

UNIT-3

Introduction to Commercial banking

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Syllabus

- Commercial Banking: Meaning and types; Functions of Commercial Banks
- The process of Credit Creation - Purpose and Limitations
- Liabilities and Assets of banks
- Evolution of Commercial Banking in India after Independence
- A Critical Appraisal of the Progress Of Commercial Banking after Nationalization
- Recent Reforms in Banking Sector in India

Meaning of a commercial bank

A commercial bank is a financial institution that provides various banking services to individuals, businesses, and organizations. It serves as an intermediary between depositors who have surplus funds and borrowers who require capital for various purposes. Commercial banks play a crucial role in the economy by facilitating the flow of funds, promoting economic growth, and offering a range of financial products and services.

Types of Commercial Banks:

1. **Retail or Consumer Banks:** These banks focus on providing services to individual customers, such as savings accounts, checking accounts, personal loans, mortgages, credit cards, and other retail banking products.
2. **Corporate Banks:** These banks primarily serve businesses, corporations, and large organizations. They provide services such as business loans, trade financing, cash management, treasury services, and other corporate banking solutions.
3. **Investment Banks:** Investment banks specialize in offering financial services to corporations, governments, and institutions. Their services include underwriting securities, facilitating mergers and acquisitions, assisting with corporate restructuring, and providing advisory services on investment decisions.
4. **Community Banks:** These banks operate at a local level and focus on serving the needs of a specific community or region. They typically provide traditional banking services to individuals and small businesses in their local area.

Functions of Commercial Banks:

1. **Accepting Deposits:** Commercial banks accept deposits from individuals, businesses, and other entities. They offer various types of accounts, such as savings accounts, checking accounts, fixed deposits, and certificates of deposit.

2. **Providing Loans and Credit:** Banks provide loans and credit facilities to borrowers, including individuals, businesses, and governments. These loans can be for personal needs, home purchases, business expansion, or other investment purposes. Banks also issue credit cards and provide overdraft facilities.
3. **Payment Services:** Commercial banks facilitate the transfer of funds between accounts, both domestically and internationally. They provide services such as electronic fund transfers, check clearing, issuing bank drafts, and facilitating online and mobile banking transactions.
4. **Investment and Wealth Management:** Some commercial banks offer investment and wealth management services. They help clients manage their investment portfolios, offer advisory services, and provide access to various investment products like mutual funds, stocks, and bonds.
5. **Foreign Exchange Services:** Banks facilitate currency exchange and provide services related to foreign exchange transactions. They assist individuals and businesses in converting one currency into another and offer hedging options to manage currency risks.
6. **Treasury Operations:** Commercial banks manage their own treasury operations, which involve activities like managing cash flows, liquidity management, risk management, and investing in various financial instruments to generate income.
7. **Advisory Services:** Banks offer advisory services to clients on financial matters, such as investment strategies, risk management, and financial planning. They provide expert guidance to individuals and businesses to make informed financial decisions.

The process of credit creation

Meaning of credit creation

Credit creation refers to the process by which commercial banks and other financial institutions create new money or credit in the economy through the lending process. When a bank extends a loan or grants credit to a borrower, it effectively creates new purchasing power in the economy.

Purpose of credit creation

The purpose of credit creation is to stimulate economic activity and support financial intermediation. By providing loans and credit, banks enable individuals and businesses to access funds for various purposes, such as investment, consumption, and business expansion. This, in turn, promotes economic growth, job creation, and overall prosperity.

Limitations of credit creation

Credit creation has certain limitations and considerations:

- a. **Reserve Requirement:** Banks are required to maintain a certain percentage of their deposits as reserves, which limits the amount of credit they can create. This reserve requirement is set by the central bank and is aimed at ensuring the stability of the banking system and controlling inflation.
- b. **Creditworthiness and Risk Assessment:** Banks need to assess the creditworthiness of borrowers before extending credit. They evaluate factors such as income, assets, credit history, and collateral. This assessment helps mitigate the risk of default and ensures responsible lending practices.

- c. **Liquidity Constraints:** Banks need to manage their liquidity positions effectively to meet the demands of depositors and maintain stability. Excessive credit creation without adequate liquidity management can lead to liquidity shortages and potential financial instability.
- d. **Interest Rates and Monetary Policy:** The central bank uses various tools, such as interest rate adjustments, to influence credit creation and manage the overall money supply in the economy. Changes in interest rates affect borrowing costs, which can impact the demand for credit and credit creation.
- e. **Economic Conditions and Business Cycle:** Credit creation can be influenced by the prevailing economic conditions and business cycle. During economic downturns, banks may become more cautious in extending credit, leading to a reduction in credit creation. Conversely, during economic expansions, credit creation may increase as banks perceive lower risks and higher demand for loans.
- f. **Prudential Regulations:** Regulatory authorities impose prudential regulations on banks to ensure the soundness and stability of the financial system. These regulations set capital adequacy requirements, risk management standards, and other guidelines to prevent excessive risk-taking and protect depositors' interests.

