UNIT 5 COMMERCIAL BANKING

Structure

5.0 OBJECTIVES

After studying this unit, you should be able to:

- explain the evolution of banking
- describe the structure of banks
- identify the functions of commercial banks
- explain the economic significance of banking
- describe the methods of credit creation by commercial banks.

5.1 INTRODUCTION

Commercial banks play an important role in the economic development of any country. The business of a commercial bank is primarily to accept deposits and advance short-term loans. Apart from this, a commercial bank performs a number of other useful functions to the community, Every commercial bank gets its funds mainly from three sources: share capital, reserve fund and deposits from the general public. Various banking systems came into existence with the development of banking in the world. In this unit, you will learn about the evolution of banking systems, the functions of commercial banks, the economic significance of banking and the method of credit creation by commercial banks.

5.2 EVOLUTION OF BANKING

The origin of modern commercial banking is traceable to ancient times. The development of early commercial banking was closely associated with the business of money-changing in private sector. Famous temples of Delphi and Olympia of Greece served as centres of deposits and lending. Banking in ancient Rome was developed on the same pattern as that in Greece. However, banking, as a public enterprise, made its beginning around the middle of 12th century in Italy. Bank of Venice established in 1157 is supposed to be the most ancient bank in the world. Therefore, a number of private banking houses were established in North Europe with the expansion of commercial activities.

5.2.1 Evolution of Banking in England

Foundation of early banking in England may be traced to the presence of the goldsmiths. In the days of Civil War, insecurity and chaos reigned in England. In order to ensure safety of their money, people approached goldsmiths, who had good and strong rooms. Goldsmiths started issuing receipts for money received containing an undertaking to return money to depositors. Subsequently, these receipts acquired the status of bank notes.

Goldsmiths later found it safe and profitable to lend out some part of money. Since lending proved profitable, it became a regular feature. Regular accounts were maintained and pass books were also issued. In due course goldsmiths lent money to Government. This further induced them to give up their primary function and confine their business to that of a banker. The huge profits earned by the goldsmiths attracted many firms and merchants towards the banking business.

These developments received a temporary setback in 1672. Soon confidence in goldsmiths was restored. The Bank of England was established in 1694. Banks in several countries in Europe came into existence on the pattern of the banks in England, which led to the spread of modem banking system all over the world. However, the growth of joint stock commercial banks started only after the enactment of Banking Act in 1833 in England.

5.2.2 Evolution of Banking in India

Money lending developed as an occupation in India from 500 B.C. But the first modem bank was set up in 1688 in Madras. 'Agency Houses' started by the British in India paved the way for establishing joint stock banks in India. Bank of Hindustan was established in 1770 in Calcutta. General Bank of India was established in 1786. Three presidency banks viz., Bank of Calcutta (1806), Bank of Bombay (1840), Bank of Madras (1843) were established. These three banks subsequently merged together to form the Imperial Bank of India in 1921 which was nationalised in 1955 and named as the State Bank of India.

Many other banks like Allahabad Bank (1865), Punjab National Bank (1894), Bank of India (1906), Indian Bank (1907), Bank of Baroda (1909), Central Bank of India (1911) came into existence. However, Indian banking system experienced a series of crisis and as a consequence witnessed a number of bank failures. This is more so during the post World War I period. Reserve Bank of India was therefore established in 1935 to regulate and control the banking system in India.

5.3 BRIEF STRUCTURE OF BANKS

Structure of banking varies from country to country. Banking structure is determined by several factors like traditions, economic conditions, political situation, public attitude, governmental factors and topographical conditions. Different banking systems came into existence with the development of banking in the world. Important among them are branch banking, unit banking, group banking and chain banking. Let us study about them in detail.

5.3.1 Branch Banking

Branch banking refers to that banking system in which two or more banking offices are operated under single ownership and management as a single institution. Thus, the business is operated by the head office through a network of branches spread in different parts of the world. In this system, every bank has legal entity with one group of shareholders and one group of Board of Directors. Banking system in India and England fall in this category.

In India all commercial banks (like the State Bank of India, Bank of India, etc.) indulge in branch banking operations. In England, major banking business is done by the "Big Five" i.e., the Midland, the Westminster, Barclays, Lloyds and the National Provincial. These five banks have over 12,000 branches and control over 75% of the banking business in the country.

