UNIT 14 COMMERCIAL BANKING

Structure

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14.0 OBJECTIVES

After going through this unit, you will be able to:

- define a Commercial Bank and describe its functions;
- illustrate the process of creation of credit by Commercial Banks;
- indicate limits to credit creation;
- highlight the role of the banking system in economic development; and
- Identify the trend and analyze the factors driving growth in the banking industry in India,

14.1 INTRODUCTION

As discussed in Unit 2, Financial intermediaries (FIs) refer to those institutions that serve the money and capital markets. They act as middlemen between lenders and borrowers, creating and issuing financial obligations of claims against themselves to acquire profitable financial claims against others. A chief function of an intermediary is to provide liquidity. FIs can be broadly classified into (1) commercial banks, and (2) non-banking financial institutions (NBFIs). Commercial Banks are the dominant financial intermediaries. Bank deposits form the dominant portion of the financial savings of the household sector, and bank credit is the most important source of external finance. Commercial Banks can be distinguished from other financial intermediaries in terms of the special power to issue liabilities that are accepted as a means of payment. Commercial banks play an important role in the economic development of any country. In this unit, you will learn about the Commercial banks, the functions of commercial banks, the method of credit creation by commercial banks, and the role of Commercial banks in the economic development of a country. This unit will also discuss some recent trends in banking sector in India.

14.2 MEANING AND ROLE OF COMMERCIAL BANKS IN ECONOMIC DEVELOPMENT

14.2.1 What is a Commercial Bank?

The term '*Bank*' has been defined differently by different economists. A Commercial bank is a profit-seeking institution which pays interest at a low rate to the depositors and charges a higher rate of interest from the borrowers and in this way, the bank earns a profit. Commercial Banks are *dealers in debt*, and this more aptly describes their activities. A deposit is a debt which the commercial bank owes to the depositor; a banknote is a sort of promissory note — an acknowledgement of the issuing bank's debt to whomsoever may be the bearer of it; using loans and overdrafts' a bank creates debts to itself. All Commercial banks deal in money and credit instruments. In the words of *Paul Samuelson*, "The primary economic function of commercial banks is to hold demand deposits and honour cheques drawn on them — in short, to provide us, the economy with the most important component of our money supply. It is to be noted that banking is a business like any other business. A Commercial bank is a relatively simpler business concern. It provides certain services for customers (depositors and borrowers) and in return receives payment from them in one form or another. It tries to earn a profit". *Acceptance of chequeable deposits from the public is only a necessary, but not a sufficient*, *function of a bank*. It must also lend to others.

It is difficult to define the term '*bank*' as the concept itself is rapidly changing given changes in social-economic conditions, government policies, priorities etc. For example: We see the new trends of digital banks, neo

banks, post payments banks, small finance banks etc. emerging in the country. We will discuss about them briefly in Section 14.7. Thus, one can say that a bank is a financial institution that deals in debts and credits. It accepts deposits, lends money and creates money. It bridges the gap between the savers and borrowers. As *R S Sayers* has emphasised, “banks are not merely purveyors of money but also in an important sense manufacturer of money”. From the above, it can be deduced that the bank is a financial institution.

14.2.2 Importance and Role of Commercial Banks in Economic Development

Commercial Banks have always played an important role in the country’s economy. They play a decisive role in the development of the industry and trade. They act not only as the custodians of the wealth of the country but also as a resource of the country, which is necessary for the economic development of a nation. Their presence is helpful to the economic activity and industrial progress of a country. Commercial Banks satisfy the financial needs of the sectors of the economy as well as all sections of the society. That means they play a very significant role in economic and social needs. The relationship between financial development and economic growth is a complex phenomenon. Finance contributes to economic *growth in the sense that it increases the volume of investment and improves resource allocation*. Whatever may have been its origin, a bank deposit serves as money, and therefore, besides representing so much purchasing power, it acquires importance because of its dynamic function of influencing the level of economic activity. Consequently, the creation of deposits by banks is a matter of vital concern to modern governments, in their efforts to achieve their economic objectives.

A well-developed banking system is an essential pre-condition to the effective implementation of monetary policy. Thus, a fine, efficient and comprehensive banking system is a crucial factor in the developmental process. Commercial Banks not only relieve the public of anxiety and risk of safeguarding their surplus income but also provide facilities for savings and investment. They are useful in promoting banking habits among the people, discouraging unprofitable locking up of the community’s wealth and reducing idle capital of the community. Commercial Banks in turn supply idle funds of the community to businessmen, industrialists and entrepreneurs who require funds for running and developing their businesses and industry. Commercial banks play an important role in the promotion of financial inclusion which is a pre-requisite of inclusive growth. *In short*, Commercial banks play an important and dynamic role in the economic life of every modern state. The economic importance of commercial banks may be viewed as follows:

a) Promoting capital formation;

b) Encouraging innovation;

c) Influencing economic activity;

d) Promoter of financial inclusion; and

e) Facilitator of monetary policy.

