entrepreneurs generally hesitate to invest in new ventures and undertake innovations largely due to lack of funds. Facilities of bank loans enable them to set up their ventures, adopt new methods of production and increase productive capacity of the economy.

The use of bank cheque, the bank draft and the bill of exchange has revolutionized the interval and international trade, which in turn has encouraged specialisation and accelerated the pace of industrialization.

Lastly, business activities are accelerated with a faster speed with the help of banks, which would have been slower in the absence of banking facilities.

16.4 Reserve Bank of India

The Reserve Bank of India (RBI) is India's central Bank. It is the apex monetary institution which supervises, regulates, controls, and develops the monetary and financial system of the country. The RBI was inaugurated in April, 1935 with a share capital of Rs.5 crores, divided into shares of Rs.100 each fully paid up. The entire share capital was, in the beginning, owned by private share holders. The Government of India held shares of nominal value of Rs.2,20,000. Later in 1949, the RBI was nationalized the central office of the bank is located in Mumbai.

16.4.1 Function of RBI

The Reserve Bank of India performs various traditional central banking functions as well as undertakes different promotional and developmental measures to meet the dynamic requirements of the country. Its major functions are as follows.

1. Monetary Management

The RBI is mainly constituted as an apex authority for monetary management. According to the preamble the RBI Act, 1934, the basic functions of the bank is to "regulate the issue of bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage"

2. Issue of Bank Notes

The RBI has the sole right to issue currency notes, except one rupee notes which are issued by the ministry of finance. The distribution of one rupee notes and coins and small coins all over the country is undertaken by the RBI as agent of the Government. The RBI follows a minimum reserve system in note issue. Initially, it used to keep 40% of gold reserves in its total assets. Since 1957, RBI is required to maintain gold and foreign exchange reserves of Rs. 200 crores, of which at least Rs. 115 crores should be in gold.

3. Custodian of Foreign Exchange Reserves

The RBI has been entrusted with the responsibility of maintaining the exchange value of the rupee. It has the custody and management of the country's international currency reserves.

Further, the RBI has the responsibility of administering the exchange controls of the country. All Indian remittances to foreign countries and foreign remittances to India are made through the RBI.

4. Banker to the Government

The RBI acts as the Governments' banker, agent and advisor. It maintains and operates government deposits. It collects and makes payments on behalf of the Govt. It helps the govt to float new loans and manage the public debt. It provides development, finance to the govt. for carrying out five year plans. It undertakes foreign exchange transactions on behalf of the union govt. It represents the government of India as the member of the IMF and the world Bank. It advises govt.on all financial matters.

5. A Bankers Bank

The RBI acts as the bankers' bank. It keeps a certain minimum cash reserves of each and every commercial banks. This minimum cash requirements can be changed by the RBI. The RBI serves as lender of last resort, by rediscounting eligible bills of exchange of commercial banks, during the period of credit crisis. The RBI is empowered to excercise supervision and control over the banking system .

6. Controller of Credit

The RBI performs the legitimate function of a central bank in the matter, of controlling credit created by the commercial banks in order to ensure internal price stability and promote economic growth. The instruments used for this purpose are changes in the bank rate, open market operations, variations in the reserve ratio, changes in the statutory liquidity ratio of the banks and moral suasion, and certain other selective weapons.

7. Promoter of Development

The RBI performs a number of developmental and promotional functions. It makes institutional arrangements for rural and industrial finance. For example, special agricultural credit cells have been set up by the bank. The IDBI has been set up to solve the allied problems of industries. RBI effectively channelises credit, especially to priority sectors such as agriculture, exports, transport operations, and small scale industries.

The bank also assists the govt. in the economic planning. The bank collects statistical data and economic information through its research departments. It publishes bulletins and annual reports pertaining to general economic, financial, and banking developments.

15.5 Development Banks

In the field of indsutrial finance, the concept of development bank is of recent origin. In a country like India, the emergence of development banking is a post - independence phenomenon. In India, the first development bank called the *Industrial Finance Corporation of India (IFCI)* was established in 1948. Fundamentally, a development bank is a term lending institution. It is essentially a multi-purpose financial isntitution with a broad development outlook.