Advantages

The widespread and phenomenal growth of branch banking is due to various advantages associated with this kind of banking system. They are:

1 **Mobilisation of savings:** Funds can be easily mobilised from the branches having surplus funds to the branches suffering from deficit of funds.

2) **Efficiency in management:** Branch banking provides greater scope for efficient management. In view of its size. experts and skilled personnel can be employed.

3) . **Large scale economies:** Branch banking enjoys the internal and external economies of scale in terms of operations like division of labour. utilisation of expert services, technological innovations, computeiisation. etc.

4) **Diversification of deposits and advances:** Branch banking provides a wider scope for the selection of diverse deposits and varied advances.

5) **Economy in reserves:** Each branch can maintain low cash reserves because funds can be moved from one branch to another.

6) **Remittance facilities:** Remittance of money from one place to another is more convenient and less costly.

7) **Uniform interest rates:** Branch banking facilitates mobility of capital and brings about uniformity in the rates of interest over a wider area.

8) **Flexibility in operations:** As branches operate in different parts of the country, it is therefore possible for branch banking to make necessary adjustments according to variations in local socio-economic conditions of different regions.

9) **Effective control by central bank:** The number of banks in the country are less in case of branch banking system. Hence the central bank of the country can easily and effectively control the commercial banking sector of the economy.

10) **Withstands depression:** Branch banking system is able to withstand adverse business conditions like depression.

Disadvantages

Branch banking system also suffers from the following disadvantages:

1) **Difficulty in management:** In view of its size of operations and spread of branches in different geographical areas, effective management becomes difficult in branch banking. Undue expansion results in mismanagement, incompetency, etc.

2) **Red tapism:** Branch banking is blamed for red tapism and abnormal delays in the disposal of urgent matters.

3) **Weaker branches:** Weaker and unhealthy branches can also survive in branch banking system. They offset the profits earned by other branches.

4) **Cut-throat competition:** Under branch banking a number of branches are opened in the same region by various banks. This results in the evils of cut-throat competition.

5) **Less personal contacts and familiarity with local conditions:** Due to their frequent transfers branch managers do not get the opportunity to develop personal contacts with customers and get fully conversant with local conditions.

6) **Utilisation of funds: Local** utilisation of funds may be less in branch banking in view of the easy availability of the facility for transfer of funds.

7) **Monopoly of power:** Branch banking creates some sort of monopoly power in a few hands which is detrimental to the country. For example, the five big banks in England control 75% of banking business and in India 93% of banking business is controlled by the public sector banks.

Though there are several disadvantages of branch banking system, they are overweighed by its advantages. In view of this the countries, where unit banking system was prevalent, are shifting over to the branch banking system.

5.3.2 Unit Banking

Unit banking refers to that system of banking in which banking operations are carried on through a single office rather than through a network of branches under the ,control

of a single bank. In other words, the single office is both the controlling as well as operating unit. Each banking unit is a separate company with separate entity. Each banking unit has its own capital, shareholders and Board of Directors. The area of operations and the size of bank are small under unit banking system compared to branch banking system. However, a few unit banks may have branches operating in a limited area. Thus, it is a localised banking system.

Advantages

Unit banking system has some advantag ver branch banking system. These are:

1) Unit banks can serve local needs of small communities in a more effective manner as it is concerned with only a limited area of operation. Moreover, personal contacts with customers is far more easier in this system.
2) There are less possibilities of mismanagement, fraud and irregularities.
3) They are free from diseconomies of operations of more than the optimum size.
4) The possibilities of delay in operations due to red tapism are remote.
5) Funds are used only within the geographical area of operations.

Disadvantages

Unit banking system also suffers from certain disadvantages. These are:

1) In case of unit banking it is difficult to mobilise savings from one place to another.
2) Due to small size of operations economies of large scale cannot be enjoyed. Further, its size does not permit it to employ specialists.
3) Cost of establishment per bank is high in case of unit banking.
4) Due to large number of banks, control of central bank becomes less effective.
5) Unit bank is too small to overcome adverse business conditions.

In view of the disadvantages of unit banking system the systems of group banking and chain banking are developed.

5 3 3 Group Banking

Group banking consists of the ownership and operation of two or more banks directly or indirectly by a corporation. The group is organised around a key bank which in turn is controlled by a holding company.

This banking system enjoys the advantages of both branch banking and unit banking. However, it suffers from certain handicaps like less direct control over the constituents, difficulty of supervision and control and influence of failure of one member on the other.

