Financial Institutions and Markets
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Lecture - 21
Commercial Bank : Structure and Services

So, after discussing about the different regulatory bodies which are functioning in the Indian market or Indian economy, we can start the discussion on the commercial bank today which is the most important financial organization in any economy, any system in the world. Because, banking sector has its own relevance, it has its own significant for the financial sector as a whole which provides all kind of amenities either from the transaction prospective or from the investment prospective.

So, keeping those things in the mind it is very important to understand how the commercial banks basically work in a system, what are the major kind of services they provide. And why the commercial banks are so special among the different financial intermediaries which work in any financial system in the country or all over the world. Today we will be discussing about the structure of the commercial bank in India and what kind of services they provide.

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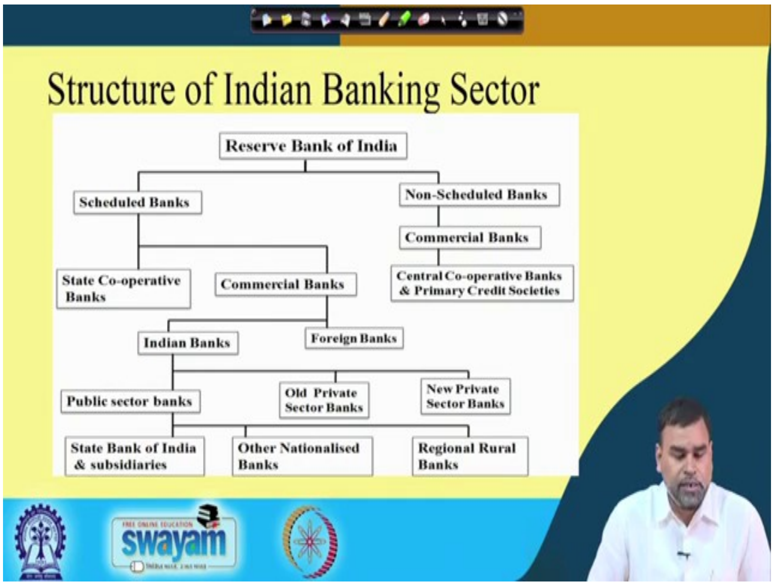

If you see that in Indian context the banks are regulated by RBI. So, RBI is the apex body which is the central bank and we have two types of banks which is scheduled banks and non-scheduled banks. The scheduled banks means the scheduled banks are basically established under the act of the Reserve Bank of India act. There are certain rules and regulations they have to follow to become that particular bank scheduled and there are some non-scheduled banks mostly the cooperative banks are the non-scheduled banks. And within this scheduled banks we have the state co-operative banks, we have the commercial banks, but the basic importance of the Indian banking sector is always concentrated on the commercial banks because, they actively participate in all kind of payment mechanism which is happening in the Indian context.

So, again Indian commercial banks are divided into two parts; one is Indian banks and the foreign banks. There are some foreign banks which are also operating in the Indian market. So, we call them the foreign banks. Then, within the Indian banks we have public sector banks and the private sector banks. you will little bit go into the deeper for the classification. There are some old private sector banks and there are some new private sector banks over the years like RBI is giving license to many private sector banks to start their banking operation or banking business in Indian financial system.

So, we have public sector banks, you have old private sector banks, you have new private sector banks and if you again go by public sector banks and we classified as State Bank of India. Now, this State Bank of India has been merged that one State Bank of India is existing, other nationalized banks like your Syndicate Bank, Punjab National Bank, then Canara Bank, these are all the public sector banks which are nationalized banks and we have the other some regional rural banks or the RRBs. So, this is the way overall the banking structure of the Indian context or Indian market looks like.

So, this is the overall structure of the Indian banks, but after looking this is basically for the understanding we have to know that, what are the different types of the banks which are existing in the Indian market.