Development banks are specialised financial institutions which perform the twin functions of providing medium and long term finance to private entrepreneurs and of performing various promotional roles conducive to economic development. As the name clearly suggests, they are development oriented banks.

A development bank may be defined as a financial institution concerned with providing all types of financial assistance to business units, in the form of loans, underwriting, investment and guarantee operations and promotional activities - economic development in general, and industrial development, in particular.

As development banks, their distinguishing role is the promotion of economic development by way of promoting investment and enterprise in their chosen spheres, whether manufacturing, agriculture, or some other. This promotional role may take a variety of forms like provision of risk capital, underwriting of new issues, arranging for foreign loans, identification of investment projects, preparation and evaluation of project reports, provision of technical advice, market information about both domestic and export markets, and management services.

The financial assistance to industry is given in the following four main forms :

(i) Term loans and advances.

(ii) Subscription to shares and debentures.

(iii) Underwriting of new issues. and

(iv) Guarantees for term loans and deferred payments.

The first two forms, place funds directly in the hands of companies as subscriptions to shares and debentures are subscriptions to new issues. The last two forms, facilitate the raising of funds from other sources. Underwriting means guaranteeing purchase of a stipulated amount of a new issue at a fixed price. The new issues may take the form of equity shares, preference shares or debentures. For attracting risk capital into the industry, such underwriting of shares by development banks is at least as important as the direct subscription to these shares. Guarantees from development banks assure creditors that their credit to industry whether in the form of loans or deferred payments is secure.

16.6. Features

1. It is a specialised financial institution.
2. It provides medium and long term finance to business units.
3. It does not accept deposits from the public.
4. It is not just a term - lending institution. It is a multi-purpose financial institution.
5. Its primary object is to promote economic development by promoting investment and entrepreneurial activity in a developing economy. It encourages new and small entrepreneurs and seeks balanced regional growth.
6. It provides financial assistance not only to the private sector but also to the public sector undertakings.
7. It aims at promoting the saving and investment habit in the community.
8. It works in the general interest of the nation.

16.7. Structure of Development Banks of India

At present there are five all India industrial development banks, viz, Industrial Finance Corporation of India (IFCI), Industrial Development Bank of India (IDBI), Industrial Reconstruction Bank of India (IRBI), National small Industries Corporation (NSIC) and Industrial Credit and Investment Corporation of India (ICICI). NSIC deals with the small scale industries. Other four institutions cater to the financial and development needs of the large industries. ICICI is a private sector institution and other four are owned by the state.

The state - level industrial development banks include State Financial Corporations (SFCs), State Industrial Development Corporation (SIDs) and State Industrial Investment Corporations (SIICs).

During the post-independence period, India is well-served by network of development banks, at the national as well as state levels. The following chart exhibits the structure of development banks in India.

16.7.1 Role of Development Banks :

The role of development banks in the industrial development of a country can be understood from the following points.

1. Help in planning, promoting and developing industries.
2. Help in providing technical and adminsitrative assistance for promotion, management and expansion of industry.

3. Help in co-ordinating the activities of financial institutions for the promotion and development of industries.
4. Help in undertaking market and investment research, surveys, and techno- economic studies helpful to the development of industries
5. Help in providing medium term and long term loans in rupees and foreign currencies.
6. Help in providing consultancy services in the form of managerial and technical advice to the industrial units in the private sector.
7. Help in providing financial assistance to sick industrial units.
8. Help in underwriting the issue of stocks, shares, bonds or debentures by industrial concerns.
9. Help in subscribing directly to the shares of any indsutrial concern.
10. Help in undertaking leasing business.
11. Help in providing funds for the purchase of capital assets in the form of land, building and machinery.
12. Help in providing assistance for computerisation, modernisation, export orientation, pollution control, expansion etc.

In short, a development bank is a development oriented bank.

16.8 Export-Import Bank of India

The Export and important Bank of India, commonly known as the EXIM Bank, was set up on January 1, 1982 to take over the operations of the international finance wing of the IDBI, and to provide financial assistance to exporters and importers.

16.8.1 Objectives

The main objectives of EXIM bank are:

1) To ensure an integrated and co-ordinated approach in solving the allied problems encountered by exporte rs in India.
2) To pay specific attention to the exports of capital goods.
3) To facilitate and encourage joint ventures and export of technical services and international and merchant banking.
4) To extend buyers' credit and lines of credit.

