**MANKAR COLLEGE**

**Banking (2nd Semester)**

**Functions of Commercial Banks:**

A commercial bank is a financial institution which performs the functions of accepting deposits from the general public and giving loans for investment with the aim of earning profit. The two most distinctive features of a commercial bank are borrowing and lending. Functions of commercial banks are as follows:

1. **Accepting Deposits**

This is the key function of a commercial bank. Banks accept deposits of money from people who have surplus money. Some types of deposits are-

1. **Fixed Deposit:** Under this scheme people deposit their money for a period of six months to five years; and fixed deposit is repayable by bank only after the expiry of the specific period. People can enjoy an attractive interest rate through this scheme. But customer can not withdraw from the deposited money before the maturity date. If so, some amount may be cut off by bank.
2. **Saving Deposit:** The aim of this scheme is to mobilize the small saving to the public. People can withdraw money from their account and also make additional deposit. There may be restrictions on the number of withdrawals and the amount of withdrawals in a given period. The rate of interest on this scheme is lower than fixed deposit.
3. **Recurring Deposit:** The aim of this scheme is to encourage regular saving by the people. A person can deposit a fixed amount every month for a fixed period. The amount deposited, together with interest, repayable on maturity.
4. **Current Deposit:** These types of account are opened by businessman to deposit and withdraw money whenever required. No interest if paid on current deposit accounts and a certain charge is made by the bank for the services provided.
5. **Lending Loans**
6. **Loans:** A loan, by a bank, is granted to a customer against some security or mortgage and a high interest rate is charged by the banks.
7. **Overdraft:** A customer having a current account is allowed to withdraw more than what he/she has deposited. The extra amount withdrawn is known as overdraft. It is allowed up to a certain limit and interest is charged by the banks.
8. **Cash Credit:** Under this scheme, a loan limit is sanctioned and a cash credit account is opened in the name of the borrower. The borrower can withdraw money subject to the sanctioned limit. Interest is charged by the bank on the withdrawn amount and not on the sanctioned amount.
9. **Collection of Cheques and Bills**

Bank collect cheques of their customers drawn on other banks and credit to the accounts of their customers. It also collects bills of exchange on behalf of their customers.

1. **Agency Functions**
2. Undertake to pay insurance premium.
3. Collect divined, interest etc. on their investments.
4. Under to buy or sell shares on behalf of their customers.
5. **Lockers Facility**

Banks provide lockers facility to their customers, where customers can keep their gold, silver (assets) and important documents.

1. **Some modern functions of a commercial banks are –**
2. **Electronic Fund Transfer systems (EFTs):** The employers can transfer salary/wage to the accounts of employees directly from the company bank account.
3. **Automated Teller Machines (ATMs):** It is self-service terminal which responds by- giving cash, taking deposits and handling other simple banking transaction.
4. **Credit and Debit Card:** By their cards customers can buy goods and enjoy services from the market directly. Credit card has an overdraft facility of a certain amount. Whereas Debit cards are issued by bank to those customers who keep deposits with it.

**Functions of Central Bank:**

A Central Bank plays an important role in monetary and banking system of a country. It has the power to regulate commercial banks, provide financial services, prevent inflation and keep unemployment low. Functions of Central bank are as follows:

1. **Bank of Issue**

Central bank has the monopoly of note-issue in every country. The currency note printed and issued by the central bank is declared unlimited legal tender throughout the country. The central bank, thus, regulates the currency and then total money supply in the economy. The central bank has to keep gold, silver or other securities against the notes issued.

1. **Banker, Agent and Advisor to Government**

The central bank operates as the government’s banker, not only because it is more convenient and economical to the government, but also because of the intimate connection between public finance monetary affairs. As banker to the government, it makes and receives payments on behalf of government. It advances short-term loans to the government to tide over difficulties. It floats public loans and manages public debts on behalf of the government. As an advisor to the government, it advises to the government on all monetary and economic matters. It also acts as an agent to the government.

1. **Custodian of Cash Reserves**

All commercial banks in a country keep a part of their cash balances as deposits with the central bank. This feature is known as **Cash Reserve Ratio (CRR).** They draw during busy season and pay back during slack season. Part of these balances is used for clearing purposes. It affects centralization of cash reserves of the member banks.

1. **Custodian of Foreign balances**

Under the gold standard or when the country is on the gold standard, the management of that standard, with a view of securing stability of exchange rate, is left to the central bank. It is the function of the central bank to maintain the exchange rate fixed by the government and manage exchange control and other restrictions imposed by the state.

1. **Lender of Last Resort**

The central bank by acting as the lender of the last resort assumes the responsibility of meeting all reasonable demands for accommodation by commercial banks in times of difficulties and strains.

1. **Clearing House**

A clearing house is an organization where mutual claim of banks on one another are offset, and a settlement is made by the payment of difference. Central bank being bankers’ bank keeps the cash balances of commercial banks and as such it becomes easier for the member banks to adjust of settle their claims against one another through the central bank.

