INTRODUCTION

Banking occupies one of the most important positions in the modern economic world. It is necessary for trade and industry. Hence it is one of the great agencies of commerce. Although banking in one form or another has been in existence from very early times, modern banking is of recent origin. It is one of the results of the Industrial Revolution and the child of economic necessity. Its presence is very helpful to the economic activity and industrial progress of a country.

Meaning

A commercial bank is a profit-seeking business firm, dealing in money and credit. It is a financial institution dealing in money in the sense that it accepts deposits of money from the public to keep them in its custody for safety. So also, it deals in credit, i.e., it creates credit by making advances out of the funds received as deposits to needy people. It thus, functions as a mobiliser of saving in the economy. A bank is, therefore like a reservoir into which flow the savings, the idle surplus money of households and from which loans are given on interest to businessmen and others who need them for investment or productive uses.

Definition of a Bank

The term ‘Bank’ has been defined in different ways by different economists. A few definitions are:

According to Walter Leaf “A bank is a person or corporation which holds itself out to receive from the public, deposits payable on demand by cheque.” Horace White has defined a bank, “as a manufacture of credit and a machine for facilitating exchange.”

According to Prof. Kinley, “A bank is an establishment which makes to individuals such advances of money as may be required and safely made, and to which individuals entrust money when not required by them for use.”
The Banking Companies Act of India defines Bank as “A Bank is a financial institution which accepts money from the public for the purpose of lending or investment repayable on demand or otherwise withdrawable by cheques, drafts or order or otherwise.”

Thus, we can say that a bank is a financial institution which deals in debts and credits. It accepts deposits, lends money and also creates money. It bridges the gap between the savers and borrowers. Banks are not merely traders in money but also in an important sense manufacturers of money.

**TYPES OF BANKS**

Broadly speaking, banks can be classified into commercial banks and central bank. Commercial banks are those which provide banking services for profit. The central bank has the function of controlling commercial banks and various other economic activities. There are many types of commercial banks such as deposit banks, industrial banks, savings banks, agricultural banks, exchange banks, and miscellaneous banks.

1. **Deposit Banks:** The most important type of deposit banks is the commercial banks. They have connection with the commercial class of people. These banks accept deposits from the public and lend them to needy parties. Since their deposits are for short period only, these banks extend loans only for a short period. Ordinarily these banks lend money for a period between 3 to 6 months. They do not like to lend money for long periods or to invest their funds in any way in long term securities.

2. **Industrial Banks:** Industries require a huge capital for a long period to buy machinery and equipment. Industrial banks help such industrialists. They provide long term loans to industries. Besides, they buy shares and debentures of companies, and enable them to have fixed capital. Sometimes, they even underwrite the debentures and shares of big industrial concerns. The important functions of industrial banks are:
1. They accept long term deposits.
2. They meet the credit requirements of industries by extending long term loans.
3. These banks advise the industrial firms regarding the sale and purchase of shares and debentures.

The industrial banks play a vital role in accelerating industrial development. In India, after attainment of independence, several industrial banks were started with large paid up capital. They are, The Industrial Finance Corporation (I.F.C.), The State Financial Corporations (S.F.C.), Industrial Credit and Investment Corporation of India (ICICI) and Industrial Development Bank of India (IDBI) etc.

3. **Savings Banks:** These banks were specially established to encourage thrift among small savers and therefore, they were willing to accept small sums as deposits. They encourage savings of the poor and middle class people. In India we do not have such special institutions, but post offices perform such functions. After nationalisation most of the nationalised banks accept the saving deposits.

4. **Agricultural Banks:** Agriculture has its own problems and hence there are separate banks to finance it. These banks are organised on co-operative lines and therefore do not work on the principle of maximum profit for the shareholders. These banks meet the credit requirements of the farmers through term loans, viz., short, medium and long term loans. There are two types of agricultural banks,
   (a) Agricultural Co-operative Banks, and
   (b) Land Mortgage Banks. Co-operative Banks are mainly for short periods. For long periods there are Land Mortgage Banks. Both these types of banks are performing useful functions in India.

