e-Pathshala पाठशाला

Subject	ECONOMICS
Paper No and Title	11- Money & Banking
Module No and Title	27- Commercial Banks
Module Tag	ECO_P11_M27

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1. Learning Outcomes

After studying this module, you shall be able to

- Understand the functioning of commercial bank.
- Know about the structure of Indian Bank.
- Know about the development in lending and capital requirements.

2. Introduction

Importance of Banks: Banks are specialised institutions which conduct the simplest operation of accepting deposits and safekeeping it. They play a crucial role in the economy by way of circulation of money received in the form of deposits through further loans and advances. Banks have existed for long and have performed this function of safe guarding people's personal wealth for centuries. Earlier goldsmiths used to perform this task of providing a secured place to people to store their wealth which could be withdrawn on demand by the public, for which they used to charge a commission either in cash of in gold itself. This system later grew to a more complex form where the gold was later loaned out so as to make profit. Today, banks not only accept deposits and give loans but provide more sophisticated services which have been possible through innovation and expansion of financial markets with due course of time. Banks perform a special task of tailoring contracts and modifying existing contracts between parties into new contracts. They are able to convert short term contacts into long term ones through spreading up of risk and also transfer the liability from one party to another. Let us look more closely into the functions performed by the banks today.

3. Functions of Banks

3.1 Liquidity and Profit Generation

The commercial banks as financial intermediary perform an important function of bridging the gap between people with excess funds and people who want to borrow them, with this function they not only create liquidity but also help reduce the cost of transaction which would be high in absence of such specialised institution. The banks are able to achieve this through economies of scale as they are able to spread this cost of large number of account holders. During this function they earn income by way of *interests, discounts, fees or commissions* depending upon the type of instrument and

scheme issued. They also ensure the flow of money through management of their profit margin and also the liability of deposits they carry.

3.2 Management of Reserves

The deposits by public are the liability of a bank which needs to be repaid after some time on demand. A bank cannot just keep accepting deposits without creating a scope of profit generation by way of loans and advances. During this process of liquidity creation, a bank cannot loan out every single penny it receives as deposits because the loans are mostly long term in nature and cannot be clued bcd on demand, but the deposits can be recalled by the depositors as per their willingness. Thus to avoid situations of illiquidity, Central Banks make it mandatory for commercial banks to hold a portion of their deposits in the form of cash reserves. Banks can also hold reserves over and above this legal requirement. This system in which the money after keeping reserve is loaned is called *Fractional Reserve System.*