Liabilities and assets of a commercial bank

Liabilities and assets are key components of a commercial bank's balance sheet, representing the sources of funds and the uses of those funds, respectively.

Liabilities of a commercial bank	Assets of a commercial bank
1. Deposits 2. Borrowings 3. Bank's own capital 4. Other liabilities	1. Loans and advances 2. Cash and cash equivalents 3. Investments 4. Reserves with central bank 5. Interbank assets 6. Fixed assets 7. Other assets

Here's an overview of the liabilities and assets typically found in a commercial bank:

Liabilities of a Commercial Bank:

- 1. **Deposits:** Deposits form a significant portion of a bank's liabilities. These include various types of accounts held by individuals, businesses, and other entities, such as savings accounts, current accounts, fixed deposits, and certificates of deposit.
- 2. **Borrowings:** Banks may borrow funds from other financial institutions, central banks, or other sources to supplement their deposit base. These borrowings could include short-term loans, interbank borrowings, repurchase agreements (repos), and long-term debt issuances.
- 3. **Bank's Own Capital:** This represents the bank's own equity or net worth, including issued common stock and retained earnings. It serves as a cushion to absorb losses and acts as a measure of the bank's financial strength.
- 4. **Other Liabilities:** Banks may have other liabilities, such as obligations related to derivatives, deferred tax liabilities, accrued expenses, and any other debts owed to third parties.

Assets of a Commercial Bank:

1. **Loans and Advances:** The primary asset of a commercial bank is the loans and advances it extends to borrowers. These include personal loans, mortgages, business loans, lines of credit, and other types of credit extended to individuals, businesses, and governments.
2. **Cash and Cash Equivalents:** This category includes the cash held by the bank in its vaults and deposits with central banks. It also comprises highly liquid instruments that can be quickly converted into cash, such as treasury bills and short-term government securities.
3. **Investments:** Commercial banks often hold investments in various financial instruments. These may include government bonds, corporate bonds, municipal bonds, equities, mutual funds, and other securities.
4. **Reserves with Central Bank:** Banks are required to maintain reserves with the central bank as a percentage of their deposits. These reserves ensure liquidity and act as a safeguard against potential withdrawals or obligations.
5. **Interbank Assets:** Commercial banks may have assets in the form of loans extended to other banks or financial institutions. These loans serve as a means of generating interest income and managing liquidity needs.
6. **Fixed Assets:** Banks own fixed assets, such as buildings, branches, furniture, and equipment, necessary for their operations.
7. **Other Assets:** This category includes any other assets held by the bank, such as accrued interest receivables, prepaid expenses, intangible assets, and any other investments or holdings.

It's important to note that the composition and proportions of these liabilities and assets can vary among banks based on their business models, size, risk appetite, and regulatory requirements. Commercial banks strive to maintain a balance between their liabilities and assets to ensure stability, liquidity, and profitability.

Evolution of commercial banking in India after independence

After India gained independence in 1947, the commercial banking sector underwent significant changes and witnessed notable developments. Here is an overview of the evolution of commercial banking in India after independence:

1. **Nationalization of Banks (1969 and 1980):** In an effort to promote social welfare and financial inclusion, the government nationalized 14 major private banks in 1969 and an additional six banks in 1980. This move aimed to expand banking services to rural areas, prioritize the needs of agriculture and small-scale industries, and ensure a more equitable distribution of credit.
2. **Priority Sector Lending:** In the 1970s, the government introduced the concept of priority sector lending, which mandated banks to allocate a specific percentage of their lending to sectors like agriculture, small-scale industries, and weaker sections of society. This policy aimed to address regional imbalances and promote economic development across various sectors.
3. **Lead Bank Scheme:** The Lead Bank Scheme was introduced in 1969 to assign each district to a specific commercial bank. The lead bank acted as a catalyst for overall development in the district, coordinating and supporting the banking needs of the region, and ensuring credit flow to all sectors.

4. **Liberalization and Financial Sector Reforms (1990s onwards):** In the early 1990s, India embarked on a path of economic liberalization and financial sector reforms. The country shifted from a controlled and regulated economy to a more market-oriented approach. Reforms such as deregulation, liberalization of interest rates, and the introduction of foreign banks led to increased competition and efficiency in the banking sector.
5. **Introduction of New Banking Models:** Alongside traditional commercial banks, India witnessed the establishment of new banking models such as Regional Rural Banks (RRBs) and Cooperative Banks. RRBs were set up in the 1970s to cater specifically to rural areas, while Cooperative Banks aimed to serve the needs of cooperatives and local communities.
6. **Technological Advancements and Digital Banking:** The advent of technology and the internet brought significant changes to the commercial banking landscape. Indian banks adopted technological advancements, computerization, and the use of core banking solutions. With the rise of digitalization, banks introduced online banking, mobile banking, and other digital services to enhance customer convenience and accessibility.
7. **Consolidation and Merger of Banks:** In recent years, the Indian government has undertaken the consolidation and merger of several public sector banks to strengthen their financial positions, improve efficiency, and address issues related to capital adequacy and governance.
8. **Inclusion and Financial Literacy:** In line with financial inclusion goals, initiatives like the Pradhan Mantri Jan Dhan Yojana (PMJDY) were launched to provide basic banking services to all citizens. Efforts have been made to enhance financial literacy and increase banking penetration in rural and underserved areas.