The boundary which demarcates the operations of commercial banks and the Financial intermediaries (Fis) is eliminated, they are allowed to move towards universal banking and they are helped to cope with the recent changes.

In the field of *international business,* commercial banks offer services such as trade finance, project finance, payroll, foreign exchange transactions and trading, lock boxes for collecting payments and general corporate finance. Without commercial banks, the international finance and import-export industry would not have grown to the level it has today. The global nature of commercial banking also makes it possible to distribute valuable economic and business information among customers and the capital markets of all countries. Commercial banking also serves as a worldwide barometer of economic health and business trends.

14.3 FUNCTIONS OF COMERCIAL BANKS

Commercial banks being financial institutions perform diverse types of functions. These functions may be broadly divided into *banking functions and non-banking functions*.

14.3.1 Banking Functions

A) *Exchanging money claims*: Exchange of money claims includes acceptance of deposits, giving loans and advances, discounting bills of exchange, and transferring money from one place to another.

1) *Accepting Deposits*: Deposits differ from one another in respect of facilities for withdrawal and rate of interest. People make their choices from various kinds of deposits based on the requirements of their families and businesses. These deposits may be in the form of: (i) saving bank deposits, (ii) current deposits, (iii) recurring/cumulative deposits, and (iv) fixed deposits.

2) *Loans and Advances*: The most important banking function, therefore, is the creation of credit. It is this function which distinguishes banks from other financial institutions. Commercial banks use the deposits of their customers as a source of lending assets. Advances may be made to clients through the loan system or overdraft system. The former is simpler. An amount is placed to the credit of the borrower who can withdraw the whole or a part of it as and when he likes. But for the period that the loan is not repaid, he pays interest on the whole sum, whether he makes use of it or not. An overdraft facility, on the other hand, means allowing a

client to draw cheques over the amount standing to his credit. Interest payable to the bank is only on the amount utilized.

3) *Discounting Bills of Exchange*: Discounting a bill of exchange is, technically speaking, purchasing a future claim of money. In essence, however, it means advancing a loan against a promise of repayment in future. An essential difference between advancing a loan and discounting a bill of exchange is that in the case of the latter, the bank is certain that money is used for genuine trade purposes.

4) *Transfer of Money*: Money may be transferred from one place to another by a bank draft or advice of a cheque. Now a days large sums of money are being transferred through NEFT (National Electronic Fund Transfer)/RTGS (Real Time Gross Settlement).

All the above banking functions can be summed up in a single function, viz. *that banks exchange money claims*. The most important banking function is the creation of credit. It is this function which distinguishes banks from other financial institutions. The basic economic function of bank intermediation can be summarized as follows:

1) *Liability-Asset transformation* i.e., accepting deposits as a liability and converting them into assets such as loans;

2) *Size transformation* i.e., providing large loans based on numerous small deposits;

3) *Maturity transformation* i.e., offering savers alternate forms of deposits according to their liquidity preferences while providing borrowers with loans of desired maturities; and

4) *Risk transformation* i.e., distributing risk through diversification would prevail while lending directly in the absence of financial transformation.

5) The functions performed by banks are changing with the changing scenario and recently they are widening their functions and becoming customer-centric.

14.3.2 Non-banking Functions

These are the services which banks render to their clients not as banks, but as profit-seeking firms. These functions, therefore, do not fall within the purview of banking proper. Thus, banks may undertake:

i) Collection of cheques, drafts, bills, *hundis,* and other instruments (inland and foreign) for their depositors;

ii) Issue of performance and financial guarantees;

iii) Provision of remittance facilities by issue of drafts, mail transfers etc.

iv) Provision of facilities of safe custody of deeds and securities and safe deposit vaults;

v) Purchase and sale of securities for their constituents;

vi) Provision of special investment services as underwriters and bankers for new issues of securities to the public. In selected cases, banks also arrange for the private placement of securities;

vii) Acting as executors and trustees;

viii) Rendering of agency services of various kinds such as sale of foreign exchange, acceptance of income-tax payment, etc.;

ix) Miscellaneous services such as the issue of traveler's cheques, gift cheques, provision of tax assistance and investment advice, references, business and statistical information etc. They also provide a wide variety of loans and offer other credit vehicles like cards and overdrafts. However, the common theme among these activities is that they are aimed at providing a financial service to an individual or business.