5.3.4 Chain Banking

Chain banking is another form of group banking. It is difficult to differentiate it from group banking. **Chain banking refers to a system where two or more banks are controlled by a single person or group of persons through stock ownership or otherwise.** Thus, there is less formal arrangement than group banking. This system was developed in USA to overcome the drawbacks of unit banking system.

This banking system enjoys the advantages of both branch banking system and unit banking system.

Check Your Progress A

1) List different types of banking systems.

....

....

2) Distinguish between branch banking system and unit banking system.

....

....

....

....

3) Which of the following statements are True and which are False?
   i) Banking system in India falls under the category of branch banking.
   ii) Savings from the bank branches having surplus funds to those suffering from deficit funds cannot be mobilised.
   iii) Branch banking system brings about uniformity in the rates of interest over a wider area.
   iv) Unit banking system is better able to withstand adverse business conditions.
   v) Cost of establishment per bank is low in ,case of unit banking.

5.4 FUNCTIONS OF COMMERCIAL BANKS

The nature and significance of a bank can be known by the variety and magnitude of the functions it performs. It is highly difficult to define the term 'bank' as the concept itself is rapidly changing in-view of changes in socio-economic conditions, government policies, priorities etc. However, a few definitions will no doubt help in better understanding the nature of banking.

5.4.1 Definition of a Bank

According to Herber Hart " ***a banker is one who in the ordinary course of business honours cheques drawn upon him by persons from and for whom he receives money on current account"***

According to Section 5 of the Banking Regulation Act, 1949, ***"a banking company means any company which transacts the business of banking. Banking means the accepting for the purpose of lending or investment, of deposits of money from the public, payable on demand or otherwise, and withdrawable by'cheque, draft or otherwise".***

This is quite a satisfactory definition of banking. Thus main functions of a bank may be divided into two categories: 1) primary functions, and 2) secondary functions.

5.4.2 Primary Functions

Initially, collection of deposits and granting advances used to be the primary functions of a commercial bank. However, in modem economies creation of credit and foreign exchange dealings are also treated as primary functions of a bank.

Collection of Deposits
The most important primary function of a commercial bank is collection of deposits. These deposits may be in the form of 1) fixed deposits, 2) savings bank deposits, 3) current deposits, and 4) recumng deposits.

1) Fixed deposits: A fixed deposit, also known as term deposit, is one where a customer keeps a specified amount with the bank for a fixed period, Fixed deposit holder gets interest on the deposit for that period. However, if he withdraws before the expiry of the stipulated period, he loses all or a major part of the interest earned on that deposit. Generally, the rate of interest on fixed deposits is the highest compared to that on other three forms of deposits.

2) Savings bank deposits: Savings bank deposits can be opened with a very small' amount. Though money in the savings account can be withdrawn at will, there are, however, certain limitations on the total number of withdrawals per week. The rate of interest on this deposit is normally higher than that of current deposit but less than fixed deposit. By mobilising small amounts from large number of individuals through savings bank deposits, banks are generally able to gather huge amount of funds.

3) Current account deposits: It is also known as demand deposit. The bank opens this account on an initial deposit of Rs. 100 but only after satisfying itself about the credit worthiness of the customer. There are no limitations on the amount of deposit and number of withdrawals. Normally no interest is paid on current deposit.

4) Recurring deposits: Another type of deposit devised recently is recurring deposits. The depositor is required to deposit a fixed amount once in every month for a specified number of years. The depositor gets the principal amount along with interest after the

expiry of that specified period. The rate of interest offered on these deposits is generally the same as that offered on fixed deposits.

Loans and Advances

Normally commercial banks grant short-term loans and advances to: 1) business and trade, 2) industry, 3) agriculture and allied activities, and 4) export and import trade. Let us understand the nature of such loans and advances.

1) **Loans to business and trade:** Commercial banks grant loans on short-term basis. Business loans are divided into (i) overdrafts, (ii) cash credits, (iii) direct loans, and (iv) bills discounted.

   i) **Overdraft** is an arrangement by which the borrower is allowed to withdraw from his account more than what is deposited in his account. It is granted against collateral security. Interest is charged on the amount overdrawn.
   ii) **Cash credit** is granted against the security of goods or personal security of one or more persons other than the principal borrower. Interest is charged only on the amount made use of by the customer under this arrangement.
   iii) **Direct loans** are granted against security of movable properties. Borrower has to pay interest on the entire amount of loan sanctioned from the date of taking the loan till the time of repayment.
   iv) If trade bills are allowed by banks for discounting, they are called **bills discounted.** Discounting of bills of exchange is the most popular method in western countries.