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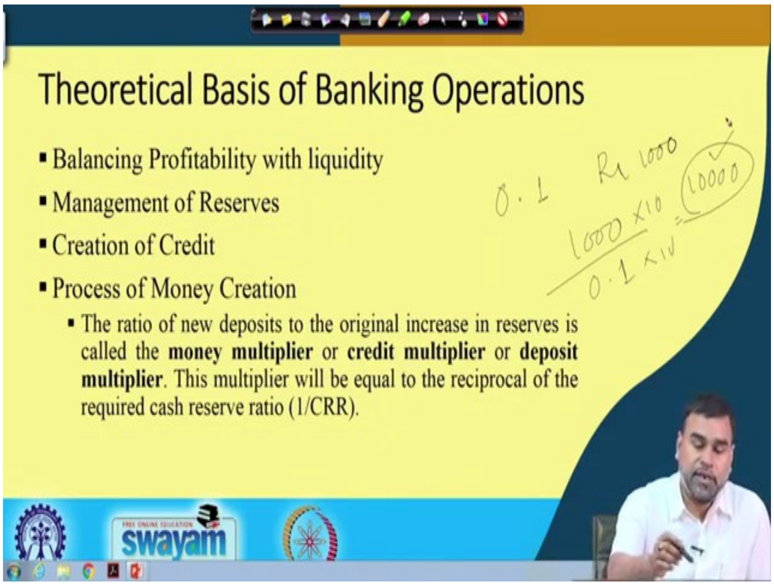

Then, if you see that the banks are little bit different bank also. People call it bank is also the finance company because like other products or other companies sell their products, bank also sell the financial products. So, that is why there is some kind of similarity or always we can consider that bank is a finance company who also works for the profitability. They also have some products and they provide the services and against that these create certain money or they basically charge some service charge from the customers and as well as also they provide certain kind of services to maximize the profitability of the other customers.

So, this is the way the bank can work like a company or bank can be considered as a finance company, but what is the basic difference between banks. Let's assume that another manufacturing company which is operating in India or any other country. So, if you see the basic difference between these two are that the other companies, the major objective is to maximize the profitability and their basic aim is how they can enhance their profitability by that. They can satisfy their shareholders and they can maximize the value of the shareholders, but whenever we talk about the bank, bank works in a different direction.

Bank cannot work only on the basis of the profitability. The basic philosophy of the banking sector is not based upon the maximization of the profitability. Bank also ensures that adequate amount of liquidity is maintained. Why the liquidity is maintained?

Because they have to fulfill the customers requirement and at a short notice and as well as at the time of requirement they should provide enough working capital finance to the companies if the company needs. So, liquidity is another aspect which is very important for the banking point of view.

The liquid is also important from the other company's point of view, but that is not that much important and their most important factor is maximization of the profitability, but whenever you talk about the banks, the banks major job is to maintain both. But, the question here is if you want to maintain more liquidity, your profitability gets hampered because the relationship between profitability and liquidity is basically inverse. If you want to use more money in the market and try to invest the money in the market, then obviously you can enhance your profitability, but liquidity, if you want to keep enough cash in your hand to fulfill the requirement of the customers demand, then what is happening money cannot go to the market. That is why the profitability gets hampered.

So, that is why balancing between profitability liquidity is very tedious job what the bank has to do. That is why this is basically the first important thing what we have to always understand that bank is different from the companies in terms of their objectives. The objective of the company is only to maximize the profit, but if you talk about the banking prospective the basic objective of the bank is not only to maximize the profit, but also to maximize the liquidity. Another thing is also management of the reserves, you see what do you mean by the reserves.

Because our banking system is a fractional reserve system out of the total deposit what are the customers keep in the bank, some of them has always go to RBI as a cash reserve requirements. Some of the money has to be kept with the banks to fulfill the customer requirements in the short run and some amount of the money has to be used as investment and some amount of the money has to be given as loan. So, we have a fractional reserve system. So, the bank is always ensuring that all type of things has been taken care of by the banks in a proper way by that at any point of time, any kind of disturbances, any kind of asset liability problem should not take place.

So, the management of reserves is quite important from the banking perspective because the requirement or the business of the banks is totally different than the normal companies which operate in the market for the maximization of the profit. Bank also can create the credit. It is not necessary that whatever deposit base we have your credit can be given from that. There is some kind of scenarios where bank can also give more loans than the whatever deposit base they have or the required amount of loan they should give it can be more than their stipulated limit because bank can create the credit. That is only possible by the banks and how they can create this, and we always consider the bank can create money.