In short, they may undertake to be '*watchmen*' of valuables, executants of wills and administrators of family trusts. Banks are said to be department stores of financial services as they render a wide variety of such services to their customers. The range of these services differs from bank to bank, depending mainly on the size and type of banks. Most of us interact with commercial banks every day, whether it is a debit card purchase, an online payment or a loan application. Beyond providing these basic services, commercial banks are in the business of capital allocation for profit – also known as investing. Today, commercial banks can invest in securities and even in issues that they help make public. A commercial bank needs to provide good service to its customers and good returns to its investors to continue to be successful.

Check Your Progress 1

1) What is a Commercial Bank? How are banks characterised as dealers in debt?

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2) "Financial intermediaries (FIs) serve the money and capital markets". Explain.

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3) List any five important functions of a Commercial Bank.

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14.4 STRUCTURE OF COMMERCIAL BANKS

The structure of commercial banking varies from country to country. Banking structure is influenced by several factors such as traditions, economic conditions, political situation, public attitude, government 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*.

Commercial banks may be either of the ***branch-banking*** type, such as the commercial banks in India, under which case each bank has several branches spread all over the country, or the ***unit-banking*** type, which originated in the U.S.A., where each bank's operations are confined to a single office. ***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 direct control over the constituents, difficulty of supervision and control and influence of failure of one member on the other. ***Chain banking*** is another form of group banking. It is similar to 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 a less formal arrangement than group banking. This system was developed in the USA to overcome the drawbacks of the unit's banking system. This banking system also enjoys the advantages of both a branch system and a unit banking system.

14.4.1 Retail Banking versus Corporate Banking

Retail banking refers to the division of a bank that deals directly with retail customers. Also known as consumer banking or personal banking, retail banking is the visible face of banking to the general public, with bank branches located in abundance in most major cities. Banks that focus purely on retail clientele are relatively few, and most retail banking is conducted by separate divisions of banks, large and small. Customer deposits garnered by retail banking represent an extremely important source of funding for most banks. ***Corporate banking, also known as business banking***, refers to the aspect of banking that deals with corporate customers. The term was originally used in the United States to distinguish it from investment banking after the Glass-Steagall Act of 1933 separated the two activities. While that law was repealed in the 1990s, corporate banking and investment banking services have been offered for many years under the same umbrella

by most banks in the United States and elsewhere. Corporate banking is a key center of profit for most banks; however, as the biggest originator of customer loans, it is also the source of regular write-downs for loans that have soured.

14.4.2 Universal Banking

Universal banking is a system in which banks provide a wide variety of financial services, including commercial and investment services. Universal banks may offer credit, loans, deposits, asset management, investment advisory, payment processing, securities transactions, underwriting and financial analysis. While a universal banking system allows banks to offer a multitude of services, it does not require them to do so. Banks in a universal banking system may still choose to specialize in a subset of banking services. Universal banking combines the services of a commercial bank and an investment bank, providing all services from within one entity. The services can include deposit accounts, and a variety of investment services and may provide insurance services. Under this system, banks can choose to participate in any or all of the permitted activities. They are expected to comply with all guidelines that govern or direct proper management of assets and transactions. Since not all institutions participate in the same activities, the regulations in play may vary from one institution to another. It is important not to confuse the term '*universal bank*' with any financial institutions with similar names.

Proponents of universal banking argue that it helps banks diversify risk in a better manner. They facilitate the possibility of lowered costs because of the economies of scale. Costs would drop because of the larger volume of investment for a given level of overhead on investment. The underlying logic for this is that the cost of offering various activities by different units is greater than when they are offered together. The economies of scale and scope are expected to help the entity deal better with business cycles. A shift in the business cycle is expected to alter the demand for products. *Multi-product firms are, therefore, inherently better placed to handle changes in the type of product demanded.* The move towards universal banking is not without concern on the regulatory front. *The advent of universal banks simultaneously increases the risk to the system in case of a failure.* Another argument often advanced to oppose the move to consolidate is that the size of the universal banks provides them with an opportunity to have monopoly, by resorting to *predatory pricing competition from small players which offer specialised services.*

14.4.3 Differentiated Banking

Differentiated banks are distinct from universal banks as they function in a niche segment. The differentiation could be on account of capital requirement, scope of activities or area of operations. As such, they offer a limited range of services / products or function under a different regulatory

dispensation. The concept is not entirely new. In fact, and in a sense, the Urban Cooperative Banks (UCBs), the Primary Agricultural Credit Societies (PACS), the Regional Rural Banks (RRBs), Local Area Banks (LABs), Small Finance Banks (SFBs), and Payments Banks could be considered as differentiated banks as they operate in localized areas and provide banking services to underserved segments of the economy/society.