2) **Loans to industry:** Banks grant loans and advances to industry for its working capital requirement. They grant the loans to industry in the form of overdraft, cash credit, and direct loans.

3) **Loans to agriculture and allied activities:** Banks provide short-term credit to agriculture and its allied activities in the form of crop loans, loans for irrigation, land development, purchase of cattle, etc.

4) **Export and import trade:** Commercial banks also grant loans and advances for export and import trade. They grant direct loans, guaranteeing deferred payments, discounting bills etc. for the purpose.

5.4.3 Secondary Functions

For the convenience of customers, banks also perform a host of non-banking functions called secondary functions. These functions can be divided into two categories: (1) agency services, and (2) public utility services.

Agency Services

Various functions performed by a banker as an agent on behalf of the customer are called agency services. These agency services include: collection of cheques/drafts, payments, sale and purchase of securities, trustee, executor and attorney, and correspondence.

1) **Collections:** Commercial banks take up collection of promissory notes, cheques, bills, dividends, subscriptions, rents, etc., on behalf of their customers as agents. The bank charges 'service charges' for rendering these services to its customers.

2) **Payments:** Banks also accept the responsibility to pay insurance premium, rents, taxes, electricity bills, etc., periodically on behalf of its customers for which they charge commission.

3) **Sale and purchase of securities:** Customers sometimes approach the bankers for sale and purchase of their securities. For these services the banks charge commission.

4) **Trustee, executor and attorney:** Banks also act as trustees, executors and attorneys on behalf of their customers. **As a trustee,** the banker takes care of funds of the customer. helps in proper management of trust. As executor, he carries out the desires of the deceased customer in terms of the will left by him. **As an attorney,** the banker signs transfer forms and documents on behalf of the customer.

5) **Correspondent:** Banks serve as correspondents, agents or representatives of their customers. They obtain passports, traveller tickets, etc.

All the abovementioned services are called agency services as the banks act as agents to the customers in rendering these services.

General Utility Services

In addition to agency services, commercial banks perform various services useful to the customer. These services include letters of credit, draft facilities, underwriting, guarantee for deferred payments, locker facilities, references, business and statistical information and foreign exchange dealings.

1) **Letters of credit:** Banks issue letters of credit to their customers. These are useful to traders to buy goods from foreign countries on credit.

2) **Draft facilities:** Banks issue drafts to customers and enable them to transfer funds from place to place.

3) **Underwriting:** Banks underwrite share capital and debenture capital to be raised by government, joint stock companies, etc.

4) **Guarantee for deferred payments:** Importers may not be in a position to pay for their imports immediately. Exporters may allow them to pay in future but only if the payment is guaranteed. In such cases banks may give guarantee for deferred payments.

5) **Locker facility:** Banks provide locker facility to customers to keep their valuables, such as securities, jewellery. documents etc.

6) **Referee:** Banks serve as referee to the financial standing, business reputation and responsibility of their customers.

7) **Business and** statistical **information:** Banks collect and classify information regarding possibilities of trade, commerce and industry and provide the same to their customers. Some banks also publish bulletins of information for use by the general public.

Check Your Progress B

1) What is a bank?

....

....

....

....

2) Name two main functions of a bank.

....

....

3) State whether the following statements are True or False.
   i) Fixed deposits cannot be withdrawn before the expiry of the stipulated period.
   ii) The rate of interest paid on savings bank account deposits is higher than that of the current account deposits.
   iii) Under current account deposits, there are no limits on the amount of deposit and on the number of withdrawals.
   iv) Commercial banks do not grant loans and advances for export and import trade.
   v) Banks act as commission agents also.
   vi) Banks also help their customers in meeting their foreign exchange requirements.