A Critical Appraisal of the Progress Of Commercial Banking in India after Nationalization

The nationalization of banks in India in 1969 was a significant step towards achieving social objectives and promoting financial inclusion. While there have been positive outcomes, a critical appraisal of the progress of commercial banking in India after nationalization reveals certain shortcomings and challenges. Here are some key points to consider:

1. **Lack of Efficiency:** Nationalization resulted in a bureaucratic and centralized banking system, which often led to inefficiencies and delays in decision-making. The public sector banks faced challenges in adapting to market-oriented practices, resulting in a slow response to changing customer demands and technological advancements.
2. **Credit Allocation Issues:** The priority sector lending guidelines introduced after nationalization aimed to channel credit to underserved sectors. However, the implementation of these policies faced challenges, such as the misclassification of loans and diversion of funds, leading to inefficiencies and suboptimal allocation of credit.
3. **Governance and Accountability:** The government's direct ownership and control over public sector banks created challenges in terms of governance, accountability, and autonomy. Political interference, including the appointment of bank officials based on political considerations, affected the decision-making process and hindered the banks' ability to operate independently.
4. **Capital Constraints:** The nationalized banks faced capital constraints due to limited access to resources, resulting in challenges in meeting regulatory capital requirements. This, in turn, impacted their ability to expand lending operations and invest in technology and infrastructure upgrades.

5. **Non-Performing Assets (NPAs):** Over time, public sector banks in India faced a significant increase in non-performing assets, indicating a deterioration in the quality of their loan portfolios. Factors such as political pressure, weak credit appraisal practices, and inadequate risk management contributed to the rise in NPAs, impacting the banks' profitability and overall financial health.
6. **Lack of Innovation and Technology Adoption:** Public sector banks lagged behind their private sector counterparts in terms of innovation and technology adoption. Slow implementation of digital banking solutions and outdated systems affected customer experience and hindered operational efficiency.
7. **Market Competition:** The nationalization of banks reduced competition in the banking sector, as the government-owned banks held a dominant market share. This limited the choices available to customers and stifled the entry of new players, resulting in reduced competitiveness and slower innovation.

It is worth noting that in recent years, the government has initiated reforms to address some of these challenges. Measures such as bank recapitalization, consolidation of public sector banks, and increased focus on governance and risk management have been introduced to improve the functioning and performance of commercial banks.

Recent reforms in banking sector in India

The banking sector in India has witnessed several reforms in recent years aimed at addressing various challenges, promoting transparency, enhancing governance, and strengthening the financial system. Here are some significant reforms implemented in the banking sector:

1. **Insolvency and Bankruptcy Code (IBC):** The introduction of the Insolvency and Bankruptcy Code in 2016 revolutionized the resolution framework for stressed assets in the banking system. It provides a time-bound process for the resolution of insolvencies, encourages creditor participation, and facilitates the recovery of non-performing assets (NPAs).
2. **Recapitalization of Public Sector Banks (PSBs):** The government has undertaken a comprehensive recapitalization plan to strengthen the capital base of PSBs. Under this plan, capital infusion has been carried out to enhance the banks' ability to absorb losses, meet regulatory capital requirements, and support credit growth.
3. **Prompt Corrective Action (PCA) Framework:** The Reserve Bank of India (RBI) introduced the PCA framework to monitor and take corrective measures for banks facing financial stress. The framework imposes restrictions on lending and expansion for banks falling under certain threshold parameters, with the objective of improving their financial health and risk management practices.
4. **Merger and Consolidation of Banks:** The government has initiated the merger and consolidation of several public sector banks to create larger, stronger entities. This move aims to improve operational efficiency, enhance risk management practices, and create stronger banks capable of supporting economic growth.
5. **Enhanced Governance and Transparency:** The RBI and the government have taken measures to enhance governance and transparency in the banking sector. Measures include strengthening the role of independent directors, improving risk management systems, implementing stricter disclosure norms, and enhancing the supervisory framework.
6. **Introduction of Payment Banks and Small Finance Banks:** The RBI has issued licenses for the establishment of Payment Banks and Small Finance Banks. Payment Banks focus on providing basic banking services and digital payments, while Small Finance Banks cater to

the needs of unserved and underserved sections of the population, including micro and small enterprises.

7. **Implementation of Basel III Norms:** India has been gradually implementing the Basel III norms to strengthen the capital adequacy and risk management standards of banks. These norms require banks to maintain higher capital buffers, improve risk management practices, and enhance disclosures to mitigate systemic risks.
8. **Digital Transformation:** The banking sector in India has been undergoing significant digital transformation. Banks are adopting digital technologies, such as mobile banking, internet banking, and digital payment systems, to improve customer experience, expand reach, and increase operational efficiency.