Reserve Bank of India set up of a committee headed by Shri Nachiket Mor, on Comprehensive Financial Services for Small Businesses and Low-Income Households to look into the issues relating to financial inclusion. The committee came up with two broad designs for the banking system in the country - the Horizontally Differentiated Banking System (HDBS) and the Vertically Differentiated Banking System (VDBS) based on the functional building blocks of payments, deposits and credit.

In a HDBS design, the basic design element remains a full-service bank that combines all three building blocks of payments, deposits, and credit but is differentiated primarily on the dimension of size or geography or sectoral focus. In a VDBS design, the full-service bank is replaced by banks that specialise in one or more of the building blocks of payments, deposits, and credit. Among others, the Committee suggested licensing of Payments Bank and wholesale banks as differentiated banks.

Check Your Progress 2

1) "Banks promote savings and help to convert hoardings into investment". Amplify.

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2) Write a note on the structure of commercial banks.

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3) What is Commercial Universal banking? Why are they popular these days?

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4) What is differentiated banking?

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14.5 CREATION OF CREDIT/DEPOSITS

Credit creation is the most significant function of commercial banks. The essential feature of commercial banking is the lending of more cash than the amount held by the bank. Loans to customers form a bank's most profitable activity, but the urge to expand this side of its business to increase its profits is tempered by its obligation to pay cash on demand. However, most borrowers do not require actual cash, although a proportion of loans will be wanted in the form of cash, for example, for the payment of wages. Expanding loans will, therefore, to some extent increase the demand for cash. This is a fact that a banker must always bear in mind when it is considering whether to increase his lending.

Banks create money by creating deposits. There are two kinds of deposits: *actual deposits and created deposits*. When a man puts a certain sum of money into his account, we call it an actual/primary deposit. When a bank gives a loan to a person an account is opened in his name and he is credited with the amount of the loan. It is sometimes said that every loan creates a deposit. Hence, if banking habits are well developed the money lent out by a bank will find its way into some deposit account in the banking system. One can, therefore, say that *every loan creates a deposit*.

Whether a bank lends by overdraft or using a loan account, the result is the same, it *increases the total volume of purchasing power, that is, the quantity of money*. Banks can also create deposits by purchasing Government stock, which is simply a method by which banks lend to the Government. The bank pays for such purchases by cheques drawn on itself, and the payees of these cheques pay them into their banking accounts, and so again the banks create deposits. *Thus, bank deposits are mainly created by the banks themselves*. This power of the banks to expand credit is of enormous economic significance, for bank deposits are a form of purchasing power which can be used for the purchase of goods and services irrespective of how they have been created. The *total quantity of money therefore depends largely on the credit policy of the banks*. The banking system as a whole is responsible for the creation of a very large proportion of the deposits of the various banks.

According to some writers, commercial banks cannot create money, they only lend the un-withdrawn part of their customer's deposits. This view is right in so far as a single bank is concerned. However, the banking system as a whole can create money. In this connection, it may be pinpointed that while no individual bank can create deposits more than its excess reserves (here 9/10 of the new deposits), the banking system as a whole however can create ten times the initial deposit. *Money Multiplier or Deposit multiplier* measures the amount of money that the Banks can create in the form of deposits with every unit of money they keep as reserves. It is calculated in the following equation:

$$\Delta d = \frac{\Delta a}{r}$$

Where:

Δd	=	increase in deposits for the whole banking system
Δa	=	increase in initial deposit
r	=	required reserve (cash) ratio

The percentage of deposits which a bank keeps in the form of cash is called the *cash reserve ratio*. The process described above takes place in the banking system as a whole. The total of bank deposits is at present many times as great as the total amount of cash in existence in the country, whether in the hands of the public or the tills of banks, so clearly the banks together must have expanded the volume of deposits without an equivalent amount of cash having been deposited with them.