5. **Exchange Banks:** These banks finance mostly for the foreign trade of a country. Their main function is to discount, accept and collect foreign bills of exchange. They buy and sell foreign currency and thus help businessmen in their transactions. They also carry on the ordinary banking business.

   In India, there are some commercial banks which are branches of foreign banks. These banks facilitate for the conversion of Indian currency into foreign currency to make payments to foreign exporters. They purchase bills from exporters and sell their proceeds to importers. They purchase and sell “forward exchange” too and thus minimise the difference in exchange rates between different periods, and also protect merchants from losses arising out of exchange fluctuations by bearing the risk. The industrial and commercial development of a country depends these days, largely upon the efficiency of these institutions.

6. **Miscellaneous Banks:** There are certain kinds of banks which have arisen in due course to meet the specialised needs of the people. In England and America, there are investment banks whose object is to control the distribution of capital into several uses. American Trade Unions have got labour banks, where the savings of the labourers are pooled together. In London, there are the London Discount House whose business is “to go about the city seeking for bills to discount.” There are numerous types of different banks in the world, carrying on one or the other banking business.
FUNCTIONS OF COMMERCIAL BANKS

Commercial banks have to perform a variety of functions which are common to both developed and developing countries. These are known as ‘General Banking’ functions of the commercial banks. The modern banks perform a variety of functions. These can be broadly divided into two categories: (a) Primary functions and (b) Secondary functions.

A. Primary Functions

Primary banking functions of the commercial banks include:

1. Acceptance of deposits
2. Advancing loans
3. Creation of credit
4. Clearing of cheques
5. Financing foreign trade
6. Remittance of funds

1. Acceptance of Deposits: Accepting deposits is the primary function of a commercial bank mobilise savings of the household sector. Banks generally accept three types of deposits viz., (a) Current Deposits (b) Savings Deposits, and (c) Fixed Deposits.

   (a) Current Deposits: These deposits are also known as demand deposits. These deposits can be withdrawn at any time. Generally, no interest is allowed on current deposits, and in case, the customer is required to leave a minimum balance undrawn with the bank. Cheques are used to withdraw the amount. These deposits are kept by businessmen and industrialists who receive and make
large payments through banks. The bank levies certain incidental charges on the customer for the services rendered by it.

(b) *Savings Deposits:* This is meant mainly for professional men and middle class people to help them deposit their small savings. It can be opened without any introduction. Money can be deposited at any time but the maximum cannot go beyond a certain limit. There is a restriction on the amount that can be withdrawn at a particular time or during a week. If the customer wishes to withdraw more than the specified amount at any one time, he has to give prior notice. Interest is allowed on the credit balance of this account. The rate of interest is greater than the rate of interest on the current deposits and less than that on fixed deposit. This system greatly encourages the habit of thrift or savings.

(c) *Fixed Deposits:* These deposits are also known as time deposits. These deposits cannot be withdrawn before the expiry of the period for which they are deposited or without giving a prior notice for withdrawal. If the depositor is in need of money, he has to borrow on the security of this account and pay a slightly higher rate of interest to the bank. They are attracted by the payment of interest which is usually higher for longer period. Fixed deposits are liked by depositors both for their safety and as well as for their interest. In India, they are accepted between three months and ten years.

2. **Advancing Loans:** The second primary function of a commercial bank is to make loans and advances to all types of persons, particularly to businessmen and entrepreneurs. Loans are made against personal security, gold and silver, stocks of goods and other assets. The most common way of lending is by:

(a) *Overdraft Facilities:* In this case, the depositor in a current account is allowed to draw over and above his account up to a previously agreed limit. Suppose a businessman has only Rs. 30,000/- in his current account in a bank but requires Rs. 60,000/- to meet his expenses. He may approach his bank and borrow the additional amount of Rs. 30,000/-. The bank allows the customer to overdraw his account through cheques. The bank, however, charges interest only on the amount overdrawn from the account. This type of loan is very popular with the Indian businessmen.