5.5 ECONOMIC SIGNIFICANCE OF BANKING

A modem bank plays a significant and crucial role in the economic development of a country. In the past bankers used to be mere dealers of money. Today, they are playing the role of a leader of economic growth. Bankers render distinct services to all types of customers. Banks not only relieve the public of great anxiety and risk of safeguarding their surplus income, but also provide facilities for savings and investment, promote banking habit among the people, discourage unprofitable locking up of community's wealth and reduce idle capital of the community. Bank in its turn supply these funds to the businessmen; industrialists and entrepreneurs who require ffinds for running and developing their business and industry. In the words of B.R. Rao, *"the tiny streamlets of capital flowing into the bank s vaults become rivers and these rivers fall into the ocean of national finances to float the vessels of commerce and drive the wheels of industry."* Banks, by their ability of creation of credit, have placed at the disposal of the nations large sums of money. Economic significance of banks can be analysed as follows:

1) Facilitates the development of trade and industry: The multifarious growth of trade and industrial sector in the modem economy is possible only if there is timely availability of finance in required quantities. Banks provide different types of loans to encourage new entrepreneurs and give financial help to the existing industrialists to diversify and develop their industrial activity. Thus, the growth and development of industry and trade is mostly facilitated by banks.

2) Facilitating the development of agriculture sector: Agriculture plays vital role in economic development of third world countries. But the development of this sector suffered from paucity of funds. Banks help agriculture and its allied activities like poultry, fisheries, piggery, etc., by providing finances and technical consultancy.

3) Facilitating the development of service sector: Banks also provide finance for various services like transport, education, etc., thereby contributing to the strengthening of the infrastructure of the economy.

4) Contributes for the balanced growth: Banks identify the nature, the scale and the location of industries needing special care. This helps in balanced growth of the economy. Banks also identify the backward regions. By providing finances to those industrial units which contribute to the growth of these backward areas, banks help in balanced regional development as well as balanced growth of the economy as a whole.

5) Encouragement for international trade: By extending credit facilities for exports and imports and providing necessary information and data on international trade, banks encourage international flow of goods and services.

6) Social service: Banks also help in fulfilling various social needs like helping the needy and poor by introducing various schemes like self-employment, village adoption, educational assistance, slum removal programmes, etc.

7) Implementation of monetary policy: Sound economic development needs appropriate monetary policy. Well developed banking system helps the economy by implementing the monetary policy formulated by the central bank of the country.

5.6 CREATION OF CREDIT

Brief introduction of the principles of portfolio management is necessary to study the concept of creation of credit.

5.6.1 Principles of Portfolio Management

Banks have to manage their portfolio (assets and liabilities) in such a way that profits are secured to meet the expenses, liquidity is assured to meet the demands of the depositors and safety of the funds is assured in order to ensure solvency.

Liquidity

Liquidity means the ability of the banker to pay back the depositors money in cash on demand. In the words of Sayers, *"Liquidity is the word that the banker uses to describe the ability to satisfy demand for cash in exchange for deposits"*. Liquidity is necessary for maintaining public confidence and is influenced by various factors like:

1) Nature of economy, i.e., developed or developing.
2) Nature of degree of development of money market.
3) Banking habits of the people in the country/region.
4) Banking structure in the country i.e., unit banking, branch banking.
5) Nature of business conditions i.e., inflation or depression.
6) Seasonal requirements such as slack season or busy season for money need.
7) Percentage of the minimum cash reserve.
8) Demand behaviour of the depositors.

Profitability

Bank is a business unit whose objective is to earn profit in order to meet the working expenses, pay the interest on deposits and to declare dividend to owners. Hence the bank has to invest funds in such a way that it earns maximum possible income. Profitability of the bank is influenced by various factors like involvement pattern, rate of return on investment, cost s f operation, etc.

Safety

Safety or solvency of a **bank depends upon the** relationship **between** assets and liabilities. If **the value** of assets is **equal or greater than to that** of **liabilities** of **the bank, the bank** is said **to be solvent.**

The three principles of portfolio management conflict with each other. The bank has to balance them for sound portfolio management.

5.6.2 Credit Creation

When a bank accepts cash and opens deposit account that deposit is called the **primary deposit**. A number of depositors deposit the money with a bank. A depositor normally does not demand the bank for the payment of his full deposit money at once. Similarly, at any point of time all the depositors do not demand the bank for repayment of their full deposit money. Hence the blinker is left with some part of the deposits for granting loans and earn profits. The banker has to keep certain percentage of the deposit as reserve to meet the demands of the depositors. This percentage of reserve is called **cash reserve ratio (CRR).**

The part of primary deposits left after meeting the requirement of cash reserve ratio are given out as loan by the bank. Normally, the sanctioned amount of the bank loan is not directly paid to the borrower but is credited to his account. Thus every bank credit creates an equivalent bank deposit. This type of deposits are called **secondary or derivative deposits.** After keeping certain percentage of this derivative deposits as cash reserve, banks grant further credit. This facility of granting credit results in creation of credit.