14.5.1 Limits to Credit Creation

The supply of money depends largely on the lending policy of the banks, but their power to create credit is restricted. They do not have unlimited power to create deposits, their ability to do so is restricted in several ways:

i) *The Clearing House Imposes a Restriction* on an Individual Bank: A single bank cannot adopt an expansionist credit policy unless the other banks are willing to do the same. In other words, the banks should keep their credit policy in line with one another, expanding or contracting credit together.

ii) *The Liquidity Ratio*: A banker knows from experience what proportion of his assets to keep in liquid form, but they must be able to convert their other assets into cash if circumstances require it without undue delay and if possible, without loss. Thus, a banker's main concern is with the liquidity of their assets. This limits the extent of their willingness to lend and the amount of investment it is prepared to undertake, for the banker must maintain certain liquidity rules.

iii) *The amount of cash in existence*: The supply of cash or legal tender money is not unlimited. The government and the central bank determine the quantity of legal tender money available in the country. The bank's power of creation of credit is limited by this quantity.

iv) *The amount of cash people prefers to hold*: The monetary habits of the people constitute a limiting factor. If people do not put money in deposits in the banks but keep their cash themselves in a liquid form, bank deposits cannot grow and banks cannot create money. Increasing confidence in banking and greater use of cheques has reduced the demand for cash.

v) *The Collateral Security Available*: Before a commercial bank grants a loan, it wants to know the purpose and length of time for which it is

required and how it is to be repaid. In addition, the borrower will probably be asked to give the bank some kind of collateral security which the bank can turn into cash if the loan is not repaid within the stipulated time. It is, however, an important banking recipe that the first consideration in such cases is the character of the borrower, for the banker prefers a loan to be repaid and for the collateral security to be at his disposal only in an emergency. The more liquid the security – that is, the greater the ease with which it can be turned into cash without loss – the more acceptable it is to the bank. The amount of security available may tend to limit bank lending.

vi) *State of the Economy*: Banks can create money only by lending money and this depends on the state of the economy. Money is borrowed when there are opportunities to use it in new ventures. When business conditions are depressed, loans are not taken and banks cannot create money. Thus, one finds that the extent to which banks can at any time create credit depends on the general state of confidence.

vii) *Monetary Policy of the Central Bank*: The final restriction on the creation of credit by commercial banks comes from the monetary authorities. The central bank of a country can, in various ways, control the volume of loans given by banks. The most important control over the expansion of bank credit, however, comes from the monetary system.

Crowther observes that "the bank does not create money out of thin air; it transmutes other forms of wealth into money". The total volume of income-yielding securities available in the country sets the overall limit to the process of credit creation. But the need for keeping a cash reserve, however, small it may be, restricts the power of the bank to 'create' money *ad lib*. 'Creating' money involves an increase in the bank's deposit liabilities, and the bank cannot afford to let its cash reserve fall below 10 per cent of its total deposit liabilities.

14.6 PRINCIPLES GOVERNING DISTRIBUTION OF ASSETS OF COMMERCIAL BANKS

A banker is torn between two conflicting motives; on the one hand, it would like to expand its loans to make more profit, and on the other, it is anxious to hold sufficient cash so that it can at all times fulfil its obligation to pay cash on demand. A banker, too, must be able to turn its assets into cash without loss if it is to satisfy the claims of its depositors on him in full. Cash is an asset that yields it no income, and so it does not wish to hold an unnecessarily large amount of it, so it will '*minimise*' its cash holdings. A banker must always be prepared, if necessary, to meet abnormal demands for cash, and so it must hold assets in fairly liquid form which in an emergency can easily be turned into cash. The liquidity of its assets is therefore a banker's primary

concern, and the *distribution of assets represents a compromise between its desire for profit and its desire for liquidity*, for the more profitable an asset the less liquid it is likely to be. The more liquid assets of clearing banks comprise the first four items in a bank's balance sheet: (i) notes and coins, (ii) balances with the Central Bank i.e. Reserve Bank of India, (iii) bills, and (iv) market loans — all of which can be turned into cash quickly with little if any, financial loss. One aspect of liquidity is the '*shift-ability*' of the asset that is, the ease with which it can be passed on to some other institutions, such as the central bank. Most bank assets are shiftable in varying degrees, except those advances which are supposed to be supported simply by the good name of the borrower.