(b) *Cash Credit:* Under this account, the bank gives loans to the borrowers against certain security. But the entire loan is not given at one particular time, instead the amount is credited into his account in the bank; but under emergency cash will be given. The borrower is required to pay interest only on the amount of credit availed to him. He will be allowed to withdraw small sums of money according to his requirements through cheques, but he cannot exceed the credit limit allowed to him. Besides, the bank can also give specified loan to a person, for a firm against some collateral security. The bank can recall such loans at its option.

(c) *Discounting Bills of Exchange:* This is another type of lending which is very popular with the modern banks. The holder of a bill can get it discounted by the bank, when he is in need of money. After deducting its commission, the bank
pays the present price of the bill to the holder. Such bills form good investment for a bank. They provide a very liquid asset which can be quickly turned into cash. The commercial banks can rediscount, the discounted bills with the central banks when they are in need of money. These bills are safe and secured bills. When the bill matures the bank can secure its payment from the party which had accepted the bill.

(d) **Money at Call:** Bank also grant loans for a very short period, generally not exceeding 7 days to the borrowers, usually dealers or brokers in stock exchange markets against collateral securities like stock or equity shares, debentures, etc., offered by them. Such advances are repayable immediately at short notice hence, they are described as money at call or call money.

(e) **Term Loans:** Banks give term loans to traders, industrialists and now to agriculturists also against some collateral securities. Term loans are so-called because their maturity period varies between 1 to 10 years. Term loans, as such provide intermediate or working capital funds to the borrowers. Sometimes, two or more banks may jointly provide large term loans to the borrower against a common security. Such loans are called participation loans or consortium finance.

(f) **Consumer Credit:** Banks also grant credit to households in a limited amount to buy some durable consumer goods such as television sets, refrigerators, etc., or to meet some personal needs like payment of hospital bills etc. Such consumer credit is made in a lump sum and is repayable in instalments in a short time. Under the 20-point programme, the scope of consumer credit has been extended to cover expenses on marriage, funeral etc., as well.

(g) **Miscellaneous Advances:** Among other forms of bank advances there are packing credits given to exporters for a short duration, export bills purchased/discounted, import finance-advances against import bills, finance to the self employed, credit to the public sector, credit to the cooperative sector and above all, credit to the weaker sections of the community at concessional rates.

3. **Creation of Credit:** A unique function of the bank is to create credit. Banks supply money to traders and manufacturers. They also create or manufacture money. Bank deposits are regarded as money. They are as good as cash. The reason is they can be used for the purchase of goods and services and also in payment of debts. When a bank grants a loan to its customer, it does not pay cash. It simply credits the account of the borrower. He can withdraw the amount whenever he wants by a cheque. In this case, bank has created a deposit without receiving cash. That is, banks are said to have created credit. Sayers says “banks are not merely purveyors of money, but also in an important sense, manufacturers of money.”

4. **Promote the Use of Cheques:** The commercial banks render an important service by providing to their customers a cheap medium of exchange like cheques. It is found much more convenient to settle debts through cheques rather than through the use of cash. The cheque is the most developed type of credit instrument in the money market.
5. **Financing Internal and Foreign Trade:** The bank finances internal and foreign trade through discounting of exchange bills. Sometimes, the bank gives short-term loans to traders on the security of commercial papers. This discounting business greatly facilitates the movement of internal and external trade.

6. **Remittance of Funds:** Commercial banks, on account of their network of branches throughout the country, also provide facilities to remit funds from one place to another for their customers by issuing bank drafts, mail transfers or telegraphic transfers on nominal commission charges. As compared to the postal money orders or other instruments, bank drafts have proved to be a much cheaper mode of transferring money and has helped the business community considerably.

**B. Secondary Functions**

Secondary banking functions of the commercial banks include:

1. **Agency Services**
2. **General Utility Services**

These are discussed below.