5) Export projection.

6) To tap domestic and foreign markets for resources for undertaking developmental and financial activities in the export sector.

7) To function as the principal financial institution for co-ordinating the working of the institutions engaged in financing of exports and imports of goods and services.

8) To provide refinance facilities to the commercial banks and financial institutions against their export-import financing activities.

16.8.2 Functions

The functions of the EXIM Bank include:

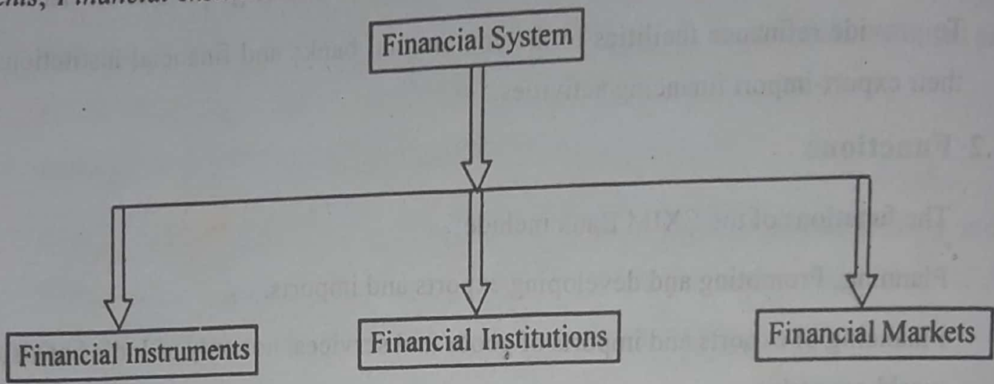
1. Planning, Promoting and developing exports and imports.
2. Financing of exports and imports of goods and services, not only of India but also of third world countries.
3. Financing of exports and imports of machinery and equipment on lease basis.
4. Financing of joint venture in foreign countries.
5. Providing technical, administrative and managerial assistance for promotion, management, and expansion of exports.
6. Providing loans to Indian parties to enable them to contribute to the share capital of joint ventures in foreign countries.
7. Undertaking market and investment surveys and techno-economic studies related to development of exports of goods and services.
8. Undertaking limited merchant banking functions such as underwriting of stocks, shares, bonds or debentures of companies engaged in exports or imports.

The EXIM bank is, thus, the latest apex banking institution in the country and has been specially set up to give a boost to indias's export promotion effort.

16.9 Indian Financial System

OVERVIEW

A financial system forms an important part of any economy. It acts as a link between the producers and users of financial services. A financial system forms an important part of any economy. While finance is the lifeblood of any country, the financial system is the network of arteries and veins carrying blood to various parts of the body. A healthy financial system accelerates the development of the economy. In simple words, financial system refers to a set of institutional arrangement through which financial surpluses in the economy are mobilised from saving-surplus units and transferred to the saving-deficit units. This institutional arrangement includes: (a) the conditions and mechanisms governing the production, distribution, exchange and holding of financial assets or instruments, (b) working of financial markets, and (c) organisation and operation of financial institutions. Thus, the important constituents of a financial system are *Financial Assets or Instruments, Financial Institutions, and Financial Markets.*



The *financial instruments* represent the claims on a system of income and/or assets of another economic unit and are held as a store of value and for the return that is expected. These instruments are the near- money assets, and are of three types: Primary instruments, Secondary instruments, and Derivatives. The primary instruments are issued by the ultimate investors directly to the ultimate savers. The examples of such assets are bills, bonds, debentures, equities, and so on. The secondary assets are issued by the financial intermediaries to the ultimate savers. The examples of such assets are bank deposits, life insurance deposits, IDBI bonds, units of mutual funds, and so on. The third type of financial instruments is derivatives. Derivatives are the instruments of the risk management. The most commonly used derivative contracts are forwards, futures, and options.