Why the bank can create money? If you see the money multiplier process, if you are you might have read it in macroeconomics and other subject the money multiplier process basically works in this way that whenever anybody wants to have a loan account, they should have a deposit account for somebody has deposited 1000 rupees and if you are deposited 1000 rupees in bank, a 10 percent has gone to let CRR, then 900 net 900 rupees will be kept as the within the bank that this 900 rupees has been given as a loan to bank B.

Somebody has account in bank B, the loan has been given there; the 900 rupees are deposited there and out of them 10 percent has gone to CRR. Then another 990 has been deducted, then 810 rupees has been deposited in that process and there are n number of banks which are existing in the system. In that process if you add on 1000 plus 900 plus 810 plus and again so on the 10 less than 10 percent of that if you go on, then if you will find that the end of the day to total circulation of the money has been gone off up to how much whenever the particular money the amount of money will be starts with the 100 rupees, then the multiplier will be basically 1 by your CRR. That means, 1000 divided by the 0.1. That means, it is going up to 10, 000.

So, this is the way the money can be created, the money multiplier process which works by the commercial bank. So, that is why the money multiplier is defined as the ratio of new deposits to the original increase in the reserves that is basically called the Money Multiplier or it can be called Credit Multiplier or it can be also called the Deposit Multiplier. So, this multiplier will be equal to the reciprocal of the required cash reserve ratio that is one by CRR.

Just now what basically I was trying to say if your CRR is 10 percent that means 0.1, then if you start your transaction of rupees 1000, then your total amount of the money will be created in the system through this process will be 1000 divided by your multiplier will be how much? 0.1. So, then if you say this thing, then it will be how much? 10000. So, 10000 rupees can be created in the system through this way.

So, this is called the Money Multiplier Process. 1 by 10 means this is 0.1. So, in this process the 10000 rupees can be created and this is only can be possible by the commercial banks. So, that is why we argue that always commercial banks can create money, then these are the different bases theoretical basis on which the banks operate in a particular system or the commercial banks can operate in a system.

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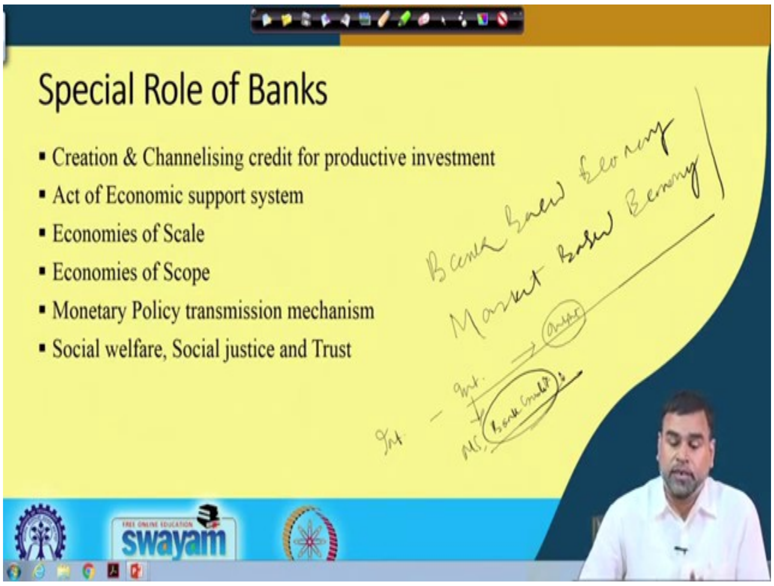

Then another question is the banks are special among all the intermediaries which work in the system. Why? They are special. There are certain characteristics were the banks have the same characteristics. Other kind of financial organizations may not have even if they are operating in the same system. Then, what are those? The banks are basically specialized or banks are special to create and channelize the credit for the productive investments because bank is the payment gateway or bank has the direct connection with the Reserve Bank of India.