1. **Agency Services:** Banks also perform certain agency functions for and on behalf of their customers. The agency services are of immense value to the people at large. The various agency services rendered by banks are as follows:
   (a) **Collection and Payment of Credit Instruments:** Banks collect and pay various credit instruments like cheques, bills of exchange, promissory notes etc., on behalf of their customers.
   (b) **Purchase and Sale of Securities:** Banks purchase and sell various securities like shares, stocks, bonds, debentures on behalf of their customers.
   (c) **Collection of Dividends on Shares:** Banks collect dividends and interest on shares and debentures of their customers and credit them to their accounts.
   (d) **Acts as Correspondent:** Sometimes banks act as representative and correspondents of their customers. They get passports, traveller’s tickets and even secure air and sea passages for their customers.
   (e) **Income-tax Consultancy:** Banks may also employ income tax experts to prepare income tax returns for their customers and to help them to get refund of income tax.
   (f) **Execution of Standing Orders:** Banks execute the standing instructions of their customers for making various periodic payments. They pay subscriptions, rents, insurance premia etc., on behalf of their customers.
   (g) **Acts as Trustee and Executor:** Banks preserve the ‘Wills’ of their customers and execute them after their death.

2. **General Utility Services:** In addition to agency services, the modern banks provide many general utility services for the community as given.
(a) **Locker Facility:** Bank provide locker facility to their customers. The customers can keep their valuables, such as gold and silver ornaments, important documents; shares and debentures in these lockers for safe custody.

(b) **Traveller’s Cheques and Credit Cards:** Banks issue traveller’s cheques to help their customers to travel without the fear of theft or loss of money. With this facility, the customers need not take the risk of carrying cash with them during their travels.

(c) **Letter of Credit:** Letters of credit are issued by the banks to their customers certifying their credit worthiness. Letters of credit are very useful in foreign trade.

(d) **Collection of Statistics:** Banks collect statistics giving important information relating to trade, commerce, industries, money and banking. They also publish valuable journals and bulletins containing articles on economic and financial matters.

(e) **Acting Referee:** Banks may act as referees with respect to the financial standing, business reputation and respectability of customers.

(f) **Underwriting Securities:** Banks underwrite the shares and debentures issued by the Government, public or private companies.

(g) **Gift Cheques:** Some banks issue cheques of various denominations to be used on auspicious occasions.

(h) **Accepting Bills of Exchange on Behalf of Customers:** Sometimes, banks accept bills of exchange, internal as well as foreign, on behalf of their customers. It enables customers to import goods.

(i) **Merchant Banking:** Some commercial banks have opened merchant banking divisions to provide merchant banking services.

**C. Fulfillment of Socio-Economic Objectives**

In recent years, commercial banks, particularly in developing countries, have been called upon to help achieve certain socio-economic objectives laid down by the state. For example, the nationalized banks in India have framed special innovative schemes of credit to help small agriculturists, village and cottage industries, retailers, artisans, the self employed persons through loans and advances at concessional rates of interest. Under the Differential Interest Scheme (D.I.S.) the nationalized banks in India advance loans to persons belonging to scheduled tribes, tailors, rickshaw-walas, shoe-makers at the concessional rate of 4 per cent per annum. This does not cover even the cost of the funds made available to these priority sectors. Banking is, thus, being used to subserve the national policy objectives of reducing inequalities of income and wealth, removal of poverty and elimination of unemployment in the country.

It is clear from the above that banks help development of trade and industry in the country. They encourage habits of thrift and saving. They help capital formation in the country. They lend money to traders and manufacturers. In the modern world, banks are to be considered not merely as dealers in money but also the leaders in economic development.
SOURCES OF BANK’S INCOME

A bank is a business organisation engaged in the business of borrowing and lending money. A bank can earn income only if it borrows at a lower rate and lends at a higher rate. The difference between the two rates will represent the costs incurred by the bank and the profit. Bank also provides a number of services to its customers for which it charges commission. This is also an important source of income. The followings are the various sources of a bank’s profit:

1. **Interest on Loans:** The main function of a commercial bank is to borrow money for the purpose of lending at a higher rate of interest. Bank grants various types of loans to the industrialists and traders. The yields from loans constitute the major portion of the income of a bank. The banks grant loans generally for short periods. But now the banks also advance call loans which can be called at a very short notice. Such loans are granted to share brokers and other banks. These assets are highly liquid because they can be called at any time. Moreover, they are source of income to the bank.