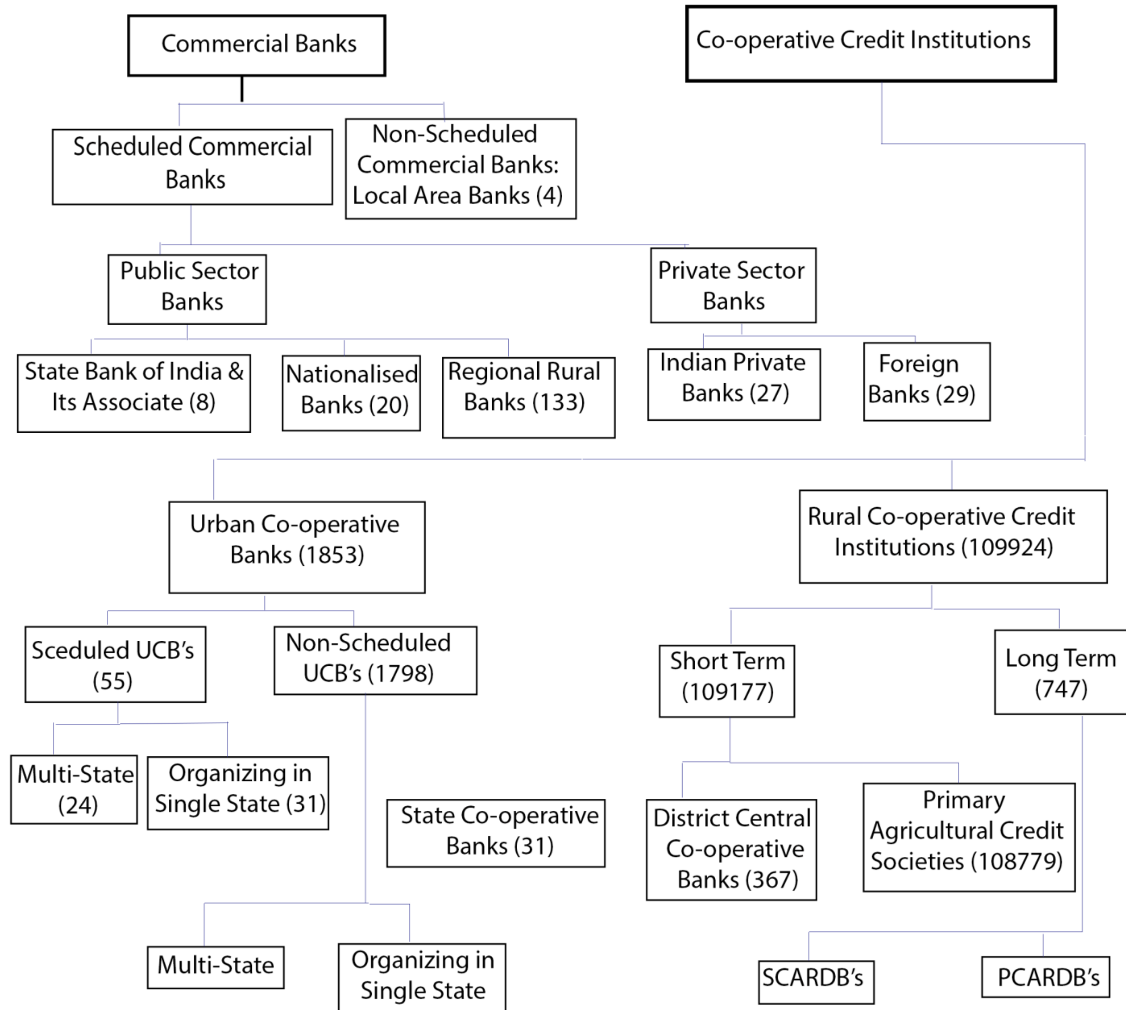
3.3 Credit Creation

Capital is necessary for economic growth and firms are in constant need for funds to take up productive activity. With expansion of human needs, households also need funds for consumption. Banks are able to provide credit for different purposes with different term structure. This function hods utmost importance as the banks are the institutions entrusted with the capability of creating money by way of loan. This ability of banks leads to expansion of money printed by the central bank and adds to the existing stock of money.

Apart from the above conventional functions, modern day commercial banks have expanded their operations. Banks are also active players in call money market or the market for short term funds. They engage in fund transfers with Central Banks and other banks. The volume of savings accepted by these institutions makes them all the more important for financial stability of the nation creating a special interest by the governments and regulating authorities to look after their financial health and operations. Information asymmetry is considered as a major drawback in financial system and as a root cause of distress. Banks can mitigate such information gaps by formulating new contracts on the basis of existing ones and can even tailor them as per specification to reduce risk. Thus every function of bank is interdependent and important.

4. Indian Banking System

The Indian banking system can be explained with the following diagram.



4.1 Structure

The Indian banking structure begins with the apex or the central bank named the Reserve Bank of India. Then comes the scheduled and non-scheduled banks. Scheduled Banks in India constitute those banks which have been included in the Second Schedule of Reserve Bank of India (RBI) Act, 1934. These could either be Public or Private Banks.

There were a total of 89 commercial banks in the year 1951 which grew to 291 in the year 2004 this number fell to 173 in 2012. The overall deposits to National income grew from 10% in 1955-56 to almost 74% in 2005-06. As per the recent statistics, overall deposits for scheduled commercial banks grew 15% in 2011-12. Banks had around Rs. 64535 Billion of deposits outstanding and Rs. 50736 billion worth loans and advances. These banks earned an income of Rs. 7418 Billion by way of interest and other sources and their total expenditure amounted to Rs. 6600 billion. The collective net profit of scheduled commercial banks was Rs. 817 billion.

The number of offices of scheduled commercial banks were 98330. The per capita deposit of these banks grew from Rs. 88 in year 1969 to Rs. 48732 in 2012. Almost 32% of advances were directed towards priority sector by these banks in 2012. The credit-deposit ratio has remained fairly stable at 78%.

There were 27 public sector banks excluding Regional Rural Banks (RRBs) in 2002, 196 RRBs, 30 private sector banks and 44 foreign banks. As per 2012, 28 public sector banks with 133 RRBs were present. There were also 27 private banks and 29 foreign banks in India during this time.

4.2 Liabilities

The main types of liabilities of commercial banks include Deposits by the public in the form of on demand or long term basis. The deposits can be divided as follows:

Current Deposits:

Checkable deposits with unrestricted withdrawals form the part of current deposits. The banks provide overdraft facility along with cheque collection and issue of demand drafts. The accounts and non interest paying and is included for money supply calculation. Saving deposits are the accounts which pay interest. The account operates in similar fashion to current account except the fact that number of withdrawals are limited.