Creation of credit refers to the power of hanks to multiply loans and advances through creating deposits. According to Newlyn credit creation refers to ***"the power of commercial banks to expand secondary deposits either through the purpose of making loans or through investment in securities".***

Thus, the banks can multiply a given amount of cash (or primary deposit) to many times of credit or derivative deposits. The **ratio of total derivati deposits to the total primary deposits of a bank is called credit multiplier.**

Credit Creation by a Single Rank

Suppose a depositor deposited (i.e., primary deposit) Rs. 2,000 in Canara Bank and whose cash reserve ratio is 10%. Now Canara Bank after keeping Ks. 200 (10% of Rs. 2,000) as reserve, can grant credit of Rs. 1,800 to a person by crediting the amount to his account. The bank can again grant a loan of Rs. 1620 (after keeping Rs. 180 i.e., 10% of Rs.' 1800) to second person by crediting the amount to his account. The bank can further grant another loan to a third person of Rs. 1458 after maintaining 10% reserve i.e., Rs. 162. This process will continue until the primary deposit of Rs. 2,000 and the initial excess reserve of Rs. 1800 (i.e. excess of 10% of Rs. 2,000) lead to derivative deposit of Rs. 1800 + 1620 + 1458 + ... = Rs. 18,000. Total primary and derivative deposits will be Rs. 18,000 + 2,000 = Rs. 20,000. **Credit multiplier is the reciprocal of cash reserve ratio i.e., 1÷1/10= 10 and the credit creation (dotal derivative deposits of Rs. 18,000) is the ten times of the initial excess reserve. Thus, credit creating ability of a bank is the product of credit multiplies and excess reserve of primary deposit (i.e., 10 X Rs. 1,800 = Rs 18,000).**

Assumptions of the Credit Multiplier

1) The cash reserve ratio remains the same at all the stages of credit creation.
2) There is no leakage in the credit creation process.
3) There is a well developed banking system in the country.
4) People in the country have banking habits.
5) Credit control by the Central Bank is absent.
6) Normal business conditions are in existence in the country.

Multiple Credit Creation by Banking System

Normally there would be more than one bank and the borrower of a bank may withdraw the money and may deposit the amount in the bank which in turn can create credit. This transfer of cash within the banking system creates primary deposits and thereby provides the facility of creation of derivative deposits. This process of creation of credit through primary and derivative deposits is called multiple credit creation by banking system.

We study the process of multiple credit creation with an example. If a depositor deposits Rs. 2,000 in Canara Bank and the cash reserve ratio is 10%, the bank can grant a loan of Rs. 1800 (Rs. 2,000 – Rs. 200) to a person by crediting the amount to his account. If that person pays the amount of Rs. 1800 to the suppliers of material by a cheque and if the suppliers of material deposit that cheque in the State Bank of India, the deposit will be primary deposit to State Bank of India. Now State Bank of India can grant a loan of Rs. 1620 after maintaining 10% cash reserve (Rs.1800 – 180) to another person. If this person pays this amount to his creditors and if they deposit the amount in Syndicate Bank, this amount of Rs. 1620 will be the primary deposit to Syndicate Bank. Syndicate Bank in its turn can grant a loan of Rs 1458 after maintaining 10% cash reserve (Rs 1620 – 162) which in turn can be deposited in another bank. Thus the credit creation or the creation of derivative deposits by the banking system will be Rs 1800 + Rs. 1620 + Rs 1458 + ... = Rs. 18,000 i.e., 10 times i.e., credit multiplier.

Limitations of Credit Creation

Conceptually either the individual banks or the banking system as a whole can create credit as discussed above. But a number of problems crop up in credit creation in practice. These problems may be viewed as the limitations of credit creation.