2. **Interest on Investments:** Banks also invest an important portion of their resources in government and other first class industrial securities. The interest and dividend received from time to time on these investments is a source of income for the banks. Bank also earn some income when the market prices of these securities rise.

3. **Discounts:** Commercial banks invest a part of their funds in bills of exchange by discounting them. Banks discount both foreign and inland bills of exchange, or in other words, they purchase the bills at discount and receive the full amount at the date of maturity. For instance, if a bill of Rs. 1000 is discounted for Rs. 975, the bank earns a discount of Rs. 25 because bank pays Rs. 975 today, but will get Rs. 1000 on the due date. Discount, as a matter of fact, is the interest on the amount paid for the remaining period of the bill. The rate of discount on bills of exchange is slightly lower than the interest rate charged on loans and advances because bills are considered to be highly liquid assets.

4. **Commission, Brokerage, etc.:** Banks perform numerous services to their customers and charge commission, etc., for such services. Banks collect cheques, rents, dividends, etc., accepts bills of exchange, issue drafts and letters of credit and collect pensions and salaries on behalf of their customers. They pay insurance premiums, rents, taxes etc., on behalf of their customers. For all these services banks charge their commission. They also earn locker rents for providing safety vaults to their customers. Recently the banks have also started underwriting the shares and debentures issued by the joint stock companies for which they receive underwriting commission.

Commercial banks also deal in foreign exchange. They sell demand drafts, issue letters of credit and help remittance of funds in foreign countries. They also act as brokers in foreign exchange. Banks earn income out of these operations.
INVESTMENT POLICY OF BANKS

The financial position of a commercial bank is reflected in its balance sheet. The balance sheet is a statement of the assets and liabilities of the bank. The assets of the bank are distributed in accordance with certain guiding principles. These principles underlie the investment policy of the bank. They are discussed below:

1. **Liquidity:** In the context of the balance sheet of a bank the term liquidity has two interpretations. First, it refers to the ability of the bank to honour the claims of the depositors. Second, it connotes the ability of the bank to convert its non-cash assets into cash easily and without loss.

   It is a well known fact that a bank deals in funds belonging to the public. Hence, the bank should always be on its guard in handling these funds. The bank should always have enough cash to meet the demands of the depositors. In fact, the success of a bank depends to a considerable extent upon the degree of confidence it can instill in the minds of its depositors. If the depositors lose confidence in the integrity of their bank, the very existence of the bank will be at stake. So, the bank should always be prepared to meet the claims of the depositors by having enough cash. Among the various items on the assets side of the balance sheet, cash on hand represents the most liquid asset. Next comes cash with other banks and the central bank. The order of liquidity goes on descending.

   Liquidity also means the ability of the bank to convert its non-cash assets into cash easily and without loss. The bank cannot have all its assets in the form of cash because each is an idle asset which does not fetch any return to the bank. So some of the assets of the bank, money at call and short notice, bills discounted, etc. could be made liquid easily and without loss.

2. **Profitability:** A commercial bank by definition, is a profit hunting institution. The bank has to earn profit to earn income to pay salaries to the staff, interest to the depositors, dividend to the shareholders and to meet the day-to-day expenditure. Since cash is the least profitable asset to the bank, there is no point in keeping all the assets in the form of cash on hand. The bank has got to earn income. Hence, some of the items on the assets side are profit yielding assets. They include money at call and short notice, bills discounted, investments, loans and advances, etc. Loans and advances, though the least liquid asset, constitute the most profitable asset to the bank. Much of the income of the bank accrues by way of interest charged on loans and advances. But, the bank has to be highly discreet while advancing loans.

3. **Safety or Security:** Apart from liquidity and profitability, the bank should look to the principle of safety of its funds also for its smooth working. While advancing loans, it is necessary that the bank should consider the three ‘C’ s of credit character, capacity and the collateral of the borrower. The bank cannot afford to invest its funds recklessly without considering the principle of safety. The loans and investments made by the bank should be adequately secured. For this purpose, the bank should