14.6.1 Liquidity versus Profitability of Assets

A bank must conduct its affairs to maintain adequate liquidity. The aim of every bank is not only to cover its expenses but also to make maximum profit. It endeavours to keep its assets in such forms as to yield maximum income. *There is a clash between the objectives of liquidity and profitability.* The most liquid of all assets is money itself. If a bank were to attend exclusively to the objective of maintaining liquidity, it would keep all its assets in the form of money. But money is the most barren of all investments because it does not yield any income whatsoever. On the other hand, if the bank were to keep its assets in the form of long-term loans, income from the assets would be high, but liquidity would be very low. *Liquidity and income-yielding capacity are the two opposite criteria for every bank based on which it has to decide the nature of its assets*. The more liquid the assets, the less income-yielding they will be, and *vice versa. The secret of success for a bank lies in striking a sound balance between liquidity and profitability. Every bank divides its assets into forms of various degrees of liquidity and profitability*. Some of its assets are kept in the form of cash which is very liquid, though non-income yielding, some assets take the form of property which is of low liquidity but yields good income. In between the two, lies other assets with different degrees of liquidity and income-yielding capacity.

The traditional concept of liquidity has been replaced by the concept of *shift-ability*. The shift-ability concept has a much wider breadth and shift-ability has made possible the flow of bank credit amongst a larger number of borrowers and for longer dates without much impairing the security of lending. In recent years the concept of liquidity has undergone further changes. The term loans are liquidated by the *anticipated income of the borrower*. In the case of the anticipated income concept, the borrower has to save and repay their loans out of earnings. This concept has the advantage of financing durable consumer goods because loans made for the purchase of durable consumer goods cannot be repaid by sale nor can they be shifted to the open market or the central bank. These loans can be later repaid out of the expected income of the borrower.

14.7 RECENT TRENDS AND PERFORMANCE OF BANKING INDUSTRY IN INDIA

Over the years, the Indian banking industry has experienced an upward trajectory majorly supported by strong economic growth, rising disposable incomes and easier access to credit. The last few years have seen fast growth in digital modes of payments which has also supported the growth of the Indian banking industry.

As of April 2024, there were 581 banks actively using UPI. The total number of digital transactions during this period amounted to 15.08 billion, with a total value of US$ 25.27 billion (Rs. 2.1 trillion).

In recent years, India has also experienced a rise in fintech and microfinancing. India's digital lending stood at US$ 75 billion in FY18 and is estimated to reach US$ 1 trillion by FY23 driven by the five-fold increase in digital disbursements. The Indian fintech market has attracted US$ 29 billion in funding over 2,084 deals so far (January 2017-July 2022), accounting for 14% of global funding and ranking second in terms of deal volume. By 2025, India's fintech market is expected to reach Rs 6.2 trillion (US$ 83.48 billion). According to the Reserve Bank of India (RBI), India's banking sector is sufficiently capitalised and well-regulated.

In past decade, the Indian banking industry has rolled out various innovative models. One of them is Small Finance Banks (SFB) like Ujjivan Small Finance Bank, AU Small Finance Bank etc. RBI granted licenses to Small Finance Banks in 2015 and since then, they have come a long way in providing banking services to the masses. In subsequent years, RBI has granted two additional SFB licenses taking the total SFBs in the country to 12. Out of these Fincare, Small Finance Bank Limited ("Fincare SFB") has merged with and into AU Small Finance Bank Limited ("AU SFB"), effective 1st April 2024. Thus, total number of SFBs is now 11. SFB has emerged as a new category of banks in India that cater primarily to the financially unserved and under-served sections of society. These banks provide basic banking services to unbanked and under-banked populations thus supporting financial inclusion. Small Finance Banks are likely to play a significant role in the future of banking in India because of their approach of reaching the unreached by extending credit to small businesses, micro-enterprises, and low-income households. SFBs are different from Commercial banks in terms of their capital requirement, services offered, loan products and target customers. Unlike Commercial banks, SFBs offer basic banking services only and have a minimum capital requirement of ₹ 200 crores as against the capital requirement of ₹ 500 crore in the case of a commercial bank.

Payments Banks is another model of commercial banking in India. However, it differs from regular banking as the Payments banks are neither allowed to

lend money or issue credit cards to their customers. At present 4 Payments banks are working in the country.

Another innovative banking model is neo-banking. Neobanks are digital-only banking platforms that operate only online. Thus, they do not have a physical presence. Sometimes, transactions in traditional banks could require a lot of time and effort. Neobanks provides a seamless online experience where customers can create accounts by themselves and use their offerings hassle-free. Since RBI does not permit fully digital banking establishments yet, neobanks in the country use partnerships with physical banks to deliver some of their key services.