Term Deposits:

These are long term or fixed deposits with different periods of maturity.

In 1994, around 73% of total deposits were owned by individuals. They owned 90% of savings deposits and 78% of term deposits. The current deposit accounts are held by enterprises and corporations for the ease of transactions. The current deposits as a fraction of total deposits reduced to 11% in 2002 from 51% in 1951 whereas this portion increased for savings deposits and term deposits at 24% and 65% respectively. The short term deposits of unto one year was around 36% of overall term deposits while that of long term deposits (3-5 years) fell to 24%. the banks wise classification shows the highest growth was registered by private banks at 38.8% followed by foreign banks at 32.6% and public sector banks at 22.9% during 2006-07.

Deposits have seen a rise in absolute size due to several factors namely:

- Rise in National Income
- Extension of Banking Facilities to new categories
- Increase in banking awareness
- Rise in returns from banks
- Deficit financing
- Rise of credit circulation
- Flow of Foreign Funds and
- Increased Competition.

The non-deposit liabilities of banks include borrowings and debt from domestic market and foreign currency. The overall borrowings for the commercial banks in 2012 stood at RS. 8348 billion.

4.3 Assets

The assets of bank includes cash balances, assets with banks, investments in government securities and bank credit. Investment specifically includes SLR vs non SLR securities. The former includes government securities and other approved securities. Banks have maintained the investment to deposit ratio over and above the stipulated 25%. The reason for this has been the rising fiscal deficit, imposition of capital adequacy norms and rise in foreign currency. The non SLR investment includes commercial paper, shares mutual funds and debentures. The scheduled commercial banks invested around Rs. 928.54 billion in non SLR securities in 2003-03. The overall investments amounted to 5% of the total assets.

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The bank credit finances major projects of the economy including infrastructure developments, agriculture schemes and projects. Banks also provide retail credit for consumption purposes like automobile, education and housing to name a few. Apart from the loans, banks also provide overdraft facility from which funds can be withdrawn up a credit limit set by the bank.

Commercial banks have expanded their operations and support business activities through Purchasing and Discounting of Bills. Banks can rediscount the bills and raise funds for themselves in the secondary markets. In 1973, cash credit was Rs. 30.18 billion which increased to Rs. 2138.45 billion in 2006. The overdraft extended from Rs. 5.96 billion to Rs. 613.58 billion in 2006. In this year the total amount of bill discounting was around Rs. 707.07 billion.

4.3.1 Developments in Credit

Lending for banks was based on Working Capital needs. The term lending by banks was fixed by RBI at Rs 50 crore for single bank single project and Rs. 200 crore for single project by all banks in 1993. These limits were removed in 1997. Lending rate of commercial banks was deregulated in 1994 with introduction of Prime lending Rate (PLR). RBI removed this system of Benchmark Prime Lending rate (BPLR) in 2003 due to transparency concerns. Banks are allowed to set aside lending rates along with floating rates on some loans products.

Sectoral composition of credit could be divided on the basis of public vs private sector, rural vs urban, industrial vs agriculture and large scale vs small scale sectors.

1. The share of Industries in bank credit increased from 34% in 1951 to 68% in 1968 but fell to 42% in 2002-03. Within industries the share of large and medium scale industries fell and of small scale industries increased considerably. The rise of productivity of industries has led to expansion and better utilisation of credit.
2. The share of Agriculture saw a rise from 2% around 1951 to around 11% in 2006. Rise of services as an important component of Indian GDP has seen a rise in its credit share to 23% in 2003.
3. Export sector has remained a special focus of bank credit, with facilities including refinancing, credit guarantees concessional interest rates and favourable repayments terms being extended to the exporters from time to time. This sector though remains necessary for profess of the economy but credit facilities have been utilised more for domestic purposes rather than for export promotion.
4. The share of government has increased considerably over past 50 years. The government share in bank credit was around 37% in 2001-02 with private sector occupying a larger share.

5. Personal loans and housing loans have increased sharply since 2002-03. The central bank and the government have initiated credit easing with rescheduling of short loans as medium and long term and higher goals for banks towards priority sector.

4.3.2 Non Performing Assets and Profitability

Interest income forms almost 80% of the overall income of the banks. The amount of interest income in 2007 was around Rs. 237271 crore. From the expenditure side, interest payments formed a major portion of the overall expenditure. The overall net earnings for the banks increased from Rs. 14 crore in 1951 to Rs. 31203 crore in 2007.

In 2011-12, the Net Interest Income was Rs. 2249 billion with Rs. 817 billion as net profits.