So, whatever credit basically they provide, they can create the credit and they provide only for the productive investment. The reason is the monitoring system of the banks is quite robust. The reason is if somebody wants to take a loan in Mumbai, but he is based in Kolkata, but the bank can be bought the property in Mumbai, the loan is taken in

Kolkata. This is possible because the monitoring system of the particular bank is quite robust because they have branch in Mumbai, they have a branch in Kolkata.

So, the reason is that from the logistic point of view and as well as from the expertise point of view, in those particular cases the transaction cost of the commercial banks will be less. If the transaction cost will be less, obviously the operations will be better and because of that they can channelize the credit in a better way for the productive investments.

That may not be possible by the other financial entities which are existing in the financial system and this is also act of the economic support system because for any kind of thing we always required the bank. If you are investing in stock market the role of bank is there, if you are investing in foreign exchange market the role of the bank is there, and even if you have insurance policy the role of the bank is there. For everything the bank is linked. So, that is basically a support system for the economy.

So, in that context we can call it the Indian banking sector is a bank based economy. There are two types of economy always you might have known. One is your market based economy and another one is the bank based economy. So, the Indian economy is a bank based economy and another thing is the market based economy. US is the market based economy. So, there are many agents who was specialized agents who participated in the different system, but in Indian context mostly we are concentrating on the banks for all type of financial transactions which are taking place in Indian Financial System.

And if you have read from the economics point of view, if you see there is economies of scale which can be possible by the commercial banks because the availability of the banks are more than the other financial entities. The banks operate in very remote rural areas; banks also operate in the metropolitan cities. Because of the economies of scale already I told you they can reduce their cost and their monitoring system will be quite robust. So, because of that whatever transaction cost we can incur if you go for dealing with other financial entities that will always be more than the transaction cost what we incur whenever we deal with the commercial banks.

So, because of that the services will be better and as well as the cost from the customer side or from the investor side also will be less. So, economies of scale which can be possible with respect to the commercial banks, the same economies of scale it may not be available with the other financial entities or other financial organizations which exist in the financial system. So, that is also another special kind of characteristics what the commercial banks have. Then we have economies of scope. Already you know that what do you mean by economies of scope.

Economies of scope in the sense we have varieties of the products in the same line which are basically provided by the companies. You can take example from the company perspective you can take the example of Hindustan Unilever who has n number of products basically come to the market and they provide, but all the products are produced in the same line. They can produce oil, they can produce soap, they can produce shampoo, and they can produce any kind of thing which are in FMCG sector.

But all the productions are made in the same line, so whenever the productions are in the same line what happens the fixed cost is always more or less same for all types of production, only change in the variable cost. So, that is why the average total cost of the company will be less. Obviously, that will have the impact on the price of the product.

So, like that at a time the bank can provide different kind of financial services. It takes the deposits, it provides loans, it also give other kind of investment opportunities within the deposit, the varieties of the deposits within the loans. They have got varieties of the loans. So, that makes that particular scope product. So, the economies of scope or the commercial bank is very high, very large. So, in that context what happened what happens then bank is able to reduce their cost and as well as they provide the better services to the customer on the basis of their requirements.

So, this is what basically the economies of scope concept which better works with the commercial banks. Obviously, they are the major participants for the transmission monetary policy transmission mechanism because, already we have discussed that the intermediate channel for the bank is basically whenever we talk about the monetary policy, we have already explained there is instrument, there is intermediate target and that is basically your final output or final objective or final goal. So, your intermediate target is the money supply and the bank credit.

So, because the bank credit is one of the intermediate target though they have an active role they play or very important role they play in the monetary policy transmission mechanism of the particular country. They are also able to maximize the social welfare because they participate in all kind of public welfare schemes whether it is microcredit or it may be providing part of the financial inclusion, it can be a part of any kind of Jan Dhan Yojana and other things which are happening in the Indian market.

So, all kind of social welfare schemes which are always linked to the commercial banks and as well as they provide the social justice because, of those though that provide equal services to all type of customers which are existing in the financial system and as well as economic system as a whole and that also carries more trust from the public. And, because of that then people are more concerned about the commercial banks or there is more faith on the commercial banks whenever they do the financial transactions instead of have the faith on other kind of financial entities who provide any kind of financial services in the economy. So, this is why we say that the banks are so special among all kinds of financial intermediaries which are working in this particular system.