In the past decade, India has also focused on increasing its banking sector reach, through various schemes like the Pradhan Mantri Jan Dhan Yojana and India Post payment banks. India Post Payments Bank (IPPB) is an accessible, affordable and reliable bank for the common man. With the help of just an Aadhaar Card, any person in a village can avail of banking facilities provided by IPPB by requesting the same from the local Postman/Gramin Dak Sevak. Schemes like these coupled with major banking sector reforms like digital payments, neo-banking, a rise of Indian NBFCs and fintech have significantly enhanced India's financial inclusion and supported the credit cycle in the country. The digital payments system in India has evolved the most among 25 countries with India's Immediate Payment Service (IMPS) being the only system at level five in the Faster Payments Innovation Index (FPII). India's Unified Payments Interface (UPI) has also revolutionized real-time payments and has strived to increase its global reach in recent years.

Trend and Performance of Commercial Banks since 2020-21

During 2020-21, scheduled commercial banks (SCBs) reported a discernible improvement in their asset quality, capital buffers and profitability, notwithstanding the disruptions of the pandemic. While credit offtake remained subdued, elevated deposit growth on the liabilities side was matched by growth in investments on the assets side.

The Indian banking sector remained resilient in 2021-22 and 2022-23 so far, as banks witnessed healthy balance sheet growth on a broad-based acceleration in credit. Deposit growth moderated from the COVID-19-induced precautionary surge. Augmented capital buffers, better asset quality and enhanced profitability indicators reflected their robustness.

Reserve Bank of India, on June 27,2024 released the 29th issue of the Financial Stability Report (FSR), which reflects the collective assessment of the Sub-Committee of the Financial Stability and Development Council (FSDC) on the resilience of the Indian financial system and risks to financial stability.

Highlights of the report are as follows:

- The global economy is facing heightened risks from prolonged geopolitical tensions, elevated public debt, and the slow progress in the last mile of disinflation. Despite these challenges, the global financial system has remained resilient, and financial conditions stable.

- The Indian economy and the financial system remain robust and resilient, anchored by macroeconomic and financial stability. With improved balance sheets, banks and financial institutions are supporting economic activity through sustained credit expansion.

- The capital to risk-weighted assets ratio (CRAR) and the common equity tier 1 (CET1) ratio of scheduled commercial banks (SCBs) stood at 16.8 per cent and 13.9 per cent, respectively, at end-March 2024.

- SCBs' gross non-performing assets (GNPA) ratio fell to a multi-year low of 2.8 per cent and the net non-performing assets (NNPA) ratio to 0.6 per cent at end-March 2024.

- Macro stress tests for credit risk reveal that SCBs would be able to comply with minimum capital requirements, with the system-level CRAR in March 2025 projected at 16.1 per cent, 14.4 per cent and 13.0 per cent, respectively, under baseline, medium and severe stress scenarios. These scenarios are stringent conservative assessments under hypothetical shocks and the results should not be interpreted as forecasts.

- Non-banking financial companies (NBFCs) remain healthy, with CRAR at 26.6 per cent, GNPA ratio at 4.0 per cent and return on assets (RoA) at 3.3 per cent, respectively, at end-March 2024.

Check Your Progress 3

1) Discuss some recent trends experienced in the Banking sector in India.

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2) What are the limitations on banks in credit creation?

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3) Why is there a clash between liquidity and profitability? What is the concept of shift-ability?

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14.8 LET US SUM UP

Financial intermediaries like banks are unique and specialize in performing functions such as (a) mobilizing savings and channelling them to the most productive users, and (b) acting as efficient conduits for payments.

Banks perform a large variety of functions. The main banking services are: Acceptance of money on deposit from the public broadly speaking, these deposits are of three main types viz., current, savings and fixed, which can be reclassified under two main heads of demand and time deposits. Commercial banks lend money, process payments, issue bank drafts and checks, and offer safety deposit boxes for items and documents. Commercial Banks provide *Grant of credit* to all sectors of the economy, and not merely to trade and commerce. This is done in various forms such as loans and advances, discounting of bills, and investment in open-market securities.

Modern commercial banking is based on a system of fractional reserves. This is why banks all over the world keep only a small portion of the deposits in liquid form. The balance is invested and it is in this way, through the making of loans and the purchase of securities, that profits are made.

The 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 the money supply. However, there are various limitations to the ability of banks to create credit. The more liquid assets comprise cash, money at *call and short notice and bills.* The banks must strike a careful balance between their obligation to their customers and the requirements of their shareholders.

Bankers are to strike a balance between two conflicting objectives. The distribution of bank assets is the result of a compromise between (a) the necessity always to be able to pay cash on demand, and (b) the desire for profit. The more liquid the asset, the less profit it will generally yield to the bank. Cash is the most liquid asset – earning no profit at all.