1) The ability of the credit creation of a bank depends upon the amount of cash. The bank can create more credit, if it has larger amounts of cash and vice versa.
2) The cash reserve ratio also affects the credit creation. The lower is the ratio, the greater is the ability to create credit.
3) The bank cannot create credit practically as discussed in the concept in view of leakages like excess reserves and currency drains.
4) The required number of reliable borrowers to avail the entire credit created by banking system may not be available.
5) Required number and nature of securities may not be available to offer to the banks as security.
6) Credit Policy of the Central bank affect the cash reserve ratio.
7) All the people in the country may not have the banking habits to the required order.
8) Business conditions of the banks like inflation, depression, etc., also affect the credit creation process.
9) All the banks may not have the same nature and extent of programmes of credit sanction and disbursement.

Check Your Progress C

1) Mention important aspects which show the economic significance of banks.

....

....

....

....

2) State whether the following statements are True or False.
   i) Banks provide different types of loans to encourage new entrepreneurs.
   ii) Banks help in balanced growth of the economy by providing finance to those industrial units which contribute to the growth of backward areas.
   iii) Banks do not encourage international flow of goods and services,
   iv) The ability of a bank for credit creation depends upon the amount of cash availability.
   v) . The cash reserve raiio is not affected by the credit policy of the central bank.

5.7 LET US SUM UP

Structure of banking varies from country to country. It is determined by several factors. Dirferent banking systems came into existence with the development of banking in the world. Important among them are: 1) branch banking, 2) unit banking, 3) group banking, and 4) chain banking.

The nature and significance of a bank can be known by the variety and magnitude of the functions it performs. These functions can be divided into (i) primary function and (ii) secondary function. Commercial banks are the most important source of institutional credit in the money market. The business of a commercial bank is primarily to accept deposits and advance loans.

Commercial banks have come to play a significant role in the economic development of countries. Without the evolution of commercial banking in the 18th and the 19th centuries, Industrial Revolution would not have taken place in England. It may be stated that without the development of sound commercial banking, underdeveloped countries cannot hope to join the ranks of advanced countries. This is because industrial development requires the use of capital which will not be possible without the existence of banks which provide the necessary funds.

Commercial banks manage their assets and liabilities with three considerations in mind, namely, liquidity, profitability and solvency. These three principles of portfolio management conflict with each other. But the bank must balance them for sound portfolio management.

Creation of credit is a major function of a commercial bank. When a bank advances loans, there tends to be a multiple expansion of credit in the banking system. Primary deposits serve as a basis for creating derivative deposits, that is, credit creation, and for increasing money supply. However, there are certain limitations of credit creation by the banks.

On the whole, banks play a dynamic role in the economic life of every modern state. An efficient and comprehensive banking system is a crucial factor in the developmental process. Thus, in the interest of rapid economic growth, it is necessary to reform and develop a sound banking system.

5.8 KEY WORDS

Branch **Banking:** A banking system under which two or more banking units operate under single ownership **and** management as a single institution.

Cash Reserve Ratio: The percentage of the deposits which the banker has to keep as liquid funds.

Chain **Ranking:** A banking system where two or more banks are controlled by a single person or group of persons through stock ownership or otherwise,

Credit Creation: The power of the banks to multiply loans and advances through creating deposits.

Credit Multiplier: The ratio of total derivative deposits to the total primary deposits of a bank.

'Group Banking: A banking system where the ownership and operation of two or more banks are held directly or indirectly by a corporation.

Liquidity: The ability of the bank to pay back the depositors money in cnsh on demand.

Overdraft: An amangement by which the borrower is allowed to withdraw from his account more than what is deposited in his account.

Primary Deposit: A deposit account opened by bank by accepting cash from the public.

Unit banking: A banking system in which banking operations art carried on through a single office.

5.9 ANSWERS TO CHECK YOUR PROGRESS

3) i) False ii) True iii) True iv) False v) True vi) True

C) 2) i) True ii) True iii) False iv) True v) False.

5.10 TERMINAL QUESTIONS

1) Compare the evolution of banking in England and India.
2) What is branch banking? Explain its advantages and disadvantages.
3) Explain the concept of 'unit banking'. What are the merits and demerits of unit banking system? Suggest measures to overcome the demerits of unit banking system.
4) Define the term 'bank'. What are the primary functions of a commercial bank?
5) Explain the secondary functions and general utility services of commercial banks.
6) Explain the contribution of commercial banks to the economic development of a country.
7) Explain the concepts creation of credit, liquidity, profitability and safety.
8) What is credit creation? Explain how banks can create credit. What arc the limitations of credit creation?

Note: These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University for assessment. These are for your practice only.