The net interest margin remained constant at around 2.8% from 2011-13. The Return on Assets (or RoA) defined as the ratio of Net Profits to Average Total Assets stood at 0.88% and the Return to Equity (or RoE) defined as the ratio of Net Profit to Average Total Equity stood at 15.33% for Public Sector banks. These ratios were 1.63% and 15.27% respectively for Private Sector Banks in the year 2011-12.

Looking at the cost of deposits, the ratio has grown from 0.9% in the year 1951 to 6.28% in the year 2011. The Spread or the difference between Cost of Funds and Return on Funds stood at 3.63%.

The biggest worry for the Indian banning system today has been the rise of Non-Performing Assets (NPAs). Estimates for Bank NPAs differ amongst institutions and the method of calculation also differ. As per RBI estimate, NPA to loans ratio was 11.4% in 2000-01 which has declined to 2.5% in 2007 but stood at 3.6% in 2013. The amount of NPAs reduced till 2007 but rose subsequently till 2013.

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(billion)

Sr. No.	Bank group	Year	Standard assets		Sub-standard assets		Doubtful assets		Loss assets	
			Amount	Per cent*	Amount	Per cent*	Amount	Per cent*	Amount	Per cent*
1	2	3	4	5	6	7	8	9	10	11
1	**Public sector banks**	**2012**	**38,255**	**97.0**	**623**	**1.6**	**490**	**1.2**	**60**	**0.1**
		2013	**43,957**	**96.4**	**815**	**1.8**	**761**	**1.7**	**68**	**0.1**
1.1	Nationalised banks**	2012	26,909	**97.5**	402	**1.5**	268	**1.0**	21	**0.1**
		2013	30,396	**96.8**	558	**1.8**	424	**1.3**	35	**0.1**
1.2	SBI Group	2012	11,345	**95.9**	221	**1.9**	222	**1.9**	39	**0.3**
		2013	13,561	**95.6**	258	**1.8**	337	**2.4**	33	**0.2**
2	**Private sector banks**	**2012**	**9,629**	**98.1**	**52**	**0.5**	**104**	**1.1**	**29**	**0.3**
		2013	**11,384**	**98.2**	**64**	**0.6**	**112**	**1.0**	**32**	**0.3**
2.1	Old private sector banks	2012	2,287	**98.2**	18	**0.8**	17	**0.7**	7	**0.3**
		2013	2,679	**98.1**	23	**0.9**	23	**0.8**	6	**0.2**
2.2	New private sector banks	2012	7,342	**98.1**	34	**0.4**	87	**1.2**	22	**0.3**
		2013	8,705	**98.2**	41	**0.5**	89	**1.0**	25	**0.3**
3	**Foreign banks**	**2012**	**2,284**	**97.3**	**21**	**0.9**	**22**	**0.9**	**20**	**0.8**
		2013	**2,610**	**97.0**	**29**	**1.1**	**27**	**1.0**	**23**	**0.9**
	Scheduled commercial banks	**2012**	**50,168**	**97.2**	**695**	**1.3**	**617**	**1.2**	**109**	**0.2**
		2013	**57,951**	**96.8**	**909**	**1.5**	**900**	**1.5**	**123**	**0.2**

Notes: 1. Constituent items may not add up to the total due to rounding off.
2. *: As per cent to gross advance.
3. **: includes IDBI Bank Ltd.

Source: RBI Report, 2012-13

RBI has also constituted debt recovery, restructuring and writing off methods like rescheduling at bank level, corporate debt restructuring, debt recovery tribunals, Sale of assets to Asset Reconstruction Companies (ARC) and recovery through SARFAESI Act, 2002.

4.4 Capital Requirements

With rising risks of assets, the Basel Committee on Banking Supervision appointed Bank for International Settlements (BIS) in 1988 which imposed minimum capital requirements for commercial banks under capital adequacy norms. This risk based capital norm was adopted by several countries across world and the current instalment is prescribed through Basel norms. It operates on Three Pillars namely Minimum Capital Requirements, Supervisory Review and Disclosures for market participants and investors. Capital adequacy resorts to sufficient capital required to cover the loss arising from changing asset quality due to inherent risks. These risks are broadly classified as Credit Risk, Market Risk and Operational Risks.

Capital is classified into two categories namely Tier 1 and Tier 2 based on upon quality of capital required. Capital funds under Basel I sold at Rs 7810 billion which were Rs. 7780 billion under Basel II in 2012. The Risk weighted Assets were Rs. 60376 billion and Rs 54621 billion respectively. The Capital to Risk Weighted Asset Ratio (CRAR) has remained above prescribed limit of 9%.