Banks not only encourage savings but also constitute the agency through which even small sums saved by individuals find their way to profitable investments. *Banks channelise funds according to priorities.* They are, therefore, in a special position to encourage those industries that are high up on the list of priorities. The more *capital formation* the faster the economic advancement of the country.

Over the years, the Indian banking industry has experienced an upward trajectory majorly supported by strong economic growth, rising disposable incomes and easier access to credit. In past decade, banking sector in India has rolled out various innovative models surrounding, digital payments, neo-banking, Small Finance Banks (SFB) etc. These developments are poised to take India's financial system to newer heights.

14.9 KEY WORDS

Banks : Financial institutions that accept deposits and make loans.

Bill of exchange (or draft) : A negotiable instrument with three parties to the agreement the drawer of the order, the drawee, who is ordered to make payment, and the payee. For instance, a commercial bank cheque is a draft on the bank by the depositor payable to a designated payee.

Cash reserve ratio (CRR) : The fraction of deposits that the RBI requires to be kept as reserves by the banks.

Central Bank : The Government agency oversees the banking system and is responsible for the amount of money and credit supplied to the economy. In India, the Reserve Bank of India is the Central Bank of the country.

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

Derivative Deposits : These consist of deposits created by the banks in the process of granting credit. The loan sanctions and credited to the accounts of the borrowers create new deposits. Since a derivative deposit is actively created by the bank, it increases the total stock of money available to the community. The creation of derivative deposits is identical to what is commonly known as credit creation by commercial banks.

Differentiated Banking : A specialised banking identity that serves the underserved segments of the economy/society efficiently.

Liquidity : The relative ease and speed with which an asset can be converted into cash.

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

Vault cash : Currency that is physically held by banks and stored in vaults overnight.

14.10 SOME USEFUL BOOKS

Auerbach, Robert D. (1983): *Financial Markets and Institutions*, Macmillan Publishing Co. Inc., New York (Chapter – 18).

Crowther, Geoffrey (1941):	'*An Outline Of Money*', Thomas Nelson and Sons Ltd., London, UK
Gupta, Suraj B. (1985):	*Monetary Economics; Institutions, Theory and Policy*, S. Chand and Company, New Delhi (Chapter – 5).
Hubbard, R Glenn (2002):	*Money, the Financial System, and the Economy*, Addison Wesley, New York (Chapter 12, 13 and 14).
Mishkin, Frederic S. (2000):	*Financial Markets and Institutions*; Addison Wesley, New York (Chapter 15 & 16).
Newlyn, W.T. (1971):	*Theory of Money*, 2nd edition, Oxford University Press, UK
Ritter, Lawrence S.,: William L. Silber, and Gregory F. Udell (2007)	*Principles of Money, Banking and Financial Markets*, 12th edition, Pearson, London, UK

14.11 ANSWERS/HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1) A profit-seeking institution which pays interest at a low rate to the depositors and charges a higher rate of interest to the borrowers and in this way, the bank earns a profit. Banks are dealers in debt- A deposit is a debt which the bank owes to the depositor; a banknote is a sort of promissory note.

2) They act as middlemen between lenders and borrowers, creating and issuing financial obligations of claims against themselves to acquire profitable financial claims against others. A chief function of an intermediary is to provide liquidity.

3) Accepting Deposits, Liability-Asset transformation, Risk transformation, Discounting Bills of Exchange, Loans and Advances.

Check Your Progress 2

1) Retail banking is the visible face of banking to the general public, with bank branches located in abundance in most major cities. **Corporate banking, also known as business banking**, refers to the aspect of banking that deals with corporate customers.

2) Refer to Section 14.4

3) A system in which banks provide a wide variety of financial services, including commercial and investment services. It combines the services of a commercial bank and an investment bank, providing all services

from within one entity. It helps banks to diversify risk, lower costs, and handle changes in the type of product demanded.

4) Refer to Sub-section 14.4.3

Check Your Progress 3

1) Refer to Section 14.7

2) Banks are dependent on other banks to maintain liquidity ratio, the amount of cash in existence, and the amount of cash people prefer to hold.

3) Refer to Sub-section 14.6.1

14.12 TERMINAL QUESTIONS

1) Explain the concept of a Bank. What are its functions?

2) How do commercial banks create credit? Are there any limitations on the power of the bank to create credit? Give reasons for your answer.

3) Examine the conflict between liquidity and profitability. How do banks strike a sound balance between these two?

4) Point out the significance of the banking system in promoting the economic development of a country.

5) Write a note on recent trends in the banking industry in India.

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