The *financial institutions* are the financial intermediaries, non-intermediaries, and regulatory. The financial intermediaries intermediate or stand between ultimate lenders, and ultimate borrowers. All banking institutions are intermediaries. Many non-banking institutions also act as intermediaries and when they do so, they are called Non-Banking Financial Intermediaries (NBFIs). The UTI (Now, AXIS Bank), LIC, and GIC are some of the NBFIs in India. The non-intermediaries are financial institutions which do the loan business but their resources are not directly obtained from the savers. In India non-intermediary institutions like IDBI, IFC, NABARD have come into existence because of governmental efforts to provide assistance for specific purposes, sectors, and regions. Besides, financial institutions also include regulatory bodies. The regulator ensures a high standard of service from intermediaries and supply of quality securities and non-manipulated demand for them in the market. In India regulators like SEBI, RBI, Ministry of Finance (MoF), Board of Industrial and Financial Reconstruction (BIFR), Board of Financial Supervision (BFS), Insurance Regulatory Authority (IRA), Securities Trading Corporation of India (STCI) and others are functioning.

A financial system operates through financial institutions and markets. Financial markets are the centres or arrangements that provide facilities for buying and selling of financial instruments and services. Financial markets deal in financial assets and/or instruments of various kinds such as currency, deposits, cheques, bills, bonds, equities, units of mutual funds, derivatives, etc. Thus, financial market means the interaction of buyers and sellers to trade financial products like stocks and bonds, etc. The financial markets can be divided into Money Market, Capital Market, Derivative Market, Insurance Market, and Forex Market. Money market provides short-term debt financing and investment. Capital market consists of stock markets and bond markets, and thus deal with medium-term and long-term borrowing and lending of funds. Derivative market provides instruments for the management of financial risks. Insurance market facilitates the redistribution of various risks. Similarly, Forex market, i.e., the Foreign Exchange market is the market in which currencies of different countries are bought and sold.

FUNCTIONS OF A FINANCIAL SYSTEM:

1. **Payment System:** A financial system ensures a payment system which enables easy and speedy exchange of goods and services.
2. **Pooling of Funds:** The financial system provides a proper link between domestic and corporate savers, and those in need of funds, so as to pool the surplus funds and channel them to productive lines.
3. **Transfer of Resources:** A financial system ensures the transfer of economic resources across time and place from the savers to the other segments of the market that is in need of funds.
4. **Risk Management:** A financial system provides different types of hedging instruments to cover all type of business risk like credit risk, legal risk, counter-party risk, systemic risk, system risk, accounting risk and operating risk, etc.
5. **Liquidity:** A financial system ensures easy liquidity, i.e., easy conversion of investment into cash in case of exigencies.
6. **Fungibility:** A financial system ensures conversion of cash into securities and back to cash without any hurdles as and when required.
7. **Price Information and Discovery Process:** A financial system provides valuable price and other relevant information to help co-ordinate decentralised decision- making. This information helps to know at what price a financial asset can be bought and/or sold in the financial market.

Indian financial system includes many institutions and the mechanism which affect the generation of savings by the community, the mobilisation of savings and the effective distribution of the savings among all those who demand the funds for investment purposes. Broadly, the Indian financial system is composed of:

1. The banking system, the insurance companies, mutual funds, investment funds and other institutions which promote savings among the public, collect their savings and transfer them to the actual investors.
2. The investors in the country composed of individual investors, industrial and trading companies and the government – these enter the financial system as borrowers.
3. New Issue Market which facilitate new savings to flow into new issues of stocks and shares.
4. Sock Exchanges which facilitate the buying and selling of shares and debentures of existing companies and help savers to shift from one type of investment to another.

The Indian financial system performs a very important role in economic development of India through saving –investment process, also called capital formation. The purpose of the financial system is to mobilise savings effectively and allocate the same efficiently among the ultimate users of funds / investors. A high rate of capital formation is an essential condition for rapid economic development. The importance of financial system in the process of capital formation arises because those who save and those who invest in India are generally not the same persons or institutions. The financial institutions and the banks act as intermediaries to bring the savers and investors together. An efficient, articulate and developed financial system is indispensable for rapid economic growth. The process of economic growth is invariably accompanied by a corresponding and parallel growth of the financial system.

The planned economic development in India had greatly influenced the course of financial development till the early 1990s. The main features of the pre-1951 organisation of the Indian financial system were:

1. Closed-circle character of industrial entrepreneurship.
2. A semi-organised and narrow industrial securities market devoid of issuing institutions.
3. The virtual absence of participation by intermediary financial institutions in the long-term finance of industry.