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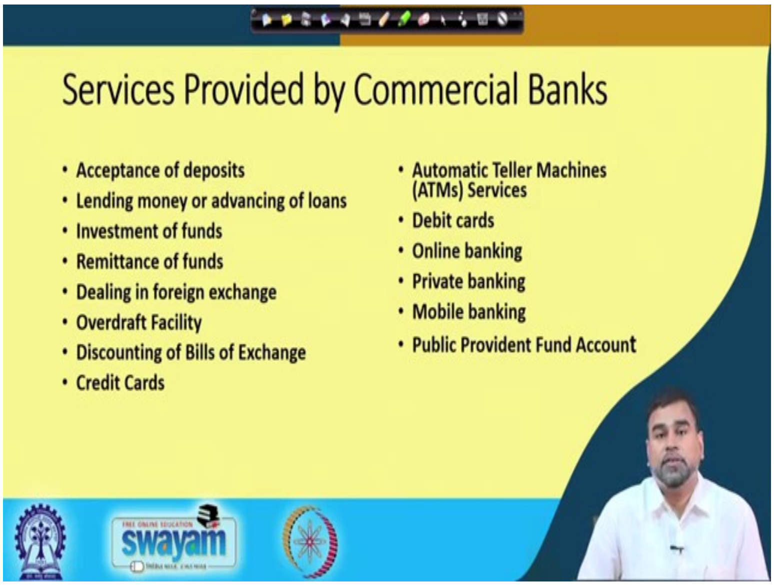

Then, we can see that what kind of services which are given by the commercial banks. Commercial bank provide many services very difficult to identify all type of services, but there are some major services. What we can highlight here then we can add also if there is not any other services left out in this particular list, but if you see that what are those services which are provided by the commercial banks. First of all commercial banks always take the deposits from the customers.

Because you see if any customer is not interested to the stock market still if they have some surplus they want to deposit the money in the bank. Why? Because that is the easiest and safest way of investing the money; so, at least some return can be realized and your bank will be safe, your money will be safe because they feel that bank is the safest place where the money can be kept. So, because of that they provide a very good services in terms of accepting the deposits and the deposits also can be very small deposits, it can be big deposits and because the bank plays a very major role in the economic system for providing the money and as well as it is the only payment gateway to a system which exists.

The money can be utilized in the system in a better way. By that it also affect the total investment in the economy and finally, the output also gets affected by that. So, the acceptance of deposit is the major service which is given by the commercial bank. There are many type of deposits, savings deposit, fixed deposits within, recurring deposits, different type of deposits which are available and depending upon the customer's requirement. The customer can go for any kind of deposits whatever they need lending money or advancing of the loans.

This is the major thing where the bank also generate profit or income from this, but this is one of the most important services what the bank gives because already I told you bank create the credit for any kind of loan whether it is a commercial loan, whether it is a housing loan, whether it is a kind of vehicle loan or personal loan or education loan different any kind of loans. All kind of loans can be given by the banks. The portfolio of loans, the lending activities of the commercial bank is quite big quite large.

So, in that context they also cater the services in a very bigger way, very larger way because depending upon any customer's requirement they provide the loan. Some customers take short term loans, some customers takes long term loans and all kind of demands are catered by the commercial banks. So, that is one of the most important services what they provide which also provided by some other entities, but the commercial banks basically is pioneering in that because the varieties of the services in terms of the lending activities what they give that may not be available with other financial entities which are operating in the financial system.

Investment of funds whatever remaining funds are there, banks basically invest that funds in the different instruments and one thing is the banks are bound to invest certain money in the SLR instruments like government securities and the rest of the money they can invest basically in the capital market or any other instruments wherever they want. So, banks also provide this investment services and any kind of other services what the customer need, they basically can invest in that particular fund which are provided by the bank's will. We will discuss more on all the kind of things or all kind of instrument which are issued by the banks in the future sessions, but banks also provide the investment services to the customers.

