Introduction: Forms, Functions and Constraints

What is Commercial Bank?

It is an institution whose current operations consist in granting loans and receiving deposits

Types of commercial banks in India: (i) Public Sector banks (ii) Private sector banks and (iii) Foreign banks

Commercial Banks and Aggregate Economy

- Payment gateway for all transactions
- Important part of monetary transmission mechanism
- Major source of finance for corporate sector

Bank Based Economy Versus Market Based Economy

- Bank based economy (BBE) is good in dealing with non-diversifiable risk
- In market oriented economy, investments in equity are more than the bank based economy
- BBE is better in inter-temporal risk sharing
- BBE is not good at financing the new technologies

Why Banks Are Special Among Intermediaries?

- Deal with financial contracts (deposits and loans) which cannot be easily resold like equity and bonds
- Good in reduction of transaction cost due to different transformation
- Economies of scope exists between deposits and credit activities

Sources of Economies of Scope and Scale

- **Large number of products**
- **Expertise in managing liquidity risk**
- **Proper diversification**

Major Factors Affecting Banking Activities

- Inflation
- Interest rate changes
- Technology
- Consumer
- Globalization
- Competition

Leading Competitors with Bank

- **Mutual Funds**: Sells shares to the public representing an interest in a professionally managed pool of stocks, bonds and other securities
- **Hedge Funds**: Sell shares mainly to high net-worth investors in a broad group of different kind of assets including the non-traditional investments
- **Investment Banks**: Provide financial consultancy, merchant banking services, services for acquisition
- **Finance Companies**: Offer loans to commercial enterprises, individuals and families using funds borrowed in the open market or loans from other financial institutions

Broad Classification of Banking Functions

- Offering liquidity and payment services
- Transformation of assets
- Management of risk
- Processing information and monitoring borrowing

Liquidity and Payment Services

- Shifting from commodity money to fiat money
- Commodity Money: Medium of exchange is commodity itself
- Fiat Money: A system in which medium of exchange is intrinsically useless but its value is guaranteed by some institution so generally accepted as means of payment
- Bank and fiat money management
  - Money change(exchange between currencies)
  - Provision of payment services
  - Payment services include management of clients accounts and guarantee by the bank

Asset Transformation

- **Convenience of Denomination**
  - ✔ **Fiat money is available in different denominations**
- **Quality Transformation**
  - ✔ **Bank deposits offer better risk-return characteristics than direct investments to diversify portfolio**
  - ✔ **Banks have more information than depositors for better investment**
- **Maturity Transformation**
  - ✔ **Short maturity deposits to long maturity loans**

Risk Management

- **Credit Risk:**

Probability of default in lending activities

- **Interest Rate Risk:**

Change in the value of assets and liabilities of banks due to change in interest rate

- **Liquidity risk:**

Not able to fulfill the requirements of depositors

Off Balance Sheet Operations

- **Loan commitments, guarantee etc**
- **Offer of derivative investments like swap hedging contracts and underwriting**
- **Objectives of off balance sheet operations**
  - ✔ **Increase in non-interest income**
  - ✔ **Decreasing leverage**
  - ✔ **Tax relaxation**

Monitoring and Information Processing

- Long-term relationship
- Mitigation of the effect of the moral hazard

Bank Goals and Constraints

- **Maximization of shareholder wealth**
  - ✔ **Maximization of market value if bank's stock and cash dividend paid**
  - ✔ **Factors affecting market value:**
    - i. **Amount of cash flow**
    - ii. **Timing of cash flow**
    - iii. **Risk of cash flow**
  - **Constraints**
    - ii. **Competition**
    - iii. **Social**
    - iv. **Regulatory: (a) Investment Constraints (b) Consumer Protection**

Reasons for Regulation of Banks

- To reduce the risk of large-scale failure in the economic system
- To avoid systematic risk and contagious effect in global economy
- To guard against deposit insurance losses
- To achieve the desired social goal
- To promote an efficient and effective banking system that finances economic growth, impartially allocates credit and meets the customer needs

Why Banks Fail?

- Credit Risk
  - ✔ Banks keep reserves for expected losses
  - ✔ If losses > reserves then the excess amount of losses are deducted from bank capital
  - ✔ Importance of bank capital
- Maximization of the utility of all the stakeholders; i.e. shareholders, managers, employees, customers, communities
- Changes in macro economic conditions
- Financial repression: excess government intervention
- Inadequate diversification of loans

Why Banks Fail? Contd…

- Bank Runs
  - ✔ It occurs when depositors and other creditors fear for the safety or availability of their funds and large number of depositors try to withdraw their funds at the same time
  - ✔ It reflects the heard behavior of depositors to obtain the limited amount of cash that is available
- Silent Run
  - ✔ It occurs when large creditors such as banks and investment companies withdraw their funds in order to protect them

Bank Regulations in India

- Banking Regulation Act (1949)
- Disclosure norms: Annual report, asset quality, liquidity, earning
- KYC norms
- Anti Money Laundering Act (AML) & Countering Financing of Terrorism (CFT)
- Protection of small investors (Deposit insurance and credit guarantee corporation)
- Prudential Norms: income recognition, asset classification and provisioning, capital adequacy, investment and capital market exposure
- Licensing: Branch authorization policy
- Regulation of Interest Rate: Deposits of NRIs, small loans upto 2 lakh, export credit
- Statutory Pre-emptions: CRR and SLR
- Corporate Governance: Fit and proper criteria; director should have knowledge about banking