The organisation of the Indian financial system during post-1951 period evolved in response to the imperatives of planned economic development. The main elements of the financial system of India were:

1. Government ownership of financial institutions. This was brought about partly through nationalization of existing institutions [SBI in 1956, LIC in 1956, commercial banks in 1969, GIC in 1972], but mainly through the creation of new institutions, namely, special-purpose term-lending institutions / development banks and UTI in the public sector.
2. Fortification of institutional structure which was partly the result of modification in the structure and policies of the existing financial institutions, but mainly due to the addition of new institutions like IDBI, IFCI, ICICI, SFCs, SIDCs, SIICs, and so on.
3. Protection of investors.
4. Participation of financial institutions in corporate management.

A serious lacuna in the organisation of the Indian financial system during pre-1990 period, related to its institutional structure, which was dominated by the development banks, which depended for resources on their sponsors, namely, RBI and Government of India. The financial system did not have the ability to autonomously mobilise savings and had degenerated into a distributive mechanism. It had also resulted in a lop-sided capital structure of corporate with a heavy component of borrowed capital. The crying need of the financial system around the early 1990s was the integration of the distributive mechanism with the savings pool of the community.

In the post-1991 period, with a decline in the role of the government in economic management, and as a logical corollary, in the distribution of finance and credit, the capital market has emerged as the main agency for the allocation of resources for all the sectors of the economy. The Indian financial system has naturally undergone major transformation. The notable developments contributing to this transformation are:

1. Reorganisation of institutional structure
2. Introduction of an investor protection framework.

A sophisticated and articulate money market has emerged. Along with deregulation of interest rates and enlargement of participants, there are a number of inter-related sub-markets: Call Money Market, T-bill Market, Commercial Bills Market, Commercial Papers Market, Certificate of Deposits Market, and so on. The money market intermediaries are Primary Dealers and Mutual Funds.

The most profound transformation in the Indian financial system has been brought with the establishment of the SEBI in 1988 to regulate and promote the securities market. Its establishment as the market regulator has brought substantial changes in market regulations like registration, membership, disclosure norms, etc. In the Indian financial system, capital market is regulated by SEBI and the RBI controls the money market, foreign exchange market, and banks. The Insurance Regulatory and Development Authority regulate the insurance market.

Starting from such a position, it is widely recognised that the Indian financial sector over the last decade has been transformed into a reasonably sophisticated, diverse and resilient system. However, this transformation has been the culmination of extensive well sequenced and co-ordinated policy measures aimed at making the Indian financial system efficient, competitive and stable.

Indian financial system is now more integrated with the world markets. India has opened up her economy and allowed international financial intermediaries to play their role along with domestic players. However, the volatility and instability in the financial system in India has increased after the introduction of the policy of liberalization and globalization. The stock markets in particular are experiencing wild swings in prices, trading volumes, and market capitalization. All these indicate the need for adopting a careful approach to the development and management of the financial system in India.

Short Type Questions

1. What do you mean by banking system?
2. Define a commercial bank.
3. State two important functions of a commercial bank.
4. What is money at call and short notice?
5. What is a bill of exchange?
6. What do you understand by credit creation?
7. State the objective of Reserve Bank of India.
8. Give two important functions of RBI.
9. What do you mean by credit control?
10. What do you mean by development banks?
11. State two important features of development banks.
12. What is the structure of development banks in India?

13. State two important roles of development banks.
14. State two important objectives of EXIM bank of India.
15. State two important functions of EXIM bank of India.
16. What do you mean by financial system?
17. Define financial markets.
18. Define financial intermediaries.
19. What are financial instruments?
20. State two important functions of a financial system.
21. What is the structure of Indian financial system?

LONG TYPE QUESTIONS

1. What do you mean by a commercial Bank ? Discuss the functions of a modern commercial bank.
2. Define a development bank. What are its features ?
3. What do you understand by a development bank? Discuss the role of development Banks in financing industries.
4. Distinguish between commercial banks and development banks.
5. What is a development bank ? How does it help in industrial development in an economy?
6. Bring out the difference between commercial banking and development banking. Elucidate the role played by development banks for the industrial development of a country.
7. Give an over view of Indian financial system.
8. What is a financial system? Explain the functions of a financial system.