Remittance of the funds basically it is, it deals with the foreign exchange business on kind of one remittances that basically comes to the banks. So, Foreign Exchange Services that also given by the banks although RBI is the sole responsible authority for this, but with the knowledge of the banks, some of the commercial banks are authorized to do the foreign exchange business and those kind of business basically are done by the commercial banks at the time of requirements. That is what they deal with the foreign exchange business.

They can provide the overdraft facility. Commercial banks provide over overdraft facility in the sense whatever money you have as a deposit on the basis of your profile on the basis of your future cash flow generation capacity. The overdraft facility also can be given or overdraft can be issued to the customer if they need it may not be applicable for all, but within certain conditions the overdraft facility can provide it to the customer if they need even if they do not have that much money as a deposit base in that particular account.

The discount, this bills of exchanges, bills market basically any kind of bills which are issued for any kind of purpose, those kind of discounting facilities are only available with the commercial banks as the bill can be shown to the commercial banks to get back that particular money whenever the bill was issued and today's world the one of the most important service what are the commercial banks are giving that is credit card. You do not have to hold the money with you, no cash transactions. All kind of transactions can be done by the credit card and credit card basically makes your consumption pattern smoother and your consumption also can increase because of that. Indirectly or directly it is affecting the total GDP or the output of the economy.

So, these are basically, this credit card is one of the major services. What they provide you do not have to go to the bank because they provide the ATM service. 2 o'clock in the night you can encash the money. You do not have to go to the bank whatever money you have kept and against your account you have the debit card which can be used also like the credit card they have provide. Today's scenario we are all doing the online banking. Those banking services are given by the commercial banks, now private banking. Some specific kinds of services are also given to some high net worth individuals and as well as the people who are the active participants in the commercial bank or the major customers of the commercial bank.

They also provide the mobile banking; technologically the banks now very strong enough. Now, the mobiles are also good enough for doing the banking transactions. And another for the small savings point of view, the banks also provide the Public Provident Fund account. You can open the Public Provident Fund account in the banks. The maximum amount in a year you can deposit 1,50,000, but that services or that accounts only can be always opened with the commercial bank.

So, instead of going to any other specialized agency those kind of services you can get it from the commercial banks and that is one of the small savings which can help you for your future for any kind of purpose, any kind of requirements. So, all these things are very clear, but let us understand how the credit card and the online banking things work.

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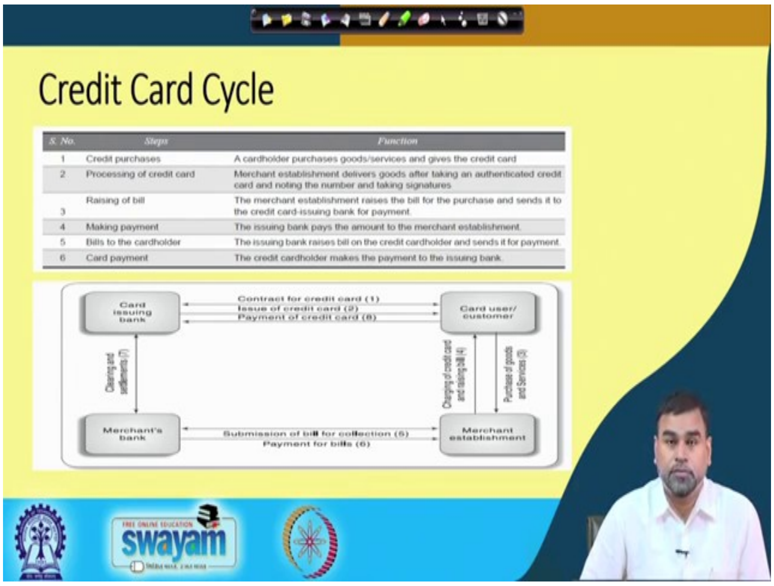

If you see whenever you have a credit card, how does the credit card cycle work. If you see the steps first we have purchased the credit card. Whenever the credit card basically used you have purchased something from a shop or anywhere else, you have used the credit card, then after that what has happened the particular processing of the credit card is done, the merchant establishment delivers the good after taking an authenticated credit card and noting the number and taking the signatures. And, nowadays also the signature is not required because you have the SIM based credit card or the chip based credit card which is available with you.