1. **Controller of Credit**

Commercial banks create lot of credit which sometimes results in inflation. The expansion of currency and credit is the most important causes of business fluctuations. The need for credit control is obvious. It mainly arises from the fact that money and credit play an important role in determining the level of incomes, output and employment. The objective of credit control function of central bank is price stability along with full employment (level of output).

1. **Protection of Depositor’s Interest**

The central bank has to supervise the functioning of commercial banks so as to protect the interest of the depositors and ensure development of banking on sound lines.

**Credit Creation by Commercial Banks-Credit Creation Multiplier:**

Commercial banks create money even though they cannot print money. Bank deposits from the basis of credit creation. Banks accepts deposits from the public by opening a deposit account known as the primary deposit. Banks do not hold the money in the account itself, and the entire amount is not withdrawn from the account at the same time. So, they advance loans to business persons and retain only a small portion of the total deposits in the bank. The central bank decides the amount to be hold in the form of cash and the remaining amount is advanced as loans to business persons only against securities. The loan creates a derivative deposit which is called a secondary deposit. This secondary deposit is called the **Creation of Credit.** The Banks are able to provide financial assistance to traders and industrialists. Their cheques and drafts are useful for trading on a large scale. Thus, the production activity increases the overall development.

**Credit Creation Multiplier:** The credit expansion the banking system is influenced by the credit multiplier. The credit multiplier is the reciprocal of the required reserve ratio or cash reserve ratio (CRR). Credit multiplier = 1/CRR = 1/r.

If the ratio is 20%, the credit multiplier = 1/20% = 1/0.20 = 5.

The formula for change in deposits in the banking system is D = (1/r) E

D = the change in banking system as a whole.

r = cash reserve ratio.

E = the primary deposit.

If the initial deposit is Rs.1000 and r = 20%, then change in deposits in the banking system as whole will be –

D = (1/r) E

Or, D = (1/20%) 1000 = (1/0.20) 1000 = 5000; So, D = Rs.5000.

**Limitations:** The credit creation by commercial banks is subject to some limitations –

1. Cash drain.
2. Transfer of deposit to non bank financial institution.
3. Willingness to borrow.
4. Different types of loans.

**Credit Control by Central Bank – Different Methods:**

The chief objective of the central bank is to maintain price and income stability. Price stability – both inflation and deflation – has harmful effects. Main reason for the fluctuations in prices as well as in overall economic activity is the changes in aggregate demand. Aggregate demand, especially the investment demand, depends upon the supply of money. And credit is the important constituent of the money supply. Thus the supply of credit greatly affects the prices, national income and employment through changes in investment demand.

It is the responsibility of the central bank to guide the money market, i.e., the commercial banks regarding supply of credit so as to maintain stability in prices as well as in overall economic activity. To overcome inflation it has to restrict the supply of credit and to prevent depression and deflation it has to expand the credit. Quantitative methods of monetary policy focus on overall supply of money.

Mainly there are two methods to control credit creation by the central bank –

1. **Quantitative methods**

The Quantitative or general credit control methods adopted by the central bank directly the total volume of credit in the economy and also the cost of credit (rate of interest). The instruments of this method are –

1. **Repo Rate:** Repo rate is the rate charged on the secured loans offered by the central bank to the commercial banks.
2. **Bank Rate:** Bank rateis the rate charged on loans offered by the central bank to the commercial banks. It is increased at the time of inflation to reduce the money supply in economy and vice versa.
3. **Cash Reserve Ratio (CRR):** Cash Reserve Ratio refers to the proportion of total deposits of the commercial banks which they must have kept as cash reserves with the central bank. The ratio is fixed by the central bank and is varied from time to time to control the supply of money in the economy depending upon the prevailing situation of inflation or deflation.
4. **Open Market Operation (OMO):** Open Market Operation is a monetary policy by the central bank deals in the sale and purchase of securities in the open market to control the supply of money in the economy. By selling the securities, the central bank soaks liquidity from the economy and by buying the securities, central bank releases liquidity.
5. **Quantitative methods**

The quantitative or selective control techniques are employed by the central bank to control the direction and use the credit rather than the volume of credit. It includes –

1. **Variation in Margin requirements:** It refers to the difference between the current value of the security offered for loan and the value of loan granted. It is used by central bank in order to stabilize the economy from inflation or deflation.
2. **Credit Rationing:** It refers to fixation of credit quotas for different business activities which is introduced when the flow of credit is to be checked particularly for speculative activities in the economy.
3. **Direct Action:** This step is taken by the central bank against commercial banks that do not fulfill conditions and requirements.
4. **Moral Suasion:** The central bank makes the member banks agree through persuasion or pressure to follow its directives which is generally not ignored by the member banks. The banks are advised to restrict the flow of credit during inflation and be liberal in lending during deflation.

**[Source: Internet]**

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