Capital to Risk-Weighted Assets Ratio under Basel I and II – Bank Group-wise

(As at end-March)

(Per cent)

Items/ Bank Group	Basel I		Basel II	
	2012	2013	2012	2013
1	2	3	4	5
Public sector banks	**11.8**	**11.31**	**13.23**	**12.38**
Nationalised banks*	11.84	11.39	13.03	12.26
SBI Group	11.97	11.14	13.70	12.67
Private sector banks	**14.47**	**15.10**	**16.21**	**16.84**
Old private sector banks	12.47	12.33	14.12	13.73
New private sector banks	14.90	15.71	16.66	17.52
Foreign banks	**17.30**	**18.76**	**16.75**	**17.87**
Scheduled commercial banks	**12.94**	**12.77**	**14.24**	**13.88**

Note: *: Includes IDBI Bank Ltd.

Source: RBI Report, 2012-13

5. Reforms and Innovations

Some of the major reforms undertaken for the banking sector after 1991 are as follows:

- Decontrolling of interest rates on commercial bank loans and Nonresident External Rupee accounts (NRNR) deposits with facilities to banks to setup their own interest rates and also free to set their own foreign exchange open position limits.
- Access to capital market for raising debt.
- Introduction of prudential norms for income recognition, asset classification and creation of provisions for bad debts and stricter disclosure norms.
- Principal of 'Marked to Market' to be followed for securities.
- Banking Ombudsman to look into and handle public grievances and improve customer service.
- Encouragement to Private sector banks and foreign banks to setup and do business through transparent norms and for investment and portfolio diversification.
- For short term liquidity, introduction of short term inter-bank call money market, auction based reverse repo along with swifter money transfer and payment settlements.
- Development of market for securitised assets, dematerialisation risk based capital adequacy norms, international best practices, "Know your Customer', provisions and settlement procedures for Non-Performing Assets (NPAs), debt restructuring, introduction of SARFAESI Act and recovery tribunals.
- Introduction of Corporate Governance, Negotiated Dealing Systems (NDS) and Real Time Gross Settlement (RTGS) services.

Indian Commercial Banks operate and compete with global banks and hence a higher competition and stricter regulation forces them to constantly innovate not just to withstand the competition i.e. to retain lower costs and higher margins, but also to expand along with changing technology for creating a safer and secured financial system. Some of the major innovations and adoptions include the following:

- Participation Certificates to sell a part of loans made by banks, which were later discontinued. Introduction of Inter Bank Participation for short term liquidity and were included for compliance under CRR and SLR requirements.
- Multiple Banks based lending to single large borrower to spread risk, reduce bak monopoly, extend knowledge and expertise amongst leading banks, and pooling of funds.
- Credit Cards have been a remarkable addition to banking innovations, adding another source of transaction for customers enabling them with overdraft facility and a newer medium of exchange.

- New cheque Clearance mechanism called MICR or Magnetic ink character recognition, computerised clearing house settlements, interbank information network or BANKNET through SWIFT (Society for Worldwide Inter-Bank Financial Telecommunications).
- Banks have computerised their daily operations.
- Establishment of Local Area Banks on lines of RRBs for a decentralised banking system.
- Introduction of risk based management system, capital adequacy norms as per Basel Recommendations and Credit Rating framework.

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- Introduction of risk based management system, capital adequacy norms as per Basel Recommendations and Credit Rating framework.

6. Summary

1. Banks rare one of the most important form of financial intermediary whig perform the task of transferring funds from people with excess towards people who want to borrow. Through economies of scale, the banks are able to reduce the transaction cost and achieve greater efficiency.
2. The main functions of banks include credit creation, liquidity and profitability management and management of reserves.
3. Indian Banking System includes the central bank at the top i.e. Reserve Bank of India followed by group of Scheduled and Non Scheduled Banks. The scheduled banks include both Public Sector and Private Sector Banks.
4. Liabilities of a Bank includes Deposits received from public and assets include Loans and Advances generated using the deposits of public through reserve system. Commercial Banks have diversified instruments and mechanism to govern the inflow and outflow of funds.
5. Commercial banks have seen a rise in business which is visible through indicators like credit deposit ratios, investment deposit ratio, Net Interest margin etc. The banks have also seen a rise in risk based assets and the introduction of capital adequacy norms have led to greater arrangement for loss absorbing capital. The banks have also witnessed the pressure of upsurge in NPAs.
6. Financial sector reform included reforms for the banking sector and up gradation of work infrastructure through technological innovations

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