Then, the bill is raised, the merchant establishment raises the bill for the purchase and sends it to the credit card issuing bank for the payment. They keep this particular bill with them and send this particular bank to make the payments to their bank, then the issuing bank pays the amount to the merchant establishment and the issuing bank raises the bill on the credit card holder and send it for the payment and the cycle will be completed whenever the credit card holder makes the payment to the bank.

You see you have made the purchase in so and so date and there is a 50 date cycle. If you are making your payment after 50 days without any interest, so that cycle will be complete only after 50 days. So, the transaction will be completed only after 50 days whenever the credit card holder pays the money to the bank from which they receive the credit card.

So, that is why the credit card is basically facilitated the people even if they do not have money with them. Immediately it can help them for the consumption in that particular point of time whenever they need. So, this is the way the credit card cycle works. So, generally the period is they kept it around for 50 days period. You get this particular period. Within that period you have to make your payments. If you do not make the payment, then maybe you can pay some penalty and all other kind of cost is involved into that, but at least the 50 days time has been given to the customer to make the payments.

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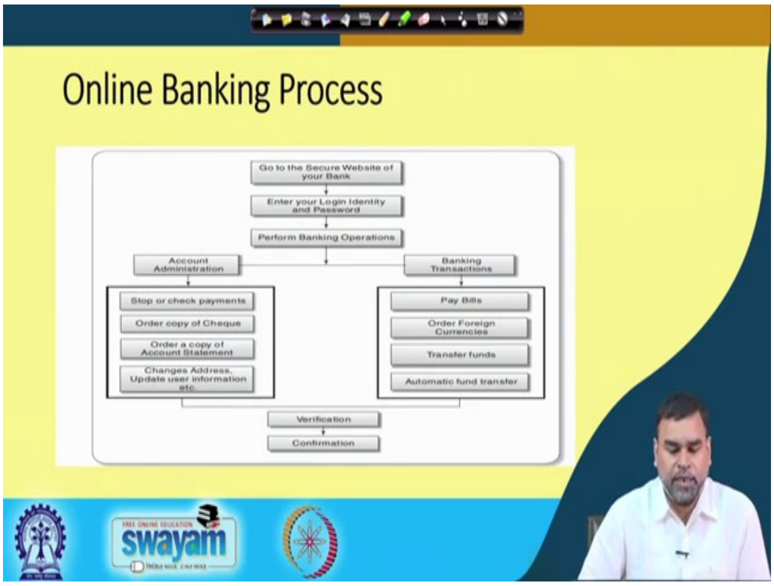

Whenever you go for online banking all of you is very much aware about this, but still if you see that we can create your login, then perform the banking operations, then in that case you can make any kind of transactions through that, you can send the money to somebody else, you can pay the bills, you can order the foreign currency, you can transfer the fund, you can also make the provisions for the automatic fund transfer or other services also online banking can give. If there is any requirement you can stop your payment or you have issued the cheque.

What do you find that is something wrong with that particular transaction, you can stop it, order the copy of the cheque, you can also order the copy of the account statement. There is no need to go to the bank and give them this request that I want the account statement because the account statement directly you can download from the banking website, all kind of information, address changes, user information everything can be done through that and once there is a verification system by the bank if all these things are updated by the verification system, then the confirmation of that particular services can be made.

So, online transactions basically online banking processes provides all kinds of services whatever we need in terms of the banking perspective which makes our life more simpler and as well as also easygoing. So, in this context if you see there is a great revolution which has taken place from the commercial banking perspective, once the technology and all kind of credit card and online transactions are happening in the particular system. So, this is basically about to the basic services of the banks and why the banks are so special among the different intermediaries.

But there are many issues which are related to the commercial banks like how we can assess the performance of the banks, what kind of financial statements the commercial banks should have and how the commercial banks manage the risk and all these issues and how these commercial banks are basically related to the special norms. So, those issues we will be discussing in the future sessions.

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Please go through these particular references for this particular session.

Thank you.